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Statement by

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before the

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of the
Committee on Banking, Currency and Housing

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The Board of Governors of the Federal Reserve System appreciates the opportunity to comment on H. R. 212. This bill has far-reaching implications for the workings of our economy. It raises momentous issues with respect to monetary and credit policies, the role of the Federal Reserve System, and whether its traditional insulation from political pressures should continue. I therefore hope that this Committee will take whatever time is needed to arrive at a full and just understanding of the proposed legislation.

Money Supply

Section 2 of the proposed bill requests the Federal Reserve Board and the Federal Open Market Committee to "direct their efforts in the first half of 1975 toward maintaining an increase in the money supply (demand deposits and currency outside banks) of no less than 6 per cent at an annual rate, over each three month period . . . ." This section further requires the Board and Open Market Committee to report to the House and Senate Banking Committees whenever the money supply deviates from the specified target for either technical or substantive reasons.

I want to make it clear at the outset that the Board fully supports the general objective of maintaining adequate growth of the monetary aggregates. Indeed, the Board and the Open Market Committee have adopted policies in recent months to encourage greater expansion in the whole family of monetary and credit aggregates. The Board is also well aware of its responsibility to the Congress, and we would welcome the opportunity of clarifying our actions and policies.

In our judgment, however, this purpose can be best served through Congressional hearings or other communications with the Congress. As the members of the Committee know, the Congress has not found it easy to legislate fiscal policy. If the Congress now sought to legislate monetary policy as well, it would enter a vastly more intricate, highly sensitive, and rapidly changing field -- with consequences that could prove very damaging to our nation's economy.

In the past few years, the Federal Reserve System has paid more attention to the growth of monetary aggregates than it did in earlier times. We appreciate the fact that an expanding economy requires an expanding supply of money, that any protracted shrinkage of the money supply may well lead to shrinkage of economic activity, and that attempts to encourage growth in money and credit will lead to a decline of short-term interest rates when economic activity is weak. But, while the Federal Reserve recognizes all this, we are also mindful of the lesson of history that rapid growth of the money supply will lay the base for a new wave of inflation, and that interest rates on long-term loans will tend to rise when a higher rate of inflation is expected by the business and financial community.

As these comments indicate, the Board and the Open Market Committee pay close attention to monetary aggregates. We do not, however, confine ourselves to the particular monetary aggregate on which H. R. 212 focuses -- namely, demand deposits plus currency outside of banks. The reason is that this concept of the money supply, however significant it may have been ten or twenty years ago, no longer captures adequately the forms in which liquid balances -- or even just transaction balances -- are currently held. Financial technology in our country has been changing rapidly. Corporate treasurers have learned how to get along with a minimum of demand deposits, and to achieve the liquidity they need by acquiring interest-earning assets. For the public at large, savings deposits at commercial banks, shares in savings and loan associations, certificates of deposit, Treasury bills, and other liquid instruments have become very close substitutes for demand deposits. Nowadays, a corporate treasurer is likely to see to it that the size of his demand deposit is no larger than the working balance required by his bank. He knows that a telephone call to his bank will suffice to convert promptly any negotiable certificate of deposit in his possession into a demand deposit, and he is therefore apt to keep the bulk of his transactions and precautionary balances in the form of interest-earning assets -- that is, certificates of deposit or other highly liquid paper.

Let me try to make what I've just said a little more concrete. During the final quarter of 1974, the narrowly-defined money supply on which H.R. 212 focuses grew at an annual rate of 4.3 per cent. Meanwhile, time and savings deposits of commercial banks, exclusive of large certificates of deposit, grew at a rate of 9 per cent; the deposits of non-bank thrift institutions grew at a rate of 7 per cent; credit union shares grew at a rate of 9 per cent; large negotiable certificates of deposit issued by commercial banks grew at a rate of 26 per cent, and so on. We at the Federal Reserve are concerned with all these aggregates because the narrowly-defined money supply, taken by itself, is an inadequate -- and at times a misleading -- indicator of what is happening to the stock of highly liquid assets available to American families and business firms. Since the demands by the public for currency, demand deposits, savings deposits, and various liquid market instruments keep changing, monetary policy has to concern itself with a large family of monetary aggregates. The aggregate specified in H.R. 212 is only one of these.

Moreover, the condition of credit markets also weighs heavily in decisions on monetary policy. There is a school of thought that holds that the Federal Reserve need pay no attention to interest rates, that the only thing that matters is how this or that monetary aggregate is behaving. We at the Federal Reserve cannot afford the luxury of any such mechanical rule. As the nation's central bank, we have a vital role to play as the lender of last resort. It is our duty to avert liquidity or banking crises. It is our duty to protect the integrity of both the domestic value of the dollar and its foreign-exchange value. In discharging these functions, we at times need to set aside temporarily our objectives with regard to the monetary aggregates.

In particular, we pay close attention to interest rates because of their profound effects on the workings of the economy. The Federal Reserve's ability to influence interest rates is far more limited than is commonly believed; but in exercising whatever influence we do have, we must think of tomorrow as well as of today. If, for example, we presently encouraged a sharp decline of interest rates on top of the decline that has already occurred in recent months, we would run the risk of seeing short-term interest rates move back up while the economy is still receding. There is, moreover, a very real possibility that, as a result of such a policy, a monetary base would be established for a new wave of inflation in the future, and that market expectations of such a development would lead rather promptly to a rise of long-term interest rates.

It should be clear from these comments that the Board is deeply concerned about proposals to legislate monetary targets. Economic and financial conditions change, public preferences for liquidity change, and what constitutes an appropriate monetary response changes. Moreover, the rate of turnover of money -- that is, the rate at which the public is willing to use the existing stock of money -- is typically much more important than the size of the stock over periods of six months, a year, or even somewhat longer.

Changes in the public's willingness to use the existing stock of money are a highly dynamic force in economic life. The turnover or velocity of money depends heavily on the state of confidence, and varies widely in the course of a business cycle. If the public lacks confidence, increasing injections of money will tend to be offset by a decline in the turnover of money. The economy will not be immediately stimulated; but a large build-up of the money stock will lay the base for an inflationary upsurge in the demand for goods and services at a later time.

As these comments indicate, it would be unwise for the nation's monetary authority to concentrate on just one aspect of financial life -- namely, the achievement of this or that rate of growth of the narrowly-defined money supply, as specified by H.R. 212. There are also technical problems of importance on which I shall not dwell, but which I must at least call to the Committee's attention. First, H.R. 212 assumes that the Federal Reserve can control the rate of growth of demand deposits plus currency in public circulation over periods as short as three months. This we are unable to do. All that we can control over such brief periods is the growth of member bank reserves; but a given rate of growth of reserves may be accompanied by any of a wide range of growth rates of the narrowly-defined money supply.

A second technical problem is that measures of the growth of the money supply over periods as short as three months are surrounded by very considerable uncertainty -- a fact that H.R. 212 overlooks.

In view of the formidable difficulties, both conceptual and technical, that surround the section of H.R 212 that I have been discussing, it is the Board's judgment that Congressional concerns with regard to money supply behavior will be better served by careful periodic review of the Federal Reserve's stewardship. I can assure you that we at the Federal Reserve are willing to report fully on the factors that have been influencing growth in money -- both narrowly and more broadly defined -- and also on how we evaluate monetary expansion in relation to economic and financial circumstances. This reporting could be done on a periodic basis, or whenever special circumstances warrant it.

Credit Allocation

Let us turn next to Section 3(a) of the bill, which makes it mandatory for the Board to allocate credit toward "national priority uses" and away from "inflationary uses." Certain broad categories of priority uses and inflationary uses are specified. The Board is given the power to add to or subtract from the listed categories by notifying both Houses of Congress. If not disapproved within a 60 day period, the Board's proposals would become effective.

It is important to note that this section of the proposed legislation amends the Credit Control Act. As the Credit Control Act now stands, the President must make a specific determination before the Board can regulate extensions of credit -- namely, that this is necessary "for the purpose of preventing or controlling inflation generated by the extension of credit in excessive volume." This provision of law is eliminated by the proposed legislation. As we understand it, therefore, the proposed bill would require the Board to undertake immediately and maintain in force a program of credit allocation that may apply to any or all markets and any or all financial institutions. In carrying out this mandate, the Board would have available to it an extremely wide range of regulatory options, as currently enumerated in Section 206 of the Credit Control Act. Supplementary reserve requirements on member banks of the Federal Reserve System would be specifically added to that list by Section 3(b) of H.R. 212.

Our financial markets are highly competitive and they have served our nation well over the years. Nevertheless, the Board recognizes that the workings of financial markets are imperfect. We have therefore been generally sympathetic to efforts aiming to improve the flow of credit into socially desirable uses through special Federal credit agencies -- as in the fields of housing, agriculture, and small business. In early 1972, the Board submitted to the Congress, after a thorough inquiry, recommendations for moderating fluctuations in the availability of housing finance. More recently, in September 1974, the Board circulated to all member banks a statement on appropriate bank lending policies prepared by the Federal Advisory Council -- a statutory body established under the Federal Reserve Act. The Board felt that the Council's statement could be helpful to commercial banks in shaping their lending policies under the conditions of credit restraint then prevailing.

But as we read H.R. 212, it envisages a comprehensive intrusion of the Federal Government into private credit markets, and thus goes much further than anything that has been seriously considered in the past. The bill delegates enormous and virtually dictatorial power to the Federal Reserve. Implementation of the bill could undermine the market system and wreck all chances for economic recovery. And it is even highly doubtful whether H.R. 212 could achieve the objectives being sought -- that is, larger credit flows to certain uses, such as essential capital investment, small businesses, and agriculture, at low interest rates.

Decisions as to social priorities in the use of credit are inherently political in character. If such decisions are to be made at all, they should be made by the Congress -- not by an administrative and nonpolitical body such as the Federal Reserve. After all, tilting credit in favor of some borrowers implies denying credit to someone else. Our economy has developed by relying mainly on the market to make such decisions. The market reflects the interaction of many thousands of borrowers and lenders. If the day ever arrives when governmental decisions are to be substituted for individual preferences expressed in the market place, then the priorities should be set explicitly by the Congress.

The specifications of H. R. 212 are so vague and general that they would inevitably involve the Board in political judgments -- an area in which it obviously has no special competence. For example, the bill requires the Board to allocate credit toward "essential and productive investment." But how are we to evaluate the credit needs of public utilities relative to the needs of defense contractors? Are we to favor the credit needs of "small business and agriculture," as the Act requires, even if that means that large corporations will be denied the credit needed to keep their employees working? Are we to favor the automobile manufacturer who turns out cars that suit our concept of what is socially desirable and punish the manufacturer whose cars fail to pass our test of social utility? And since the Act requires the Board to move credit away from financial activities such as corporate acquisitions, would we have to deny credit to finance a merger of two firms, even though such a merger is expected to result in a strong enterprise that can better expand job opportunities in its area? Questions such as these may be multiplied by the hundreds and thousands.

Moreover, would it really be wise in an interdependent world to discourage loans to foreigners? Such a policy would handicap our exporters and importers; it would lead to retaliation by other countries; it could cause goodwill towards our nation to vanish; and it would surely diminish, as the entire bill before us would tend to do, confidence in the dollar.

I must add that administration of the credit control program envisaged in H. R. 212 would be enormously complex and costly. I doubt whether it is even feasible. In view of the variety of financial channels available to borrowers and lenders, controls would have to be comprehensive if they were to be at all effective. They would need to include not only the banks but also other institutional lenders, such as the thrift institutions, finance companies, insurance companies, and pension funds. They would need to cover financing through the public markets for debt and equity securities. They would need to embrace the entire network of trade credit. They would have to regulate access to lending and investing alternatives abroad. Such a task has not been attempted in the history of this country -- not even in wartime.

The ultimate difficulty is that a comprehensive allocation program would disrupt the orderly processes of financial markets. It could well create serious industrial imbalances and depress sharply the economic activity of many industries and communities. In the Board's judgment, there is no good substitute for the decision-making process provided by our highly developed, sensitive, and intensely competitive financial system.

Nevertheless, as noted earlier, the Board recognizes the worthwhile nature of special governmental efforts to strengthen market processes or supplement private credit flows -- as in the case of housing. The need for such special efforts varies with economic and over-all financial conditions. The need is most evident in periods of general credit restraint, when the supply of credit falls short of demand. On the other hand, when credit conditions are easing, as at present, market processes typically assure that credit for commercially feasible projects of a productive and socially useful character will be in reasonably ample supply.

There is no evidence that a significant amount of credit is being squandered on wanton or speculative enterprises. In the latter part of January, the Board addressed an inquiry to a sample of banks to gauge their response to the principles suggested earlier by the Federal Advisory Council -- recognizing, of course, that credit and economic conditions change. The inquiry covered questions on the demands by bank customers for the kinds of loans specified by the Federal Advisory Council as well as questions on bank policies with respect to approval or disapproval of such loan requests.

Not all of the banks have as yet replied, but we do have responses from about 80 per cent of the sample on the questions pertaining to credit demands and credit policies. On the basis of a preliminary tabulation of these results, about three-fourths of the banks report that loan requests for purely financial or speculative purposes, a category that figures prominently in H.R. 212, were significantly fewer in December 1974 than in previous years or that none were in fact received. Moreover, about 90 per cent of the banks report that they have become more restrictive in their attitude toward such loans.

Our preliminary assessment of the survey thus suggests that bank loan policies are generally consistent with the Federal Advisory Council's statement. I believe that even in absence of this statement, most banks would have put in place similar policies, in view of the limited funds available to them, their risk exposure, and their sense of obligation to the local community and the nation. As soon as tabulation and analysis of this special inquiry are completed, the results will be forwarded to this Committee and made available to other interested parties.

I believe that allocation of credit among competing uses is becoming a less serious problem for our banks. For credit demands have diminished, interest rates have declined substantially from their peaks of last summer, and many banks and other financial institutions have recently improved their liquidity positions.

I realize that some might argue that H.R. 212 would increase the flow of funds to high priority areas, and perhaps even reduce interest rates for those areas. Such an argument would have to assume that a comprehensive, leak-proof credit control program can be devised and enforced. That is impossible in a complex economy possessing highly developed credit and money markets. Inflation, if nothing else, will lead lenders to seek every possible avenue to increase their yields. Gray markets will flourish, as borrowers also attempt to protect themselves against credit shortages. In addition, both lenders and borrowers will inevitably turn to foreign credit markets. The ones who would probably suffer most are small businesses and home buyers. In short, the Board firmly believes that credit allocation, as envisaged in the proposed legislation, will injure our economy, besides failing to achieve the purposes it seeks to promote.

Supplementary Reserve Requirements

In addition to the already substantial list of regulatory measures available under the Credit Control Act, H.R. 212 enables the Board to impose reserve requirements on assets with a view to rechanneling credit flows. The bill would permit the Board to require a member bank to maintain, besides the reserves required to support its deposits, a supplemental cash reserve whose size would depend on the distribution of the bank's loans and investments. A supplemental cash reserve would be held against loans and investments other than the so-called "national priority uses," while a reserve credit would be given for "national priority" loans and investments. The total of any such credit, however, could not exceed a bank's supplemental reserve.

Suggestions for redistributing credit flows through differential reserve requirements on bank assets have been advanced from time to time during recent years. The logic of these proposals may seem simple and even appealing. Banks would be encouraged to channel more funds into high priority uses, and away from others, because the structure of reserve requirements would make it profitable to do so. A market device -- rather than compulsion -- would thus be employed to accomplish a desired social objective.

Careful reflection on the implications of these proposals, however, reveals that they would seriously weaken the capacity of the Federal Reserve to control the growth of the monetary aggregates.

Let us see how markets would react. To the extent that member banks were induced by differential reserve requirements to shift funds toward certain priority uses, yields on those assets would decline, while yields on other classes of loans and investments would rise. The many lenders to whom the asset reserve requirements did not apply -- such as nonmember commercial banks, mutual savings banks, life insurance companies, pension funds, and so on -- would therefore be encouraged to direct their loanable funds away from projects of the priority type. Borrowers displaced at member banks, meanwhile, would turn to other lenders or to the open market for credit, thereby forcing up yields and thus encouraging individuals and other lenders to supply them with funds. These offsets would be so substantial, in my judgment, that they would largely negate the results of the supplemental reserve requirements. Moreover, I need hardly say that exemption of nonmember banks from the provisions of Section 3(b) would induce some, perhaps many, member banks to change their status.

Finally, this Committee should consider carefully the administrative costs and problems that would be encountered in any serious effort to implement a supplemental reserve program effectively and equitably. Very likely, it would be necessary to require that member banks report detailed data on the structure of their assets on a daily basis, just as they now do for deposits. Otherwise, a bank could acquire an asset eligible for a reserve credit one day and sell it to another lender the next -- thereby benefiting from the reserve credit, but contributing nothing meaningful to expansion of credit supplies of the desired kind. Also, it might well become necessary to attach supplemental reserve requirements and credits to particular loans, rather than to the dollar amount of loans in any given category, and this would require the development of elaborate bookkeeping systems for keeping track of many millions of individual loans.

Concluding Comments

In conclusion, let me state once again that the Board recognizes that adequate expansion of money and credit is needed to cushion recessionary forces and to encourage early recovery in economic activity. I must warn you, however, that the course of monetary policy cannot be guided effectively by a single measure of the money supply, as this bill would require. A careful weighing of the behavior of various monetary and credit aggregates is essential.

The Board also recognizes that the nation's best interests are served when credit flows are channeled into productive uses and away from speculative channels. The market itself is a good disciplinarian in this respect, though it often works with a lag. Developments in credit markets of late have been moving in a constructive direction. Banks and other business enterprises have come to recognize that decisions made in a euphoric inflationary environment are not always those that contribute most to their own benefit or that of the national economy. If inflationary pressures continue to unwind this year, as I believe they will, managerial talent will be concentrated more intensively on efficiency in business enterprise, and participants in financial markets will seek to avoid the speculative excesses of the recent past.

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