Statement of Wm. McC. Martin, Jr., Chairman,
Board of Governors of the Federal Reserve System
before the Committee on Banking and Currency,
House of Representatives,
June 16, 1966

You have asked me to comment on the draft bill prepared as a result of your Committee's meeting of June 13.

If the problem you are most concerned with is to insure against too sharp a cutback in residential construction, we think the best course is to inject funds directly into the mortgage market by increasing FNMA's purchase authority. I am pleased to note that the draft bill includes, in section 5, provisions to authorize such an increase.

The bill would also broaden the permissible range of reserve requirements on time and savings deposits to a range of 3 to 10 per cent, and this is agreeable to the Board.

The bill also includes authority to differentiate on any reasonable economic basis among deposits for purposes of reserve requirements and interest ceilings. This would increase flexibility to deal with unforeseen situations as they develop.

The draft bill would also rewrite section 14(b) of the Federal Reserve Act, relating to purchase of Government obligations. The principal purpose is apparently to make obligations of the Federal Home Loan Banks and those issued by FNMA in its secondary market operations eligible for purchase. The impact of such purchases on bank reserves could be neutralized by offsetting sales of direct Treasury obligations, but this would increase the cost of Treasury borrowing. The potential effect of open market purchase of Government agency obligations of all kinds--not just these two--needs extensive study at an analytical and technical level. Such a study is now under way.

The revision relating to purchase of these instruments, however, includes changes which raise basic questions relating to the conduct of monetary policy. Thus, the draft bill apparently would make purchases under section 14(b) subject to regulations by the Board, although it would also continue the present provisions making such purchases subject to direction and regulations of the Federal Open Market Committee. It also provides for a mechanism under which the Secretary of the Treasury, after consultation with the Secretary of Housing and Urban Development and the Chairman of the Federal Home Loan Bank Board, would advise the Federal Open Market Committee as to "open market policy with respect to" FHLB and FNMA obligations. The result, I believe, would be to increase pressures to divert open market operations from general economic objectives to the support of specific markets for credit. As a consequence, the effectiveness of monetary policy as a general instrument for economic stabilization would be threatened.

In addition to these substantive provisions, the draft bill contains a number of expressions of the sense of Congress. One such expression urges the Board to prohibit interest on time deposits held less than 91 days. Since roughly half of the outstanding negotiable CD's of $100,000 or over mature in three months or less, and new instruments with maturities as short as 3 to 4 months are selling at yields of 5-1/2 per cent, such an action could result in a sharp contraction of outstanding CD's.

This would force many banks to sell assets, and might have serious adverse effects on the mortgage market as well as the market for municipal obligations.

Another "sense of Congress" expression favors a prohibition of interest on savings deposits held less than 30 days. While this would pose no problem for banks that compute interest on the minimum balance held during a quarter, banks that compute interest on a daily basis could face serious operating difficulties in complying with the requirement where a depositor makes frequent deposits and withdrawals.

The draft expresses the sense of Congress that reserve requirements should be raised on "large" negotiable CD's and all CD's with "near-term" maturities. Small changes in reserve requirements would have relatively little effect, either in increasing liquidity or in reducing the profit to the bank from selling CD's and investing the proceeds (the reduction would be about one-twentieth of a percentage point for each one per cent increase in reserve requirements). Large changes under present circumstances could have serious and unpredictable effects on credit availability to particular sectors and regions of the economy. In addition, differentiation in reserve requirements between large and small CD's could pose administrative difficulties. For example, higher requirements on large CD's could be evaded by issuing smaller denominations in multiple units.

The increased flexibility proposed by this bill could be utilized more effectively if the bill permitted graduation of reserve requirements by size of bank. This would greatly improve the competitive position of small banks. Equivalent requirements also should be extended to all insured commercial banks so that the reserve burden would be shared by all banks enjoying the benefits of deposit insurance.

Finally, the bill would urge the Board to limit the rate of interest paid on time deposits held by depositors eligible to hold savings deposits to levels "appropriate in the light of rates which may soundly be paid by thrift institutions generally." The difficulty I see with this kind of expression of the sense of Congress is that it seems to indicate a belief that present levels are not appropriate, without saying what those levels should be. I want to make my own position on this as clear as possible. I cannot tell you today what I would do next month with broadened authority to change Regulation Q ceilings, and, of course, I cannot tell you what other Board members would do. As you have observed during these hearings, there are differences of view among the Board members. We are, however, fully agreed that it is better to leave a decision of this kind to an administrative agency with discretion to take whatever action seems appropriate in the light of changing circumstances. I can understand your position: you are not sure that the Board will use whatever authority you wish to give us to differentiate between the money-market CD's and other time deposits, and you would like some guarantee. But I cannot give you that guarantee. I think it would be a mistake for any administrative agency to make such a commitment. I also think it would be a mistake for you to compel action. But if you wish to do so, I think it is only fair that you also take the responsibility for the action. Therefore, I believe if you are not willing to leave this to

Board discretion you should specify in the bill the rate you think should be put in effect, as the Weltner and Hanna bills would do.

If you fix a rate, rather than leaving it to our discretion, you face a difficult choice, it seems to me. The 5 per cent ceiling, as of last month, would have had only a moderate overall effect in curbing banks' ability to compete for savings in small denominations. Only about 190 banks were offering rates in May exceeding 5 per cent on consumer-type time deposits. The amount of deposits of the types on which rates in excess of 5 per cent were offered was $3.5 billion. A 5 per cent ceiling might well put some individual banks in a difficult position with respect to holding their existing deposits, however, and this number would grow if market rates continued to rise. Whether such a ceiling would step up new mortgage commitments by savings and loan associations depends on the extent to which they may be holding back out of fear that their commercial bank competitors may go above 5 per cent in bidding for funds.

If, on the other hand, you fix a 4-1/2 per cent ceiling, you run the risk--as I have previously testified--of preventing a large number of banks from meeting competition for savings funds. More than 900 banks in May were offering rates exceeding 4-1/2 per cent on consumer-type time deposits. The amount of deposits of the type on which rates of more than 4-1/2 per cent were being offered was $8.5 billion, of which over $3 billion was in member banks in the San Francisco district. Forcing them to roll back rates offered to the 4.5 per cent level would almost certainly cause them to lose a significant portion of these funds. It would also make it impossible for them to compete effectively in the future. Such a ceiling probably would have the effect of penalizing most the growing and capital-short parts of the country, and the attendant loss of access to credit facilities by small businesses and other borrowers heavily dependent upon these banks might be more serious than the problems the Committee is now seeking to resolve.