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Statement by

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before the

Subcommittee on Financial Institutions

of the

Committee on Banking, Housing and Urban Affairs

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I appreciate this opportunity to present the views of the Board of Governors of the Federal Reserve System on S. 1201.

Section 1 of the bill would extend for a two-year period the authority granted in 1966 for flexible, coordinated regulation of rates payable on time and savings deposits. For a number of years the Board has recommended that this authority be made permanent. This recommendation does not, of course, mean that rate ceilings should always be in force. On the contrary, we hope that changes in the structure of our financial institutions and in economic and financial conditions will, in time, warrant a suspension of such ceilings so that depositary institutions can compete more freely for the savings of the public. Recognizing that ceilings are not always useful, Congress in 1966 authorized the regulatory agencies to suspend them when it is appropriate to do so.

In addition to authorizing suspension of ceilings, the 1966 amendments widened the grounds for differentiating between kinds of deposits in establishing ceilings. Both of these features of the 1966 law proved to be of great value last summer, when ceilings on large-denomination CD's with short maturities were suspended, thereby helping to relieve tensions in the commercial paper market that arose in the wake of the Penn Central bankruptcy.

This authority lapsed on March 22, but apparently will soon be extended until June 1. This temporary reversion to the pre-1966 law has created no real problems in view of current market conditions. At other times, however, return to the pre-1966 law could force retention of ceilings when they are no longer needed, or require imposition of ceilings without regard to size of deposit. The authority to differentiate between large-denomination money-market CD's and smaller consumer-type deposits may be needed again if we are to avoid undesirable shifts of funds out of thrift institutions or disruption in financial markets generally. The Board therefore continues to believe that the 1966 law should be made permanent.

Section 2 of the bill would remove the time limitation on the authority of the President to establish voluntary programs, including programs for restraining credit, under the Defense Production Act. The authority to establish voluntary credit restraint programs under that Act was terminated by the Congress in 1952, but was restored two years ago in Public Law 91-151. The Board recommended against restoration of this authority in 1969, on the ground that it was not needed. However, Congress decided that this authority, along with authority for mandatory credit controls, should be on the statute books in case of need, so that the President "would be afforded the broadest possible spectrum of alternatives in fighting inflation." Since the 1969 legislation provided permanent authority for mandatory credit controls, we see no reason for treating the authority for voluntary programs differently.

Section 3 of the bill would extend the authority granted to the President in the Economic Stabilization Act of 1970 to impose mandatory controls over prices, rents, wages, and salaries. The Board believes that measures besides general monetary and fiscal policies are needed under present conditions to deal with the twin problems of inflation and unemployment. As I suggested earlier this month in testifying before the full Committee, a multi-faceted incomes policy is called for to improve the functioning of our labor and product markets--a policy that the Board believes should include a Wage-Price Review Board. Such a board, with power to mobilize public opinion in support of voluntary efforts to curb inflationary wage and price actions, would be more in harmony with our traditions than would mandatory controls, which should be used only as a last resort.

If the Congress believes, nevertheless, that the President should have standby powers to freeze wages and prices, provision should be made for prompt Congressional review of any freeze order. The Board endorses the approach taken by the House in H. R. 4246, which assures such a review by providing that if the authority to impose mandatory controls is exercised it shall expire shortly thereafter. Congress could, of course, extend the authority if upon review it determined that such action was necessary. The Board recommends that you adopt this House provision. We are inclined to believe that such a procedure would offer more positive Congressional control over this very broad grant of power than would reliance solely on a termination date fixed without reference to whether the authority is exercised. While S. 1201 would restore the general authority for a relatively short period (until September 30 of this year), Congress presumably would not wish to review the grant of standby authority at intervals as short as six months. By restoring the standby authority for a longer period, as the House bill does, but providing that it shall expire in six months in case it is exercised, Congressional review will be assured when it is most timely.

Let us turn now to Section 5 of the bill, passing over Section 4 for a moment. Section 5 would amend the standby authority for selective credit controls granted by the Credit Control Act of 1969. The 1969 legislation provides that the President may authorize the Board to control "any and all extensions of credit" whenever he determines that such action is necessary to prevent or control "inflation generated by an excessive volume of credit." S. 1201 would authorize imposition of such controls if either the President or the Board made the required determination of need. The Board hopes, as I am sure the members of the Committee hope, that it will never be necessary to use this authority. And if, contrary to our expectations, conditions should arise calling for such action, we would hope and expect that the Board and the President would agree that it was in fact needed. Thus we see no necessity at present for authorizing the Board to act without a Presidential finding.

Finally, Section 4 of S. 1201 would authorize the Board to require banks that are members of the Federal Reserve System to maintain supplemental reserves against assets, in addition to the reserves they must now maintain against depositary liabilities.

The purpose of the supplemental reserve requirements would be to facilitate flows of credit into specified channels and restrain flows into sectors where, in the Board's judgment, such restraint would "help stabilize the national economy." The Board unanimously recommends against enactment of this section of the bill at the present time.

All of us agree, I am sure, on the need to explore ways to avoid unwanted selective effects of general monetary restraint. But use of reserve requirements for this purpose poses problems for which we do not yet have answers. Much further study is needed.

One problem arises from the fact that the requirements would apply only to member banks. A set of requirements designed to induce member banks to make more loans in specified areas, and less in others, would increase the burden of maintaining membership in the Federal Reserve System, and thus increase the competitive advantage of nonmember banks. This would be particularly true if the order of priorities or the extent of incentives and penalties were subject to frequent changes. The System is already experiencing attrition of membership which, as it continues, progressively lessens the effectiveness of changes in reserve requirements as an instrument of monetary policy.

The main reason member banks are leaving the System now is that they believe reserve requirements are too costly. If attrition were increased by adoption of supplementary reserve requirements, the effectiveness of such requirements in influencing credit flows would be reduced. For that reason as well as for reasons of equity, supplementary reserve requirements on assets, if contemplated at all, should apply to all insured commercial banks. Furthermore, consideration would need to be given to imposing such requirements on other credit-granting institutions as well.

Another shortcoming of supplementary reserve requirements is that they would complicate the already intricate task of the Federal Reserve System in discharging the main responsibility assigned to it by the Congress--namely, to conduct monetary policy so as to promote prosperity while protecting the integrity of the nation's money. Once supplementary reserve requirements came into use, shifts in the level of required reserves would result from every shift in the lending policies of commercial banks. As required reserves rose or fell, funds for expansion of bank credit would be absorbed or released. These movements would introduce an additional element of uncertainty into the task of achieving, through open-market operations, a desired rate of growth in the money supply or in bank credit.

Even if these operational difficulties could be overcome, there would still be fundamental objections to this section of the bill. I trust you will consider most carefully the implications of granting the central bank the vast discretionary authority contained in this bill to determine social priorities in the use of credit. The Federal Reserve System has the critically important assignment of providing for aggregate supplies of money and credit needed to promote healthy economic growth with reasonable price stability. Congress has granted the System a considerable measure of independence, to ensure that it will be insulated from short-run political pressures in performing this function. We believe there is great value to our society in this arrangement, and that its continuance depends on confining the discretion of the central bank, in the main, to matters of general monetary policy.

S. 1201 authorizes the Board to establish supplementary reserve requirements to facilitate flows of credit into housing, small businesses, exports, municipal finance, farms with sales of less than $100,000 a year, and development of areas of low income or high unemployment. Increasing credit flows for these purposes implies reducing them for others--relatively, if not absolutely. The implications of such a wide-ranging substitution of public for private decisions need to be considered with utmost care.

Our free credit markets have served our nation well over the years by channeling financial resources to productive and socially beneficial uses. The Board recognizes, nevertheless, that market mechanisms are imperfect and that the effects of monetary ease or restraint do not affect all sectors of the economy uniformly. There is ample justification, therefore, for serious efforts to improve the functioning of our financial markets--particularly, to cushion the effects of monetary restraint on sectors such as housing.

Such efforts have been made on an extensive scale in our country, and they have typically taken the form of supplementing the market mechanism rather than subjecting the decision-making process of private financial institutions to detailed and shifting governmental rules. Federally sponsored credit agencies that borrow funds in the money and capital markets and channel them to sectors of high social priority have played a particularly constructive role in this regard. So also have government loan guarantees to encourage private investment in risk enterprises or in low- and middle-income housing.

For most of the specific sectors singled out for special attention in S. 1201, special credit facilities already exist. The nation's home building industry, for example, is provided special assistance, particularly in periods of monetary restraint, by the Federal Home Loan Banks, FNMA, GNMA, and through a variety of programs operated by the Department of Housing and Urban Development; small firms are aided in securing credit by the Small Business Administration; the nation's farmers are assisted by the Farmers Home Administration and the several lending agencies of the cooperative Farm Credit System. These agencies have performed a vital service in improving the functioning of financial markets. If the Congress should conclude that the sectors singled out for special attention in S. 1201 deserve more ready access to sources of credit, certainly the most direct and probably also the best means of accomplishing this objective would be to expand the scope of operations of existing Federal credit agencies in these fields, and to create new entities where they seem needed.

However, if after due deliberation the Congress were to decide that supplementary reserve requirements on assets of banks are to play some role in redistributing fund flows in financial markets, we would strongly urge that the order and degree of priorities should be determined by the Congress and embodied in legislation. Broad discretionary authority of this kind should not be lodged in the Federal Reserve, which is not the appropriate body to make fundamental decisions regarding social priorities.

It may be useful to note that the trend over the past 10 years or more in central banks of other industrial countries has been <u>away</u> from practices that discriminate in favor of particular sectors and <u>toward</u> policy instruments that have broad application and generalized effects.

Let me say, in conclusion, that while grave doubts surround the specific provisions of Section 4 of the bill, the Board recognizes the need to continue to explore means by which undesirable selective effects of general monetary policies can be prevented.

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