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FROM Jeanne Ashenbrenner

Attached is a copy of the article that appeared in the February 28 edition of the American Banker.

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An Attack on Attrition
by
David P. Eastburn, President
Federal Reserve Bank of Philadelphia

The commotion that occurred in New England recently when several banks withdrew from the Federal Reserve System may be the spark that finally ignites some action to solve the Fed's membership problem. Much discussion is going on within the Federal Reserve System to develop strategies for a feasible, practical counterattack on member bank attrition. Paying interest on reserves held at the Fed is an idea whose time may be approaching.

The problem of declining membership is hardly new. The Fed used to count as members over 50 percent of all commercial banks. Now it has only 40 percent. Of even greater importance, Fed member banks used to hold nearly 90 percent of all commercial bank deposits. Now they claim only 76 percent. Between 1965 and 1975 the banking industry grew from 13,542 institutions to 14,633. The Fed's rolls simultaneously slipped from 6,220 to 5,788. What's more, during that period, 29 banks that withdrew from System membership had assets greater than $100 million. The departure, or threatened departure, of these relatively large institutions has become acute in recent years and underscores the fact that membership is costly to a wide spectrum of banks, not just to small country banks or banks located in a specific geographic region. This dissatisfaction with the balance of costs and benefits of membership is nationwide, and the pressures to alter the ground rules under which reserve requirements are set are broadly based as well.

Why the Concern?

If the only costs of Fed membership losses were the bruises inflicted on the egos of central bankers, there would be no serious concern. Un-

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fortunately, there are significant costs to society: (1) blunted monetary control, and (2) increasing distance between banks and the ultimate source of liquidity--the Fed.

Monetary Control. Money is important to the health of the economy. It helps determine the number of jobs, the pace of inflation, the tempo of production, and the volume of sales. Maintaining an appropriate flow of money is the main job of the Federal Reserve. Basically, the Fed controls the money supply by changing the level of reserves in the banking system. The money supply is a multiple of the reserve base. As more and more banks leave the System that multiple becomes less predictable. At some point, this loss of precision could seriously hamper the effectiveness of the Fed to gauge the money supply. That's a point none of us wants to reach.

Stability of the Banking System. Another major cost to the public of eroding membership is the potential instability it introduces into the banking system. Prior to the creation of the Fed in 1913, commercial banks held large shares of their required reserves with other commercial banks. These recipient banks, in turn, held reserves against those deposits with still other banks. This system of "pyramiding" reserves made the entire banking system unstable and contributed to the financial panics experienced in the late 1800s and early 1900s. The Federal Reserve System was created to provide a more stable reserve deposit system, a system under which member banks held their reserve deposits only at the Federal Reserve District Banks.

As more and more banks leave the System pyramiding increases. The distance between the Fed and many banks lengthens. Potential instability

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unnecessarily slips back into the banking system. Hopefully, old lessons will not have to be relearned the hard way--through experience.

The Search for a Solution

Somehow the burdens of membership have to be reduced. The costs of an effective central bank must be borne more equally. The list of possible solutions reads like a familiar litany to bankers--uniform reserve requirements, lower reserve requirements, counting interest-bearing assets, paying interest on reserves, and so on. All have their advantages and disadvantages. But the one that looks more and more attractive is paying interest on required reserves on deposit at the Fed. It can stop the membership drain and enhance the effectiveness of monetary management. It can achieve equity within the context of the dual banking system. It opens the door for a straightforward solution to the problems of access and pricing of Fed services.

A feasible package of paying interest on reserves might include several elements. The first is that interest payments could be phased in over several years. This would permit interest payments to come from increases in Fed earnings. The Treasury would not have to take a reduction in payments from the Fed. In addition, banks would pay taxes on interest payments. The Treasury over the long haul could actually end up with more revenue from the Fed.

A second element might be to link the payment of interest on reserves to strengthening bank capital positions. The mechanics would have to be worked out, but the idea is that interest payments would go into retained earnings rather than dividends. Banks would then be better positioned to expand their lending and facilitate the business expansion.

A third element could include special consideration for smaller banks. All required reserve balances would be eligible for a flat rate of return.

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Reserve balances under some amount would be eligible for an extra return. This would help smaller banks justify maintaining membership.

A fourth element is more controversial. Some bankers believe that paying interest on demand deposits is inevitable. If that is so, bankers could make an equity argument. Fed payments on reserves could be thought of as an offset to payment of interest on demand deposits. It has some appeal. Consumers receive additional interest income and bankers are compensated by receiving interest on their deposits as well.

Conclusion

The loss of members from the Federal Reserve System is a national problem with potentially serious consequences. The time for solution is now. Paying interest on required reserves held by members at the Fed makes a lot of sense. The benefits to the economy and financial stability are substantial and the costs are manageable.

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