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Statement by

J. Charles Partee

Member, Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs

United States House of Representatives

July 14, 1978

I am pleased to have the opportunity to present to this Committee the views of the Board of Governors of the Federal Reserve System on H.R. 12621 and H.R. 13148. The Board appreciates your timely consideration of these two amendments that we have proposed to the Federal Reserve Act.

Let me begin with H.R. 12621, a proposal to expand the class of collateral eligible to secure Federal Reserve notes. As this Committee is aware, the currency of the United States consists almost entirely of Federal Reserve notes, which are liabilities of the Federal Reserve Banks. By law, these notes must be collateralized dollar-for-dollar by assets of the Federal Reserve, and only those assets specified in Section 16 of the Federal Reserve Act are eligible as collateral. At present, the list of eligible assets is restricted to gold certificates and Special Drawing Rights certificates, direct obligations of the United States, banker's acceptances and other paper eligible for discount, and certain loans to member banks. H.R. 12621 would add the obligations of Federal agencies to the class of assets eligible to secure Federal Reserve notes.

A brief review of the attached balance sheet of the Federal Reserve Banks may help to illustrate the increasing need for the expansion of eligible assets. The major liabilities are member bank reserve balances, the deposits of the Treasury and Federal Reserve notes. By far the largest and fastest growing item is the liability for currency outstanding, which represented 72 per cent of total liabilities and capital of the Federal Reserve Banks at the end of 1977, compared with about 59 per cent of the total ten years ago. Since total assets must by definition equal liabilities and capital accounts, this means the proportion of our assets pledged to secure Federal Reserve notes has also been growing significantly.

Among the items on the asset side of the Federal Reserve's balance sheet are gold certificates, Special Drawing Rights certificates, U.S. Government and Federal agency securities, banker's acceptances, loans to member banks, and other miscellaneous assets. The largest single entry is, of course, the System's holdings of U.S. Government securities, whicn represented about 74 per cent of total assets at the end of 1977.

Virtually all of the increase in the assets of the Federal Reserve over the past decade is accounted for by net acquisitions of U.S. Government and agency issues. In recent years, we have been able to conduct limited open market operations in the growing secondary market for agency issues, so that our holdings of such obligations--which under existing law are not eligible to secure Federal Reserve notes--now total about $8.5 billion, compared with only $38 million a decade ago. The net result is that, over the decade, while Federal Reserve notes outstanding have increased at an 8-1/2 per cent annual rate on average, eligible collateral has grown only at a 6-3/4 per cent annual rate.

In the past few years, moreover, growth in the currency needs of the economy appears to have accelerated--to an annual rate of about 10 per cent on average. Experience has shown that the economy's currency requirements tend to be a fairly stable proportion of GNP. Thus, if nominal GNP--which reflects inflation as well as real growth--continues to rise at its recent rate of 10 to 11 per cent per year, and if eligible assets grow at the 7 per cent rate of recent years, it can be projected that the Federal Reserve's stock of eligible collateral will be completely pledged in 3 to 4 years, other things equal.

A shortage of collateral is thus a very real possibility. Indeed, over the past one and one-half years, the excess of eligible assets above collateral requirements has declined sharply. Excess Reserve note collateral averaged more than $20 billion at year-end for the years 1970-76. It averaged only $11 billion in the first half of this year. And with the introduction of the new note option to the Treasury's tax and loan account program at depositary institutions, expected this fall, excess Federal Reserve note collateral is likely to decline considerably further. This will result from a reduction in the System's portfolio of Government securities associated with the transfer of Treasury balances from the Reserve Banks to commercial banks and other depositary institutions. If agency issues were to be made eligible to secure Federal Reserve notes, the more ample excess collateral "cushion" would permit greater operating flexibility during this transition.

It should be emphasized that the Federal Reserve holds assets far in excess of its notesoutstanding. However, with a diminished level of excess eligible collateral, some technical operating difficulties can arise. For example, since each Reserve Bank must individually secure its notes outstanding, the recent sharp decline in excess collateral has meant that, on occasion, a Reserve Bank runs short of eligible assets.

In such an event, that Bank has had to borrow Government securities from another Reserve Bank in order to meet collateral requirements. The System's operational flexibility would be enhanced by the passage of H.R. 12621, as the proposed expansion of collateral assets would likely eliminate the need for these loans between Reserve Banks.

On occasion, also, excess collateral can be reduced sharply by the need to offset sudden and unexpected increases in Federal Reserve float. Such an episode occurred this past January, when harsh winter weather conditions interrupted the transport of checks through the clearing process. As a result, float rose by about $10 billion above its average level in a matter of just a few days. In such a situation, open market operations are automatically undertaken to offset the reserve effect of the increase in float. With the excess collateral cushion shrinking, there is growing danger that such smoothing operations might have to be constrained at times in order to avoid a corresponding reduction of assets eligible to secure Federal Reserve notes.

If the authorization to secure Federal Reserve notes with agency obligations is not enacted, we will have no alternative other than to take measures necessary to ensure compliance with the law. The inventory of currency at Federal Reserve Banks may have to be cut back, thereby reducing flexibility to meet unanticipated increases in the public's demand for cash. A developing shortage of eligible collateral could well force the System to cease purchases of Federal agency issues for the Open Market Account, and to replace agency securities with other assets eligible as collateral. Since the volume of agency obligations has been increasing rapidly of late, it would not seem desirable, as a matter of public policy, to substantially curtail the Federal Reserve's participation in this active and growing secondary market. And in the extreme case, if all eligible collateral were to be pledged, the System would find itself unable to issue additional currency in response to the public's need, since the issuance of notes without collateral is unlawful.

The Board urges that H.R. 12621 receive the prompt attention of the Congress in order to avoid the unnecessary potential difficulties related to currency issuance that I have outlined. Passage of this bill also will remove the inconsistencies in treatment that now exist in the Federal Reserve Act so that all securities eligible for open market operations would also be eligible to secure Federal Reserve notes. Moreover, it would correct the current anomalous situation whereby loans to member banks that are secured by agency obligations are eligible collateral for Federal Reserve notes, but direct System holdings of the agency securities are not.

Let me turn now to H.R. 13148, a bill to expand the number of Class C directors of Federal Reserve Banks from three to six.

Each of the twelve regional Federal Reserve Banks has a board consisting of nine directors who are to be chosen without discrimination on the basis of race, creed, color, sex or national origin. The three Class A directors are elected by, and must by law be "representative of," the member banks of the District. The three Class B directors, who represent the public, are also elected by member banks with due but not exclusive consideration to the interests of agriculture, commerce, industry, services, labor and consumers. Class C directors are appointed

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By statute, Class C directors must have been residents of their Federal Reserve District for two years, and cannot be officers, directors, employees or stockholders in any bank. Beyond these statutory guidelines, the Board of Governors typically seeks other attributes in candidates for Class C directors. Each of the Bank boards needs members with experience in managing an organization, since directors must oversee the operations of their respective Reserve Banks. Other important responsibilities include voting on changes in the discount rate, reviewing loans and discounts to member banks in their respective Districts, and providing important, timely and valuable intelligence about economic conditions in their regions of the country. The Board believes it highly desirable to select directors who will contribute to the fulfillment of these responsibilities.

The chairman of the board of each Reserve Bank, as well as the deputy chairman who serves in the chairman's absence, must be designated by the Board of Governors from among the Class C directors. Thus, at present, most or all of the Class C directors must assume--or have the potential for assuming--one of these roles. Under these circumstances, it is of particular importance that Class C directors bring to the Federal Reserve a record of managerial capacity that is essential to the effective supervision of an operation as large and complex as a Federal Reserve Bank.

The Board is keenly aware of the additional criteria for Class C director selection specified by the Federal Reserve Reform Act of 1977. We fully support the intent of the Congress to broaden the representation of interests on Reserve Bank boards. But in practice, we have come to recognize that it is difficult to provide representation of a wide diversity of interests among only three Class C directors.

Moreover, since the directors serve staggered terms, only one Class C vacancy occurs each year at each Reserve Bank. And because the complexity of the Bank's business has given special value to on-the-job experience, Board-appointed directors are typically reappointed to a second 3-year term. Thus, throughout the System only about six new Class C directors are chosen in any given year. The Board's commitment to broader representation can be achieved only very gradually with such a limited number of new appointments. Of course, the Class B director appointments also may well include persons of diverse backgrounds and interests, but their selection is a process over which the Board of Governors has no direct control.

In the interest of promoting broader representation of agriculture, labor, services, consumers and other groups among Reserve Bank directors, the Board of Governors recommends the passage of H.R. 13148. The increase from three to six Class C directors at each Federal Reserve Bank would provide 36 immediate openings for which the Board can consider individuals with a variety of backgrounds and interests. And with the greater number of Class C directors at each Reserve Bank, it will be more feasible to carry out the provisions of the Federal Reserve Act that call for both broader representation among, and selection of the chairman and deputy chairman from, the Class C directors.

In summary, I want to convey the Board's recommendation for prompt passage of these two bills. If enacted, the first of these proposals will enhance greatly the Federal Reserve's flexibility in meeting the collateral requirements for Federal Reserve notes, and the second will be of substantial benefit in helping to broaden promptly the diversity of backgrounds and interests represented on the boards of directors of our regional Federal Reserve Banks.

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CONDENSED BALANCE SHEET OF THE FEDERAL RESERVE BANKS
In millions of dollars

ASSETS

	December 31 1967	December 31 1977
Gold certificates	11,480	11,719
Special Drawing Rights Certificates	0	1,250
Loans to member banks secured by eligible paper	143	262
Acceptances	164	954
U.S. government securities	49,112	102,819
Federal agency obligations	38	8,455
Other Assets	14,393	14,267
Total assets	75,331	139,726

LIABILITIES AND CAPITAL ACCOUNTS

	December 31 1967	December 31 1977
Federal Reserve Notes:		
Outstanding (issued to Reserve Banks)	44,311	100,535
Less: Held by Reserve Banks	1,940	7,382
Federal Reserve notes, net	42,370	93,154
Member bank reserve accounts	21,000	26,709
U.S. Treasury deposits	1,123	7,164
Other deposits	797	1,514
Other liabilities	8,841	9,126
Capital accounts	1,200	2,058
Total liabilities and capital accounts	75,331	139,726

Details may not sum to totals due to rounding.

ATTACHMENT