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Statement by

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before the

Committee on Banking, Finance and Urban Affairs

House of Representatives

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I am pleased to have the opportunity to present the views of the Board of Governors on H.R. 8094, the "Federal Reserve Reform Act of 1977." The stated purpose of this bill is "to promote the accountability of the Federal Reserve System."

Let me say at the outset that the Board fully recognizes its accountability to Congress for its performance of the duties Congress has given it. My colleagues and I appear frequently before this Committee and other committees of the House and the Senate to report to you and to answer for our actions. We have participated earnestly in the quarterly dialogue on monetary policy initiated under House Concurrent Resolution 133 of the 94th Congress. I am scheduled, as you know, to appear before this Committee on Friday to continue that dialogue. Last year the Board recommended that the House and Senate Banking Committees evaluate our performance as bank supervisors through periodic oversight hearings on the condition of the banking system, and the first such hearing was held by the Senate Banking Committee this March. In April we advanced the dialogue further by presenting testimony on the budget of the Federal Reserve System before the same Committee. I believe that through proceedings such as these we are evolving an effective means by which the Congress can fulfill its oversight responsibilities with respect to the Federal Reserve while respecting the basic principle of an independent central bank.

The most significant provision of H.R. 8094 is Section 1 of the bill. The objective of monetary policy set forth in this section -- namely, that it "shall be governed by the national policy to promote maximum employment, production, and price stability" -- is consistent with the Board's understanding of the intent of Congress, and it also reflects the actual practice of the Board and the Federal Open Market Committee. In the Board's judgment this would be an appropriate addition to the Federal Reserve Act. It is a clearer statement of national policy than is contained in the Employment Act of 1946, which uses the term "purchasing power" rather than "price stability."

On the other hand, the Board is disturbed by the bill's language relating to hearings on monetary policy, which differs in several major respects from that of the Concurrent Resolution it would replace. The Concurrent Resolution was the carefully-framed product of extended discussions between the Banking Committees and the Board. It has been thoroughly tested in the course of the nine hearings held under its provisions over the past two years. We know of no good reason for revising it;

indeed, some of the proposed revisions, if enacted, would be inimical to the orderly functioning of financial markets.

The provision calling for projections of interest rate levels for twelve months ahead is particularly ill-advised. Neither the Board nor the FOMC makes such estimates. To be sure, some if not all members have more or less well-defined expectations about the likely course of rates in coming months, but members of the Board and of the FOMC do not discuss such expectations in public. Federal Reserve officials are extremely careful to avoid any public comment that might suggest or imply some particular outlook for interest rates.

The reason for reticence on this subject should be obvious. While the Federal Reserve cannot determine market interest rates, it certainly can influence them -- particularly in the short run. Participants in financial markets know this, and they have strong incentives to make use of any clues they can get to the System's intentions. If, for example, bondholders conclude from a remark by a System official that rates will be rising in the future, they may deem it advantageous to sell their holdings immediately -- and that may cause rates to rise prematurely. It may also cause rates to move up unnecessarily if the view of the System official was not well founded but nevertheless was taken seriously.

But if the casual comments of a Federal Reserve official can affect market interest rates, public reports each quarter on the interest-rate expectations of the Board or the FOMC could rock financial markets. The expectations voiced by the Board at a quarterly hearing might change a week or a month later, and in any event might be mistaken. If we made specific pronouncements about the future of interest rates, many traders would no doubt tend to respond promptly. Inappropriate as well as violent changes of interest rates could take place and the economy suffer from the financial instability so generated. The capacity for mischief inherent in the interest-rate provision is so apparent that I find its inclusion in the bill inexplicable.

The provision calling for quarterly testimony on monetary velocity twelve months ahead is questionable for other reasons. Particular considerations -- often of a sort that defy quantification -- weigh heavily in the thinking of most, if not all, members of the FOMC. In the nine hearings held thus far under House Concurrent Resolution 133, I have tried to set forth the reasons underlying the Federal Reserve's policy decisions. In fact, I have often commented in general terms on expectations for velocity, speaking for the FOMC or the Board when that was appropriate and for myself when it was not. But in so doing, I have consistently emphasized the sensitivity and flexibility of monetary policy, which can change by the month or even by the hour, and which should never become the prisoner of some preconceived number.

Conceivably, in response to a Congressional mandate, the FOMC could vote on some numerical figure for monetary velocity. But any such exercise is not necessary for effective policy formulation; if undertaken, it would divert members of the FOMC from basic analysis in which they have some competence to a numerical guessing exercise; the end result would be artifical at best, and would be grossly misleading at worst.

Finally, I must advise this Committee that the Board seriously questions the provision calling for quarterly reports on the "proposed composition of the Federal Reserve's portfolio" twelve months ahead. In the first place, such reports could influence current interest rates as market participants drew inferences about Federal Reserve purchases or sales in different sectors of the market. Second, such reports could prove highly misleading. In view of the uncertainties about future conditions in securities markets, numerical projections of likely changes in the portfolio during the coming twelve months cannot be made with much confidence.

Of course, the FOMC could always instruct the Manager of the System Account to make its guesses come true, or perhaps to reduce particularly large misses, whether or not the open market operations required were consistent with the needs of the Nation. I very much doubt that Congress will want to force the Federal Reserve into that kind of predicament.

These observations on the deficiencies of Section 1 of this bill suffice, I hope, to show why the Board recommends that the language providing for quarterly hearings on the conduct of monetary policy follow much more closely the carefully framed and thoroughly tested language of House Concurrent Resolution 133.

Section 2 of the present bill would prohibit discrimination and broaden the list of interests to be considered in the selection of Reserve Bank directors. We are in sympathy with the concerns underlying this provision and we support it. As I stated last year, the Federal Reserve is fully committed to the principle of equal employment opportunity, and we have made vigorous efforts over the years to employ and promote qualified women and minority group members to the staffs of the Board and the Reserve Banks. Moreover, we have recently increased our emphasis on the appointment of such persons to the Boards of Directors of the Reserve Banks. While we have achieved some success, we recognize that it has not been sufficient. Last year I advised you that the System had 6 women serving as members of Reserve Bank branch boards. For 1977, this figure has increased to 17 women directors, 4 on head office boards and 13 on branch boards. This year our minority directors have increased from 13 to 16, including 3 who serve on the boards of head offices. We appreciate Chairman Reuss's continuing interest in this matter, and I assure the Committee that we intend to continue our efforts to enlarge the representation of women and members of minority groups on the Reserve Bank boards.

Another change in the provisions of Section 2 relating to directors would expand the categories of individuals to be considered in the selection of Class B and C directors. The Board endorses this proposed broadening in the representation of the public on Reserve Bank boards. Indeed, in connection with the FINE Discussion Principles we recommended that consideration be given to appointment of Class B directors by the Board rather than their election by member banks.

We continue to hope that the Committee will consider whether its objectives in this section of the bill may not be better achieved by providing for Board appointment of Class B directors. As the bill stands, both Class A and Class B directors would still be elected by member banks, in accordance with the nomination and balloting procedures set forth in Section 4 of the Federal Reserve Act. Under these procedures it is difficult to see how the bill's anti-discrimination provisions can be enforced in elections in which literally thousands of member banks will be voting on a large number of nominees. This difficulty could be overcome by specifying that Class B directors are to be selected by the Board. Such an amendment would have the added benefit of putting to rest the mischievous fiction that the member banks control the Federal Reserve by virtue of their ability to elect six of the nine directors of each Reserve Bank.

Section 3 of the bill provides for Senate confirmation of the person appointed by the President as Chairman of the Board. As I recently testified before the Subcommittee on Domestic Monetary Affairs, we have no objection to this provision.

The Board has serious problems with the provisions of Section 4 relating to so-called "lobbying communications" with regulated institutions. Unlike the existing provisions of law relating to lobbying by government officials, which make it a crime to use appropriated funds for such purposes, H.R. 8094 would enact a direct prohibition against communication by any Federal Reserve official with any institution regulated by the Federal Reserve "to influence legislative actions affecting the Federal Reserve System."

The Board seriously doubts whether such a prohibition is consistent with the First Amendment to the Constitution, which commands that Congress shall make no law abridging freedom of speech. Moreover, this provision of the bill is so broadly worded that it could have a chilling effect on perfectly innocent communications that, besides being Constitutionally protected, are not intended to be included within the scope of this bill. Just what legislation, for example, would be excluded from the bill's reference to "legislative actions affecting the Federal Reserve System"? How explicit must the intention be to "influence" such actions? Need the Federal Reserve official urge bankers to write their Congressman in order to violate such a prohibition?

Are we prevented from informing banks about changes that the Federal Reserve is proposing in the laws that govern banking? Would we violate the law if a banker decided on his own to write his Congressman after listening to our description or analysis of a pending bill? Indeed, may not this provision be violated whether or not the banker who received a communication from the Federal Reserve subsequently communicated with his Congressional representative? With such uncertainties the inevitable effect would be to inhibit Federal Reserve officials from discussing any proposed or pending legislation in a public forum -- particularly if bankers were present. I cannot believe that Congress would want to limit so severely the ability of Federal Reserve officials to discuss legislative ideas or that it would want to create such impediments to the free flow of information or opinion to the Congress itself.

Moreover, since three members of each Reserve Bank board of directors are bankers, as provided by law, the bill could even be construed to prevent any discussion of pending legislation at Reserve Bank board meetings. In fact, since Federal Reserve banks could themselves be considered institutions "subject to the regulatory authority" of the Board of Governors, the bill might be read to prohibit communication between the Board and the Federal Reserve Banks about such proposed legislation. Similarly, the bill could be interpreted to prohibit the Board from discussing legislative matters with the Federal Advisory Council, a body composed of bankers that was created by the Federal Reserve Act for the express purpose of counselling with the Board on matters affecting the System. Again, I cannot believe such results could be intended.

The officers and directors of the Reserve Banks, as well as members of the Federal Advisory Council, are appointed under law. The Board has a responsibility to keep them informed on legislative issues, and they naturally share our concern for legislation that may have an impact upon the System. Their interest in these matters exists quite apart from the positions that some of them hold in private business institutions. Neither government service nor election to a Reserve Bank directorate should require an individual to forfeit those rights of expression and petition that are generally guaranteed by the First Amendment.

We appreciate that Section 4 of the bill is intended to protect against the possibility that regulated institutions, hoping to curry favor with their regulator, may be induced to promote the regulator's interest in particular legislation. One who entertains such a fear must be assuming that men and women who work in regulated businesses would let themselves be used by unscrupulous regulators to express views that may not be their own. I see little basis for any such cynicism about bankers or their regulators, or -- for that matter -- about the ability of Congressmen to protect themselves against misleading rhetoric of their constituents.

We live in disturbed times, and if Congress should consider Section 4 a proper subject for new legislation, I still see no basis for singling out for special treatment the Federal Reserve -- an institution whose integrity should not be so lightly questioned. I cannot deny a theoretical possibility of misconduct in the future; and if Congress believes it appropriate to address the issue, it should do so in the broad context of all federal regulatory agencies -- not excluding Cabinet departments.

Finally, Section 5 of the bill would add "Federal Reserve bank director, officer, or employee" to the list of individuals covered by the conflict of interest prohibitions of Section 208 of the Criminal Code. This section of the Code prohibits any covered employee or official from participating personally and substantially in any matter in which he, or certain persons or entities related to him, has a financial interest, unless he first makes a full disclosure to the official who appointed him and receives appropriate clearance in advance.

In principle we have no objection to this proposal. The Board of Governors has since the inception of the Federal Reserve System recognized the need to assure that the highest standards of personal integrity are observed, not only by Board officials and employees, but by all those associated with the System. As early as 1919, the Board stated that:

> "it has always entertained the view that no director or officer of a Federal Reserve bank should permit his connection with the bank to be used in furthering his private business or the interest of any corporation with which he may be associated."

The Board has requested the Reserve Banks to distribute to their directors, officers and employees the Code of Ethics for Government

Service, and it has asked each Reserve Bank to adopt rules on employee responsibilities and conduct comparable to those adopted by the Board itself in furtherance of Executive Order 11222. These rules constitute a broad prohibition of conflicts of interest.

While we thus concur with the principle underlying this proposal, we are disturbed by its discriminatory nature. I believe that there are many positions comparable to those of Reserve Bank directors that are not now covered by Section 208 of the Criminal Code. The directorates of the Federal Home Loan Banks is the example that comes to mind most readily. If Congress is to consider extending the criminal penalties for conflicts of interest, it seems highly inappropriate to do so by singling out one group as a special target and without benefit of some deeper study of the proposal.

If such a study were undertaken, consideration would need to be given to the unique status of Reserve Bank directors in the structure of the Federal Reserve System. The Federal Reserve Act provides for a balancing of economic interests on Reserve Bank boards -- lenders, borrowers, and public representatives. Directors are required by the Act and by their oath of office to administer the affairs of the Bank "fairly and impartially and without discrimination." The legislative history of the Act indicates clearly that Congress viewed Class C directors as having a responsibility, as "representatives of the United States," to ensure that this requirement of impartiality was carried out. The Federal Reserve System has been untouched by conflict-of-interest scandals in its 64 years of existence, and we certainly have the power to deal effectively with misconduct -- even to remove officers and directors -- if any such thing should occur. In light of this, and particularly if the Board of Governors appointed three additional public representatives, it is very doubtful that Section 5 of the present bill is at all necessary. Not only that, there is at least the possibility that specific reference to directors under the Criminal Code would diminish the ability of the Federal Reserve Banks to attract highly qualified citizens to their directorates.

We urge the Committee to move very cautiously on Section 5, not only for the above reasons but also because of what appears to be a technical flaw in drafting. Subsection (b)(1) of Section 208 of the Criminal Code provides that the Government official responsible for the appointment of another person covered by the Code may permit that person to participate in a particular matter where the person's interest in the matter is not substantial. It so happens, however, that the Reserve Bank directors in Classes A and B are elected by member banks, so that there is no appointing official in their case. The obvious, but perhaps unintended, discrimination against those directors should be noted by the Committee.

In summary, the Board supports enactment of several provisions of this bill. We believe, however, that the objectives of the quarterly hearings on monetary policy can be best achieved by retaining the tested language of House Concurrent Resolution 133. We urge the Committee to drop the provision of the bill relating to "lobbying" because it is unjustifiably broad and of doubtful constitutionality. And we also urge the Committee to study very carefully the implications of amending the Criminal Code before taking any serious legislative move in such a direction.

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