MONTHLY

Review

FEDERAL RESERVE BANK
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THE BUSINESS SITUATION

—*Demand for Credit Strengthens*

INTEREST RATES are now high in relation to experience of the past twenty-five years, and comment on the plight of borrowers—including the United States Treasury—is widespread. At the same time the money supply has continued to rise at a substantial rate and the total volume of funds flowing to borrowers has been at near record levels.

The increase in the cost of credit during the past year has reflected mainly a sharp increase in demand for funds rather than a restriction of supply. An increase in borrowing characteristically occurs during a period of optimism and economic expansion; presently, fears of future decline in the purchasing power of the dollar may in some measure act to stimulate demand for funds. Consumers have been heavy borrowers, especially to finance record house buying; business demand for funds to support investment in inventories and plant has been rising; and governments have drawn unusually heavily on the economy's credit supply.

Demand for Funds

The quickened tempo of building construction has been accompanied by a rapid rise in mortgage debt. In the first quarter of 1959 such debt was increased by about $5 billion or double the pace of a year ago. In addition to private outlays, construction by state and local governments continued at a high level in early 1959. New schools, roads, and other facilities together with current operating needs sent state and local governments to the capital markets for some $3 billion of new funds in the first four months of 1959, just slightly below the record amount in the corresponding period last year.

The Federal Government also has been contributing to the demand for funds. In the first four months of 1959 the Federal marketable debt rose $5.1 billion as against a $1.8 billion rise in the like period last year. However, it is expected that the Federal Government's cash budget will be in balance in the near future which should reduce the Treasury's demand for funds.

A brightened economic outlook in 1959 has stimulated an accumulation of business inventories following the sustained liquidation which took place during the 1957-58 recession. In the first quarter of 1958 business firms liquidated inventories by $2 billion on a seasonally adjusted basis. By contrast they expanded stocks of goods by $1 billion in the first quarter this year. Burgeoning activity has also encouraged some increase in business outlays for plant and equipment. In the second quarter, this investment is expected to reach a seasonally adjusted rate of $8 billion, up 6 per cent from the like quarter last year.

Steadily rising personal income together with greater optimism concerning the future have contributed to an upsurge in consumer durable goods purchases and a related expansion in consumer credit. The latter increased $1.4 billion in the first three months of 1959 on a seasonally adjusted basis as compared to a decline of $0.2 billion last year.

Supply of Funds

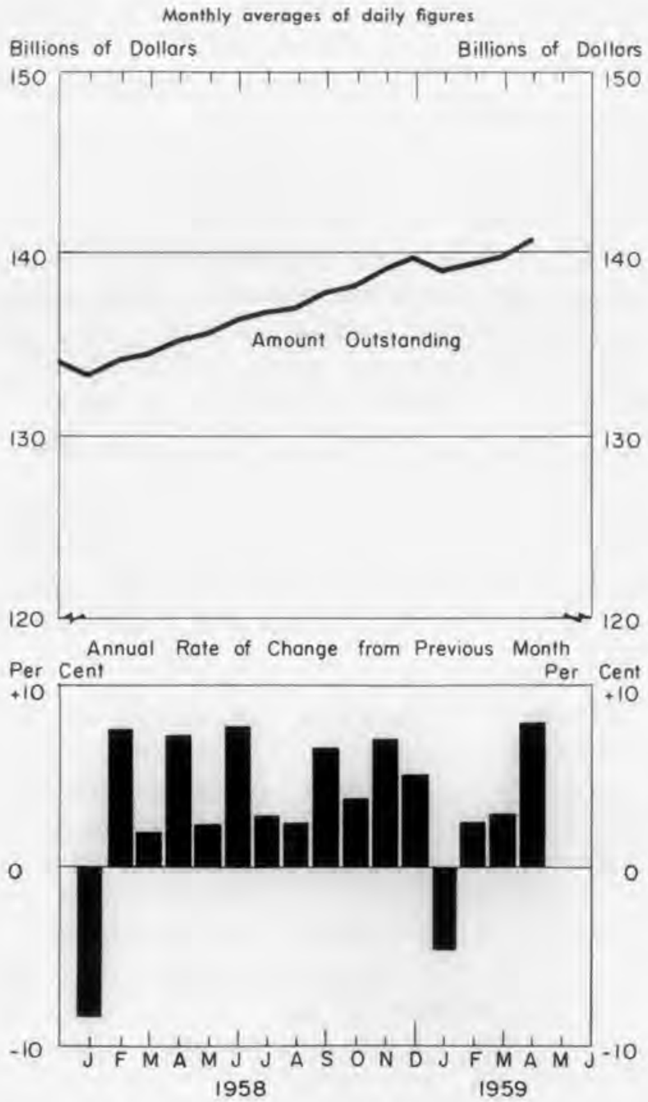
Funds available to accommodate the increased credit demand of businesses, governments, and consumers stem primarily from current saving, credit creation by the banking system, and activation of cash balances.

According to preliminary information, the rate of personal saving in the first quarter of 1959 was about the same as a year earlier, amounting to an annual rate of about $21 billion as compared with $20 billion last year. An increase in corporate saving, largely reflecting a sharp gain in net profits, has also increased the supply of funds available for investment. Corporate profits after taxes were $5.5 billion in the fourth quarter of 1958 after adjustment for seasonal influences. Although data are not yet available, indications point to a still higher figure for the first quarter of 1959. By comparison, in the first quarter last year corporate profits after taxes were less than $4 billion. As a result many commercial and industrial firms have temporarily been able to finance expansion programs and also have funds to lend to others.

Credit and money creation by the banking system has been substantial during the past year. From February to November, 1958, daily average demand deposits and currency (adjusted for seasonal variation) increased at a rate of 5.0 per cent per annum. From November 1958 to February this year the annual rate of increase was 0.9 per cent, but in March and April the rise was at the annual rate of 5.4 per cent. This compares with a postwar average rate of increase in the money supply of about 2.5 per cent. The expansion in the seasonally adjusted money supply during the first four months of 1959 was made possible, in part, by a less than seasonal contraction in Reserve Bank credit.

Another important source of funds in recent months has been more intensive utilization of cash balances.

MONEY SUPPLY
Seasonally Adjusted
Demand deposits adjusted and currency outside banks

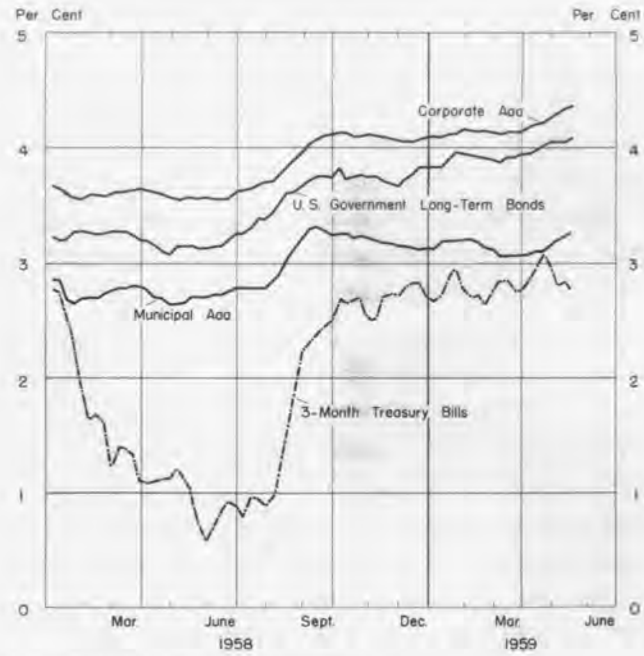


Turnover of demand deposits at the 337 reporting centers (outside the seven big financial centers) was at the seasonally adjusted rate of 23.9 times per year in the first quarter of 1959. By comparison, turnover was at a rate of 22.9 times per year in the first quarter of last year.

Recent Course of Interest Rates

From last September through March this year the marked rise in the demand for credit was virtually matched by an increase in the supply of funds. Interest rates generally were remarkably stable during this period, with some rates working up and some drifting lower (see chart).

SELECTED YIELDS
Weekly Averages of Daily Figures



Latest figures plotted: Week ended May 15.

However, during April and early May, the demand for funds was rising at a faster pace than the available supply. Hence, interest rates have been moving up on most marketable issues. The following table shows selected interest rates as of the end of last September, the end of March, and May 18.

SELECTED INTEREST RATES

	Sept. 30, 1958	March 31, 1959	May 18, 1959
Three-month Treasury Bills	2.70%	2.78%	2.84%
Long-term Government Bonds	3.80	3.96	4.11
Corporate Bonds:			
Highest grade	4.13	4.15	4.38
Medium-grade	4.91	4.83	4.95
Highest grade Municipal Bonds	3.25	3.06	3.25
Prime Rate on Business Loans	4.00	4.00	4.50

Function of Interest Rates

In a free market system the interest rate is the price which balances the supply and demand for funds. Although saving is large, it is not unlimited. The function of interest rates is to allocate the limited amount of funds among competing uses. It is quite generally believed in this country that allocation in the market place is usually preferable to rationing by Government fiat.

A basic economic problem is limiting the plans of those seeking to invest in capital goods under conditions of high-level employment to the amount others are willing to save. Just as a family cannot buy all that it would like or could use, so an economic society cannot both consume and invest in unlimited amounts. With a given state of technology and a limited amount of resources (workers, land, and plant and equipment) possibilities for current production are not unlimited. Since we cannot obtain all the things we want, we must pick and choose. The various uses for funds have to compete for savings. The resultant price for funds—the interest rate—has to be paid for current borrowing and for refinancing by individuals, businesses, and governments.

Indeed, the economy as a whole is much more restricted than an individual family, a single business firm, or a governmental unit. A family can for a while spend more than its income. A business can invest more than it saves, or a government can run a deficit by borrowing. But an entire economy cannot consume and invest more than it produces. In other words, new capital goods must be matched by saving, either voluntary, or involuntary through inflation.

By and large, interest rates are what they are, and become what they become, as a reflection of how useful and valuable the users of funds find them. Businessmen, consumers, and the Government pay the interest rates which they pay because they find the use of the funds worth the cost. A higher rate now than at some earlier period indicates a stronger demand for funds relative to the supply available, which reflects the fact that projects on which the funds are used are deemed increasingly attractive.

The productivity of capital may have increased in recent years for a number of reasons. For one thing business concerns have been spending more and more on research and development. As a result of these programs new plants are being constructed and new equipment is being installed which has caused an increase in the demand for funds.

It may also be that the demand for capital is in some degree a reaction to steadily increasing wage rates during the postwar period. Some firms, as a result of higher labor costs, have sought to substitute machines for workers as a method of controlling expenses. Hence, the higher wage rates in the postwar period may have increased the demand for funds, tending to push up interest rates.

Another force tending to sustain the demand for credit has been the guarantee of loans by the Government. A Government guarantee generally reduces the risk of default to the lender enabling the borrower to obtain more favorable terms. Hence, some borrowers who might not have obtained funds without the guarantee do in fact get them, thereby contributing to the pressure on interest rates.

Saving, on the other hand, may have been discouraged to some extent in recent years by inflation. Since a large portion of saving is in the form of deposits or other liquid debt instruments, and since inflation reduces the purchasing power of funds invested in these instruments, it may be that some savers feel that it is better to consume more of their income currently. Evidence as to the effect that continued price increases have had on the propensity to save is not conclusive. However, to the extent that saving has been reduced, this reduction has been a factor in pushing interest rates up. But whether the rate of current saving is affected or not, it appears quite likely that its form is altered by inflation, encouraging the purchase of property and other equities and discouraging the purchase of fixed debt instruments.

Because of the numerous forces bearing upon interest rates, it is impossible to state with certainty what interest rates will do in the future. There is some feeling that the demand for credit will rise in the next few months as businessmen seek additional funds to expand inventories and finance new plant and equipment. On the other hand, the demand for money by the Federal Government may decline as it comes closer to balancing its budget. In any case, changes in interest rates will be a natural response to changes in supply and demand forces.

—Expansion of Economic Activity Continues

TOTAL PRODUCTION of goods and services in the nation has now been increasing for about a year. Gross national product reached a seasonally adjusted annual rate of $467 billion in the first quarter of the year, and signs point to a continued increase. The first-quarter rate at current prices was more than 9 per cent higher than the rate in the first quarter of last year, and "real" total production—measured at 1958 prices—was 8 per cent higher than a year ago.

Consumer income after taxes during the first quarter of this year was about 5 per cent higher than in the same quarter of last year, and 1.6 per cent above the late 1958 level. Since consumer prices have remained stable since last June, "real" income of consumers has risen appreciably. Per capita real disposable income in the first quarter of this year was approximately 2.2 per cent higher than in the corresponding quarter of 1958, although slightly below the level reached two years ago.

Production of goods and services expanded further during April and early May, as evidenced by the growing volume of industrial production and the sharp upswing in employment. Consequently, consumer income and spending are likely to be substantially higher in the second quarter than in the first three months of this year.

Industrial Output in April Shows Further Gains

The rapid rise in business activity experienced during the first quarter of this year continued in April and early May. The seasonally adjusted index of industrial production increased between March and April by 2 points to 149 per cent of the 1947-1949 average. The pre-recession peak was 146. Manufacturing of durable goods, especially machinery, showed sharp increases, while activity in the building materials and automotive industries remained at high levels.

Steel production in April continued to expand, reaching the highest level in history. Average weekly output increased by about 2 per cent over March, and was more than double the April 1958 rate. Total output during the first four months of this year was 71 per cent larger than during the corresponding period last year, the bottom of the recession, reflecting the continuously strong demand from such major consumers as the automobile, construction, and machinery industries.

Production of durable producer goods, notably of machinery, has been growing at an increasing rate. April output of machinery, seasonally adjusted, was about 2.5 per cent higher than the March total, and about 19 per cent ahead of a year ago, but was about 8 per cent below the monthly high established in December 1956.

Output of consumer durables reached the highest volume of the year in April. Passenger car production rose to a seasonally adjusted annual rate of about six million units, and production for the first four months of this year ran about 40 per cent ahead of the volume produced during the corresponding period of last year. Production of television sets and furniture also advanced between March and April.

Construction Activity Remains High

Estimated expenditures for new construction outlays in April reached a seasonally adjusted annual rate of $53.9 billion. Although this was slightly below the March rate, it was still substantially above the rate achieved in any previous April. New construction expenditures during the first four months of this year ran at an annual rate of $54.3 billion, as compared with total 1958 spending of $49 billion, a high for any one year.

Spending on private construction in April was about 15 per cent greater than in April of last year, largely because of an increase in residential building. Total expenditures on private construction during the first four months of this year amounted to $10.7 billion, up 11 per cent from the corresponding 1958 period.

Public construction outlays during the first four months of this year totalled $4.4 billion, as compared to $3.8 billion in the first four months of 1958. The bulk of the increase resulted from growing expenditures for highways, housing, and military construction.

The value of construction contract awards, which provides some indication of future construction activity, was 43 per cent greater in March than in February, and was 23 per cent larger than in March of last year. The increase over February was considerably larger than the usual seasonal increase, and was mainly the result of a marked rise in awards for residential construction and power projects. The total for the first quarter of this year was 18 per cent larger than the corresponding 1958 total. Most pronounced was the rise in contract awards for residential construction, especially for one- and two-family houses. On the other hand, the value of contracts awarded for school construction was 20 per cent lower in the first three months of this year than in the first quarter of 1958.

Sales, Inventories, and New Orders Advance

Sales of manufacturers, wholesalers, and retailers combined reached a seasonally adjusted total of $59.1 billion in March, an increase of $1.1 billion over the previous month, and of $7.8 billion over March 1958. The sharpest gain in March of this year was registered in the sale of durables by manufacturers, which rose by about 3 per cent over February. Both wholesale and retail sales increased about 1.7 per cent, seasonally adjusted, during the same month, and retail sales in April were virtually unchanged from March.

Inventories of manufacturers, seasonally adjusted, had risen to $50.3 billion by the end of March. This was an increase of $400 million over February, but inventories were still $1.7 billion below the March 1958 level. During the first three months of this year manufacturers' inventories showed an increase of $1.1 billion, seasonally adjusted, as compared with a $1.5 billion decline during the first quarter of last year. Stocks of metal producers and fabricators have been gaining the largest share in recent months, reflecting rising industrial activity and efforts of steel users to hedge against a possible summer strike. Wholesale and retail inventories at the end of March were at virtually the same levels as at the beginning of the year, and only wholesale inventories showed any change—a 4 per cent decline—from the March 1958 level.

Manufacturers' new orders reached a seasonally adjusted total of $30 billion in March, an increase of about 1 per cent over February. New orders to steel producers declined from their high February level, but this drop was more than offset by a further rise in orders received by manufacturers of other durable goods. Machinery—both electrical and nonelectrical —and transportation equipment registered the largest gains. Orders for machine tools, especially of the cutting and forming type, also continued to rise substantially.

Employment and Income Continue to Rise

One of the most outstanding features of the April economy was the sharp decline in unemployment and the corresponding rise in employment. Unemployment last month dropped by an estimated 735,000, almost double the usual seasonal decline during this time of the year. The percentage of the civilian labor force which remained unemployed dropped from 5.8 in March to 5.3 in April. This constitutes the sharpest monthly decline since the turn from the 1957-1958 recession, and brings the percentage unemployed to the lowest point since December 1957.

Total employment in April increased by 1,200,000, also about double the usual seasonal increase. Nonfarm employment rose approximately 500,000, mainly as a result of the substantial increase in construction activity in recent months and because of stepped-up hiring by durable goods manufacturers.

The sharp rise in employment was accompanied by a further growth in personal income which reached an annual rate of about $373 billion in April, almost 7 per cent higher than the rate of the corresponding month last year. The increase reflected both a lengthening of the factory work week and higher wage and salary payments, especially in manufacturing and construction. Average weekly earnings in manufacturing rose by 63 cents to $89.87 in April, a new high.

Prices Are Subject To Upward Pressures

Industrial wholesale prices as a group rose at an annual rate of 3 per cent during March and April, under the pressure of increased business activity. Advances were most pronounced among leather and leather products, lumber and wood products, and textiles. Leather prices in March were about 9 per cent higher than a year ago, and 3 per cent higher than in February. Increased shoe production and an unusually small supply of hides were the main forces behind the price rise. Metal and metal products, fuel, and power, were among the items which experienced less marked price increases.

Selected Consumer Price Indices
1947-49=100

CHART 1

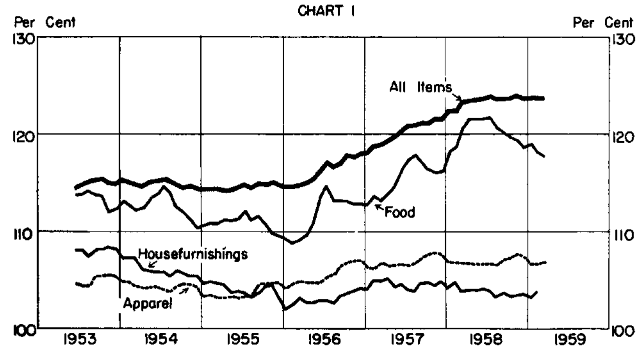


CHART 2

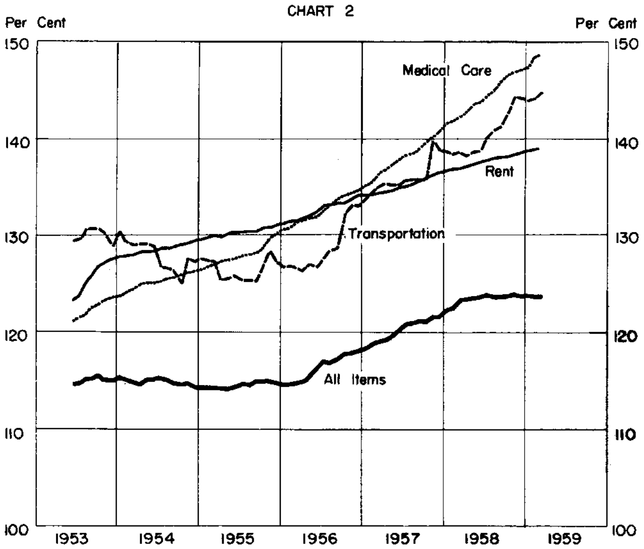
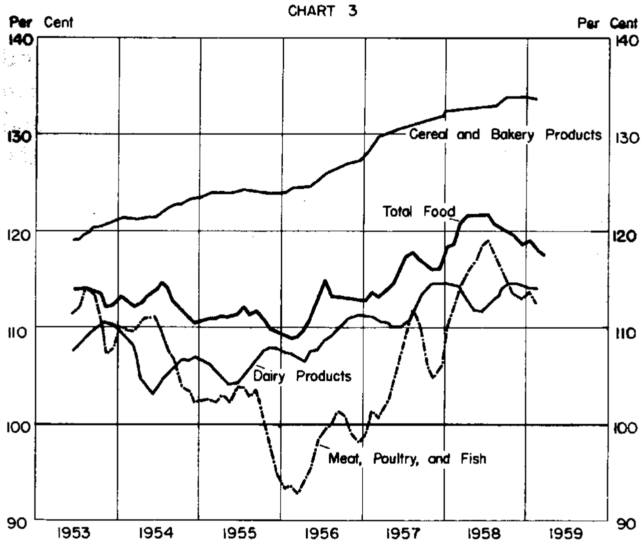


CHART 3



Latest Data Plotted: March
Source: Bureau of Labor Statistics

Wholesale prices of farm products increased slightly in April for the first time since May of last year, but declined again in the first two weeks of this month. The wholesale price index for all commodities which rose 0.1 to 119.6 in March (1947-1949=100), gained 0.2 in April.

The consumer price index in March remained at the February level, as a decline in food prices offset a further increase in prices of nonfood products and services. Declining food prices have accounted for much of the stability in the consumer price index since last summer, as shown in Chart 1.

Commodity Imports Increase

United States trade with other countries during the first quarter of this year showed a further rise in imports and a decline in exports. Sharp increases in the purchase of foreign automobiles, steel, petroleum products, rubber, and wool exceeded declines in imports of newsprint, cattle and meat by almost $1 billion at an annual rate. The decline in merchandise exports reflected mainly a further drop in sales of machinery and equipment to foreign customers.

Despite the large first quarter balance of payments deficit, United States gold sales during this period were small, mainly as a result of substantial repayments by Germany to the United States and by the United Kingdom to the International Monetary Fund. Gold sales picked up again in April and reached substantial proportions in the final two weeks of last month and the first week of this month.

STABILITY in the consumer price index between 1953 and 1956 was in part produced by declines in the cost of food, housefurnishings, and transportation, which offset increases in, among others, the cost of rent and medical care. The 1956-1958 inflation was largely manifest in a sudden and substantial upturn in prices of foodstuffs and transportation, and continuing increase in the cost of medical care and rent. Since the middle of last year a sharp drop in total food prices and continuing stability in prices of apparel and housefurnishings have again offset increases in the cost of services. Among food prices, those of meat, poultry, and fish combined have experienced the most significant decline. Prices of dairy products in March of this year were about the same as in the fall of 1957, and those of cereals and bakery products combined were moderately higher.

Central Reserve Cities, Reserve Cities, and Reserve Requirements—A Brief Survey

IT HAS SOMETIMES BEEN SAID of American commercial banks that they are the most closely regulated business firms in the world. Banking laws abound in precise prescriptions and carefully worded proscriptions relating to the conditions under which banks may be organized as well as the nature and magnitude of their operations. This close supervision of commercial banks reflects a public acknowledgment that they are intimately involved with the nation's money supply and are thus heavily vested with the public interest.

In part, this involvement stems from the legal obligation of a commercial bank to surrender the bulk of its assets on demand, and in cash. Commercial banks, however, are organized and operated on the assumption that only a relatively small amount of their resources need be reserved in cash for such surrender. Originally, the determination of this "reserve" was, and in England and many other countries still is, left to the discretion of the individual banks. However, in the United States during the 19th century many states as well as the Federal Government changed it from a matter of private decision to one of legal requirement. By the turn of the century required reserves had become an accepted feature of banking statutes. While these requirements varied in detail and application, they were the pivot in every framework of public control and were motivated by a common intention to assure the safety of deposits by providing a source of funds to meet anticipated withdrawals.

Yet if American banking history, from its beginnings to the bank holidays of the 1930's, proved anything, the high incidence of bank failure during this period demonstrated that a nominal ratio of reserves to deposits did not, of itself, adequately provide individual safety for the depositor nor collective safety for the banking system. Nonetheless, the notion that it did persisted well into the 20th century, surviving and, indeed, underlying the attempted solutions to the varying and manifest inadequacies of the American banking system set out in the National Banking Act of 1863 and the Federal Reserve Act of 1913. Both of these major reforms addressed themselves to the structure of the banking system and not to its underlying rationale. Both involved the common theme of providing safety by requiring that reserves be maintained by individual banks. The latter legislation, in particular, attempted to accomplish this by "mobilizing" reserves, in a tightly knit system of twelve regional quasi-public institutions.

Yet from the earliest days of the Federal Reserve System, reserve accounts were seen to have a dimension distinct and apart from their protective function. Thus, in discussing the transition from the higher percentage requirements of superseded national banking legislation to the lower ones of the Federal Reserve Act, the Federal Reserve Board said not one word about depositor safety. Rather, its first report discussed decreased reserves solely in terms of the increase in member bank lending power caused by this release of funds and the consequent effect on the pattern of interest rates.[1]

That results of this type should be produced through reserves as a matter of policy rather than happenstance was increasingly comprehended, and after a decade of Federal Reserve operation, the primary function of reserves gradually was seen as a means of adjusting the volume of commercial bank credit and the nation's money supply rather than a resource for the safety of depositors. However, the old idea that reserves provided for deposit safety still had widespread adherence until its total inadequacy was revealed by the wholesale collapse of the banking system in the 1930's. Its theoretical *coup de grace* was contained in a 1931 report of a Federal Reserve Committee which summed up an exhaustive investigation of the subject with the statement " . . . it is no longer the primary function of legal reserve requirements to assure or preserve the liquidity of the individual bank."[2]

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[1] *First Annual Report of the Federal Reserve Board* (1914), page 11.

[2] *Nineteenth Annual Report of the Federal Reserve Board* (1932), page 260.

The statutory requiem of the protective function of reserves was contained in successive acts of Congress passed in 1933 and 1935. It should be noted, however, that depositor safety did not thereby cease to be an object of legislative concern for each of these enactments was paralleled by other Congressional action, first instituting and then refining deposit insurance as the means by which this end was to be achieved.[3] The 1933 statute concerning reserves gave the Federal Reserve Board power—providing Presidential concurrence was forthcoming — to raise requirements in any amount to offset inflationary credit developments. This authority was restated and modified by the Banking Act of 1935, which cast statutory reserve requirements in their present form by setting a basic reserve subject to limited adjustment by the Board of Governors on its own motion:

RESERVE REQUIREMENTS OF MEMBER BANKS
(Percentages of Deposits)

	Demand Deposits		Time Deposits	
	Min.	Max.	Min.	Max.
Central Reserve City Banks........	13	26	3	6
Reserve City Banks..............	10	20	3	6
Country Banks..................	7	14	3	6

One of the more striking incidents of this profound conceptual change is the fact that it came about with a minimum of textual alteration. The basic statute still employs much of the terminology and many of the concepts of an earlier era. This legacy of the past has produced inequities, which the Board of Governors has attempted to ameliorate in 1958 and again this year by suggesting that certain amendatory proposals be made to the basic statute. In brief, these suggested revisions would authorize the Board to:

(1) 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 their business, reserves at the lower requirement level prescribed for country or for reserve city banks.

(2) 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.

(3) 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.

The scope and goal of such proposals might be illuminated by a brief survey of present requirements, their origin and development.[4]

Reserve Classification—

Statutory Background

The Federal Reserve Act today, as it did in 1913, uses a dual standard for prescribing reserves. One is the character of the deposit involved, the other is the location of the bank. Under the first criterion, time and savings deposits carry lower reserves than deposits which are payable on demand. The reserve requirement against time and savings deposits is uniform, applying equally to all member banks regardless of size or location.

The second criterion is geographic and applies only to demand deposits. Accordingly, banks in "central reserve cities" (New York and Chicago) may be required to carry the highest reserves; banks in "reserve cities" (relatively large cities and towns) carry a lesser percentage; banks located elsewhere (the so-called country banks) carry the lowest percentage of all. This tripartite statutory classification of member banks did not originate with the Federal Reserve Act but was, in the most literal sense, transferred from the then existing national banking legislation.

Such legislation had from its earliest days provided for a pyramidal system of holding reserves. National banks outside of large cities were required to keep at least 40 per cent of their reserves in their vaults and permitted to keep the remainder (up to 60 per cent) with banks in reserve cities. The latter, in turn, were expected to maintain reserve balances at central reserve city banks, which were at the very top of the pyramid and were required to keep their reserves in cash.

The rationale for both the distinction between time deposits and demand deposits and the geographical differentiation of the latter was rooted in the original

[3] The Federal Reserve System provides additional liquidity and safety for member banks when it lends to and purchases assets from them.

[4] The Board's proposals were incorporated in current bills in both houses of Congress (S. 1120 and H.R. 5237). As reported by the Senate Banking and Currency Committee, S. 1120 continues the vault cash proposal and the proposal concerning the carrying of reduced reserves, but abolishes the central reserve city designation. H.R. 5237 was similarly reported by a Subcommittee of the House Banking and Currency Committee, except that three years would be allowed for abolition of the central reserve city classification.

concept of reserves as a source of depositor protection. The amount of reserves necessary for this function was assumed to depend on the character and behavior of the deposit to be protected. Hence, a substantial differential was applied to slower moving time deposits, and the same logic underlay the locational classification of those payable on demand.[5] Deposits in country banks were deemed to be relatively static, those in larger cities somewhat more dynamic, and those in large financial centers, the ultimate reserve depositaries of the nation, highly volatile.

While this device of private reserve depositaries under the National Banking System was probably better than no device at all, the flow of funds between the country and the cities in a sequence of deposit and redeposit made for recurrent and periodic attacks of financial indigestion. When loan demand was slack, country banks built up interest-earning reserve balances at city banks. These concentrated pools of funds in the nation's financial centers quickly dried up when grass roots loan demand tautened, as country banks abruptly drew down their reserve balances in order to satisfy the needs of their own customers.

In addition to this seasonal tug on money markets which was reflected in alternating periods of credit ease and tightness and high and low interest rates, there was the recurring problem of financial panics. All too often, at the first signs of crisis, the outlying banks called upon their reserve city balances and the reserve city bank, in turn, pressed their central reserve correspondents. This phenomenon of runs on banks by banks resulted in forced liquidation, loss, and frequent disaster.

The creation of the Federal Reserve System with its regional *reserve* banks, which was largely prompted by this inadequacy of the credit apparatus, weakened the rationale for a threefold classification of banks based largely upon the use of private reserve depositaries. This was particularly true after a 1917 amendment to the Federal Reserve Act required *all* member bank reserves to be kept with the reserve banks (the original Act required only one-third of the reserves to be so deposited). Despite the 1917 amendment, however, the designation of central reserve city, reserve city, and country banks with their differential reserve requirements was retained. While the necessity for such a classification was less compelling after 1917 than it was before, the necessity was only diminished, not eliminated. Member banks continued to carry accounts with banking institutions in the larger cities for a variety of reasons, and the big city banks—particularly those in the New York and Chicago money markets—had a large portion of their demand deposit liability in this highly volatile form.[6] Banks in other reserve cities, while receiving deposits from country banks, tended, in turn, to maintain substantial balances in New York and Chicago.

Central Reserve and Reserve Cities—

Administrative Designation

The original Federal Reserve Act gave the Federal Reserve Board discretion to classify and reclassify localities as central reserve and reserve cities, and the continuous use of this authority has reflected the changing pattern of American finance. In some cases changes in classification were made upon petition of the banks in a city, on other occasions the Board acted upon its own initiative. During the thirty years following the 1917 amendment the entire matter of classifying cities for reserve purposes was under more or less continuous study and in 1947 the Board set forth certain standards of classification which were based primarily on the volume of interbank deposits. Thus, the designation "central reserve city" which had been confined to New York and Chicago for thirty years was continued.[7] Other localities were

[5] The reserve differential applicable to time deposits was not provided by national banking legislation, but was introduced by the Federal Reserve Act.

[6] Nonmember banks, whose reserve requirements are fixed solely by state statutes, also carry out-of-town bank balances, and the latter accounts are recognized in varying degrees as reserves by the applicable laws. The resulting network of correspondent banking is heavily dependent upon and, in a sense, complements Federal Reserve organization to provide a financial apparatus of astonishing speed, capacity and sensitivity. The Federal Reserve wire transfer facility interlocks the reserve account of each member bank, wherever located, with every other one, and the interbank balances carried with member institutions in turn fan out to encompass every bank in the country. Thus, in addition to their primary function as instruments of monetary policy, reserve accounts are the conduits of American finance through which are channelled clearings, collections, transfers of funds, and fiscal agency transactions in astronomical amounts and with speed, safety, and efficiency.

[7] St. Louis was the only other city to hold this status under the original Federal Reserve Act. In 1922 the Federal Reserve Board made it a reserve city following two requests for such reclassification by the St. Louis Clearing House Association.

classified as reserve cities if they contained (a) a Federal Reserve bank or branch or (b) banks with interbank deposits totaling between one-fourth and one-third of 1 per cent of all such deposits held by all member banks in the United States. Those cities which were already classified as reserve cities but could not meet the new criteria retained their designation if every member bank in the city requested it, and from time to time institutions so located have vigorously applied to maintain their status even though reclassification as "country banks" might have meant a substantial increase in earning assets. Under these criteria 49 communities are currently designated reserve cities.

Small Banks in Big Cities

However, there was one incident of classification, originating with the national banking legislation and subsequently adopted root and branch by the Federal Reserve Act, which involved substantial inequities. This concerned the so-called "neighborhood" banks whose metropolitan addresses mask the real character of their operations. As early as 1917, the Board noted that these institutions were in justice entitled to requirements based on their essentially parochial operations. In 1918 Congress responded by authorizing the Board to grant banks in the "outlying" districts of large cities a lower reserve requirement than that applicable to other banks in the same community.[8] By its very terms this provision could not apply to small downtown banks, and the Board was unable to accord the latter institutions the reserve adjustment available to banks of like character located elsewhere in their city. The Board of Governors has accordingly suggested that its 1918 authorization to modify reserve requirements of "outlying" banks be extended to a logical conclusion by enlarging its power to modify the reserve requirements of individual banks located in the center of reserve or central reserve cities if the character of a bank's business so justifies.

The Vault Cash Problem

The 1917 amendment to the Federal Reserve Act requiring that all reserves be carried in reserve banks did more than undercut the original logic of the threefold geographical classification alluded to earlier. It made vault cash, the coin and currency banks kept on the premises to meet over-the-counter withdrawals, an addition to, rather than a part of, required reserves. The expanding use of checks continually reduced a bank's need for till money but did not eliminate it, and a subsequent System study revealed that the wholly accidental factor of proximity to a Federal Reserve office and the latter's stock of currency had a material bearing on a member bank's supply of vault cash. Investigation showed that banks near Federal Reserve offices carried fairly little cash, while those located elsewhere carried relatively larger amounts.

While all member banks today hold between $2 billion and $2.5 billion of vault cash, about 60 per cent of this total is held by country banks where it constitutes from 3 to 4 per cent of their demand deposits. For reserve city banks, vault cash comprises from 1.5 to 2 per cent and for central reserve city banks less than 1 per cent of their demand deposits. "Since vault cash holdings and reserve balances at the reserve banks are interchangeable and both have the same effect in limiting the volume of credit a bank may extend, it is logical and proper that both be counted as reserves."[9] Furthermore, the distribution of vault cash among member banks tends to reduce the reserve requirement differential between them. Whereas the reserve requirements of demand deposits alone were 11 per cent for country banks, 16½ per cent for reserve city banks, and 18 per cent for central reserve city banks, the ratio of reserve requirements and vault cash holdings together were 14.3 per cent for country banks, 18.1 per cent for reserve city banks, and 18.6 per cent for central reserve city banks.

Since this proposal, if adopted, would add $2 billion to member bank reserves it has been indicated that any such change would be accomplished gradually.[10]

8 Thus, for example, banks within the city limits of New York and Chicago but outside the respective "financial districts" are classified as either reserve city or country banks depending on their exact location.

9 From the statement of Governor Balderston on S. 1120 before the Senate Banking and Currency Committee, March 23, 1959.

10 *Ibid.*

Reserve Requirements for Central Reserve City Banks

The last proposal of the Board, which would revise reserve requirements for central reserve city banks, does not directly grow out of existing imperfections in the law but rather is partly a consequence of remedying them. For if vault cash is to be counted as part of the member banks' reserve, country banks would derive the greatest benefit and central reserve city banks the least. For this and other reasons, the Board has suggested that reserve limits for such banks might well be reduced to the levels which pertain to reserve city banks, that is, 10 to 20 per cent.[11]

However, in submitting the latter proposal the Board suggested retention of the central reserve city classification on the grounds that the characteristics of deposits of large banks in New York and Chicago might justify a special reserve category for those institutions. The Board noted in statements filed with both the Senate and House Banking and Currency Committees that the "central reserve city" classification enabled it to deal with any undue concentration of reserves in money market centers, and pointed out that New York and Chicago continue to stand out strikingly in many respects from other cities. Along the latter lines, the Board cited the high concentration of interbank deposits lodged in the large Chicago and New York banks, their retention of the bulk of the more active balances of businesses and financial institutions, and their superior position—when compared with banks in other large cities—to invest available funds actively and promptly in local money markets.[12]

A Perspective

The Board has emphasized that its current proposals involve neither organic revision nor radical reordering of current reserve statutes. Rather, it has emphasized that from the administrator's point of view, the present law gives it an adequate tool and that the suggested revisions, essentially peripheral, are put forward in the interest of fairness to the institutions which are regulated. Indeed, its proposals merely attempt to give concrete expression to the general proposition enunciated in 1931 that "legal requirements differentiate in operation between highly active deposits and deposits of a less active character. Requirements for reserves should also be equitable in the incidence, simple in administration, and, so far as possible, not susceptible of abuse."[13]

11 See Board testimony, *Hearings before the Committee on Banking and Currency, United States Senate*, 86th Congress, 1st Session, March 23-24, 1959.

12 *Ibid.*

13 Report of Committee on Bank Reserves, *Nineteenth Annual Report of the Federal Reserve Board* (1932), page 261.