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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions

of the

Committee on Banking and Currency

United States Senate

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I appreciate your invitation to present the views of the Board of Governors of the Federal Reserve System on S. 2577. Of most immediate concern are the provisions of Section 1 of the bill, which extend for an additional year the flexible authority originally granted by the Congress to the Federal agencies in 1966 to regulate rates of interest paid on time and savings accounts of Federally-insured commercial banks, mutual savings banks, and savings and loan associations. Unless renewed by Congress once again, as it has been in the previous two years, this authority will soon expire.

The experience of the past three years has indicated that the authority first granted in 1966 to distinguish between large money market certificates of deposit and other time and savings deposits in establishing ceiling rates, and to bring the nonbank savings institutions under the same type of rate regulations as commercial banks, has been a useful addition to our instruments of financial regulation.

As the Committee will recall, expiration of the existing statutory provisions would reinstate the former law, under which ceiling rates of interest on time and savings deposits were mandatory for insured banks. Under the present authority, ceiling rates may be suspended by the regulatory authorities if economic and financial conditions warrant such action.

It would be desirable to grant this authority to the Federal agencies on a permanent basis, rather than just extending it for another year. This recommendation does not arise from a

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belief that we should continue indefinitely regulating the rates that financial institutions may pay on time and savings deposits. On the contrary, our long-run objectives should be to suspend these ceilings when that can safely be done, in order to increase the prospects for achieving a more efficient use of our financial resources, and to provide greater rewards to savers for their contribution to financing investment. To the maximum extent possible, the distribution of savings flows among competing financial institutions, and between financial institutions and the securities market, should be determined by market forces, rather than by administrative regulation.

Permanent extension of the authority we now have for regulating these ceiling rates would permit the Federal regulatory agencies to make longer-range plans for moving toward the ultimate objective of freer competition for savings. Accordingly, the Board recommends that you make this authority permanent, rather than extending it for only one year.

Section 2 of the bill would extend interest rate controls to savings institutions whose deposits are not insured by a Federal agency. Although we believe such an extension is within Congressional powers, this would represent a departure from the traditional pattern of Federal regulation of deposit-type institutions. Our ability to use monetary policy as an economic stabilizing device has not been seriously weakened in recent years by the ability of the

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noninsured thrift institutions to pay higher rates than the insured banks and savings and loan associations. But it does seem inequitable to permit some institutions--solely because they are not Federally insured--to have a competitive advantage in the markets for savings funds. Moreover, sizable rate differentials, should they occur, could give rise to disruptive effects in the distribution of fund flows among types of institutions and regions of the country. Consequently, the extension of interest rate controls along the lines of Section 2 of the bill would seem to be justified.

Sections 3 and 4 would make two principal changes in the provisions of the Federal Home Loan Bank Act that govern financial relationships between the Treasury and the Federal Home Loan Bank Board. The first of these expresses the intent of Congress as to the circumstances in which the existing authority for Treasury lending to the Federal Home Loan Bank Board should be exercised. The language suggests that direct Treasury support to the Federal Home Loan Bank System, and through it to the markets for home financing, would occur only infrequently and under relatively unusual circumstances, ". . . when alternative means cannot effectively be employed. . . ." "Alternative means" would seem to include the process by which the Federal Home Loan Bank Board normally raises funds in the open market. The limited line of credit with the Treasury thus would be used to backstop, rather than to replace, the market as a primary source of funds.

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This provision of the bill is a substitute for an alternative proposal considered last year that was also intended to supplement the flow of funds to housing in periods of tight money. The Board was strongly opposed to that earlier proposal, because the means to be used would have entailed direct borrowing by Federal housing agencies from the Federal Reserve. By attempting to use the credit-creating powers of the central bank to ensure a sustained flow of funds into mortgages, the earlier proposals ran the serious risk of committing the Federal Reserve System to undertake support programs to subsidize various sectors of the economy as they may from time to time be pinched by monetary restraint. Such programs, if they are to be more than token gestures, would make it difficult if not impossible to carry out our primary role in economic stabilization. These objections, however, do not apply to borrowings from the Treasury.

The second principal change relating to Federal Home Loan Bank borrowings is contained in Section 4 of the bill, the effect of which is to revoke the Treasury's veto power over open market borrowings by the Federal Home Loan Banks. It would be hard to justify this change on the grounds that it would place the Federal Home Loan Bank System on an equivalent status with other Federal lending agencies. The lending agencies whose open market borrowings are not subject to formal Treasury approval are all farm credit

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agencies. The Treasury now maintains a close liaison with farm credit agencies in the scheduling of new security offerings even without a veto. However, the demands of the farm credit agencies on securities markets--unlike those of the housing agencies--are not characterized by massive swings from net repayment to net borrowings as the economy moves from periods of monetary ease to periods of monetary restraint. It seems to the Board that the debt management problems of the Treasury could be magnified, and the smooth functioning of money and capital markets disturbed, if the Federal Home Loan Banks, as well as the Federal National Mortgage Association, were not required to seek approval from the Treasury before issuing securities in the market. Accordingly, the Board does not recommend enactment of this provision.

Sections 5 and 6 of the bill deal with regulatory authority to control the ability of member banks to attract lendable funds by issuing securities through affiliates or other means, or by borrowing from foreign branches. There is a common thread to these two sections. Both measures are concerned with the policy implications of nondeposit sources of funds to the banking system. It might be worthwhile, therefore, to consider rather generally what has been happening in this area this year, and the significance of these developments for monetary policy, before turning to the specific provisions of these two sections.

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As you know, it became necessary to initiate a program of firmer monetary restraint late in 1968 to combat the inflationary forces that have been so pervasive in our economy during the past several years. By its very nature, a program of increased monetary restriction operates through the banking system--slowing down the growth rate of bank deposits, and thereby making less funds available for private spending. One of the important features of monetary restraint this year has been the effect on the liquidity positions of larger banks resulting from the ceilings on interest rates payable on large-denomination CD's. These ceilings have remained unchanged since April 1968, even though yields on Treasury bills and other short-term securities that compete with CD's in the money market have risen to levels far above those of a year ago. The larger banks, consequently, have experienced very large declines in their outstanding CD's.

Over the first eight months of the year, outstanding large-denomination CD's at large city banks declined by about $10 billion. This sharp descent put the banks under great pressure to find methods by which they could meet customer loan demands--including binding commitments previously made to businesses and other loan customers. Sales of liquid assets by banks were extremely large in the early months of this year, and as liquidity positions were depleted, the banks looked increasingly toward expansion in nondepositary liabilities

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to obtain loanable funds. The principal source of nondepositary funds this year has been the market for Eurodollars. The larger city banks garnered roughly $8 billion from this market between mid-December 1968 and the end of August 1969.

In the spring months, when the costs of Eurodollars had soared to unprecedented levels and questions began to rise as to whether the supply could continue to grow, the banks began to explore other new avenues for obtaining funds. The two important sources have been issues of commercial paper through affiliated bank holding companies, and sales of existing assets under repurchase agreements. We first began gathering data on these and other nondepositary sources of funds in May of this year. It was learned that outstanding nondepositary sources of funds (other than Eurodollars) late in May totaled about $2-1/2 billion. By the end of August, this figure had increased to about $4-1/2 billion.

We have been watching these developments closely, to determine whether they were undercutting our program of monetary restraint or having other undesirable effects on the structure of credit availability to businesses and other borrowers and therefore on the pattern and structure of output, or leading to inequities within the banking system, or permitting the banks to escape the effects of reserve requirement regulations or ceiling rates of interest on deposits, or leading to practices inconsistent with the principles of sound banking. At the same time, we wanted to avoid unnecessary interference

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with the workings of financial markets, and we recognized that banks that were experiencing runoffs of CD's needed a safety valve--such as the Eurodollar market--to help them adjust their positions, in order to avoid excessive strains in money markets. All of these facets of the problem have had to be considered very carefully.

In some cases, it seemed to the Board that the banking practices developing were quite clearly in conflict with statutes and regulations prohibiting interest payments on demand deposits and establishing ceiling rates on time deposits. Board actions were taken, therefore, to close loopholes in existing laws and to clarify and strengthen applicable regulations.

The most difficult issue to resolve, however, has been the extent to which nondepositary sources of funds have been an escape hatch enabling the banks to frustrate the objectives of monetary policy, as opposed to a safety valve to ease adjustments in financial markets as policies of monetary restraint were taking hold. On this general question, there are differing shades of opinion among Board members, and the problem itself has changed in character as the scope and magnitude of these new sources of funds has grown. The consensus of the Board is that the devices used by banks to obtain nondepositary funds, while they have not made it impossible to achieve the overall objectives of monetary policy, may have delayed the impact of monetary restraint on spending. Furthermore, they have also had

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undesirable effects on the distribution of monetary restraint among the various sectors of the economy.

The conclusion that these new devices have not completely undermined monetary policy is suggested by the data in the attached table. We have succeeded in slowing down the growth rates of all the major money and banking quantities this year, even though these loopholes have existed. The growth rate of the money supply has slowed, as has the growth of money and commercial bank time deposits taken together. Bank credit growth has also moderated despite the huge inflow of Eurodollars borrowed by banks from their foreign branches. Even if rough allowance is made for loans that have been sold and are no longer recorded in the balance sheet of the banking system, the total quantity of funds the banks have been able to supply to credit markets has still grown much more slowly this year than in 1968.

In considering the implications for monetary policy of these nondepositary sources of funds, it is important to note that acquisition of these funds by banks does not alter total bank reserves. This is perhaps most evident in the case of issues by banks of commercial paper through holding companies. The issuing bank obtains funds by the sale of such paper, but some other bank loses funds as the buyer of the commercial paper draws on his deposit balance. Reserves are transferred from one bank to another in the system, but the total is not increased. A similar transfer of reserves occurs when the funds attracted by Eurodollar borrowings represent deposits

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held by U.S. residents that were previously transferred out of the U.S. banking system and into the Eurodollar market in search of higher yields.

The larger part of Eurodollar borrowings originates from increased holdings of Eurodollar deposits by private foreigners, but there is no net addition to bank reserves in the U.S. in this case either. This reflects the fact that increased private foreign holdings of Eurodollar deposits occur essentially at the expense of the dollar reserves of central banks abroad; the form of U.S. liquid liabilities to foreigners is changed but the total amount of those liabilities is not altered.

While nondepositary sources of funds do not add to total bank reserves, they may still be a matter of concern for monetary policy. If there are no reserve requirements against nondepositary sources of funds, attracting these funds permits the banking system to increase the amount of total loans and investments it makes per dollar of reserves. The Federal Reserve must take this fact into account in the formulation of its open market policies. If it does so, growth in reserves can be slowed sufficiently to moderate the increase in bank credit.

In deciding what growth rate of reserves is appropriate, in the light of these new sources of funds available to banks, we have had to consider not only the fact that bank customers gain more

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ready access to funds, but also the effects of the banks' actions in obtaining funds through nondepositary sources on the supply of funds available to finance spending outside the banking system. When banks issue commercial paper through holding companies, and make the proceeds available to businesses in the form of loans, they draw funds from other markets, and thereby reduce the supply of loanable funds available to other borrowers, especially borrowers in short-term credit markets. This pushes up interest rates in short-term credit markets, and indirectly in other credit markets as well. The result is that at least part of the expansive effects on private spending that are associated with increased credit availability at banks are offset by reduced credit supply elsewhere in the financial system.

These partial offsets are present even when the funds being obtained by banks come from Eurodollar borrowings that represent increased holdings of Eurodollar deposits by private foreigners. As noted earlier, an increase in the dollar assets of private foreigners is at the expense of the dollar reserves of foreign central banks, and changes in central bank dollar holdings typically show up as purchases or sales of Treasury bills in U.S. credit markets. Attraction of private foreign deposits through the Eurodollar market does not, therefore, lead to an equivalent rise in the aggregate supply of loanable funds in U.S. credit markets--that is, the total supply of funds seeking investment in Federal as well as private obligations.

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These considerations suggest that the nondepositary sources of funds used by banks this year have not rendered monetary policy ineffective in moderating the growth of private expenditures, but they may have delayed its impact somewhat, by permitting the banking system to increase its loans to businesses at too rapid a rate during the first five months of this year. The slowdown in overall bank lending and investing capacity observed this year did not affect bank lending policies as soon or as much as would have been desirable. But as the year progressed and pressures on bank liquidity intensified, an increasing number of banks began to tighten their lending policies significantly. Some evidence of this is appearing in our recent banking statistics. In the period from June through August, the growth rate of business loans at banks--even after allowance for loans sold by banks and no longer recorded on bank balance sheets--declined to about one half of the average monthly rate of increase in the first five months of this year.

In addition to delaying the impact of monetary restraint, these new devices used by banks to raise funds have been undesirable on other grounds. For one thing these sources of funds have been available mainly to the larger banks in the system, and especially to those who have branches abroad or affiliated holding companies. Consequently, the incidence of monetary restraint in the banking system has been unevenly distributed. Additionally, the amounts of funds brought in by our banks through Eurodollar borrowing has been so massive that it has

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threatened to disrupt the money and capital markets of our European trading partners and to put excessive strains on the international rsserve positions of some countries.

Furthermore, the availability of nondepositary sources of funds has altered the distribution of monetary restraint among the various sectors of the economy in undesirable ways. As I noted earlier, access to the Eurodollar markets and to the commercial paper market has enabled the larger banks in the system to continue, until quite recently, making a larger amount of credit available to businesses in the form of loans than was desirable, especially in view of the fact that increased business investment spending has been a major source of excessive aggregate demands for goods and services this year. Thus, we have not been able to obtain the degree of monetary restraint that would have been desirable over the type of spending that has been most instrumental this year in the continuation of inflationary developments. The actions taken by the Board to diminish the access of banks to nondepositary sources of funds thus seem justified by the need to obtain a more even distribution of the effects of monetary restraint in the banking system and in the various sectors of the economy, and to avoid disruptively large flows of money and capital in international markets.

With this background, let me turn now to the provisions of the bill with respect to controlling member banks' abilities to attract funds. Section 5 would add a provision to Section 19 of the

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Federal Reserve Act authorizing the Board to limit the rate of interest that may be paid on obligations issued by an affiliate of a member bank. The Board has examined the scope of its authority under present law to bring such paper within the coverage of its rules governing member bank reserves (Regulation D) and payment of interest on deposits (Regulation Q). We believe that in this area certain actions could be taken within the framework of the present provisions of Section 19 of the Federal Reserve Act. For example, the Board might define as deposits, for the purposes of Regulation Q, funds obtained by a member bank through the issuance of commercial paper by an organization that owns the stock of a member bank or by a corporation that is controlled by such an organization.

Enactment of Section 5 would, however, strengthen the Board's authority to apply Regulation Q in such a manner. Such clarification would be desirable and therefore the Board favors enactment of this provision. However, it would seem appropriate to extend the provision to grant similar authority to the Federal Deposit Insurance Corporation to control issues of commercial paper through holding companies by insured nonmember banks.

Section 6 of the bill would add a provision to Section 19 of the Federal Reserve Act that would authorize the Board to establish a 100 per cent reserve requirement against increases in member bank borrowings from foreign branches. As members of this Committee know, the Board recently acted to establish a 10 per cent marginal reserve

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requirement on these borrowings, and also imposed comparable reserve requirements on loans to U.S. residents by these branches and on borrowings by member banks from foreign banks other than branches. This action reflected our concern that excessive Eurodollar borrowings would have disruptive effects in financial markets, both domestic and foreign.

The reserve requirement on borrowings from foreign banks other than branches is based on Section 19; the requirements on borrowings from foreign branches and loans by those branches to U.S. residents were based on the Board's authority in Section 25 of the Federal Reserve Act (and Section 9 so far as State member banks are concerned) to regulate foreign branches of member banks.

Unlike Section 19, Section 25 does not limit within specified percentages the reserve requirements that the Board may establish. Consequently, the Board could under existing law establish a 100 per cent reserve requirement against member bank borrowings from their foreign branches. Enactment of Section 6 of the bill would only provide an alternative basis for such action.

The choice of a 10 per cent marginal reserve requirement imposed against borrowings from branches reflected the desire for consistent treatment as between borrowing from branches and from other foreign banks. The 10 per cent requirement was the maximum that can be lawfully imposed on time deposits under Section 19.

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Accordingly, if the Board were to be given additional authority with respect to the establishment of reserve requirements against foreign borrowings by member banks, in the Board's view the appropriate action would be to provide authority to increase reserve requirements on borrowings from foreign banks (under Section 19) to the same extent that the Board may now impose reserve requirements on borrowings from branches (under Section 25).

Sections 7 and 8 of the bill would restore to the President lapsed authority in the Defense Production Act of 1950 to encourage representatives of all the major sectors of the private economy to enter into voluntary agreements and programs furthering the objectives of the Act, and would exempt participants from prosecution under the antitrust laws because of their activities in such programs. Under the original Act, the President used his authority to instruct the Federal Reserve Board to establish industry-wide committees of the major financial institutions for the purpose of creating lending criteria that would channel credit to the most essential uses. It is quite clear, however, that the authority under the Defense Production Act of 1950 restored by these two provisions of S. 2577 is very general, and would permit the establishment of a wide variety of voluntary programs if they were deemed by the President to further the objectives of that Act. These objectives were to facilitate large transfers of resources from civilian to military uses as quickly as possible during

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a period of national crisis, and to do so in ways that would minimize the strains on wages, on prices, and on the distribution of resources for civilian use.

Restoration of such authority would seem to provide the statutory basis for voluntary controls over credit, or in other areas, only during an emergency such as existed when the Defense Production Act of 1950 was enacted, as reflected in the language of that Act. With regard to the voluntary programs authorized under Section 708 of the Defense Production Act, for example, participants would be exempted from prosecution under the antitrust laws only when the programs are ". . . found by the President to be in the public interest as contributing to the national defense. . . .".

It may be, however, that the content of these provisions is less important than their effect on people's attitudes. Whatever the programs are, and whenever they could be established, they would have to be voluntary. Analysis of their possible effect becomes more a matter of judging how people would react to their enactment and to their subsequent use than of identifying what--if any--new authority they confer on the President.

Presumably the President does not need statutory authority to urge public-spirited citizens to cooperate in programs for the common good, apart from the need for exempting participants from prosecution under the antitrust laws. And if "voluntary" programs are not always purely voluntary--if there are pressures that can

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be brought to bear to achieve compliance that might not otherwise be forthcoming--this, too, might happen with or without express statutory authority.

We are dealing, then, with intangibles. Presumably, enactment of Sections 7 and 8 would tip the scales, however slightly, toward increased use of some form of selective credit restraint program. At the same time their enactment would add, however slightly, to skepticism about the Government's capacity and determination to restore price stability without selective controls. The Board's judgment is that selective controls of this type are not needed now and that inflation will be brought under control without them. Therefore, we do not recommend enactment of these sections.

After the Board had discussed its position on S. 2577, as outlined in this statement, I was informed that S. 2499 would also be considered during these hearings. S. 2499 would authorize the Federal Reserve Board and the FDIC, after consultation, to establish by regulation the maximum rates of interest that may be charged by member banks and insured nonmember banks, respectively. While I have not had an opportunity to discuss this issue with the Board, let me offer my personal views on S. 2499 for whatever assistance they may be in your deliberations.

As I have indicated before, I believe that the way to get interest rates down is to stop the inflation that is raising them. I also believe that we can bring inflation under control without

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selective controls. A selective control of the kind established by S. 2499 would, in my judgment, have unfortunate effects--if, in fact, it succeeded in limiting interest rates charged by banks. The efforts to circumvent the regulations would be strenuous, as they have been in other areas where maximum lending rates have been imposed by Government. And to the extent that such ceilings were effective, they would be apt to have perverse effects. For years, interest rate ceilings on Government bonds have made it impossible to market them. Also, interest rate ceilings on mortgages have, at times, and in some areas, made it impossible for home buyers to find mortgage money. So it seems likely that if the Board and the FDIC were to establish ceilings much below what the market would otherwise set, the result would be not to benefit borrowers but to deny them bank credit. And if Government agencies had the authority provided in S. 2499 to fix differing rate ceilings for different kinds of loans, these agencies would have an awesome responsibility for determining which classes of borrowers should be favored, and which hindered, in seeking loans from banks.

With all its imperfections, general monetary restraint seems clearly preferable to controls of this sort. Let me say again that the policies of restraint now in place can do the job if we can convince people that we are determined to restore price stability.

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SELECTED INDICATORS OF MONETARY
AND CREDIT EXPANSION
Per Cent Increase, At Annual Rates

	1968	1969 First 8 Months
Total member bank reserves	7.9	-3.1
Money supply (currency and demand deposits)	7.[illegible]	2.9
Time and savings deposits at commercial banks	11.3	-8.1
Money supply plus time and savings deposits	9.2	-2.7
Credit proxy (total member bank deposits)	9.[illegible]	-6.3
Credit proxy, adjusted for Eurodollar borrowing	9.8	-2.6
Total bank credit, end of month	11.[illegible]	2.2

NOTE: Annual rates of increase in percentage terms shown here for 1969 are computed on the basis of changes from December 1968 to August 1969. August 1969 data are partly estimated.

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