MEMORANDUM REGARDING PROPOSED REVISION
OF RESERVE REQUIREMENTS AS TO MEMBER BANKS.

As an amendment to the bill regulating security exchanges, the Federal Reserve Board wishes to reiterate its recommendation made two years ago for basing member bank reserve requirements not solely on the volume of deposits but also on the rapidity of their turnover, in other words, on the extent to which the deposits are utilized.

Member bank reserve balances are high-power money. On the basis of one billion dollars of excess reserves, member banks can extend credit amounting to between ten and fifteen billion dollars without having to resort to borrowing at the Federal Reserve banks. The volume of excess reserves at the present time is one and one-half billion dollars, and these excess reserves furthermore may increase greatly when a period of credit expansion sets in. Under existing law national banks can issue an additional seven hundred million dollars of bank notes, which when deposited with the Federal Reserve banks add to the reserves of member banks. There is also still a billion or a billion and one-half of currency that has not returned from hoarding but is likely to be utilized and thus flow back into the banks when an expansion sets in. In these circumstances if an expansion of credit should get under way, the member banks will have a large volume of reserves without recourse to the Federal Reserve banks. These banks therefore would be out of touch with the market and thus not in a position to exert a restraining influence through discount policy.

The Board's proposal carries out to its logical conclusion the existing distinction between time deposits, which require a 3 percent reserve, and demand deposits, which require a 7, 10, or 13 percent reserve, depending upon the location of the bank. The proposal would result in an automatic increase of reserve requirements when boom conditions arise and an

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automatic decrease of reserve requirements in times of depression. The proposal furthermore has the advantage of making the increase in reserves applicable not to all banks in all localities alike, but rather to those banks in those communities only where excessive speculative activity is manifesting itself. If this proposal were adopted, its operation, together with the authority existing under the Thomas Amendment to raise reserve requirements with the consent of the President when an emergency arises from excessive credit expansion, would make it possible for the Federal Reserve Board to combat the recurrence of speculative excesses. The proposal, therefore, presents a logical complement to the bill for the regulation of security exchanges.

The proposal would counteract two abuses that have developed under existing law and have created serious obstacles to credit control. One is the evasion of reserve requirements by classifying as time deposits many deposits that to all intents and purposes are demand deposits, a practice that has developed since the classification of deposits in one or the other category has determined the volume of reserves that a bank must carry. And the other, the reduction of actual reserves carried through diminishing the volume of till money which under existing law does not count as reserve. The proposal would permit banks within certain limitations to count their vault cash as reserves and would therefore close the door to the practice of greatly reducing actual reserves by diminishing cash holdings to a nominal amount.

In times of great speculative activity, such as 1928 and 1929, the banks under a law like the one proposed would have had to carry three or four hundred millions of additional reserves and would, therefore, have had to increase

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their borrowings at the Reserve banks by that amount. This would have greatly increased the power of the System to exercise a restraining influence at an early date. On the other hand in times of depression when deposits are inactive member bank reserve requirements would diminish and there would be a decrease in the volume of idle funds that the banks would be required to carry as reserves. In effect, the plan would supplement open-market operations by the Reserve banks, by withdrawing funds from the market under boom conditions and furnishing additional funds at times of depression.

The plan would also work for a more equitable distribution of reserves as between city banks and country banks. City banks, owing to their proximity to the Reserve banks, have been able to reduce their vault cash to a very small proportion of their deposits, while at country banks a much more considerable proportion has been necessary. As a consequence the actual distribution of effective reserves differs from that contemplated by the law and is much more favorable to banks in financial centers. The Board's proposal would do away with this disparity.

Most important of all, however, the proposed plan would result in an increase of reserve requirements not only at the time when such an increase will be in the interests of sound banking conditions but also at the spot where speculative excesses get under way, and at the banks where enhanced activity of deposits will be caused by a rising tide of speculation. Big nation-wide booms develop at financial centers, and this proposal by imposing restraints on speculation in these centers without increasing the burden of idle reserves for banks in those communities to

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which the boom has not penetrated, will not only be more equitable but will serve the purpose of applying restraining influences automatically at the right time, in the right places, and to the right institutions.

With the heavy responsibilities imposed upon the Federal Reserve System in connection with the possibilities of speculative expansion, the adoption of this plan would place into their hands an instrument that would be of great assistance in serving the interests of trade and industry by restraining the use of credit for speculative purposes.

Concretely under the proposal, member banks would be required to carry 5 percent reserves against their net deposits plus 50 percent of the amount of the bank's average daily debits to deposit accounts. In order to avoid too heavy burdens in extreme cases, the proposal provides that in no case shall aggregate reserves required of a bank exceed 15 percent of its gross deposits.

In computing their reserves, the member banks would be permitted to count as reserves a certain proportion of their vault cash. At banks in cities near the Federal Reserve banks or branches, the banks would be required to carry four-fifths of their total reserves as deposits with the Federal Reserve banks, while at other banks they would only be required to carry two-fifths of their reserves as balances with the Reserve banks.

As an exhibit in connection with this statement I should like to submit the report of a committee of the Federal Reserve System on bank reserves presented to the Federal Reserve Board in 1931. Your attention is particularly called to the chart on page 10 of this report which shows that demand deposits and consequently reserve balances of member banks showed practically no increase during the period of the greatest credit expansion in 1928 and 1929, while

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bank debits during that period increased at a very rapid rate. Another chart on page 19 of the report shows how under the proposed plan reserve requirements would have risen rapidly during the expansion and would have declined much more rapidly than actual reserves after the depression set in.

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