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Statement by

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before the

Subcommittee on Financial Institutions  
Supervision, Regulation and Insurance

of the

Committee on Banking, Currency and Housing

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I am pleased to have the opportunity to present the views of the Board of Governors on the proposed Financial Reform Act of 1976.

The scope of the proposed Act is awesome, its provisions are complex, and its implications far-reaching. The members of the Board and our staff have already devoted many days to the study of the proposed legislation, but I am bound to say at the outset that we as yet have a very imperfect understanding of some parts of the Committee Print. If our experience is at all indicative, I would urge this Committee to proceed cautiously, as it has been doing, and avoid the temptation of legislating change for the sake of change.

I shall confine my testimony today to matters that relate directly to the Federal Reserve System. Other parts of the proposed legislation are not escaping our attention, and I want to assure you that we at the Federal Reserve shall render all the help we can to this Committee in dealing with them.

The most dramatic change proposed by this legislation is the creation of a Federal Banking Commission. This proposal would eradicate the Office of the Comptroller of the Currency, and would divest from the Federal Reserve System the bank

regulatory functions it has performed for over 60 years. In the Board's judgment, such radical surgery would weaken bank regulation at a time when the banking system needs firm, experienced, and responsible regulatory guidance. Beyond that, it would be a serious blow to the public interest if, in the name of "reform" of the regulatory structure, the Congress were to cripple the one agency of Government that has rather consistently had the courage to resist the inflationary forces that have wrought so much havoc and anguish in our country.

There is a need for some reform in Federal bank regulation, but it is not of the kind called for in the proposal before the Committee. Indeed, there is some danger that the excited cry for "reform" of the regulatory structure may itself unjustifiably shake public confidence in the banking system, weaken our Nation's economic prospects, and cast doubt on the future of the dollar in both domestic and international markets.

The Board's position on the question of regulatory reorganization can be summarized briefly.

First, under the present regulatory structure, our banks have met satisfactorily the critical test of adversity. Despite some isolated points of weakness, the banking system as a whole has

emerged from the severest business recession since the 1930's in thoroughly good condition. To scrap the present regulatory structure now, in favor of a completely new and untried scheme, would run the risk of weakening both bank regulation and the banking system.

Second, the proposal to lop off the Board's bank regulatory role, would -- whether by intent or inadvertence -- drastically diminish the ability of the Federal Reserve to perform its monetary policy mission. Monetary policy and bank regulation are organically intertwined. Over the years, Congress has consistently rejected attempts to diminish the effectiveness of the Federal Reserve. If there is to be any move now to emasculate the Federal Reserve, the public interest requires that this be argued explicitly rather than in the name of "reform" of the bank regulatory structure.

Third, not only have the proponents of "reform" failed to make a factual case for restructuring the agencies, but the proposal before the Committee will not cure the defects with which the present system is charged. If the present system cannot easily be understood, if it has overlapping authorities, and if it promotes "competition in laxity," the new system proposed in the Committee Print is subject to the same charges.

I would like now to expand on the Board's position that the proposed Federal Banking Commission could, either deliberately or inadvertently, frustrate monetary policy and destroy the effectiveness of the Federal Reserve in seeking to achieve the economic goals set by the Congress.

At present, our national policy is to encourage economic expansion even as we attempt to unwind the inflation, so that more jobs may be created and the rolls of the unemployed be reduced. This objective requires a moderately active lending policy on the part of banks, including a willingness to take reasonable risks. But the banking community's willingness to expand credit could easily be inhibited by a Federal Banking Commission that had no responsibility for over-all economic policy and that looked only to its own special concerns -- such as loan quality standards, adequacy of bank capital, and the state of bank liquidity.

This is not mere speculation. The rigid bank examination standards used by Federal regulators during the Great Depression of the 1930's -- when the interdependence of monetary and supervisory policy was not well understood -- unquestionably retarded the process of economic recovery. Indeed, the issue became so critical to the Federal Reserve, and so divisive within the

Government, that it was only after a Presidential initiative that the regulators agreed with the Board that examination standards were too exacting. Finally, in 1938, an accord was reached among the bank regulatory agencies that set forth new examination standards to prevent further frustration of monetary policy.

It must be clearly understood that even an aggressive monetary policy would have difficulty in overcoming bank supervisory standards of undue strictness. The Federal Reserve might indeed pump up bank reserves in an effort to encourage credit expansion. But in the face of an overly strict regulator, banks may react by avoiding the risks of lending and devote their resources largely to buying government securities; in other words, banks might turn themselves into warehouses of Treasury paper while businesses around the country languish. In such circumstances, the Federal Reserve's plan to expand credit would obviously be frustrated. Businessmen, farmers, homebuyers -- all those who rely on banks for credit -- would be pinched despite massive reserves supplied by the Federal Reserve.

The same result could occur if a Federal Banking Commission applied restrictive standards in an untimely

fashion to bank capital or bank liquidity. Credit expansion could be thwarted if an overly cautious supervisor insisted that banks improve their capital or liquidity positions before they used any increased liquidity provided by the Federal Reserve for expanding loans. In the real world, there must be a balance between economic and regulatory concerns, so that the one will not stifle the other.

In another area, as many of you know, it is possible for one bank to lend its excess reserves to another bank through the federal funds market. At present, in order to implement its monetary policy, the Federal Reserve is always involved in increasing or decreasing the availability of funds in that market. A Federal Banking Commission, however, would have the power to set limits on the use of the federal funds market and thus could frustrate any given monetary stance. The same would apply to bank borrowings from the Euro-dollar market which has at times been an important source of funds to the American banking system.

I have thus far suggested how inappropriate supervisory policies of a Federal Banking Commission could thwart economic stimulation. Now, let us imagine a period during which the economy has developed a strong momentum and the Federal

Reserve decides that monetary restraint is needed. This could be accomplished only if the Federal Banking Commission had in preceding years paid adequate attention to commitments by banks to make future loans. If it had not done so, the Federal Reserve's ability to take counter-inflationary steps would be severely limited. For, as a practical matter, unless the Federal Reserve made sufficient funds available to enable the banks to fulfill their commitments, a wave of bankruptcies could be set off among businesses. In effect, therefore, the Banking Commission will have made the Nation's monetary policy.

But that is by no means the whole of this sorry tale. Apart from its open market operations, the Federal Reserve has the responsibility -- and this is central to the stability of our financial system -- of providing temporary assistance through the discount window to banks whose liquidity has been reduced as a result of an unexpected outflow of deposits or an unforeseen expansion in loan demand.

Our ability to carry out this function prudently depends on the backlog of knowledge that we have built up about individual banks as well as the entire banking system. At present, we have

direct knowledge concerning the quality of management and the problems faced by member banks and bank holding companies. Under a Federal Banking Commission our direct contacts with the institutions that may need to borrow from us would be lost. We would then have to rely on reports from another government agency in assessing the need for borrowing and the ability of the institution to repay. These reports might be furnished promptly upon request, or they may not be. They might be prepared with care, or they may not be. Indeed, it is conceivable that the information provided to us could be slanted in order to induce the Federal Reserve to provide liquidity for a purpose unrelated to the functions of the discount window.

Splitting off the Board's bank regulatory functions could also have a profound effect on our ability to interpret the behavior of the monetary aggregates that we are charged with controlling. We live in a world of very rapid change in financial technology. New financial practices have been spreading rapidly through our markets for the past 20 to 30 years. Of late, moreover, the innovative process has been accelerating and it appears that the amount of money needed during the past year or two to

finance a given dollar volume of economic activity has been substantially smaller than would have been the case in earlier years.

One very recent development that has had a considerable impact on the behavior of demand deposits was the regulation, issued by the banking agencies last November, which enabled partnerships and corporations to open savings accounts at commercial banks in amounts up to \$150,000. When this regulatory change was made, the Federal Reserve was acutely aware of its possible impact on the monetary aggregates. A special survey was therefore immediately undertaken; and it showed that within two months after the regulatory action, some \$2 billion had been placed in savings accounts of this type. Had we not monitored bank activity in this area so promptly, misunderstandings could have resulted and we might have reacted erroneously to the decline of demand deposit balances by increasing bank reserves and thus rekindling inflationary pressures.

In short, there is no escape from the conclusion that the proposed Federal Banking Commission would frequently be in a position of making, diluting, or frustrating monetary policy. The role of the Federal Reserve, its ability to promote the Nation's industry and commerce, its ability to protect the domestic and

international value of the dollar, might well be weakened to a point where continued discussion about the cherished independence of the Federal Reserve System would be entirely pointless. For the Federal Reserve would be left with only a vestige of its authority and power to carry out monetary policy. Prompt and bold action to prevent a crisis, such as the Federal Reserve took in June 1970 when the Penn Central went into bankruptcy, would then no longer be possible.

Even if conflicts with the Federal Banking Commission were avoided, I doubt that we could discharge our obligations in a manner that would be satisfactory to the Congress and the American people. Knowing less and less about banks, we at the Board would end up living in an ivory tower. As our understanding of the real relationship between the world of finance and the world of business withered away, we would probably concern ourselves increasingly with esoteric, theoretical issues. Life at the Federal Reserve might become more pleasant for some of us, as we debated the merits of  $M_1$  as over against  $M_5$  or  $M_7$ , or whether a new variant of  $M_7$  should not be immediately constructed; but it is not clear that the stability of our financial system, or international respect for the dollar, would be enhanced thereby.

Since the proposal for restructuring the Federal bank regulatory agencies would have such far-reaching effects upon

the Board's activities, there should be compelling reasons for advancing it. What good, one may ask, does this measure seek to accomplish? What advantage does it hold out to compensate for the destructive thrust that I have delineated? I submit that when the case in favor of the proposal is analyzed, it simply does not stand up.

One argument offered in support of the proposed restructuring is that the present system is much too confusing. I have no doubt that if we were setting out today to create a system of bank regulation where none existed before, we would arrive at something other than the present structure. Much of our present regulatory framework can be understood only by reference to historical developments in our country. True, the system is complex, but we live in a complex world and the bank regulatory system is part of it. Simplification of governmental structure is certainly a desirable objective, but the simplification must be of a kind that serves the public interest.

Granted that the present system is in some respects confusing, the proposal before the Committee would create a regulatory scheme that may be no less confusing. According to the Committee Print, national banks would be regulated by the Federal Banking Commission, while state banks would be

regulated by the Federal Deposit Insurance Corporation. But if a state bank happened to be a subsidiary of a bank holding company, it would be removed from FDIC jurisdiction and become subject to the Federal Banking Commission. To be more precise, if 24 per cent of the bank's stock were owned by a corporation, the bank would be regulated by the FDIC; but if 26 per cent were owned by the same corporation, the bank would be regulated by the Federal Banking Commission. Thus, regulatory jurisdiction could change at the whim of a minority shareholder. If our citizens have difficulty understanding the present structure of regulation, they will not be significantly enlightened by this new proposal.

It is also argued that the agencies perform overlapping functions. This, too, is true to a degree. There are undoubtedly some common functions that could be handled more efficiently. But the new proposal does not eliminate overlaps. Indeed, it purposely continues two Federal agencies having many identical functions.

In some respects, the Committee Print creates more overlapping than exists in present law. For example, Title I empowers the Federal Banking Commission to enforce against any insured bank the prohibitions of sections 22 and 23A of the

Federal Reserve Act, dealing with loans to affiliates and executive officers. Yet under Title III, identical authority is vested in the Federal Deposit Insurance Corporation, again with respect to any insured bank. In addition, the bill assigns to both the Commission and the Corporation the power to issue cease-and-desist orders against banks under their respective jurisdictions to remedy any violation of law -- including presumably, sections 22 and 23A of the Federal Reserve Act. The bill thus creates confusion and overlap in an area where none existed before.

Another argument advanced in favor of regulatory reform is that the present system inspires "competition in laxity." This criticism has been made for many years. Indeed, I have made the same point in public statements. There is, of course, a danger that our present tripartite system may encourage banks to play one agency off against another. But the proper remedy for this consists, first, in a determination by the agencies not to allow themselves to be so used, and, second, in proper oversight by the Banking Committees of the Congress.

Absolute consistency in bank regulation is not necessarily a virtue. On the contrary, some diversity of viewpoint among

the banking agencies can be healthy for the banking system. For example, I think that a good case can be made for the proposition that banking has benefitted from some of the provocative and innovative policies that were first advanced during the tenure of Comptroller Saxon in the early 1960's.

In any event, the Committee Print does little to eliminate "competition in laxity." It reduces the number of Federal banking agencies from three to two, but it still offers ample opportunity for the banks to play the agencies off against one another. Banks will still have the opportunity to choose between state and national charters, and by that choice may elect one of two Federal regulators. And even if a state charter is elected, the bank will still be able to choose between two Federal regulators by deciding whether or not to do business as a holding company subsidiary. Thus, even under this "reformed" structure, many of the old tensions will remain.

The Committee should also consider carefully what may be lost with this restructuring. The Federal Banking Commission will be a brand new agency. It will have no tradition, no history, no body of precedent to bring to bear upon its judgments. How it will develop, whether or not it will deal at arm's length with the banks being regulated, cannot

be predicted. The Federal Reserve, on the other hand, is a known quantity as a bank regulator. It has a record of accomplishment, a distinguished tradition, and a reputation for integrity and thoughtful decision-making. The fact that Congress has repeatedly seen fit to assign the Board of Governors the task of developing industry-wide regulations in the increasingly important consumer protection area must mean that the Congress, if not also the country at large, has confidence in the Board's objectivity and judgment.

Some have argued also that the condition of the banking system, particularly the fact that the number of banks on the so-called problem bank list has increased, constitutes proof that the present system has failed. The implicit assumption underlying such an argument is that bank supervisors can practically assure that problems will not arise. But this assumption is utterly unrealistic. No matter how strict the system of supervision, managerial misjudgments or outright fraud will occur at times. Supervisors cannot guarantee that bad loans will never be made, or that banks will never fail. Nor can they foresee with any precision what effects a business recession may have on many individual borrowers. They can, however, identify weaknesses that turn up, and they certainly can take steps to correct them and minimize the chances of their repetition. The problem bank list is thus simply a tool to direct supervisory attention where it is most needed. The very

existence of a problem bank list -- indeed, a list that keeps changing -- indicates that the bank regulators are attending to their job.

The recent furor over the condition of banks and the so-called problem bank list has been based on massive exaggeration and misunderstanding. It is true, of course, that some of our banks -- particularly the larger banks -- participated in the euphoria of the early 1970's. But they have learned their lesson, and they are again emphasizing careful appraisal of risk and the maintenance of adequate return on assets. Today's bankers are a chastened and prudent lot; they reject the goal of growth for growth's sake.

One aspect of this change of attitude is the increased liquidity of commercial banks. Holdings of liquid assets at large banks rose 33 per cent during 1975. At the same time, these banks sharply reduced their reliance on volatile sources of funds.

With greater attention to the precepts of sound financial management, commercial banks improved their profits last year despite the negative impact of increased loan loss provisions and a reduction in the size of their loan portfolios. The 50 largest bank holding companies, for example, reported a 7-1/2

per cent increase in net income during 1975; if loan loss provisions had been the same as in 1974, the increase would have amounted to 42 per cent.

A large share of these improved earnings was used to build up the capital position of banks. The total capital of all insured commercial banks rose to \$75 billion in June of 1975 from less than \$72 billion at the end of 1974. Furthermore, the ratio of capital to assets, which had declined steadily during the early 1970's, rose appreciably during the first half of 1975; and we can be quite sure that once data for the second half of the year become available, they will reveal additional improvement.

Further strengthening of the capital position of some of our banks would undoubtedly be prudent and wise. Fortunately, the stock and bond markets are more receptive to new bank issues today than they were last year, and this has occurred despite the adverse publicity regarding so-called "problem" banks and other sensational stories in the press. The fact is that bank stock prices have risen significantly since late 1975. Apparently, the abler market analysts have read the dramatized reports about banking difficulties as stale news that, taken as a whole, had little relevance to the current situation.

In sum, our commercial banking system today is basically sound, and is well prepared to provide the credit needed to support the economic expansion that is again underway in our country.

Let me now turn to some alternative courses of action that this Committee might wish to consider. While the Board sees no clear need for a major restructuring of bank supervision, it does recognize that improvements in bank regulation can and should be made. To this end, the Board has recommended several remedial measures to the Congress over the past year, which we are glad to see incorporated in the Committee Print. These measures would bring U.S. offices of foreign banks under Federal supervision, permit more expeditious handling of problem bank cases, strengthen penalties for violation of cease and desist orders, place limits on insider loans, permit easier removal of bank officers for unsound practices, and enable the Board to require a bank holding company to divest an unsound subsidiary.

In addition, over the past 18 months, the Board has conducted an intensive review of its regulatory and supervisory function and has introduced a number of measures to improve bank examination, supervision, and regulation. These include efforts to identify problems in their early stages through a

stronger computerized surveillance system. The other bank regulatory agencies have likewise been engaged in improving their regulatory capability.

Several weeks ago, I proposed a program for Congressional oversight of the bank examination function, because the Board believes that Congress should take a more active role in the regulatory process. The essence of this proposal is to provide the Banking Committees with statistical information and analyses that would relate to the conduct of the examination process and the condition of the banks.

I have in mind that such data would include, for example, information as to trends of capital, liquidity, earnings, classified loans, and portfolio losses. These data could be set forth in appropriate categories relating to such factors as the size and regional location of the banks. In addition, information could be provided on the examination process itself -- that is, on the number and duration of examinations, the size of the examination force, the costs incurred, and the nature and promptness of remedial efforts.

The Board believes that data and analyses of this sort would provide a meaningful factual basis for the Banking Committees to evaluate the effectiveness of bank supervision.

Moreover, we would further propose that such data and analyses be furnished to the Congress regularly, perhaps once or twice a year, so as to enable the Banking Committees to carry out their oversight responsibilities in this area on a continuing basis.

The Board has also considered at great length over the past year the additional steps that might be useful in helping to achieve the goal of more efficient and uniform bank examination and surveillance. No one proposal for reform has developed the support of a strong majority within the Board, but we believe that two proposals have significant promise.

The first of these calls for the creation of a Federal Bank Examination Council to focus on the most critical need -- namely, modernized bank examinations and vigorous follow-up procedures to cure weaknesses that are uncovered. The Examination Council would have authority to set standards and procedures that would apply to all the Federal banking agencies. It would also review significant problem cases, when and as they develop. All three agencies would be represented on the Council.

It is entirely possible that experience with such a Council will in time support a conclusion that some further consolidation

of banking supervision and regulation would be desirable. If that turns out to be the case, the decision would be based on actual experience and a greater practical awareness of the difficulties to be overcome and the advantages to be reaped.

The second proposal is to consolidate the functions of the office of the Comptroller of the Currency within the Federal Reserve. This change would accomplish in a constructive manner what the draft legislation seeks to accomplish through the Federal Banking Commission.

There is logic in this proposal since all national banks are required by law to be members of the Federal Reserve System and are thus already subject to many of our regulations. At present, however, their primary examination and supervision rests with the Comptroller. Also, the Board has supervisory responsibility for all bank holding companies, yet many of the major subsidiaries of these holding companies are national banks. In addition, the Board must approve the opening of foreign branches of national banks, but the supervision of these branches rests with the Comptroller. Similarly, the Board authorizes Edge Act corporations, but many of the banks that control them are supervised by the Comptroller.

The examination and supervision of national and State member banks could be integrated efficiently through this proposal. At the same time, the continued existence of the FDIC -- together with the additional Congressional oversight that I have outlined -- would enable another Federal banking agency to check or stimulate the supervisory and regulatory actions of the Federal Reserve.

The Board firmly believes that alternatives such as these should be explored thoroughly before the creation of an entirely new agency is given serious consideration.

Let me now touch on some of the provisions of Title V of the Financial Reform Act of 1976 that have a special interest to the Board. The attached Appendices spell out the Board's views in some detail.

The Board believes that Congress should continue to hold oversight hearings on monetary policy as provided by House Concurrent Resolution 133 but we see no need to make this a permanent part of the law. Each Congress should have an opportunity to decide for itself just how it wants to participate in this essential interchange.

Because circumstances change and the thrust of policy necessarily changes with them, the Board believes it would be especially unwise to legislate in detail how monetary policy objectives should be set forth and therefore, by implication, the terms under which policy should be conducted. One provision of the Committee Print would require the Federal Reserve to specify the interest rate levels that are intended or expected over the succeeding 12 months. But no one has yet developed the expertise to predict the course of interest rates. If the central bank is forced to announce interest rate intentions or expectations, the result could only be misleading. Interest rate movements depend basically on many factors outside the control of the Federal Reserve, including the expectations of borrowers and lenders about the future rate of inflation.

The Board also believes it would be a serious mistake to require the Federal Reserve to describe monetary policy in terms of its expected effects on statistical measures of employment, production, and the price level. There is a looseness in the relationship between monetary policy and economic developments that makes projections of this type exceedingly imprecise. Our experience has been that economic projections require continuous updating. Publication of one

projection, and then another two weeks or a month later, would be highly confusing to the public and might well feed back adversely on business and consumer attitudes.

On another provision, the Board opposes the proposal that would require Presidential appointment and Senate confirmation of Federal Reserve Bank presidents. Since the term of office for a Reserve Bank president is only five years, these positions could be turned into political plums to be dished out by the party that happens to be in power at any given time. The Federal Open Market Committee could then become a focal point for partisan political activity since the Reserve Bank presidents also serve on that body. The position of Reserve Bank president is a career post in the Federal Reserve System, and we have been extremely fortunate in being able to attract people of outstanding ability to these jobs. These positions should not be brought into the political arena.

In conclusion, we see no compelling need to legislate fundamental changes in the structure of bank regulation at this time. The fact that only a handful of banks failed during the recent recession is a triumph for bank regulation in this country. During the Great Depression, literally thousands of banks failed. But Congress in its wisdom adopted several laws in the 1930's

that reshaped bank regulation and gave us the strongest banking system in the world. Congress can be proud that the measures it adopted in the 1930's -- including a strengthening of the Federal Reserve and creation of the Federal Deposit Insurance Corporation - have worked so well and withstood the test of time.

The remedial legislation we have proposed to Congress will provide the regulatory agencies with authority they need for more effective supervision. If some structural changes are also believed to be necessary, the adoption of either of the two proposals that I have sketched -- moving the Comptroller's office to the Federal Reserve or establishing a Federal Bank Examination Council -- deserves thoughtful consideration.

Because of the strong feelings among members of the Board concerning Title I of this legislation, I have devoted most of my testimony to that section of the Committee Print. I should point out, however, that there are major principles embodied in this legislation -- particularly those relating to uniform reserve requirements, regulation of foreign banks, and additional supervisory authority over domestic banks -- that the Board warmly supports. We will be glad to work with the Committee on perfecting amendments to these important sections.

I again urge the Committee to avoid precipitous action on the complex and comprehensive piece of legislation that is before you. This Committee should not let itself be stampeded by dramatic headlines to adopt legislation that will effect major changes in Government. To do otherwise would be out of line with the careful procedures that have been so wisely observed by this Committee over the years.

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Supplemental Statement of the Board of Governors  
on Section 503 of Title V of Committee Print

The Board believes that Section 503 of the proposed bill, which legislates oversight hearings on monetary policy and specifies the topics to be covered in such hearings, is unnecessary and does not serve a constructive purpose. During the past year, the Federal Reserve Board has regularly accounted to Congress for its conduct of monetary policy through the quarterly hearings resulting from House Concurrent Resolution 133. These procedures have worked reasonably well. It is the Board's expectation that oversight hearings would be continued, whether or not a new Resolution is passed by the next Congress. The Board therefore believes that the provision of Section 503 concerning quarterly hearings is not needed and also, for reasons to be given below, is unwise in its particulars.

It would be especially unwise to legislate in detail how monetary policy should be described and therefore, by implication, the terms under which it should be conducted. Circumstances change, and the thrust of policy necessarily changes with them. In that respect, the provisions of the Concurrent Resolution are reasonably flexible--and therefore more realistic than those of Section 503. First of all, the Resolution refers to the specification of policy aims in terms of credit flows as well as monetary aggregates. Second, it notes that

account may need to be taken of international flows of funds and conditions in international money and credit markets. Third, and most important the Resolution explicitly recognizes the great merit of flexibility by indicating that the ranges of growth or diminution in the monetary and credit aggregates specified in advance in the oversight Hearings are not required to be achieved "if the Board of Governors and Open Market Committee determine that they cannot or should not be achieved because of changing conditions."

Section 503 carries the process of advance specification of unknown factors a giant step further by requiring the Federal Reserve to announce "ranges within which the levels or rates of change" not only of monetary aggregates, but also of interest rates, are intended or expected to vary over the next twelve months. However, if the central bank is forced to announce interest rate intentions or expectations--imprecise as these guesses must be--it would be misleading to the public and the effectiveness of monetary policy would be impaired, with harmful consequences for the economy and the nation.

The announcement of interest rate intentions or expectations by the Federal Reserve would lead many borrowers and lenders to believe that the System could--and in practice would--guarantee particular interest rate levels. But the Federal Reserve does not have the power to do this, because interest rates depend basically

on many factors outside the control of the central bank. Fundamentally, interest rate movements reflect the interaction of changing demands for credit with the available supply of funds from a wide variety of institutional and other lenders. Interest rates are influenced not only by the strength of the economy and by the public's willingness to defer current consumption and save for the future, but also--and this has been especially important in recent years--by the expectations of borrowers and lenders about the rate of inflation.

If the Federal Reserve nevertheless attempted to keep particular interest rates at some specified level, this might well lead to inappropriate rates of growth in bank reserves and money. If, for example, interest rates came under upward pressure because of rising demands for funds, System efforts to prevent, or limit, interest rate increases could result in unduly rapid monetary expansion, thereby feeding inflationary pressures. If, on the other hand, interest rates came under downward pressure because of slackening business activity and declining demands for funds, System efforts to prevent, or slow down the declines could result in monetary growth rates below those needed to reinvigorate the economy.

Thus, the announced interest rate intentions or expectations may well prove to be inconsistent with stated objectives in terms of

monetary growth rate ranges. Efforts to maintain interest rate levels would have harmful effects on the economy and would in the end fail.

The Board also strongly believes that it would be a mistake for the Congress to require the Federal Reserve to describe monetary policy "in terms of its expected effects on statistical measures of employment, production, and purchasing power (price stability), as contrasted with the effects which could be expected from alternative policies." Economic activity, prices, and employment depend on many powerful influences apart from instruments under the control of the Federal Reserve. Fiscal policy is one. Labor market policy is another. The state of public confidence--the willingness to spend freely from income and accumulated savings--is still another. Thus, there is a looseness in the relationship between monetary policy and economic developments that makes projections of the effects that different policy postures might produce exceedingly imprecise. The sorry track record of most projections during the past year or two makes that clear.

Thrusting economic projections by the Federal Reserve into the public arena would surely lead many to exaggerate the influence that monetary policy has on the economy, and would not enhance understanding of monetary policy, or of the objectives of policy-makers.

Moreover, our experience has been that economic projections require continuous reevaluation and updating if they are to serve a useful purpose in policy-making. But publication of first one projection, and then another two or four weeks later, soon followed by yet a third, would be highly confusing to the public and might well feed back on business and consumer attitudes.

Because the Federal Reserve is aware that the linkages between monetary policy actions and the economy are extremely loose, the Federal Open Market Committee has never officially attempted to reach agreement on specific projections of economic magnitudes. Our staff does present projections that aid in Committee deliberations. But staff projections do not necessarily represent the expectations held by the policy-makers of the likely course of economic activity. Different individuals may well have different evaluations of the economic outlook, and all have learned from experience the necessity of remaining flexible in their views in order to take account of the stream of incoming evidence. Therefore, we believe that a requirement calling for the adoption and publication of specific economic projections by the Federal Reserve would seriously mislead the public about the likelihood of a particular economic outcome, would adversely affect policy discussions

within the Federal Open Market Committee by introducing concerns of a public relations nature, and would inevitably politicize the policy-making process.

Supplemental Statement of the Board of Governors  
on Sections 504 and 505 of Title V of Committee Print

I have indicated the Board's strong reservations about the wisdom of the part of Title V dealing with the appointment of presidents of Federal Reserve Banks. In addition, however, there are certain other provisions in Title V which are troublesome. These provisions have to do, first, with the composition, terms, methods of selection, and responsibilities of boards of directors of Federal Reserve Banks; and secondly, with membership and holding of capital stock in Reserve banks.

Before any changes are enacted in the above areas, they should be subjected to a fundamental test -- namely, will such changes improve the effectiveness and efficiency of the Federal Reserve System? If not, no public advantage will be derived from their enactment.

Let me state briefly some of the benefits the System receives from Reserve bank directors. First, they make an important contribution to our economic intelligence system, through a detailed knowledge of the state of business and consumer psychology and through a "feel" for prospective developments in their particular sphere of activity. This "grass-roots" input from directors serves as an important complement to the

work of our economic research staffs. Secondly, many of our directors bring to us important management skills and "know-how" in their oversight responsibilities for efficient operation of Federal Reserve Banks. It is important, therefore, to secure knowledgeable, effective, and highly-motivated persons to serve in such capacities. With those thoughts in mind, I submit the following comments.

1. Repeal of Section 4(6) of the Federal Reserve Act which now provides that "every Federal Reserve Bank shall be conducted under the supervision and control of a board of directors" is undesirable. This responsibility of Reserve bank directors is discharged subject to the statutory provision for general supervision by the Board of Governors, which is a sound and sensible arrangement.
2. Removal from boards of directors the authority to appoint Reserve bank presidents, subject to approval of the Board of Governors, would undermine the role of the directors in overseeing the efficient and effective performance of the Reserve banks.

3. Limiting directors to a single three-year term (as opposed to the present practice of two three-year terms) would create more turnover, less continuity, and perhaps lead to greater difficulty in recruiting qualified directors. In addition, a single 3-year term would limit their effectiveness because of the time necessary for a new director to understand the range of activities and responsibilities.
4. Elimination of "membership" as such in the Federal Reserve System and making the holdings of Federal Reserve Bank stock optional could in time lead to the disappearance of Reserve banks as a constructive influence at the regional level. In our judgment, all financial institutions which hold their reserves with the Reserve banks, and are thus entitled to use their services, should be required to hold at least a nominal amount of stock in Reserve banks.
5. Removal of the right of member institutions in the Federal Reserve System to elect any directors of Reserve banks is undesirable. In order to maintain a strong interest by member institutions in the effective and efficient performance of central bank services by the Reserve banks, the member institutions should continue to elect some of the directors of Reserve banks.