Higher Expectations and Uniform Reserve Requirements

by

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So much is being written by so many uncertain observers about such a confusing prospect for 1974 that I prefer to use this opportunity to call attention to a longer-run problem. This is the danger that the Federal Reserve will be unable to deal with the future unless it has sharper tools to work with.

I begin with the assumption that society will set progressively higher performance standards for the economy. It will demand more goods and more of the "right" goods, lower unemployment and more job opportunities for specific groups, more income and a better distribution of income.

An important reason for disappointment with our economy's performance in recent years has been that our standards have risen faster than our ability to meet them. If continued frustration is to be avoided, we must learn not only to slow the trend toward ever-higher aspirations but to accelerate our capabilities for achieving our objectives. The burden for the first rests largely on society at large, the burden for the second on policymakers.

Three broad avenues are open to policymakers as they try to improve their control over the economy. They must search for new tools to meet new goals, sharpen existing tools, and learn to become more proficient at using all available tools. Policymakers have moved ahead on all three fronts. But discussion of them would take us too far afield. Instead, let me focus on a very traditional tool that is of special concern to the Federal Reserve and the banking community--controlling the money supply.

In the face of growing demands for sharper policy tools, this one is actually being blunted. Control of bank deposits--which account for about four-fifths of the money supply--is being eroded by the decline in Federal Reserve membership. The Fed's handle on bank deposits and the money stock has traditionally been member bank reserves. Through open market operations the Fed tries to provide the amount of reserves consistent with desired deposit levels. However, in recent years the Fed's control of the money supply through the reserve base has deteriorated as the proportion of deposits in member banks has shrunk from more than 85 percent 25 years ago to about 75 percent last year.

The Federal Reserve permits members to hold as reserves only assets issued by and hence under the direct control of the Fed. States, however, allow banks under their jurisdiction to count correspondent balances and some earning assets such as Government securities. As a result, changes in nonmember holdings of correspondent balances and Government securities can change the reserve base and hence the banking system's power to issue deposits quite independently of the Fed's policy intent. So, for example, if the Fed is being restrictive, it will absorb member bank reserves, but this policy can be subverted if nonmembers acquire additional Government securities or correspondent balances that offset restrictive open market operations.

As control of the money stock is gradually being lost because of declining membership, the Fed and the banking community face different sides of the same dilemma. In an age of growing concern with corporate responsibility, bankers are forced increasingly to make short-run choices between what's good for their stockholders and what's good for an effective monetary policy. Many recognize that the benefits of a healthy banking structure and economy are shared by all bankers and that the burdens of an effective monetary policy should be shared by all bankers as well.

In short, I see a future in which an ever more demanding public expects improved performance and in which policymakers seek the best tools possible in order to meet these rising standards. Anticipating this future, the Fed has suggested uniform reserve requirements for members and nonmembers, submitting a proposed legislative package to Congress last month.

The uniform reserve requirement plan provides necessary control over the money supply without threatening the dual banking system. Membership in the Fed is not critical to an effective monetary policy if <u>ALL</u> banks are required to maintain uniform reserves at the Fed. Actually, without uniform reserve requirements, the dual banking system will be strangled in states where reserve requirements so unfairly favor state nonmember banks.

Monetary policy is clearly a national responsibility; it cannot be divided into 50 slices and still be effective. Monetary policy is the job of the Federal Reserve. To carry out its responsibilities in a world in which its capabilities are likely to be stretched to the limit, the Fed must have its tools in good working order.

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