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Statement of  
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before

Subcommittee No. 2  
of the  
Banking and Currency Committee of the  
House of Representatives

April 7, 1959.

STATEMENT BY VICE CHAIRMAN C. C. BALDERSTON  
OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM  
BEFORE SUBCOMMITTEE NO. 2 OF THE BANKING AND CURRENCY COMMITTEE OF  
THE HOUSE OF REPRESENTATIVES

APRIL 7, 1959

Mr. Chairman and Members of the Committee:

The Board of Governors favors enactment of the proposal before your Committee, H.R. 5237, to amend section 19 of the Federal Reserve Act by making three changes in the present law respecting the reserve requirements of member banks.

This bill, it should be emphasized, is not designed to make any radical changes in the existing system of reserve requirements that would have an important bearing on monetary policies. The application of its provisions would have to be effected in a manner and be accompanied by other measures, so as not to negate policies directed toward provision of an appropriate supply of bank credit and money. In the judgment of the Board, the basic characteristics of the existing system of reserve requirements provide a workable and effective medium for execution of monetary policy. The amendments proposed are for the purpose of removing from the present law some structural inequities and difficulties of administration. The amended law would provide a means of effecting gradually a better structure of reserve requirements within the existing framework; adaptable to meeting over the foreseeable future the prospective monetary and credit needs of a growing economy.

The bill proposes three changes in existing law that would authorize the Board to:

(1) Permit member banks to include in their required reserves all or part of their vault cash holdings in addition to balances with Federal Reserve Banks.

(2) Set the reserve requirements for demand deposits of central reserve city banks within a range of 10 to 20 per cent, instead of the present authorized range of 13 to 26 per cent.

(3) Permit individual member banks in any part of a reserve or central reserve city to carry, where reasonable and appropriate in view of the character of business transacted by the individual banks concerned, reserves at the lower requirement level prescribed for country or for reserve city banks.

The relatively simple changes the bill would make in the text of Section 19 of the Federal Reserve Act are described precisely and completely in an attachment to this statement.

The purposes and possible effects of the proposed changes may be summarized briefly.

Vault cash as reserves:

Present limitation of reserves to balances held at the Reserve Bank results in an inequitable situation as between individual banks, because many banks find it necessary for operating purposes to hold relatively larger amounts of vault cash than do other banks. The counting of vault cash as reserves would correct

that inequity. Since vault cash holdings and reserve balances at the Reserve Banks both have the same effect in limiting the volume of credit a bank may extend and are interchangeable, it is logical and proper that both be counted as reserves. Doing so would also have collateral advantages: one would be to reduce the costs of transporting and handling currency; another would be to facilitate the holding by member banks of larger stocks of currency that would be available over widely dispersed areas for use in the event of a national emergency.

In the original Federal Reserve Act member banks were permitted to hold somewhat more than half of their required reserves as cash in their own vaults. In 1917 the total reserve requirements were reduced and member banks were required to hold the full amount with Federal Reserve Banks. This was a wartime measure designed to mobilize the gold reserves of the country in the Federal Reserve Banks. Under the Gold Reserve Act of 1934, all of the country's gold stock is held in the Treasury, which issues gold certificates or gold-certificate credits against most of it to Federal Reserve Banks, and the gold stock can be drawn upon only to cover international payments. Thus, there is now no possibility of banks depleting the gold supply by withdrawals to hold as reserves or for other domestic uses, and that reason for not counting banks' vault cash holdings as reserves no longer exists. Taken by itself any withdrawal of currency by a bank either to hold in its vault or to meet customers' demands results in a drain on member bank reserve balances, unless additional reserves are provided by

some means. Likewise a return flow of currency adds to the availability of reserves. It is for this reason that reserves and vault cash are said to be interchangeable.

Permitting vault cash to count as reserves would release a corresponding amount of reserves now held on deposit at the Reserve Banks and thus add approximately \$2 billion at a single stroke to the available supply of bank reserves. Unless other action were taken to absorb some of the reserves released, this would increase the lending potential of the banking system by more than a tenth. It would also distort existing differentials in reserve requirements as between classes of banks. Any such change, therefore, would have to be put into effect gradually, and most likely be offset by adjustments in the reserve requirement percentages, as well as by open market operations. When initiating the change, the Board could permit member banks to count as part of their required reserves either all of their vault cash or only a specified portion thereof.

Vault cash holdings vary considerably among individual banks and also vary from time to time for any single bank. Inequities in the present system of reserve requirements arise primarily from the differences among banks in the same class as to their holdings of vault cash. About a fourth of the country member banks, for example, hold cash amounting to more than 5 per cent of their net demand deposits, or close to half of their required reserves against such deposits, while another fourth show cash to demand deposit ratios of

less than 2 1/2 per cent. A fourth of the reserve city banks hold cash amounting to less than 1 1/4 per cent of demand deposits, with a fourth showing ratios of more than double that figure.

There are wide differences between the reserve classes in their vault cash holdings, but these average differences are more than offset by the differentials in the reserve requirement percentages established for each class. Vault cash holdings and reserve requirements of each class are shown:

Cash in Vault of Member Banks by Class of Bank  
First Half of February 1959

	Amounts (In millions of dollars)	Ratios (%) vault cash to		Ratios of vault cash** plus required reserves to net de- mand deposits
		Total required reserves*	Net demand deposits	
All member banks	2,039	11.2	2.0	--
Central reserve city banks				
New York	130	3.3	.6	18.6
Chicago	30	2.9	.6	18.6
Reserve city banks	645	8.3	1.6	18.1
Country banks	1,234	22.8	3.3	14.3

\* Including requirements of 5% against time deposits.

\*\* Not including requirements against time deposits.

Of the \$2 billion of vault cash held by all member banks, in February, about three-fifths, or \$1 1/4 billion, was held by country banks, whose holdings constitute over 3 per cent of their net demand deposits and nearly a fourth of their total required reserves. Vault cash holdings of reserve city banks as a group amounted to over 1 1/2 per cent of demand deposits and 8 per cent of required reserves, while the ratios for central reserve city banks as a group were very small. These average ratios vary somewhat from time to time, but the margins are broadly similar.

These margins of difference in vault cash holdings to some degree compensate for differences in reserve requirements. When vault cash holdings are added to required reserves, the amounts currently tied up by the combination, expressed as ratios to net demand deposits, show much smaller margins of difference between classes than the reserve requirement percentages alone would indicate. While reserve requirements on demand deposits alone are 11 per cent for country banks, 16 1/2 for reserve city banks, and 18 for central reserve city banks, as of February 1959 the combined ratio was 14.3 per cent for country banks on the average, 18.1 per cent for reserve city banks, and 18.6 per cent for central reserve city banks. In addition to these amounts, member banks have a reserve requirement of 5 per cent on time deposits at all classes of member banks.

If vault cash were permitted to be counted as reserves without any alteration of reserve requirement percentages, member banks could reduce their required reserve balances held at the Reserve Banks and the margins between classes in such balances needed would be greater than those now in effect. The differences between country banks and reserve city banks in requirements against net demand deposits would be

5 1/2 percentage points (16 1/2 minus 11), as compared with the present margin of less than 4 points in effective requirements, as measured by the combined total of required reserve balances and average vault cash holdings (18.1 minus 14.3). The difference between country banks and central reserve city banks would be 7 points (18 minus 11) as compared with a little over 4 points on the average at present (18.6 minus 14.3). As previously stated, some realignment of requirements would be needed in effecting the shift to the new basis.

Percentage Range for Central Reserve City Banks:

By using its legal authority to change requirements for the three broad classifications of member banks, the Board can reduce any undue distinctions between classes of banks.<sup>1/</sup> The effect of counting vault cash as reserves, as pointed out, would be to lower the amount of reserves required to be held at the Reserve Bank. The reduction would be substantial for most country banks, which now have the lowest reserve requirements, and for some reserve city banks, but negligible for most central reserve city banks, which have the highest reserve requirements.

Partly because central reserve city banks would obtain little benefit from counting vault cash as reserves, the Board is proposing that permissible requirements for central reserve city banks be lowered to the 10 to 20 per cent range authorized for reserve city banks. No changes are proposed in the permissible limits of the percentage requirements against net demand deposits as now stated in the law for reserve

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<sup>1/</sup> Under the present law requirements may vary as follows:

	Minimum	Maximum	Present
Against net demand deposits			
Central reserve city banks	13	26	18
Reserve city banks	10	20	16-1/2
Country banks	7	14	11
Against time deposits - all banks	3	6	5

city and country banks--10 to 20 per cent and 7 to 14 per cent, respectively.

Another reason for lowering the range for central reserve city banks is that, in the judgment of the Board, a maximum of 20 per cent is believed to provide sufficient leeway for any increases that may be needed in the foreseeable future. With long-run growth in the economy, banks will need to expand credit and the supply of money. Reserves required for this purpose may be provided by reducing requirements gradually in the course of time.

This amendment would retain three classes of banks in recognition of fundamental differences in the character of demand deposits held. The Board could retain higher requirements for central reserve city banks than for reserve city banks even though the amendment to the law would establish an identical range of permissible requirements for central reserve city banks as for reserve city banks--by lowering from 26 per cent to 20 per cent the maximum and from 13 per cent to 10 per cent the minimum that could be required of any central reserve city bank against demand deposits.

No change is recommended in the provision of the law that permits the Board to change reserve requirements within the permissible limits for the different classes of banks. These limits permit a doubling of requirements above the statutory minimum, but the absolute range of variation would be narrowed. Moreover, the Board would retain authority to reclassify cities, which, together with the other amendment proposed with respect to the classification of individual banks, would make possible adjustments to remove or reduce any inequities between banks or classes of banks.

It has been proposed that the central reserve city classification be abolished and that there be authority for only two classes of banks -- reserve city banks and others. The principal reason advanced for this proposal is that the original basis for the establishment of central reserve cities is no longer applicable. Under the National Bank Act, central reserve cities were required to hold larger reserves because deposits with central reserve city banks could be counted as reserves by other banks; this has not been permitted since 1917. It is also stated that, although banks still maintain substantial balances with central reserve city banks for operating purposes, the dominance of New York and Chicago in this respect has greatly diminished.

The Board, however, favors the retention of the three classes for a number of fundamental reasons. The proposal to abolish the central reserve city classification is much more sweeping than the provision in the pending bill to lower the maximum and minimum figures for central reserve city banks to the same range as that permitted for reserve city banks.

Practical objections to a mandatory requirement that reserve requirements be made identical for all city banks relate to the problem of absorbing the reserves released and the shifts in established relationships among banks. The change would necessitate either a reduction in central reserve city requirements or an increase in those for reserve cities. If requirements at central reserve city banks were lowered to the level of reserve city banks, the effect would have to be absorbed by raising requirements for country banks, if necessary to maintain an appropriate total level of required reserves. If the total level of required reserves were lowered, the additional reserves would need to be absorbed by other

means to avoid undue credit expansion. In any event, there would be a re-alignment of requirements that would alter long-established relationships among banks; the present central reserve city banks would have lower requirements and country banks would probably have higher requirements relative to the average for all member banks than would be the case if the three-way classification were retained.

Retention of the central reserve city classification is essential in order to make it possible to deal with any undue concentration of available reserves in money market centers, such as has happened and might arise again in the future. Absorption of such a pool of reserves through open market operations or through a widespread increase in requirements might be impossible without undue effects on other banks having relatively small amounts of reserves available. Such a situation developed in the 1930's when large amounts of both foreign and domestic balances were concentrated in New York, and New York City banks held very large excess reserves. Authority to maintain three classes of banks provides the Federal Reserve with more flexible powers to deal with such variations in the distribution of reserves.

More fundamentally, the Board feels that differentials in requirements among banks are desirable for purposes of effectuating monetary policy. There are fundamental differences in the character of deposits held by different banks and in their impact on the economy. Since the principal function of reserve requirements is to influence the impact of the use of money on the economic situation, such requirements should make allowance not only for the quantity of money outstanding but also for the rate of its use.

These differences are recognized in existing law with respect

to requirements against demand and time deposits and to those against demand deposits for the three different classes of banks. They are sufficiently distinct and important to justify three classes of banks rather than only two. Just as there are significant differences between the larger city banks and the smaller country banks which make it appropriate to require different amounts of reserves, there are also differences between large banks concentrated in the leading financial centers and banks in other cities. Differences between large city banks and banks located in small places are numerous and clear. Likewise, New York City and Chicago as banking centers stand out in many respects from other cities. The differences may not be as great as they were in the past but they are still striking.

As an illustration of these differences, of the ten largest banks, as measured by total deposits, all but two are in New York and in Chicago, and those two are State-wide branch banks with a substantial volume of deposits at their country branches. Total deposits at all banking offices located within metropolitan areas amount to about \$58 billion for New York and nearly \$13 billion for Chicago. The next largest are Los Angeles with about \$8 billion and San Francisco and Philadelphia with less than \$7 billion each.

Interbank demand deposits, which are an indication of the ability of banks to attract funds and which have been used in the past as the principal standard of classification, total over \$4 billion at central reserve city banks in New York and \$1.2 billion at such banks in Chicago. The largest total held in any other city is less than \$500 million. Of the eleven banks holding the largest amount of interbank demand deposits, ten are central reserve city banks.

Still another reason for retaining three classes of banks is that large banks in financial centers, which hold the bulk of the more active balances of businesses and investment institutions and also balances of other banks, are in a better position to put available funds to use actively and promptly in the central money markets than are smaller banks or those located elsewhere. Banks outside the financial centers, on the other hand, find it necessary for operating purposes to carry a portion of their secondary reserve assets in the form of balances with other banks, on which they receive no earnings and the carrying of which limits their lending capacity. Even reserve city banks maintain substantial amounts of balances with other banks, particularly in New York and Chicago. New York banks maintain only negligible balances with other banks and Chicago banks have less than other cities in relation to their balances due to banks. These two cities are central markets for money to an extent that is not true of other large cities.

Typical depositors in large city banks include businesses, individuals, and institutions which have large amounts of funds and use them much more actively than do most of the depositors in the smaller banks. They are in a better position than customers of banks located elsewhere to keep a portion of their liquid funds in short-term marketable assets and to keep their deposit balances small relative to the volume of their payments. This is another way of saying that large city banks hold greater amounts of deposits that have high expansionary or inflationary potentials than do the smaller banks.

A rough indication of the impact of bank deposits on economic activity is provided by figures of debits to deposit accounts. As measured by the ratio of debits to deposits outstanding, the average rate of

turnover of demand deposits, other than interbank and U. S. Government deposits, for all banks in New York City exceeds 50 times a year and even when allowance is made for operations of certain financial types of deposits that have extraordinarily high rates of turnover and are heavily concentrated in New York, the average is still over 30. The average for all banks in Chicago is over 30 per cent, and that for Chicago central reserve city banks alone is higher. Nearly all of the large central reserve city banks show rates of turnover exceeding 30.

Of the large reserve city banks, only a few have turnover rates of over 30 times a year and more than half have rates of less than 25. For most of the smaller reserve city banks the turnover rates are below 20. At banks in other places, annual rates of turnover of demand deposits are generally less than 20 even for the largest banks, and less than 15 for the bulk of the small banks. For time deposits the rate of withdrawals is only about once every two years.

It is evident that there are sufficiently wide differences in the character of banks and in the impact of their deposits on the economy to provide a basis for differentials in reserve requirements on the existing pattern of three broad classes. In no other city is there as much concentration of banks that may be characterized as central reserve city banks or the elements of a central money market as there is in New York and to a lesser extent in Chicago. Since banks under the proposed amendments would continue to be classified by cities, the classification of cities is necessarily based upon the extent of such concentration rather than upon a relatively few individual cases.

Relief for individual banks:

Because reserve classifications are made by cities, individual banks located in a city but differing in nature from the leading banks in the city are compelled to observe higher requirements than banks of a similar nature located elsewhere. Under existing law, the Board may permit such banks if located in outlying districts to carry the lower reserves specified for banks in one of the other classes. This provision now permits the Board to alleviate inequities which arise when banks located in such outlying districts are predominantly engaged in business that is similar to that of banks with a lower reserve classification. It does not, however, permit the Board to bring equivalent relief to such banks if they are located in the central or financial districts of reserve or central reserve cities. While the number of such cases is not large, they do represent cases of unfairness that are not essential for policy reasons.

The amendment proposed would permit more flexibility in exempting individual banks than is possible under existing law and thereby facilitate the elimination of some existing inequities. To accomplish these purposes the pending bill would strike out of the law the present relief provisos applicable only to "outlying district" banks, and add a new paragraph which would authorize the Board to permit member banks in any part of a reserve or central reserve city to carry reduced reserves. Instead of being confined solely to the geographical test, the Board would be authorized to grant permission for reduced reserves on such basis as it might deem reasonable and appropriate in view of the "character of

business" transacted by the member bank involved. Determination of character of business for this purpose would take into consideration total volume of deposits, holdings of interbank deposits, the distribution of other deposits among different groups of owners, the turnover of deposits, the requirements of other banks in the same area doing a similar type of business, and other relevant factors.

As under present law, the amendment would make it possible for the Board to permit a member bank in a reserve city to carry the lower reserves specified at the time for country banks rather than that fixed for reserve city banks; and, similarly, a member bank in a central reserve city could be permitted to carry the lower reserves specified at the time either for reserve city banks or country banks. The amendment would not authorize the Board to permit any member bank in such cities to carry reduced reserves equal to some percentage other than one prescribed by the Board for one of the designated classes of banks.

Again as under present law, the amendment would not authorize the Board to increase the percentages of reserves required to be maintained by individual member banks. The Board would, however, retain the authority which it now has under the law to designate new reserve requirements of all member banks in such cities, except such banks as may be specifically permitted to carry the lower requirements of another class.

The proposed amendment would make it possible for the Board to grant permission for reduced reserves upon the vote of a majority of a quorum, rather than only upon the affirmative vote of five members of the Board as required by the present law.

Other Observations      Before undertaking to answer whatever questions you may have, I should like to make, in conclusion, a few general observations.

The Board has given consideration to the careful and comprehensive study of the problem of reserve requirements and the proposals for changes made by the Economic Policy Commission of the American Bankers Association, and also to other plans for fundamental revisions in the reserve requirement structure. The Board has concluded, however, that far-reaching changes in the law are not necessary. In particular, the Board opposes, for reasons already stated, the abolition of the three reserve classes of banks. It would also not favor a mandate to reduce reserve requirements to any predetermined level by a given time. With the amendments proposed, along with other provisions of existing law, the Board would have adequate authority to make any changes in the structure and level of reserve requirements that are likely to be appropriate under present or foreseeable conditions.

No change is recommended by the Board in permissible requirements against time deposits from the present range of 3 to 6 per cent. It is recognized that savings deposits in banks do not need to have as high requirements as demand deposits, which comprise the most active elements of the money supply, and the law correctly provides for differentials in such requirements. In the opinion of the Board, the present limits on requirements against time deposits are about as low as would be warranted for sound and effective operation of the banking system.

The principal function of reserve requirements, it is now generally recognized, is to serve as an instrument for regulating the ability of banks to expand credit and add to the available supply of money. Under existing law, Federal Reserve policies and actions may influence both the available supply of reserves and, within statutory limits, the amount of reserves required to be held.

The desirable ultimate level of reserve requirements need be no higher than essential for purposes of monetary policy. Yet requirements should not be so low as to raise questions about liquidity or safety in the asset structure of banks. Nor should they be so high as to hamper unduly the earning capacity of banks and their ability to perform essential functions. The precise level of requirements that may be appropriate for monetary policy at any particular time in the future must be predicated on economic and financial developments at home and abroad.

Any changes in the general level of reserve requirements must be made only gradually and in relatively small steps in order to avoid undesirable disturbances to credit markets, conflicts with appropriate monetary policies, and undue upsets to long-established competitive relationships and banking practices. In order to provide for future contingencies, authority to vary requirements over a fairly wide range needs to be retained.

Experience indicates that changes in reserve requirements have more erratic effects upon the credit situation than changes in the availability of reserves effected by other means. Legislative authority with respect to both the level and structure of reserve requirements for member banks, therefore, should be sufficiently flexible to enable adjustments

to be made in ways, in amounts, and at times that are consistent with the aims of monetary policy, with the international position of the country, and with the maintenance of a sound and effective banking system. Existing law with the amendments proposed would permit moving gradually toward a more equitable and rational structure of reserve requirements with a minimum of interference with major policy objectives.

TEXTUAL CHANGES WHICH WOULD BE MADE IN SECTION 19 OF THE  
FEDERAL RESERVE ACT BY H. R. 5237

[Omitted material stricken through; new material in capital letters]

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Every bank, banking association, or trust company which is or which becomes a member of any Federal reserve bank shall establish and maintain reserve balances with its Federal reserve banks as follows:

(a) If not in a reserve or central reserve city, as now or hereafter defined, it shall hold and maintain with the Federal reserve bank of its district an actual net balance equal to not less than seven per centum of the aggregate amount of its demand deposits and three per centum of its time deposits.

(b) If in a reserve city, as now or hereafter defined, it shall hold and maintain with the Federal reserve bank of its district an actual net balance equal to not less than ten per centum of the aggregate amount of its demand deposits and three per centum of its time deposits: ~~Provided, however, That if located in the outlying districts of a reserve city or in territory added to such a city by the extension of its corporate charter, it may, upon the affirmative vote of five members of the Board of Governors of the Federal Reserve System, hold and maintain the reserve balances specified in paragraph (a) hereof.~~

(c) If in a central reserve city, as now or hereafter defined, it shall hold and maintain with the Federal reserve bank of its district an actual net balance equal to not less than ~~thirteen~~ TEN per centum of the aggregate amount of its demand deposits and three per centum of its time deposits; ~~Provided, however, that if located in the outlying districts of a central reserve city or in territory added to such city by the extension of its corporate charter, it may, upon the affirmative vote of five members of the Board of Governors of the Federal Reserve System, hold and maintain the reserve balances specified in paragraphs (a) or (b) thereof.~~

NOTWITHSTANDING THE OTHER PROVISIONS OF THIS SECTION -

(1) THE BOARD OF GOVERNORS, UNDER SUCH REGULATIONS AS IT MAY PRESCRIBE, MAY PERMIT MEMBER BANKS TO COUNT ALL OR PART OF THEIR CURRENCY AND COIN AS RESERVES REQUIRED UNDER THIS SECTION; AND

(2) A MEMBER BANK IN A RESERVE CITY MAY HOLD AND MAINTAIN THE RESERVE BALANCES WHICH ARE IN EFFECT UNDER THIS SECTION FOR MEMBER BANKS DESCRIBED IN PARAGRAPH (a); AND A MEMBER BANK IN A CENTRAL RESERVE CITY MAY HOLD AND MAINTAIN THE RESERVE BALANCES WHICH ARE IN EFFECT UNDER THIS SECTION FOR MEMBER BANKS DESCRIBED IN PARAGRAPHS (a) OR (b), IF PERMISSION FOR THE HOLDING AND MAINTAINING OF SUCH LOWER RESERVE BALANCES IS GRANTED BY THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, EITHER IN INDIVIDUAL CASES

OR UNDER REGULATIONS OF THE BOARD, ON SUCH BASIS AS THE BOARD MAY DEEM REASONABLE AND APPROPRIATE IN VIEW OF THE CHARACTER OF BUSINESS TRANSACTED BY THE MEMBER BANK.

Notwithstanding the other provisions of this section, the Board of Governors of the Federal Reserve System, upon the affirmative vote of not less than four of its members, in order to prevent injurious credit expansion or contraction, may by regulation change the requirements as to reserves to be maintained against demand or time deposits or both (1) by member banks in central reserve cities or (2) by member banks in reserve cities or (3) by member banks not in reserve or central reserve cities or (4) by all member banks; but the amount of the reserves required to be maintained by any such member bank as a result of any such change shall not be less than the amount of the reserves required by law to be maintained by such bank ~~on the date of enactment of the Banking Act of 1935~~ nor more than twice such amount.

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