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Statement of

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of the

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The Federal Reserve Board appreciates this opportunity to comment on issues related to H.R. 859 and H.R 758. The Board strongly supports the provisions in these bills that would eliminate the prohibition of interest on demand deposits, authorize the Federal Reserve to pay interest on balances held by depository institutions at Reserve Banks, and provide the Board with increased flexibility in setting reserve requirements. As we have previously testified, unnecessary restrictions on the payment of interest on demand deposits at depository institutions and on balances held at Reserve Banks distort market prices and lead to economically wasteful efforts to circumvent these restrictions. And those efforts are more readily undertaken by larger banks, especially for their larger business customers. Moreover, these bills would enhance the toolkit available for the continued efficient conduct of monetary policy. In addition, the provision of increased flexibility in setting reserve requirements would allow the Federal Reserve to reduce a regulatory burden on depository institutions to the extent that is consistent with the effective implementation of monetary policy.

As background for considering paying interest on balances held at Reserve Banks, let me begin by discussing the role of such balances in the implementation of monetary policy. The Federal Open Market Committee (FOMC) formulates monetary policy by setting a target for the overnight federal funds rate--the interest rate on loans between depository institutions of balances held in their accounts at Reserve Banks. While the federal funds rate is a market interest rate, the Federal Reserve can strongly influence its level by adjusting the aggregate supply of deposit balances held at Reserve Banks through open market operations--the purchase or sale of securities that causes increases or decreases in such balances. However, in deciding on the appropriate level of balances to supply in order to achieve the targeted funds rate, the Open Market Desk must estimate the aggregate demand for such balances.

Depository institutions hold three types of balances at the Federal Reserve--required reserve balances, contractual clearing balances, and excess reserve balances. Required reserve balances are the balances that a depository institution must hold to meet reserve requirements. At present, the Federal Reserve requires depository institutions to maintain reserves equal to 10 percent of their transaction deposits above certain minimum levels. Reserve requirements may be satisfied either with vault cash or with required reserve balances, neither of which earn interest.

Depository institutions may also commit themselves in advance to holding additional balances called contractual clearing balances. They are called clearing balances because institutions tend to hold them when they need a higher level of balances than their required reserve balances in order to pay checks or make wire transfers without running into overdrafts. Currently, clearing balances do not earn explicit interest, but they do earn implicit interest for depository institutions in the form of credits that may be used to pay for Federal Reserve services, such as check clearing. Finally, excess reserve balances, which earn no interest, are funds held by depository institutions in their accounts at Reserve Banks in excess of their required reserve and contractual clearing balances.

To conduct policy effectively, it is important that the combined demand for these balances be predictable, so that the Open Market Desk knows the volume of reserves to supply to achieve the FOMC's target funds rate. It is also helpful if, when the level of balances unexpectedly deviates from the Desk's intention, banks themselves engage in arbitrage activities that help to keep the rate near its target. Depository institutions must maintain their specified levels of both required reserve and contractual clearing balances, not day-by-day, but on an average basis over a two-week maintenance period. The required amounts of both types of balances are known prior to the beginning of the maintenance period, so the Open Market Desk knows the balances it needs to supply on average over the period to satisfy these needs. Moreover, the two-week averaging creates incentives for depository institutions to arbitrage the funds rate from one day to the next in a manner that helps keep that rate close to the FOMC's target. For instance, if the funds rate were higher than usual on a particular day, some depository institutions could choose to hold lower balances on that day, and their reduced demand would help to damp the upward pressure on the funds rate. Later in the two-week period, when the funds rate might be lower, those institutions could choose to hold extra balances to make up the shortfall in their average holdings of reserve balances.

The averaging feature is only effective in stabilizing markets, however, if the sum of required reserve and contractual clearing balances is sufficiently high that banks hold balances, on the margin, as a means of hitting their two-week average requirements. If their sum dropped to a very low level, depository institutions would be at increased risk of overdrafting their accounts at Reserve Banks because of unpredictable payments out of their accounts late in the day. Depositories would then need to hold higher levels of excess reserves as a precaution against such overdrafts, and demand for these excesses would vary from day to day and be difficult to predict. For example, on days when payment flows are particularly heavy and uncertain, or when the distribution of reserves around the banking system is substantially different from normal, depositories need a higher than usual level of these excess balances as a precaution against the risk of overdrafts. The uncertainties about the level of balances that depositories wish to hold on a given day would make it harder for the Federal Reserve to determine the appropriate daily quantity of balances to supply to the market to keep the federal funds rate near the target level set by the FOMC. Moreover, if the demand for balances were determined largely by daily precautionary demands for excess reserves, there would be less scope for arbitrage of the funds rate by depositories across the days of a maintenance period. As a result, the funds rate could become more volatile and could diverge markedly at times from its targeted level.

Moderate levels of volatility are not a concern for monetary policy, in part because the Federal Reserve now announces the target federal funds rate, eliminating the possibility that fluctuations in the actual funds rate in the market would give misleading signals about monetary policy. A significant increase in volatility in the federal funds rate, however, would be of concern to the extent that it affects other overnight interest rates, raising funding risks for most large banks, securities dealers, and other money market participants. Suppliers of funds to the overnight markets, including many small banks and thrifts, would face greater uncertainty about the returns they would earn and market participants would incur additional costs in managing their funding to limit their exposure to the heightened risks.

As we have previously testified, the issue of potential volatility in the funds rate has arisen in recent years because of substantial declines in required reserve balances owing to the reserve-avoidance activities of depository institutions. Depositories have always attempted to reduce required reserve balances to a minimum, in large part because those balances earn no interest. Since the mid-1970s, some commercial banks have done so by sweeping the reservable transaction deposits of larger businesses into instruments that are not subject to reserve requirements. These wholesale business "sweeps" not only have avoided reserve requirements, but also have allowed some businesses to earn interest on instruments that are effectively equivalent to demand deposits. In recent years, developments in information systems have allowed depository institutions to sweep transaction deposits of retail customers into nonreservable accounts. These retail sweep programs use computerized systems to transfer consumer and some small business transaction deposits, which are subject to reserve requirements, into savings accounts, which are not. Largely because of such programs, required reserve balances have dropped from about $28 billion in late 1993 to around $7 billion or $8 billion today.

Despite the reductions in required reserve balances, the federal funds rate has not become more volatile to date. To an extent, this stability reflects the increasingly important role of contractual clearing balances, which have risen over the last decade in part as banks have sought to reduce risks of overdrafts after they implement retail sweep programs. As I noted previously, clearing balances earn implicit interest; reserve balances do not. Moreover, the declines in short-term interest rates since early 2001 have reduced the opportunity costs of holding transaction deposits and reserves, thereby slowing the further spread of sweep programs. Lower interest rates have also boosted the amount of contractual clearing balances needed to be held to pay for any given level of Federal Reserve services. In addition, improvements in information technology have evidently allowed depository institutions to become much more adept at managing their reserve positions, and as a result, their needs for day-to-day precautionary balances have fallen considerably. A number of measures taken by the Federal Reserve also have helped to foster stability in the funds market. These include improvements in the timeliness of account information provided to depository institutions; more frequent open market operations geared increasingly to daily payment needs rather than two-week-average requirements; a shift to lagged reserve requirements, which gives depositories and the Federal Reserve advance information on the demand for reserves; and improved procedures for estimating reserve demand.

However, if interest rates were to return to higher levels, sweep activity could intensify again and potentially become a concern. To prevent the sum of required reserve and contractual clearing balances from dropping even lower and to diminish the incentives for depositories to engage in wasteful reserve-avoidance activities, the Federal Reserve has long sought authorization to pay interest on required reserve balances and to pay explicit interest on contractual clearing balances. H.R. 758 would provide such authorization. With interest paid on required reserve balances, some sweep programs would likely be unwound, and new programs would be less likely to be implemented, thereby helping to boost the level of such balances. Eliminating such wasteful reserve-avoidance activities would also tend to improve the efficiency of the financial sector.

Payment of explicit interest on contractual clearing balances could result in an increase in the level of these balances; some depositories are currently constrained in the amount of such balances that can earn usable credits because of their limited use of Federal Reserve services. Moreover, payment of explicit interest would help to maintain the level of clearing balances at a time of rising interest rates. At present, some depositories pay for all their Federal Reserve services with credits earned on clearing balances; these institutions would not be able to use their additional credits if interest rates were to rise. If enough institutions were in this position, contractual clearing balances might drop below levels needed to be helpful for the implementation of monetary policy. With explicit interest, the level of balances on which interest could be effectively earned would not be limited to the level of charges incurred for the use of Federal Reserve services. Therefore, these depositories would not be impelled to reduce their balances when interest rates rise.

The authorization to pay interest on excess reserve balances, contained in H.R. 758, would be a potentially useful addition to the monetary toolkit of the Federal Reserve, although such interest payments are not needed for monetary policy purposes at the current time. An interest rate on excess reserves would tend to act as a floor on overnight interbank lending rates; a depository would not likely lend balances to another depository at a lower interest rate than it could earn by keeping the excess funds in its account at the Federal Reserve. Some other central banks pay interest on non-reserve deposits to provide such a floor for interest rates and also use a penalty interest rate on their lending to provide a ceiling for overnight rates. In January of this year, the Federal Reserve instituted a lending facility that should similarly help to mitigate upward spikes in overnight interest rates. It is unclear how well a ceiling and floor arrangement, as used by other central banks, would work in the United States, but the ability to pay interest on excess reserves might prove useful in the future as policy implementation evolves.

At present, the Federal Reserve is constrained in its flexibility to adjust reserve requirements. By law, the ratio of required reserves on transaction deposits above a certain level must be set between 8 and 14 percent. The authorization of increased flexibility in setting reserve requirements, included in H.R. 758, would allow the Federal Reserve to consider the possibility of reducing reserve requirements below the minimum levels currently allowed by law, and even, conceivably, to zero at some point in the future, provided we are also granted the authority to pay interest on contractual clearing balances to ensure a stable and predictable demand for the remaining deposit balances at the Federal Reserve, an essential pillar for the effective implementation of monetary policy. If explicit interest could be paid on contractual clearing balances, the level of such balances could potentially be high and stable enough for monetary policy to be implemented with existing procedures for open market operations, even with lower or zero required reserve balances. If the Federal Reserve were granted the additional authorities included in H.R. 758, we would carefully study the new range of possible strategies for implementing monetary policy in the most efficient possible way for banks, the markets, and the Federal Reserve.

H.R. 758 also includes a technical provision related to pass-through reserves. This provision would extend to banks that are members of the Federal Reserve System a privilege that was granted to nonmember institutions at the time of the Depository Institutions Deregulation and Monetary Control Act of 1980. It would allow member banks to count as reserves their deposits in affiliated or correspondent banks that are in turn "passed through" by those banks to Federal Reserve Banks as required reserve balances. The provision would remove a constraint on some banks' reserve management and would cause no difficulties for the Federal Reserve in implementing monetary policy. The Board supports it.

The efficiency of our financial sector also would be improved by eliminating the prohibition of interest on demand deposits, as provided for in H.R. 859. This prohibition was enacted during the Great Depression, a time when Congress was concerned that large money center banks might have earlier bid deposits away from country banks to make loans to stock market speculators, depriving rural areas of financing. It is doubtful that the rationale for this prohibition was ever valid, and it is certainly no longer applicable today. Funds flow freely around the country, and among banks of all sizes, to find the most profitable lending opportunities, using a wide variety of market mechanisms, including the federal funds market. Moreover, Congress authorized interest payments on household checking accounts with the approval of nationwide NOW accounts in the early 1980s. The absence of interest on demand deposits, which are held predominantly by businesses, is no bar to the movement of funds from depositories with surplus funds--whatever their size or location--to the markets where the funding can be profitably employed. In addition, small firms in rural areas are able to bypass their local banks and invest in money market mutual funds with transaction capabilities. Indeed, smaller banks have complained that they are unable to compete for the deposits of businesses precisely because of their inability to offer interest on demand deposits.

The prohibition of interest on demand deposits distorts the pricing of transaction deposits and associated bank services. In order to compete for the liquid assets of businesses, banks set up complicated procedures to pay implicit interest on compensating balance accounts. Banks also spend resources--and charge fees--for sweeping the excess demand deposits of businesses into money market investments on a nightly basis. To be sure, the progress of computer technology has reduced the cost of such systems over time. However, the expenses are not trivial, particularly when substantial efforts are needed to upgrade such automation systems or to integrate the diverse systems of merging banks. Such expenses waste resources and would be unnecessary if interest were allowed to be paid on both demand deposits and the reserve balances that must be held against them.

The prohibition of interest on demand deposits also distorts the pricing of other bank products. Many demand deposits are not compensating balances, and because banks cannot pay explicit interest, they often try to attract these deposits through the provision of services below their actual cost. When services are offered below cost, they tend to be overused to the extent that the benefits of consuming them are less than the costs to society of producing them.

H.R. 859 would delay the effectiveness of the authorization of interest on demand deposits for one year. The Federal Reserve Board believes that a short implementation delay of one year, or even less, would be in the best interest of the public and the efficiency of our financial sector. A provision of H.R. 758 would in effect allow implicit interest to be paid on demand deposits without any delay through a new type of sweep arrangement, but this provision would not promote efficiency. It would allow banks to offer a reservable money market deposit account (MMDA) on which twenty-four transfers a month could be undertaken to other accounts of the same depositor. Banks would be able to sweep balances from demand deposits into these MMDAs each night, pay interest on them, and then sweep them back into demand deposits the next day. This type of account would likely permit banks to pay interest on demand deposits more selectively than with direct interest payments. The twenty-four-transfer MMDA, which would be useful only during the transition period before direct interest payments were allowed, could be implemented at lower cost by banks already having sweep programs. However, other banks would face a competitive disadvantage and pressures to incur the cost of setting up this new program for the one-year interim period. Moreover, some businesses would not benefit from this MMDA. Hence, the Board does not advocate this twenty-four-transfer account.

Small businesses that currently earn no interest on their checking accounts would see important benefits from interest on demand deposits. Larger firms, too, would benefit as direct interest payments replaced more costly sweep and compensating balance arrangements. For banks, interest on demand deposits would increase costs, at least in the short run. However, interest on required reserve balances and possibly a lower burden associated with reduced reserve requirements would help to offset the rise in costs for some banks. And to the extent that banks were underpricing some services to attract these "free" deposits, those prices would adjust to reflect costs. Over time, these measures should help the banking sector attract liquid funds in competition with nonbank institutions and direct market investments by businesses. Small banks in particular should be able to bid for business demand deposits on a more level playing field *vis-à-vis* both nonbank competition and large banks using sweep programs for such deposits. Moreover, large and small banks will benefit from the elimination of unnecessary costs associated with sweep programs and other reserve-avoidance procedures.

The payment of interest on demand deposits would have no direct effect on federal revenues, as interest payments would be deductible for banks but taxable for the firms that received them. However, the payment of interest on required reserve balances would reduce the revenues received by the Treasury from the Federal Reserve. The extent of the revenue loss, however, has fallen over the last decade as banks have increasingly implemented reserve-avoidance techniques. Paying interest on contractual clearing balances would primarily involve a switch to explicit interest from the implicit interest currently paid in the form of credits, and therefore would have essentially no net cost to the Treasury. The payment of interest on excess reserves could also be authorized without immediate effect on the budget because the Federal Reserve does not expect to use that authority in the years immediately ahead.

H.R. 758 includes a provision to transfer some of the capital surplus of the Federal Reserve Banks to the Treasury in order to cover the budgetary costs of paying interest on required reserve balances. The Board has consistently pointed out that such transfers are not true offsets to higher budgetary costs. Let me take a moment to explain why.

The Federal Reserve System derives the bulk of its revenues from interest earnings on Treasury securities that it has obtained through open market operations. The System returns a very high proportion of its earnings every year to the Treasury. In 2002, it turned over $24.5 billion, or about 94 percent of its earnings. In most years, the System retains a small percentage of those earnings in its surplus account. The surplus account is a capital account on the Federal Reserve Banks' balance sheets. Since 1964, the Federal Reserve has followed the general practice of allowing the surplus to match the paid-in capital of member banks. Each member bank is required by law to subscribe to the capital stock of its Reserve Bank in an amount equal to 6 percent of its own capital and surplus. The Board requires that half of that subscribed capital be paid in. The Federal Reserve's surplus account is currently about $8-1/2 billion, while its total capital amounts to about $17-1/2 billion. Total assets of the Federal Reserve are around $720 billion.

Traditionally, the Federal Reserve and virtually all other central banks have maintained an appreciable level of capital. Maintaining a surplus account may help support the perception of the central bank as a stable and independent institution by ensuring that its assets remain comfortably in excess of its liabilities. However, the need for capital is limited by the modest variability of the Federal Reserve's profits, the safety of its primary asset, Treasury securities, and the substantial regular flow of earnings from its portfolio of securities. Moreover, a central bank can avoid defaulting on financial obligations by issuing additional currency to discharge them. As a consequence, it is difficult to defend a particular level of surplus as clearly necessary and appropriate.

Whatever the benefits of the surplus account, it should be emphasized that its maintenance is costless to the Treasury and to taxpayers. Indeed, a transfer of Federal Reserve surplus to the Treasury would provide no true budgetary savings or offset to expenses. The transfer would allow the Treasury to issue fewer securities, but the Federal Reserve would need to lower its holdings of Treasury securities by the same amount to make the transfer. Thus, the level of Treasury debt held by the private sector would be unchanged, and the Treasury's interest payments, net of receipts from the Federal Reserve, would also be unaffected. Over the years, Congress generally has concurred with this view, with a few exceptions. Indeed, congressional budget resolutions passed in 1996, 1997, 2000, and 2001, as well as a report last year by the General Accounting Office, noted that transfers of surplus have no real budgetary or economic effects.

In summary, the Federal Reserve Board strongly supports the proposals in H.R. 859 and H.R. 758 that would authorize the payment of interest on demand deposits and on balances held by depository institutions at Reserve Banks, as well as increased flexibility in the setting of reserve requirements. We believe these steps would improve the efficiency of our financial sector, make a wider variety of interest-bearing accounts available to more bank customers, and better ensure the efficient conduct of monetary policy in the future.