# RESERVE BANKING IN A DYNAMIC ECONOMY

by

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before the

FIFTY-FIRST ANNUAL CONVENTION

of the

NATIONAL ASSOCIATION OF SUPERVISORS
OF STATE BANKS

Lord Baltimore Hotel                Baltimore, Maryland

WEDNESDAY,
September 24, 1952
2:40 P.M.        (E.D.S.T.)



For Release at Time of Delivery.

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This was to have been one of those "off the cuff" and "off the record" presentations. But a few days ago a member of the press reminded me that scheduling an "off the record" talk arouses curiosity and increases expectations to the point that unless I intended to divulge some confidential information or unless I intended to be critical of someone or something, it would be better for me to speak on the record so as not to mislead you as to the nature of my remarks. Since I proposed to be neither confidential nor critical, I was easily persuaded two or three days ago to change the form of presentation. In this process even the title of my talk has undergone a change so that now it is "Reserve Banking in a Dynamic Economy" rather than "Elements of Monetary Policy."

It is my purpose to review with you basic changes in reserve banking practices. The past two years have provided a reorientation of these practices that has been a matter of considerable public interest. Since you are responsible for supervising the State chartered units in our commercial banking system, you have a special interest in reviewing credit and monetary policy because it affects financial institutions in your State whether or not they are members of the Federal Reserve System.

## Two Decades of Financial Abnormality

For more than two decades, our economy has experienced varying degrees of financial abnormality. The credit crisis of the late Twenties and the early Thirties was followed by a prolonged depression of unprecedented severity. As a result of this background, lenders and borrowers during the latter half of the Thirties were timid in re-expanding credit. At the same time, international forces caused a very large flow of gold into this country. This combination of factors resulted in the accumulation of substantial excess reserves by our banking system as a whole.

Reserve banking operations had to be adjusted to this abnormal banking liquidity as well as to the desirability of reestablishing a financial climate favorable to credit expansion and economic recovery. In practice, there was a virtual disappearance of member bank rediscounts and a minimum volume of open market operations. Such changes in the open market account of the Federal Reserve System as were undertaken in this period were mainly associated with the maintenance of orderly conditions in the market for Government securities and with adjustments in member bank reserve requirements under new legislative authority enacted in the early Thirties.

The first half of the Forties ushered in World War II with its problems of financing huge Government deficits. The financial headaches created by the wartime deficits carried over into the last half of the Forties.

During the war period, Treasury requirements for money to finance global war deserved and received primary consideration at the calculated risk of substantial wartime credit and monetary expansion. You will recall that the pivotal reserve banking policy was the maintenance of a stable interest rate structure for the public debt. The market structure of interest rates had as its principal anchor a 3/8 per cent rate on 3-month Treasury bills and from that rate the structure graduated upward to a 2-1/2 per cent rate on long-term Treasury bonds. Working with the Treasury, the Federal Reserve during war years used every means at its command to facilitate the Government's financing through the credit and money market. This involved adjusting reserve requirements, setting preferential discount rates for member bank advances secured by short-term Government obligations, and carrying on extensive open-market operations to support the established pattern of market interest rates.

Readjustment to postwar conditions entailed carrying over some of the reserve banking practices adopted to meet the war emergency. The transition from a war to a peacetime economy required many adjustments but reorientation of discount and open market operations could take place only gradually. In the Government securities market, because of the sheer size of the war accumulated public debt, the dominant focus continued to be the maintenance of orderliness and stability, and this pattern persisted into the first year of the current defense emergency. The nature of the inflationary threat posed by the defense emergency ultimately brought about a joint decision by the Treasury and Federal Reserve to conduct reserve banking and debt management operations so as to minimize further monetization of the public debt.

Supplemental Measures of Credit Restraint

These periods of extreme financial abnormality brought many departures from operating procedures worked out during the formative period of the Federal Reserve System. To prevent the development of inflationary pressures from excessive credit expansion, it became necessary to adopt various supplemental measures of reserve banking policy.

Throughout World War II, the use of credit for purchasing and carrying stock exchange securities was closely watched. Margin requirements, which had been subject to regulation since 1934 with a view to lessening the impact of stock market speculation on credit and banking conditions, were eventually increased substantially above prewar levels. The Board's Regulations T and U governing margin requirements have been at a 75 per cent level during most of the postwar period.

Regulation of consumer credit terms -- both as to amount and maturity of new credit contracts -- was another supplementary device in use during a substantial part of the past decade. First introduced in 1941, the regulation of consumer credit under Regulation W applied during the war to charge accounts, instalment sales of a comprehensive list of consumer goods, and instalment and single-payment loans. During the postwar period, it was limited to the most volatile portion of this credit -- the instalment segment. As you know, the most recent authority of the Board of Governors to regulate this type of credit lapsed on June 30 of this year.

In 1950, a third type of supplementary credit instrument was authorized, namely, regulation of credit terms on loans to finance new residential and nonresidential construction. The bulk of real estate credit is in the form of home mortgage debt which has roughly tripled since the end of World War II, rising from about 19 billion dollars to approximately 57 billion dollars at the present time. In view of mandatory provisions of certain amendments to the Defense Production Act adopted during the last session of Congress, this regulation was suspended two weeks ago. I should like to express the appreciation of the Board for your splendid cooperation in helping us to introduce, explain, and enforce both these Regulations.

These particular devices affected only selected credit areas and, hence, were only partial supplements to instruments which affected the availability and supply of credit generally. These limitations of application and effectiveness led to considerable use during the past decade of the authority to change member bank reserve requirements. During war years, changes in reserve requirements related primarily to war financing needs. In the postwar period, they were used both to offset the effects on bank reserve positions of reserve banking support of the Government securities market and to affect directly the liquidity position of banks.

You may recall that the postwar use of the reserve requirement instrument was accompanied by extensive study and discussion of supplemental reserve requirement proposals, such as a plan for holding supplemental reserves in short-term Government securities, another for holding reserves equal to deposits in excess of a specified amount, and still another for increases in reserves related to bank loan expansion. While these proposals may now be largely of historical interest, they represented efforts to find substitutes for traditional methods of reserve banking at a time when these methods were not wholly effective because of the necessity for reserve banking support of the market for Government securities.

Restoration of Flexible Reserve Banking

After more than a decade of departure from reserve banking procedures developed earlier to deal with credit and monetary problems, readjustment to these procedures has not been easy. There are some who have complained that the pace has not been fast enough, that we have been crawling when we should have been running. There are others who have doubted the wisdom and effectiveness of the steps which have been taken. Nevertheless, readjustment has gone forward step by step and accomplishments to date in restoring responsive credit and monetary operations along traditional lines have exceeded the expectations of many.

One of the major difficulties in making the transition has been caused by the size and composition of the Government debt. Still another important consideration has been the delicate economic balance of the postwar period in which there have been substantial risks that abrupt and far-reaching changes in reserve banking operations might tip the scales too far in one direction. Finally, there has been the problem of credit and money market reorientation to changed reserve banking procedures.

Discontinuance of the wartime preferential discount rate on advances to member banks secured by short-term Government securities in 1946 marked the beginning of postwar reserve banking transition. Then, in combating postwar inflationary pressures, support prices on short-term Government securities were gradually lowered; the discount rate was raised in successive steps; and reserve requirements were tightened close to statutory limits. As I observed earlier, open market operations in this period, in addition to functioning in general support of the Government securities market, also served to facilitate banking adjustments to higher reserve requirements.

By 1949, economic developments pointed up the fact that inflationary pressures resulting from the war were beginning to lessen. The major portion of pent-up demand of both business and consumers had been satisfied. In recognition of this easing of inflationary pressures, the Federal Reserve moved to increase the availability and use of credit by relaxing terms on instalment and stock market credit and later by reducing reserve requirements and adjusting open market operations accordingly.

Credit and monetary action in 1949 helped to cushion economic recession and to set the stage for recovery. During the first half of 1950, recovery gained full momentum.

Impact of Korea

The final stage in the readaptation of reserve banking operations was precipitated by new inflationary pressures inherent in the full-scale defense program which this country embarked upon after the outbreak of hostilities in Korea. The prospect of a garrison economy for an extended period of time required a thoroughgoing review of all financial measures which could be brought to bear on inflationary forces. It was obvious that, if these pressures were to be held in check, primary reliance would have to be placed on measures curbing inflationary pressures at their source. This approach increasingly involved a coordinated program of fiscal, debt management, and credit and monetary policies.

Of prime importance in this program was maintaining the defense effort as long as possible on a pay-as-we-go basis, thus avoiding a fundamental mistake of World War II financing. The maintenance of a balance in the Government's cash accounts throughout 1951 and the first half of this year shut off what could have otherwise been a substantial source of inflationary pressure.

In March 1951, the Treasury and the Federal Reserve took a major step in coordinating debt management and credit and monetary policies in such a way as to assure successful financing by the Government and at the same time to minimize the monetization of the public debt. A conversion offer carried out at that time for the two longest-term restricted bonds substantially reduced the amount of Government bonds in the market and paved the way for discontinuance of Federal Reserve purchases of such bonds in support of their prices.

Primary Instruments of Reserve Banking

Emergence of a flexible and self-sustaining market for Government securities was a vital development in reestablishing a more normal pattern of reserve banking operations. It has necessitated a full-scale review of the methods and techniques of open market and discount functions to determine how the credit market can operate smoothly with minimum intervention by the Federal Reserve System and without monetization of the public debt. This review has involved consideration of such questions as: What are the rules of the game for reserve banking in a flexible credit market? Giving account to the generally accepted goal of economic stability at high levels of output and employment, how are reserve funds most effectively supplied to the market to meet the changing credit needs of commerce and industry? What does this objective mean with respect to the use of open market and discount operations? With respect to changes in reserve requirements? With respect to margin requirement on stock market loans? How can the Government's borrowing be best accomodated in a flexible market?

All those connected with financial markets -- the Reserve System, commercial banks, investment banking houses, security dealers, savings institutions and investors as well as borrowers -- are in the process of adjusting their operations to the fact of a self-sustaining credit market. They must re-acquire a body of market experience under varying supply and demand conditions on which to base operating decisions.

The Secretary of our Federal Open Market Committee, W. W. Riefler, has recently pointed out that reserve banking experience during the Twenties indicated that a combination of responsive discount and open market operations was an effective means of regulating the availability and supply of credit. In that period, bankers were sensitive in their lending and investment decisions to variations in the source of their required reserves. Whenever open market operations withdrew reserves from the market, banks tended to become more restrictive in their lending policies even though they could, and did, make up any reserve deficiencies at the discount window of the Reserve Banks. Further, interest rates were influenced both by the volume of member bank borrowing and by changes in the discount rate. Finally, although it was difficult of measurement, tightness or easiness in the credit market was reflected through banker sentiment and the attitudes of many businessmen.

The past 18 months have provided additional experience supplementing that of the Twenties. As there has been more frequent resort to the Federal Reserve discount window, it appears that member banks have not been unmindful of the substantial shifts in the volume of their borrowing. With tightness in the availability of reserve funds, there is evidence that banks have shown increasing reluctance to enter into new commitments as the level of discounts and other borrowing has risen. Interest rates have reflected these changes.

In other words, recent as well as earlier experience would indicate that open market operations can be used to increase or decrease the dependence of member banks on borrowing; and further, that because of the natural hesitancy of bankers to carry extensive borrowings on other than a temporary basis, the total of member bank indebtedness will exert a determining influence on the availability and supply of credit.

Role of Reserve Requirements

Earlier in the postwar period, changes in member bank reserve requirements assumed unusual importance as a reserve banking instrument. As I said before, this was the case largely because the System's older instruments for influencing the total volume of credit and money were severely limited in use at that time. The present increased emphasis on discount and open market operations indicates, in my opinion, that changes in reserve requirements will resume a more secondary role in reserve banking operations. Changes in reserve requirements are a harsh instrument because they have disproportionate effects among individual institutions. Their across-the-board characteristics are devoid of the element of flexibility which is essential for frequent use in influencing the total volume of bank credit and bank deposits. They are a measure to be used in unusual circumstances for contracting or expanding the liquidity position of the entire banking system. This was the original conception of their use.

General Observations

The development of more flexible debt management, credit, and monetary policies over the past 18 months has been accompanied by relative economic stability at a high level of output and employment. The economy has been able to absorb an expanding defense program which now runs at the rate of over 50 billion dollars a year and at the same time has actually produced more for other purposes than it did before Korea.

While financial measures have been indispensable and primary in attaining this degree of stability, I do not want to give the impression that I think they alone were responsible. Nor do I want to give the impression that at long last we have found a formula for economic stability and that our job is done.

In a truly dynamic economy, the job of maintaining economic stability is never done.

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