PRELIMINARY MEMORANDUM ON MONEY MARKET AND CREDIT CONDITIONS
FOR THE FEDERAL OPEN MARKET COMMITTEE,
OCTOBER 22, 1935.

Excess Reserves and Federal Reserve Policy

Five months have passed since the last meeting of the Federal Open Market Committee when we discussed Federal Reserve policy with particular reference to the question of excess reserves. During this period the System holdings of government securities and total Reserve Bank credit outstanding have remained virtually unchanged, but excess reserves have increased from $2,180,000,000 on March 6 to $2,910,000,000 on October 16. This increase has been due mainly to further gold inflow, and to a less extent to Treasury disbursements of free gold and an increase in silver certificates in excess of retirements of national bank notes.

In attempting to reappraise our policy with respect to excess reserves at the present time, we must find answers to two questions. First, what evidence is there that our present policy is having desirable results? Second, what dangers are there that a continuance of the present policy may have undesirable results? Having answered these questions, we shall be in a better position to consider whether and when and in what ways our policy might wisely be changed.

As stated in a memorandum presented at a meeting of the Executive Committee on April 17, 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 to buy government securities, thus forcing down the yield on these securities to the point where bank and other investment funds would flow over into private capital investment. The signs then discernible that this pressure had begun to work have since become clearer. One very favorable indication is the progress of the government war debt conversion program, which has now been entirely completed. There have been converted over $8,000,000,000 of bonds into bonds and long-term

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notes at a saving of over 1% on the bonds and more on the notes. Probably the chief financial development of the last seven months has been the appearance in large volume of private refunding issues bearing interest rate reductions of from 1% to 1 3/4%. During the seven months period ended with September, over $1,300,000,000 of domestic corporate refunding operations were conducted. In addition, there was $750,000,000 of state, municipal, and farm loan refunding, exclusive of government guaranteed issues. This is evidence that the reduction of yields on short-time investments and on government securities is having its expected effect upon the yields of corporate and other bonds.

In this period, also, the signs of business revival have become clearer. Perhaps the best evidence is that the decline this year from the spring peak of business activity was markedly less than in any year since the depression began, and was arrested earlier than is usual. From the high point of January, general business activity lost by May only about 25% of the previous advance, since which time the index of production has tended moderately upward. In the three preceding wave movements since the bottom of the depression in 1932, from two-thirds to 100% of each upward movement was lost in the subsequent decline. At present it appears that a number of consumer goods industries are nearly back to their pre-depression level. The automobile industry has made a notable recovery, although at the moment production is low owing to the early introduction of new models. The heavy goods industries still remain the center of the depression but steel production has now recovered to 50% of capacity and machine tool orders recently have made the best showing since 1929, although they have declined somewhat in the last two months.

There is thus some fairly clear evidence both in interest rates and in the state of business that our long-continued policy of easy money and excess reserves is having the desired results. To what extent these results should be

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ascribed primarily to credit policy or to other factors is now, as always, problematical. Doubtless, the long duration of depression and the consequent wearout and obsolescence of durable goods has been an important, and perhaps the chief, factor in recovery. Also, the strengthening of the capital structure of the banking system undoubtedly played a large part in stopping the cumulative processes of hoarding and deflation. Another important factor has been the rise of agricultural prices and the consequent increase of farm income. Another factor in all probability, though this has been a much debated question, has been the government spending program. But there can be no doubt that the presence of large excess reserves has played a fundamental role, not only in financing governmental expenditures but also in paving the way for the revival of private capital investment.

As the process continues, we should expect to see its effects in further expansion of bank deposits and bank assets. Already the expansion of bank deposits has proceeded at a pace that has been exceeded only during the World War. Net demand deposits of weekly reporting member banks (91 cities) have increased by $6,400,000,000 since March 1933, and $1,400,000,000 of this increase has occurred in the past seven months. The total of net demand and time deposits of these banks, exclusive of government deposits, now amount to more than $20,000,000,000 and exceed the pre-depression level. Time deposits remain substantially smaller than in 1929-1930, and demand deposits in "country" member banks (which are not largely represented in the weekly reporting member banks) are still considerably below 1928-1929 levels, but have shown a rate of expansion during the past year nearly as rapid as in the city banks.(1) On the other hand, loans and investments of the reporting member banks have made a more moderate recovery, amounting to

(1) The latest figures of deposits of all banks in the country are for December 31, 1934, when the total was $44,800,000,000, exclusive of interbank deposits. This is the highest since the December 1931 call. The peak of deposits of all banks was approximately $56,800,000,000.

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$3,315,000,000 (October 9) since March 1933. This change has resulted from an increase of $4,153,000,000 in bank holdings of U. S. government securities, including government guaranteed securities, accompanied by a decline of $807,000,000 in loans, and little change in securities other than governments. Since last March total loans and investments of banks have shown a net increase of $581,000,000. Loans on securities have decreased moderately to the lowest levels of recent years, and all other loans are little changed for the period, a seasonal increase of $200,000,000 in the last two months having offset an earlier decline. On the other hand, an increase of $801,000,000 has occurred in bank investments, of which government securities have accounted for $682,000,000.

These figures indicate, first, that our easy money policy and the monetary and fiscal policy of the government have been followed by an extraordinary expansion of bank deposits, which thus far has come primarily from expansion of bank investments in government securities and from heavy gold inflow (and in the first few months after the bank holiday from return of currency from hoarding); and second, that in the aggregate the recovery of private business has thus far not been financed by private borrowing from banks. It is not unusual in an early stage of recovery from depression for business expansion to be financed out of corporate funds previously idle or invested outside the business. In this connection, refunding issues themselves become a source of funds available for further production, in so far as they release earnings which might otherwise have to be set aside to pay off or reduce maturing capital issues. But this phase of recovery is usually preliminary to borrowing of new money, and before we can accept present indications as conclusive evidence that business revival is firmly established, we must look for an increase both in bank assets other than government securities and in new corporate issues. It is especially important, during this recovery, to watch for these developments because, in the present instance, government borrowing and

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spending are undoubtedly supplying an important part of the funds which industry is using, and the transition from public to private spending, as recovery proceeds, should be indicated by a transition from government security flotations to new corporate issues and private borrowing from banks.

This brief review of the business and financial situation appears to indicate that our credit policy is now being accompanied, quite definitely, by desirable developments. What are the dangers which may arise from a continuance of this policy, and what are the sign posts which should tell us when and how to change it?

There are two possible dangers from a continuance of our present policy. The first is inflation arising from expansion of public credit through the continued financing by the banks of government budgetary deficits. The second is inflation arising from expansion of private credit. The first danger is that with which we were primarily concerned in the memorandum presented last April. As was then indicated, there is an important difference between the effects of pressure of excess bank reserves against a fixed total of government debt and this same pressure when exerted against a continuously increasing volume of public debt. In the latter case, there is danger that the overflow of bank funds into private channels may not occur, that the banks will become more and more heavily loaded with government securities, and the government do a larger and larger part of the nation's borrowing and spending. 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

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being attended by grave economic and political disruption and disorder terminating in collapse.

The continuance of our present policy, as was pointed out in the earlier memorandum, rests upon the assumption that this danger can be avoided. There is an important economic difference between budgetary deficits arising from extraordinary expenditures of a compelling nature, such as the financing of a war or huge indemnity payments, and budgetary deficits resulting from depression. There is a definite economic basis for the theory that in the latter case a reversal of the forces which in depression produce the deficits should in recovery correct them, for as recovery proceeds the need for extraordinary government expenditure should be reduced and government revenue should be increased through the reemployment of the factors of production. But, on the other hand, it would be both naive and dangerous to suppose that the process is self-operative, and that recovery will now automatically correct the budgetary deficit. If the basis of our present policy of continuance of large excess reserves is correct, namely, that recovery from depression affords an opportunity for transition from public to private spending but that failure to seize this opportunity at the proper time can have only harmful results, it will be necessary from this time forward to keep a close watch upon the course of government revenue and expenditure.

The threat of uncontrollable government inflation now appears to be less than it did to many observers last winter. This is true not only because the recovery appears really to be under way, but also because the deficits themselves are proving to be considerably less than was feared six months or a year ago. The actual deficit for the past fiscal year was $3,575,000,000, including $574,000,000 of sinking fund, as compared with the official estimate of $4,869,000,000. Though the original estimate was doubtless overstated deliberately, the decrease has been due also to the increase of revenue and to the lag of actual expenditure behind the

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estimates. It has been easier to appropriate money than to devise the means of spending it; the result is that expenditures are still being made to a large extent out of appropriations from the preceding fiscal year and actual expenditures continue to run behind the estimates. In the past 3 months, actual net expenditures have averaged $275,000,000 a month as against the first official estimate for this fiscal year's deficit of $4,529,000,000 which has been revised to $3,282,000,000 in the President's recent budget message. There is also some recent evidence of a desire on the part of the Administration to control extraordinary expenditures.

It would be unsafe, however, to assume that the government's spending program will dry up from either lack of desire or lack of ability to find ways to spend the money. There are still some 19,000,000 people on relief, there is the $4,800,000,000 appropriated by the last Congress, there is every indication of a renewed drive in the next session of Congress for a bonus law which, if enacted, would probably add some $2,000,000,000 of extraordinary expenditure, and a Presidential election is approaching. Probably the most serious problem now bearing upon our policy regarding excess reserves arises from the contemplation of these actual and potential extraordinary appropriations. What will be their effect upon the business recovery which is now under way? If business confidence is not shaken and if the banks continue to absorb government securities, public spending on such a scale as this might well impart an undue stimulus to business activity. It is not impossible that we might find ourselves, much sooner than we now think, facing our second danger, that of undue private business and credit expansion. On the other hand, if such a program of public spending, particularly if the bonus is added, should shake business confidence and impair the ability or willingness of the market to absorb government securities, we might find ourselves facing the first danger outlined above, pure governmental inflation.

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The possibilities which have been discussed do not, however, appear to necessitate as yet any change in our policy regarding excess reserves. They merely raise questions for the future and indicate what factors in the current situation should be most closely watched. If this really is the beginning of a genuine recovery, it ought to mean that steps will be taken looking toward, not an immediate balancing of the budget, but some fairly definite schedule of tapering off extraordinary expenditures,the speed with which that is done depending upon the progress of recovery. It may well be that we shall have a permanent problem of relief as England has. The very fact that relief has been organized on a national scale may mean that unemployables previously taken care of informally and privately will become permanently a charge upon the public budget. Passage of the social security legislation, which is desirable in principle, almost certainly means a permanent increase in relief expenditures as compared with the pre-depression period. But the important considerations should be that such expenditures should be kept down to the adequate minimum, and above all that they should be made to find their place in a balanced budget.

If, as recovery proceeds, the effective steps are not taken toward budget balancing, there would certainly be ground for questioning whether the Reserve System is justified in continuing its present policy with respect to its security portfolio and excess reserves. We need not stop to consider anew the difficulties of making a reversal of our policy effective under such circumstances. Some of them have already been discussed in the earlier memorandum, such as the Stabilization Fund and the powers granted in the Thomas Amendment, whereby the Administration could easily override our efforts if it chose to do so. There is the further very practical difficulty that if we should attempt to sell our securities to the market, which at the same time was being offered new government issues to finance budgetary deficits, the result might be such an impairment of the market as might

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not only give a severe setback to business recovery but force the government along the road toward inconvertible currency inflation, which so far it has avoided. The mere mention of these possibilities indicates how indispensable it is for the Reserve System and the Administration to cooperate in the formulation of a program best suited to recovery and to the transition from public to private spending which should accompany recovery.

If matters proceed satisfactorily in this regard, the larger question for the future will be the relation of our policy to the progress of business recovery. There is the very definite possibility that private credit expansion, once it gets under way, may be difficult to hold within wholesome bounds. Total reserves are now more than double required reserves and interest rates are unprecedentedly low. As has frequently been pointed out in our earlier discussions, we ought not to allow our fears as to how we are to control credit expansion in the future to obscure our realization that in some form and to some extent such expansion is not only inevitable but desirable if we are to have a genuine and complete recovery. What the Reserve System ought now to be considering very seriously is both the methods whereby credit expansion is to be controlled in the future and the timing of this program of control. One previous source of rapid credit expansion peculiarly difficult to control, stock exchange speculation, has received special attention during the depression, and it seems probable that the new powers of the Board of Governors of the Federal Reserve System and of the Securities Exchange Commission to govern not only the supply of such credit, but what is perhaps even more important to regulate the demand for it, will put us in a stronger position in this respect than ever before, particularly as the "loans for the account of others," which were so serious a problem in 1927-29, are now forbidden by law. But it seems inevitable that with excess reserves of such magnitude, undue credit expansion will sooner or later get under

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way through one channel or another unless appropriately controlled. This is not the place to examine in any detail the criteria by which undue credit and business expansion can be recognized. That is a most difficult and a highly controversial question. It will probably not become a pressing question until the heavy goods industries have recovered and the general index of production has returned to normal. At the present time the Board index stands at 89 as compared with 58 at the bottom of the depression in July, 1932, and with 119 in 1929. Building contracts are still 71% below estimated normal, and steel ingot production 28% below.

The more pressing question is that of the nature of the control program. We have the following major instruments of control: power to alter reserve requirements, discount rates, open market operations, and powers of "direct control" against stock market use of credit. In what order should these powers be used if and when control becomes essential? This is a question of very great magnitude which cannot be discussed fully within the scope of the present memorandum, which is addressed mainly to the question whether there is any immediate ground for a change in our credit policy.

But there is a direct connection between this question of the order in which the instruments of control should be used and the question of our attitude toward the continued growth of excess reserves. During the past two years it has been repeatedly pointed out that excess reserves have gone on increasing, very rapidly and very substantially, not as a result of open market operations or of any deliberate policy of the Federal Reserve System, but in response to recurring inflows of gold following upon devaluation of the dollar. At the time of the passage of the Gold Reserve Act in January, 1934, excess reserves, mainly as the result of open market operations, were $800,000,000; they are now $2,900,000,000. Granting

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that it has been the Federal Reserve policy ever since February 1932 to maintain pressure for credit expansion through excess reserves, no one supposes that the System would have deliberately created any such volume of reserves as now exists; and the question has been repeatedly raised whether, granting the desirability of large excess reserves, it is desirable to permit them to accumulate indefinitely. It may well be asked whether, at some point, we should not intervene, not to prevent credit expansion but merely to prevent further accumulation of superfluous reserves which will only add to the difficulties of credit control when the time for it arrives?

This question, which is surely very pertinent, reveals the extraordinary nature of our current situation which is without precedent in central banking history. If a central bank creates reserves by open market operations, it can contract them by the same method. But today excess reserves owe their origin, in the main, not to open market operations but to the modification of our monetary standard. So long as gold continues to flow in on such a scale as this year and last, we could not hope to eliminate excess reserves by open market operations alone. As a practical matter, the most that we could do through the sale of government securities would be to reduce them in part and thus psychologically to check their use in credit expansion. It is partly because we fear that the sale of securities at this time would have such a result now when expansion is still necessary for business recovery that we have continued in our present policy. If, on the other hand, a reversal of our open market position did not prevent credit expansion now, our sales would only weaken our power to control such expansion later.

In these circumstances it seems not unlikely that the first step in control may have to be the raising of reserve requirements. Must we not recognize that the modification of our monetary standard in January, 1934, carried with it as one

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of the necessary conditions of its continued operation the necessity of some fundamental readjustment of our whole system of reserve requirements?

But whatever program of control may be chosen, it seems certain that coordination of Federal Reserve policy and the Administration's fiscal policy is the first and the fundamental prerequisite to its success. Upon the achievement of this coordination depends fundamentally the timing of any control program, for whether we employed open market operations or an alteration of reserve requirements as our first measure of control, we would be facing the definite risk of a stoppage in the government bond market, with all of the undesirable consequences which might follow therefrom, unless our policy were closely timed and coordinated with a Treasury program of budgetary economy and control.

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