For release on delivery

Statement by

J. Charles Partee

Member, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

U. S. Senate

June 6, 1977

I appreciate the opportunity to appear before this distinguished committee to present the views of the Federal Reserve Board on H.R. 5675. The Board strongly recommends the enactment of this bill, because by providing a means for earning a direct return on the Treasury's liquid balances it will materially reduce certain operational difficulties encountered by the Federal Reserve in its day-to-day management of monetary policy.

Until recent years, Treasury cash management practices were conducted with a view to keeping fluctuations in Treasury balances from influencing the supply of bank reserves and short-term interest rates. This policy, in effect, recognized that the level of the Treasury balance is quite volatile because cash flows to the Treasury--from taxes and Federal borrowing--tend to be bunched at particular times of the month and year, whereas cash outlays are more evenly distributed. It makes a difference whether the Treasury maintains its cash balance with private depositories or with the Federal Reserve. By holding most of the balance in tax and loan accounts at commercial banks the potential reserve effects of fluctuations in the Treasury's cash position were minimized. When funds moved to or from the Treasury, they simply shifted between private and public demand deposits at banks and exerted little net impact on the total supply of reserves available to the banking system. The need for Federal Reserve open market operations to offset the reserve effects of variation in the Treasury's balance was reduced correspondingly.

The Treasury did maintain an operating balance at Federal Reserve Banks as well, on which the bulk of its checks were drawn. But as checks for outlays were cashed, the operating balance was quickly replenished by "calls" on the Treasury's tax and loan accounts at private banks. In this way the Treasury held a roughly constant balance with the Federal Reserve System.

Of course, some deviation in the level of the operating balance was inevitable. An accurate current measure of the volume of Treasury checks written was difficult to obtain, and it was hard to forecast exactly when outstanding checks would clear through the Federal Reserve. Nevertheless, the procedure was highly effective in reducing the degree of fluctuation in the Treasury's account at the Federal Reserve Banks. Thus, from the standpoint of minimizing the impact of swings in the Treasury's cash position on the supply of bank reserves, the former Treasury tax and loan account system worked well, and the implementation of monetary policy was insulated quite successfully.

In 1974, however, the Treasury reexamined the tax and loan account system, especially with regard to the foregone potential interest earnings on its cash balances. An earlier study had concluded that the Treasury was adequately compensated for this revenue loss by services provided by the banks. But with the general rise in market interest rates that had occurred during the late 1960's and early 1970's, and the need to maintain larger balances consistent with growing Federal outlays, it appeared that the foregone interest income on the Treasury's balance had come to exceed substantially the value of services rendered to the Treasury by the depository institutions maintaining tax and loan accounts.

The Treasury did not have the authority to invest directly in short-term earning assets, and thus to earn some income with its idle cash. But it was assured of an indirect return when it reduced its non-interest bearing deposits at commercial banks and transferred the bulk of its cash balance to the Federal Reserve System. When the Treasury's account with the Federal Reserve is increased, the System makes corresponding additions to its holdings of government securities. And since virtually all of the earnings on Federal Reserve assets are turned over to the Treasury, this transfer of deposits provides a return to the Treasury that would not be available if the balances remained with depository institutions.

Unfortunately, this change in procedure has complicated the task of managing monetary policy. This is so because virtually all of the short-run volatility in Treasury deposits now occurs in the accounts held with Federal Reserve Banks. Since variation in the level of such deposits has a dollar for dollar impact on the supply of reserves available to the banking system, the current concentration of the Treasury's cash position in these accounts greatly increases the need for offsetting Federal Reserve open market operations.

When most of the Treasury's cash balance is held at Federal Reserve Banks--as has been the case since 1974--increases in the Treasury's account reduce the overall reserve position of the banking system, and decreases ease that position. Erratic swings in the Treasury balance are often large and concentrated, so that the Federal Reserve must take action through open market operations to offset the unwanted influence on bank reserves. The need for intervention in the Government securities market on this scale has sometimes made the conduct of monetary policy in the short run more difficult.

A few comparisons will help to illustrate the significance for open market operations of this shift in Treasury policy. In 1970--before the Treasury began to alter its cash management techniques--the average weekly change in Treasury deposits at the Federal Reserve was only $124 million. In 1976--after the new policy had been fully implemented--the average weekly change jumped to $2.0 billion. Principally due to this enormous increase in volatility, the average weekly change in reserves provided or absorbed by the Federal Reserve rose to nearly $2.5 billion in 1976 from less than $400 million in 1970.

The shift is even more striking when one focuses on the weeks of peak need to offset technical factors affecting bank reserves. In 1970, the maximum week-to-week change in reserves resulting from open market operations amounted to just under $1.2 billion, and the movement in the Treasury balance necessitated only $130 million of this change. By 1976, however, open market operations added or absorbed more than $4.0 billion of reserves in twelve different statement weeks, and in each case fluctuation in the Treasury balance was the dominant factor requiring action. The largest of these week-to-week changes required Desk intervention totalling $6.0 billion.

To date the Federal Reserve has generally been able to execute the requisite volume of open market operations needed to offset the unwanted reserve effect of these enlarged swings in the Treasury balance. However, there have been significant difficulties. The Treasury balance has become harder to estimate, large day-to-day variations in the balance make it more difficult to develop a consistent short-term operating strategy and the sheer size of the operations required has at times constrained the System's flexibility in pursuing the more general objectives of monetary policy.

The Federal Reserve's success in offsetting the reserve impact of sharp fluctuations in the Treasury balance has been aided by the availability of a relatively large market supply of Government securities, as is typical of periods with relatively low interest rates and low inventory financing costs. As the economy continues to expand, however, the picture could change. If pressures on financial markets intensify, Government securities are likely to be less readily available in the market and a large volume of open market operations may become more difficult to accomplish.

Thus, from a monetary policy standpoint, the Board urges action on the proposed legislation. Passage of H.R. 5675 would permit the Treasury to receive at least the volume of earnings it is obtaining now without the present complications and operational costs to Federal Reserve open market policy. Moreover, there should be distributional advantages if the Treasury maintains its balance with depository institutions. Then, when balances shift between the private sector and the Treasury, the supply of funds in regional and local credit markets can remain unaffected. If these funds are moved instead to and from the Federal Reserve, there can be unsettling transitory effects on individual credit markets, since the impact of offsetting open market operations tends to focus initially on major money market center institutions.

I have left all comments on the technical implementation of H.R. 5675 to Mr. Mosso, since he has direct responsibility for administration of Treasury balances. However, I would like briefly to comment on one provision of the bill. Under present law, commercial banks, mutual savings banks and federally chartered credit unions may all hold Treasury deposits. Savings and loan associations are the only type of depository institution not authorized to participate in the tax and loan account system, and this bill would add them to the list. In this connection, I would like to point out that savings and loans typically hold a very large share of their earning assets in long-term mortgage loans. Since

Treasury operating balances are by their very nature inherently volatile, it seems particularly important that the regulatory authorities insist that these institutions add to their short-term liquid assets in amounts commensurate with any such balances obtained.

##########