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# EXCESS RESERVES AND FEDERAL RESERVE POLICY

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In discussing excess reserves at the last meeting, the directors asked this question: What is the duty of a central bank or banking system in a situation like the present? Can we by analysis of the situation ascertain the principles which should be applied? Having done that, we would be in a better position to consider questions of expediency and methods of procedure.

Before attempting to answer this question, it may be well to review briefly the genesis and growth of the present excess reserves of the member banks of the country. The program of open market purchases of government securities, which began at the outset of the depression in 1929, has gone through a number of phases. In the earlier years its main purpose was to enable the member banks to reduce their rediscounts at the Reserve banks, in the hope, based on previous experience, that this reduction of member bank indebtedness would check deflation and might stimulate credit expansion. The creation of excess reserves, which represented an entirely new phase of open market policy, may be said to have begun after the passage of the Glass-Steagall Act in February, 1932. By the summer of 1932 our open market purchases had led to the accumulation of fairly substantial excess reserves, principally in New York and Chicago banks. The next phase of the program was the resumption of open market purchases after the banking crisis of March, 1933, as one of various emergency measures, which included also deposit insurance and the Reconstruction Finance Corporation program of bank capital rehabilitation. By January, 1934, excess reserves amounted to about $800,000,000, which were now fairly well distributed throughout the country. It is important to point out that the Reserve System's active program of increasing bank reserves came to an end at this time,* and that the great increase in excess reserves which has occurred since

* Our purchases of government securities actually ceased in November, 1933, but the full effect upon excess reserves was not apparent until after seasonal return flow of currency to the Reserve banks in January, 1934.

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January, 1934, has been due mainly to the devaluation policy of the Administration and the resulting inflow of gold. Our first conclusion therefore is that the Administration's policy and not the Reserve System has been responsible for the recent growth and the present large amount of excess reserves, and that as matters now stand both the responsibility for and the power over present excess reserves lie principally with the Administration.

Nevertheless, we must ask ourselves: What is our duty within the limits of our power? We are faced with this situation: Excess reserves are now about $2,250,000,000; the public debt is steadily mounting; the government securities issued to finance the deficits are being bought mainly by the banks, and largely by reason of the pressure of excess reserves upon the banks. The theory of creating excess reserves was that in a depression, when the capacity and willingness of banks to lend and of private enterprise to borrow have been impaired, excess reserves would put pressure on the banks thus forcing down the yield on government securities to the point where bank and other investment funds would flow over into private capital investment. There is some evidence that this pressure has begun to work; the yield on government securities has been reduced; there are signs that mortgage money is becoming more plentiful; and there are some signs that the long-awaited movement toward refunding of outstanding private capital issues is getting under way. But there will be no proof that the process has succeeded until these signs are followed by the appearance of new corporate issues which will serve to relieve present pressure on the Treasury directly, or through other governmental agencies, to satisfy the country's current capital requirements.

Meanwhile, there are certain definite obstacles and dangers. The opening of the private capital market appears to be blocked by obstacles mechanical, psychological, and economic and bank funds continue to flow almost exclusively into government securities. There is thus a grave danger that so long as the avenues

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into private capital investment remain blocked and so long as the pressure of excess reserves is exerted not against a fixed total of government debt but against a continuously expanding volume of such debt, the overflow of bank funds into private channels may not occur, the banks will become more and more heavily loaded with government securities, the government will do a larger and larger part of the nation's borrowing and spending. If this process should continue, should we not expect on the basis of the experience of other nations that eventually a point will be reached where the banks will be unable or unwilling to absorb the government debt, so that the government will find itself forced either to expend its stabilization fund, still further increasing excess reserves, or to request the Reserve banks to purchase more government securities in the open market, or to borrow directly from the Reserve banks, or to issue some form of inconvertible paper money? With some 10,000,000 workers still unemployed, some 22,000,000 of the population on relief rolls, the capital goods industries still in a state of severe depression, with government deficits mounting at a rate of perhaps $3,500,000,000 a year, and with the private capital market still practically dormant after five years of depression, no one can say with certainty that this is not a likely prospect. In the experience of other nations a long-continued process of governmental deficit financing through the banking system has always led at some point to rapidly rising prices, either through actual monetary expansion or through fear of potential expansion, and at this point the process has always become cumulatively uncontrollable, government deficits rising by reason of the rise of prices and the lag of revenue behind expenditures, the whole process being attended by grave economic and political disruption and disorder terminating in collapse.

This is indeed a black picture, and we have to face it as one of the major possibilities of our present situation. It has often been said that the signs of an approaching inflation are always ignored or minimized until it is too late to take decisive action. What then is the duty of a central bank or banking system,

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charged with some responsibility for monetary control in the public interest? As a first approach to this question, it is natural to ask ourselves whether there is not some orthodox answer which can be drawn from the accepted theory and the historical experience of central banking. If there were such an answer, it might greatly lessen the difficulty, at least of deciding what we ought to do, even if it did not dispose of the questions of expediency. Unfortunately, there appears to be no such answer. Modern central banking is too young and has developed under circumstances too rapidly changing and abnormal to provide us with any clear and sure light to guide our steps in times like these. Before the war, for example, perhaps the only clear and generally accepted rule of central banking was that the discount rate should be raised upon the occasion of gold outflow; and yet it now seems, as we review that period in retrospect, that when we applied this rule, when England went off gold in September, 1931, and gold began to leave the United States in huge amounts, the rate increase probably served more to add to the deflationary movement of succeeding months than to check the gold outflow. As to a proper central banking policy with respect to excess reserves, the historical record tells us nothing. But it may have been regarded as orthodox, or at least prudent, in January, 1933, when excess reserves were about $600,000,000, to sell securities in order to prevent any further increase of excess reserves, even though as events proved we were on the eve of the banking crisis, which was to force us into renewed open market purchases. These decisions, for which the Reserve System has been criticized, do not of course throw any light on our present problem, but they do show perhaps that in such extraordinary times as these, there are no such clear and definite rules of procedure for central banks as the term orthodoxy may imply.

It might, nevertheless, seem worth while to attempt to derive an answer to our present problem from the previous experiences and practices of foreign central banks which have been faced with the duty of controlling an inflation.

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But our problem is quite different from theirs. Inflation abroad was accompanied by a high degree of business activity and usually also by direct government borrowing from central banks. Under such circumstances it is not difficult to decide what a central bank ought to do. The Federal Reserve System has the much more difficult problem of endeavoring to foresee when and how these conditions may arise. Our dilemma is that if we take action now based upon the assumption that they will arise, our action may be premature and may choke off an incipient recovery such as our present policy is designed to facilitate. We have also to bear in mind that the present extraordinary governmental expenditures are of quite different character from those which have in previous cases been the sources of uncontrollable inflation, such as war time expenditures, or the German reparation payments, or the French reconstruction of invaded territory. All these expenditures were of a compelling nature from which there was no escape but which necessarily became greater as the inflation proceeded; our extraordinary expenditures are a phenomenon of depression. While there is of course no certainty, there is at least a fair possibility that if and when we achieve recovery, extraordinary expenditures will be reduced through the re-employment of the factors of production. Moreover, we are faced with the fact that in a period of depression, as contrasted with a period of boom, some expansion of credit is essential and it is the duty of a central bank or banking system to do what it can to facilitate that expansion. We must not allow our very natural fears as to how we are to control this expansion in the future to obscure our realization that in some form and to some extent it is not only inevitable but desirable, if we are to have any real recovery. It thus becomes a nice question, if credit expansion does not, as promptly as we desire, take the form we wish it to take, namely an expansion of the private use of credit, at what point and on what grounds we are justified in taking measures which might interfere with its taking the form of a public use of credit.

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The question of policy must therefore turn in the final analysis upon a carefully considered view of the existing economic situation and its prospects. It becomes a question of weighing the dangers inherent in our present course against the possibility of a successful outcome. Reviewing the events of the past two years, we do not find the picture wholly black. A certain amount of progress has been made. For the world as a whole, the depression reached its bottom in the summer of 1932, and even for this country the banking crisis in early 1933 did not push production any lower than it had been the preceding summer. Since March, 1933, we have pursued a highly erratic course of ups and downs, but each succeeding recession has been somewhat less than the preceding. Since last summer the course of business has been upward.

Perhaps the greatest single change in the last two years has been the improvement in the economic position of agriculture. Agricultural prices have risen markedly, and the 1909-13 relation of agricultural prices to industrial prices, which appeared during the first year of this Administration to be the principal goal of policy, has been achieved. Though some of the means employed have been artificial and there is no certainty of the continuance of this balance of agricultural and industrial prices, we have reason to feel that its achievement may have introduced a new element of political stability and to some extent have freed the hands of the Administration to deal with the industrial problem.

Another major change has a bearing on the outlook for the capital goods industries, which are the real seat of the depression. It is becoming apparent that the long lapse of time is taking its toll increasingly of equipment in use through the process of wearout and obsolescence, even though many obstacles remain to be removed. Reports for recent months from the machine tool industry, often an important forerunner of industrial recovery, indicate the most active year since 1930. Both the railroads and the utilities appear to have reached the point of

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being in need of equipment if their political or financial difficulties can be resolved. There are scattered evidences of a changing situation in real estate. In various parts of the country pressure for rent reductions has relaxed, families which had doubled up are seeking separate housing, vacancies have lessened.

On the whole, and recognizing frankly the extreme difficulty of analyzing so tangled a situation as this, we feel that we would do better, in the absence of any important change in the situation, to continue upon our present course of maintaining existing aggregate holdings of government securities rather than to take the alternative course, which carries with it the implication of a definite judgment that our present policy cannot succeed. We ought, however, to recognize that in order to succeed our policy, with respect to excess reserves, should be part of a broader monetary policy, which in our view should be on some such lines as the following:

1. The continuance of our present open market position.
2. The removal of mechanical obstacles to the opening of the private capital market, such as the prohibition of underwriting by banks and the undue severities of the Securities Act.
3. The encouragement of all sound steps which will increase the availability and reduce the cost of mortgage money.
4. The revival of confidence, which alone will free private capital, by steps looking toward (a) international monetary stabilization, and (b) a budget policy aimed not at an immediate balance but at some fairly definite schedule for tapering off extraordinary expenditures.

If this program could be adopted, we are satisfied that it would go far toward hastening a general economic recovery. There would, of course, remain much to be done. It is probable that in the sphere of the National Recovery Administration many helpful changes are now going on underneath the surface; but in the field of building construction there is a difficult problem of cost-price adjustments, in the field of railroads there appears to be much need for financial reconstruction as the necessary preliminary to railroad buying of equipment, and in

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the public utilities there is clearly need for some clarification of the present conflict which, while removing previous malpractices wherever they may be found, would make it possible for this industry, and for investors in it, to contribute their very important share to the national spending.

This memorandum has been addressed mainly to the question of what the Federal Reserve System, as a central banking system, ought to do in the present situation, and a program of action has been suggested. What is the alternative to such a program? If, for example, we should decide that we ought to reverse our present course and reduce our holdings of government securities, what prospect is there that our reversal of policy would accomplish our purpose, or that the reversal might not of itself become destructive? Through its stabilization fund the government could exercise a dominant influence over member bank reserves. It could also resort, if it chose, to paper money inflation. Moreover, with the whole question of central banking now very much in the air, the government could readily alter fundamentally the entire central banking, and also the commercial banking, machinery of the country. It seems clear that we could act effectively only with the consent and cooperation of the Administration. And there is the further question whether the Administration, even if we should propose and it should consent to such a reversal of policy, would be well advised to do so. If as a result there were any marked decline in government securities or commodity prices or production, the Administration would probably have to face renewed agitation either for inflation through greenbacks, further devaluation, more silver certificates, and the like, or for increased governmental intervention in the regimentation or management of industry. Perhaps at the moment these dangers appear to be less imminent than a year ago, but that fact does not lessen the danger that a reversal of our policy would strengthen the hands of one or the other of these groups who do not think as we do, and might well result in serious and damaging losses to the banking system.

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A second question requiring careful consideration would be as to the time and the nature of our action. If we should decide upon a reversal of our policy, we ought to choose our ground carefully so that our motives could be easily understood and, in so far as is practicable, publicly justified. The action should be taken at a time and in a manner which would indicate as clearly as possible that the dangers of the present course are becoming greater, while the prospects for a favorable outcome have been lessened. It would seem much more justifiable under present conditions to refuse a request to buy more government securities than to begin a policy of selling. Still more clearly, if the government should at some future stage endeavor to borrow directly from the Reserve banks, there might then be every reason for resisting. Without waiting for either of these events, if we could be sure that the present situation can have no other outcome than a destructive inflation, it might then be our duty to reverse our policy. But is it possible to be sure of this at the present time, when there is yet no actual evidence of inflation but on the contrary a general agreement that we need more activity both of credit and of business? A reversal of our policy at the present time would appear to rest upon more certainty of the future dangers in our situation than is yet warranted and to under-emphasize its more constructive and encouraging aspects.

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Assuming, therefore, that it is the carefully considered view of this Board, on the basis of its analysis of the situation as set forth in this memorandum, that the Federal Reserve System ought not, at present, to make any major change in its credit policy, we may ask ourselves whether there is any lesser, intermediate action which should be taken with respect to its government security account. In our recent discussions, it has been frequently pointed out that it is desirable to introduce some measure of flexibility into this security account. In

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a large complex money market which is subject to many influences of a seasonal or transitory nature, there is inevitably a certain amount of variation in the magnitude of reserves. Similarly, there may be fairly wide short-time variations in the condition of the government security market and this market, in circumstances like the present, is a dominant feature of the money market. It is generally agreed that one important function of a central bank or banking system is to smooth out such seasonal or accidental variations affecting the money market, at least so far as they threaten to assume disturbing proportions; and to this end it ought to be free to act even though such action involves changes in the amount or character of its government security holdings. To maintain a completely rigid open market position not only lessens the power of the Federal Reserve System to smooth out minor irregularities in the market but causes the public to attach an undue importance to the size of its security account, and to small changes in the account when they do occur.

Owing to the present great size of excess reserves and the extraordinary ease of the money market, there has been less occasion than in normal times for smoothing out seasonal irregularities or for making changes in the System security portfolio which were not connected with major policy. At the same time, by reason of the unprecedented magnitude of the excess reserves, which has been a factor in the high prices of government securities, and in the large purchases of such securities by the banks, bankers and the general public are more than ordinarily alert and sensitive to every circumstance which might affect the market for government securities. We must, therefore, recognize that there is much more danger than would ordinarily be the case that even minor variations in the System's security account might set in motion forces of an importance not intended and very difficult to control. A diminution in our portfolio, after so long a period of inactivity, might at the present time precipitate a serious selling movement among the banks,



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which quite apart from its effect upon the price of government securities and the government's fiscal policy, would defeat the very purposes which the policy of excess reserves has sought to accomplish. It therefore seems that flexibility, desirable as it would be under more normal conditions, for the time being, should give way to larger considerations. When the time does come to reverse our policy, our present holdings of government securities will probably be inadequate (apart from changes in reserve requirements) for the task of controlling the enormous potential expansion of credit which present excess reserves make possible, and we shall need to rely, so far as we can, upon the psychological effects of our action. The very conspicuousness of our present rigid position may then become a powerful aid in emphasizing to the public the significance of a reversal of our policy.

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FACTORS OF INCREASE IN MEMBER BANK RESERVES

(Millions of dollars)

| | Feb. 24, 1932 to Aug. 10, 1932 |
|---|---|
| **Sources of additional reserve funds:** | |
| U. S. Securities purchased by Federal reserve banks | 1,110 |
| Decrease in reserve requirements | 36 |
| All other | 30 |
| Total | 1,176 |
| **Uses of reserve funds:** | |
| Decrease in gold stock | 345 |
| To retire discounts at Federal reserve banks | 383 |
| To retire bills held by Federal reserve banks | 94 |
| Demand for currency | 115 |
| To meet Treasury withdrawals | 19 |
| Total | 956 |
| Net addition to excess reserves | 220 |

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FACTORS OF INCREASE IN MEMBER BANK RESERVES

(Millions of dollars)

| | Aug. 10, 1932 to Jan. 3, 1934 |
|---|---|
| **Sources of additional reserve funds:** | |
| U. S. Securities purchased by Federal reserve banks | 581 |
| Increase in gold stock | 318 |
| Bills purchased by Federal reserve banks | 82 |
| Increase in Treasury currency outstanding | 239 |
| Total | 1,220 |
| **Uses of reserve funds:** | |
| To retire discounts at Federal reserve banks | 346 |
| To meet Treasury withdrawals | 46 |
| To meet increased reserve requirements | 61 |
| Demand for currency | 84 |
| All other | 96 |
| Total | 633 |
| Net addition to excess reserves | 587 |

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## FACTORS OF INCREASE IN MEMBER BANK RESERVES

(Millions of dollars)

| | Jan. 3, 1934 to Mar. 6, 1935 |
|---|---|
| **Sources of additional reserve funds:** | |
| Increase in gold stock | 1,515 |
| Return flow of currency | 34 |
| Expenditure of Treasury free gold and increase in silver currency | 520 |
| Total | 2,069 |
| **Uses of reserve funds:** | |
| To retire discounts at Federal reserve banks | 100 |
| To retire bills held by Federal reserve banks | 115 |
| To meet increased reserve requirements | 503 |
| All other | 9 |
| Total | 727 |
| Net addition to excess reserves | 1,342 |

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