John Mingo
2/6/80

The Secretary of the Treasury

John:

Many thanks to you and your colleagues for working up my monetary improvement testimony and briefing. Good job!

Bill

Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 566-2041

FOR RELEASE UPON DELIVERY
Expected at 10:00 a.m.
February 5, 1980

Testimony of the Honorable G. William Miller
Secretary of the Treasury
Before the
Senate Committee on Banking, Housing and Urban Affairs

Mr. Chairman and members of this distinguished Committee:

It is a pleasure to present the views of the Administration on S. 353 and amendments and on related bills, amended S. 85 and H.R. 7, to improve the conduct of monetary policy. As you know, I worked closely with the Congress on this legislation as Chairman of the Federal Reserve Board, and am prepared to render whatever assistance I can on behalf of the Administration. The importance of monetary policy in our efforts to control inflation means that the continued attrition of member banks from the Federal Reserve System is of grave concern. It is imperative that the Congress take appropriate action now to ensure the viability of our country's mechanism for conducting monetary policy.

One year ago, before the House Committee on Banking, Finance and Urban Affairs the Administration outlined its three basic objectives regarding monetary improvement legislation. They continue to be:

1) to give the Federal Reserve the best possible tools with which to administer monetary policy,

2) to provide an equitable competitive environment for depository institutions doing the same types of business, and

3) to limit the annual cost of a monetary improvement program to $200 million or less net of income taxes.

As presently written, amended S. 85 would meet all the objectives we consider essential to an effective monetary policy mechanism. H.R. 7, as passed by the House, was a step in the right direction

M-315

and is very close to meeting each of our goals. But amended S. 85 would build on the initiative of H.R. 7 both by broadening the reserve coverage and by reducing substantially the cost to the taxpayer. For reasons which I will discuss below, S. 353 has the potential of achieving our objectives only if the amending emergency provisions are operative. Then its deposit coverage and its cost would come closer to, but would still fall short of, meeting our targets.

Universal Required Reserves

The use of reserves in this country has been a tradition since active management of the money supply began. Consequently, all the proposals on this subject now before the Congress are concerned with designing a reserve structure which is effective, equitable, and affordable. Indeed the search for the "ideal" reserve system for this country has become especially important since the Federal Reserve's October 6 announcement that it would henceforth pay more attention to monetary aggregates rather than interest rates in conducting open market operations. Thus, it is even more important that there be a precise connection between the monetary aggregates and the reserve base which is altered through open market sales and purchases.

From the central bank's point of view, an effective reserve structure requires universal, uniform reserves, imposed on balances constituting the monetary aggregates, and set at sufficiently high levels to ensure adequate control. The reserve structure should be universal because, in the absence of such universality, uncontrollable shifts of funds from reservable deposits to non-reservable ones act to weaken the linkage between the reserve base and the money supply. Similarly, the reserve structures should be uniform as to each class of deposit at all depository institutions, to minimize the effects of uncontrollable shifts of funds among depository institutions, subject to differing reserve ratios.

Indeed, universality of reserves is the key to our solution to the problem of effective monetary control. If we are to use reserves in the management of monetary policy for the benefit of everyone in society, the cost of holding such reserves should be regarded as a price or franchise tax for participation in the monetary system. Like any tax, the cost of holding reserves should be set at the lowest level consistent with their intended purpose, and that cost should be distributed as equitably as possible. At the same time that such costs are distributed universally, so should the benefits of the monetary system. Thus, as I will discuss in greater detail below, universal reserve requirements ought properly to be accompanied by universal access to Federal Reserve System services and, on an equal basis, to the Federal Reserve discount window. In our opinion, only a mandatory reserve structure coupled with universal access to System services is likely to achieve these objectives. It would minimize the cost of running the monetary system by distributing the cost among the greatest number of institutions and institutional customers.

Not only should reserves be universal, but reserve ratios should be set at a sufficient level so that the "multiplier" is not too large. If the multiplier is too great, then small errors in managing the reserve base will be magnified into large changes in the monetary aggregates. Of course, universal reserve ratios must not be set at a level so high as to create artificial pressures for the growth of money substitutes entirely outside the traditional banking system, thus impairing the base upon which the Federal Reserve conducts its monetary policy. Therefore, an important objective in devising the new reserve structure is to give the Federal Reserve the confidence to raise or lower reserve requirements within specified ranges without a concern that an increase in reserve ratios will induce reliance on non-deposit substitutes and, therefore, reduce reserve coverage. The present reserve system, so much in need of reform, has the opposite effect. It encourages member banks to withdraw from the System in order to be on a competitive parity with non-members, and such departures tend to accelerate when interest rates are high or reserve ratios are raised, just when the sensitivity of monetary policy may be most important. In fact, the two largest banks ever to withdraw from the System -- both with over one billion dollars in deposits -- are doing so in the present inflationary and high interest rate environment. In our view, only a mandatory reserve system would either stem or lessen such attrition.

The reserve structure should not make an institution's participation in the system dependent on criteria other than those related to the effective conduct of monetary policy. Other criteria, such as the choice of a supervisor, or the desire to do correspondent banking business by reselling System services, which are available only to members, should not affect decisions to hold reserves on which management of the money supply is contingent. Nor should the Federal Reserve be persuaded to conduct its supervisory responsibilities, price its services, or engage in businesses that compete with private vendors in order to induce institutions to join or remain within the System.

Competitive Equality

In the last few years the Congress has been extending the use of Negotiable Order of Withdrawal accounts to increased numbers of insured depository institutions. Therefore, this is a proper time to consider extending reserve coverage to all depository institutions doing the same types of business -- that is, to all institutions providing transactions accounts. This would also insure that reserve coverage is uniform on these new and fast growing accounts except for some forebearance for smaller institutions. Each of the proposals before us attempts to provide some measure of competitive equality in its coverage. One amendment of S. 353 would include NOW accounts, but only the proposed amendment providing for emergency supplemental reserves is likely to cover NOW accounts at any significant number of thrift instutitions. That is, it is unlikely that thrift institutions would voluntarily hold reserves, especially those that are members of the Federal Home Loan Bank Board System. Under amended

S. 85 all depository institutions would hold reserves against transactions accounts. In contrast, virtually all thrift institutions would be exempted initially from reserve requirements in H.R. 7 (because their transactions balances will be low for years to come) and most of the thrifts would remain exempted for some time due to the bill's provision for indexing the exemption level.

We recognize that smaller depository institutions may not be able to bear the full burden of required reserves as easily as can larger institutions. Moreover, monetary control probably would not be seriously impaired by exempting smaller institutions or by reducing their reserve burden. This is because the total reserves of smaller institutions, in excess of vault cash, would constitute only a minor proportion of the total manageable reserves on deposit with the Federal Reserve. Several approaches have been advanced to lessen the reserve burden on smaller institutions, such as an exemption from reserves, a lower reserve level or an interest participation program. We are not committed to any one approach, but we would support a "two-tier" system for smaller institutions, as long as such a system does not seriously increase the overall cost of an improved reserve structure.

Revenue Loss Projections

As I have indicated, the preferable approach to monetary control is to set reserves universally and uniformly across all institutions, which would in turn allow some reduction in reserve ratios. While universality of reserves on transactions accounts is a provision in only one of the bills under consideration, each of them would reduce reserve ratios in such a way as to reduce aggregate reserves held by all participating institutions. Under each of the bills, the Federal Reserve would have fewer reserves and therefore receive less interest income from the government securities in which it invests reserves -- and the Federal Reserve, in turn, would transfer less net income to the Treasury each year. In effect, under each of the bills, there is a specific cost to the taxpayer for the much needed improvement in monetary control.

The Administration has for some time indicated that a cost of $200 million, when the program is fully effective, is an "acceptable" price to pay for being able to deal with the monetary control problem. Mr. Chairman, I must tell you that, having testified on the 1981 budget only last week, the limit of $200 million is necessary to maintain fiscal responsibility. The $200 million figure would be the net cost after taking into account any income received by the Federal Reserve from the pricing of its services or from the pricing of float. In addition, the figure would be net of any recaptured income taxes from current member banks. That is, it anticipates that members will be paying additional taxes on increased income from funds no longer held as reserves, since the proposed new reserve systems provide for generally lower reserve ratios.

Our joint estimates with the Federal Reserve Board indicate that amended S. 85, including the proposed amendments, would meet the objective of universality and involve the lowest cost to the Treasury. When fully effective, it would cost approximately $74 million annually in foregone revenues. By comparison, we estimate that H.R. 7 would cost about $357 million annually if the mandatory provisions were effective and about the same under the voluntary provisions. The amended S. 353, which would include the income from the pricing of Federal Reserve services and float, would cost $579 million.

The estimates given above are, of course, somewhat imprecise. For comparison purposes, however, we believe the numbers are adequate. They are based on 1977 data on deposits and reserves, and they assume that there is no transition period (i.e. the new reserve structure becomes effective immediately). In actuality, each of the bills before us has a transition period -- a phase-in period -- of four to ten years, during which the reserve ratios of existing Federal Reserve members are to be reduced and reserves of non-members are to be gradually increased. We cannot know with any certainty what would be the growth of deposits subject to reserve requirements and revenues from pricing of Federal Reserve services during such a phase-in period. Thus, we cannot know the true costs of each of the proposals during a phase-in period. However, the Federal Reserve has agreed that any revenue loss during the phase-in will be completely offset by transfer to the Treasury of funds from the System's surplus account. I should note that, with respect to phase-in costs, H.R. 7 would lower reserves for most present member banks sooner than it would require the accumulation of new balances from institutions entering the new reserve system. The transition approach of the other bills is less costly because the reduction in reserves of existing members would be timed to coincide more closely with the contribution of balances from new participants in the system.

S. 353: The Voluntary Reserve Approach

S. 353 would rely on the payment of interest on reserves to induce depository institutions to keep balances with the Federal Reserve System. The interest payments would be set 1/2 percent below the yield on the System's U.S. Government securities portfolio. The problem with this approach is that, depending on a banker's preference toward risk, the banker might still opt to withdraw from the Federal Reserve System in order to gain a higher yield on his reserves elsewhere. In 1979 the average yield on the Federal Reserve's portfolio was 8.6 percent; hence the interest payments to reserve holders would have equalled an annual rate of 8.1 percent if this legislation had been in force last year. This compares with an average prime rate for commercial bank loans during 1979 of about 12-1/2 percent. Given this disparity in yields it is unclear how many depository institutions would keep interest-bearing reserves in the System in lieu of using the funds to make loans or purchase other earning assets. Moreover, with the proposed amendment mandating the pricing of Federal Reserve services added to S. 353, the benefits to banks of receiving interest on reserves would be substantially reduced.

Access to and Pricing of Services

Both amended S. 85 and H.R. 7 would require the Federal Reserve to price its services and make them available to all depository institutions. No longer would access to the Federal Reserve System's services be used as an inducement to membership and thus to hold reserves -- and the universal availability of Federal Reserve services should benefit the banking system as a whole. Moreover, requiring that the Federal Reserve price services on a basis involving full allocation of cost, with appropriate allowances for costs unique to private organizations, such as capital and taxes, should allow other vendors to compete with the Federal Reserve more effectively. Traditional market mechanisms will then become more important in establishing the prices of services and the relative roles of the competing vendors. Thus, we are in full agreement with those proposals which would lead to full access to and pricing of System services.

Conclusion

In conclusion, Mr. Chairman, we believe that the reserve structure ultimately chosen by the Congress needs to have a fairly universal, uniform coverage of deposits and depository institutions. Such coverage should be sufficient to ensure that the Federal Reserve has adequate tools with which to conduct monetary policy, and should be structured to hold the cost to the taxpayer to an acceptable level. At the same time, the legislation should provide for a more universal access to the Federal Reserve's services, and at a realistic price.

This concludes my formal testimony, Mr. Chairman. I would be pleased to answer any questions the Committee may have.

o O o

Department of the TREASURY
NEWS
WASHINGTON, D.C. 20220 TELEPHONE 566-2041

FOR RELEASE UPON DELIVERY
Expected at 10:00 a.m.
February 5, 1980

Testimony of the Honorable G. William Miller
Secretary of the Treasury
Before the
Senate Committee on Banking, Housing and Urban Affairs

Mr. Chairman and members of this distinguished Committee:

It is a pleasure to present the views of the Administration on S. 353 and amendments and on related bills, amended S. 85 and H.R. 7, to improve the conduct of monetary policy. As you know, I worked closely with the Congress on this legislation as Chairman of the Federal Reserve Board, and am prepared to render whatever assistance I can on behalf of the Administration. The importance of monetary policy in our efforts to control inflation means that the continued attrition of member banks from the Federal Reserve System is of grave concern. It is imperative that the Congress take appropriate action now to ensure the viability of our country's mechanism for conducting monetary policy.

One year ago, before the House Committee on Banking, Finance and Urban Affairs the Administration outlined its three basic objectives regarding monetary improvement legislation. They continue to be:

1) to give the Federal Reserve the best possible tools with which to administer monetary policy,

2) to provide an equitable competitive environment for depository institutions doing the same types of business, and

3) to limit the annual cost of a monetary improvement program to $200 million or less net of income taxes.

As presently written, amended S. 85 would meet all the objectives we consider essential to an effective monetary policy mechanism. H.R. 7, as passed by the House, was a step in the right direction

M-315

and is very close to meeting each of our goals. But amended S. 85 would build on the initiative of H.R. 7 both by broadening the reserve coverage and by reducing substantially the cost to the taxpayer. For reasons which I will discuss below, S. 353 has the potential of achieving our objectives only if the amending emergency provisions are operative. Then its deposit coverage and its cost would come closer to, but would still fall short of, meeting our targets.

Universal Required Reserves

The use of reserves in this country has been a tradition since active management of the money supply began. Consequently, all the proposals on this subject now before the Congress are concerned with designing a reserve structure which is effective, equitable, and affordable. Indeed the search for the "ideal" reserve system for this country has become especially important since the Federal Reserve's October 6 announcement that it would henceforth pay more attention to monetary aggregates rather than interest rates in conducting open market operations. Thus, it is even more important that there be a precise connection between the monetary aggregates and the reserve base which is altered through open market sales and purchases.

From the central bank's point of view, an effective reserve structure requires universal, uniform reserves, imposed on balances constituting the monetary aggregates, and set at sufficiently high levels to ensure adequate control. The reserve structure should be universal because, in the absence of such universality, uncontrollable shifts of funds from reservable deposits to non-reservable ones act to weaken the linkage between the reserve base and the money supply. Similarly, the reserve structures should be uniform as to each class of deposit at all depository institutions, to minimize the effects of uncontrollable shifts of funds among depository institutions, subject to differing reserve ratios.

Indeed, universality of reserves is the key to our solution to the problem of effective monetary control. If we are to use reserves in the management of monetary policy for the benefit of everyone in society, the cost of holding such reserves should be regarded as a price or franchise tax for participation in the monetary system. Like any tax, the cost of holding reserves should be set at the lowest level consistent with their intended purpose, and that cost should be distributed as equitably as possible. At the same time that such costs are distributed universally, so should the benefits of the monetary system. Thus, as I will discuss in greater detail below, universal reserve requirements ought properly to be accompanied by universal access to Federal Reserve System services and, on an equal basis, to the Federal Reserve discount window. In our opinion, only a mandatory reserve structure coupled with universal access to System services is likely to achieve these objectives. It would minimize the cost of running the monetary system by distributing the cost among the greatest number of institutions and institutional customers.

Not only should reserves be universal, but reserve ratios should be set at a sufficient level so that the "multiplier" is not too large. If the multiplier is too great, then small errors in managing the reserve base will be magnified into large changes in the monetary aggregates. Of course, universal reserve ratios must not be set at a level so high as to create artificial pressures for the growth of money substitutes entirely outside the traditional banking system, thus impairing the base upon which the Federal Reserve conducts its monetary policy. Therefore, an important objective in devising the new reserve structure is to give the Federal Reserve the confidence to raise or lower reserve requirements within specified ranges without a concern that an increase in reserve ratios will induce reliance on non-deposit substitutes and, therefore, reduce reserve coverage. The present reserve system, so much in need of reform, has the opposite effect. It encourages member banks to withdraw from the System in order to be on a competitive parity with non-members, and such departures tend to accelerate when interest rates are high or reserve ratios are raised, just when the sensitivity of monetary policy may be most important. In fact, the two largest banks ever to withdraw from the System -- both with over one billion dollars in deposits -- are doing so in the present inflationary and high interest rate environment. In our view, only a mandatory reserve system would either stem or lessen such attrition.

The reserve structure should not make an institution's participation in the system dependent on criteria other than those related to the effective conduct of monetary policy. Other criteria, such as the choice of a supervisor, or the desire to do correspondent banking business by reselling System services, which are available only to members, should not affect decisions to hold reserves on which management of the money supply is contingent. Nor should the Federal Reserve be persuaded to conduct its supervisory responsibilities, price its services, or engage in businesses that compete with private vendors in order to induce institutions to join or remain within the System.

Competitive Equality

In the last few years the Congress has been extending the use of Negotiable Order of Withdrawal accounts to increased numbers of insured depository institutions. Therefore, this is a proper time to consider extending reserve coverage to all depository institutions doing the same types of business -- that is, to all institutions providing transactions accounts. This would also insure that reserve coverage is uniform on these new and fast growing accounts except for some forebearance for smaller institutions. Each of the proposals before us attempts to provide some measure of competitive equality in its coverage. One amendment of S. 353 would include NOW accounts, but only the proposed amendment providing for emergency supplemental reserves is likely to cover NOW accounts at any significant number of thrift instutitions. That is, it is unlikely that thrift institutions would voluntarily hold reserves, especially those that are members of the Federal Home Loan Bank Board System. Under amended

S. 85 all depository institutions would hold reserves against transactions accounts. In contrast, virtually all thrift institutions would be exempted initially from reserve requirements in H.R. 7 (because their transactions balances will be low for years to come) and most of the thrifts would remain exempted for some time due to the bill's provision for indexing the exemption level.

We recognize that smaller depository institutions may not be able to bear the full burden of required reserves as easily as can larger institutions. Moreover, monetary control probably would not be seriously impaired by exempting smaller institutions or by reducing their reserve burden. This is because the total reserves of smaller institutions, in excess of vault cash, would constitute only a minor proportion of the total manageable reserves on deposit with the Federal Reserve. Several approaches have been advanced to lessen the reserve burden on smaller institutions, such as an exemption from reserves, a lower reserve level or an interest participation program. We are not committed to any one approach, but we would support a "two-tier" system for smaller institutions, as long as such a system does not seriously increase the overall cost of an improved reserve structure.

Revenue Loss Projections

As I have indicated, the preferable approach to monetary control is to set reserves universally and uniformly across all institutions, which would in turn allow some reduction in reserve ratios. While universality of reserves on transactions accounts is a provision in only one of the bills under consideration, each of them would reduce reserve ratios in such a way as to reduce aggregate reserves held by all participating institutions. Under each of the bills, the Federal Reserve would have fewer reserves and therefore receive less interest income from the government securities in which it invests reserves -- and the Federal Reserve, in turn, would transfer less net income to the Treasury each year. In effect, under each of the bills, there is a specific cost to the taxpayer for the much needed improvement in monetary control.

The Administration has for some time indicated that a cost of $200 million, when the program is fully effective, is an "acceptable" price to pay for being able to deal with the monetary control problem. Mr. Chairman, I must tell you that, having testified on the 1981 budget only last week, the limit of $200 million is necessary to maintain fiscal responsibility. The $200 million figure would be the net cost after taking into account any income received by the Federal Reserve from the pricing of its services or from the pricing of float. In addition, the figure would be net of any recaptured income taxes from current member banks. That is, it anticipates that members will be paying additional taxes on increased income from funds no longer held as reserves, since the proposed new reserve systems provide for generally lower reserve ratios.

Our joint estimates with the Federal Reserve Board indicate that amended S. 85, including the proposed amendments, would meet the objective of universality and involve the lowest cost to the Treasury. When fully effective, it would cost approximately $74 million annually in foregone revenues. By comparison, we estimate that H.R. 7 would cost about $357 million annually if the mandatory provisions were effective and about the same under the voluntary provisions. The amended S. 353, which would include the income from the pricing of Federal Reserve services and float, would cost $579 million.

The estimates given above are, of course, somewhat imprecise. For comparison purposes, however, we believe the numbers are adequate. They are based on 1977 data on deposits and reserves, and they assume that there is no transition period (i.e. the new reserve structure becomes effective immediately). In actuality, each of the bills before us has a transition period -- a phase-in period -- of four to ten years, during which the reserve ratios of existing Federal Reserve members are to be reduced and reserves of non-members are to be gradually increased. We cannot know with any certainty what would be the growth of deposits subject to reserve requirements and revenues from pricing of Federal Reserve services during such a phase-in period. Thus, we cannot know the true costs of each of the proposals during a phase-in period. However, the Federal Reserve has agreed that any revenue loss during the phase-in will be completely offset by transfer to the Treasury of funds from the System's surplus account. I should note that, with respect to phase-in costs, H.R. 7 would lower reserves for most present member banks sooner than it would require the accumulation of new balances from institutions entering the new reserve system. The transition approach of the other bills is less costly because the reduction in reserves of existing members would be timed to coincide more closely with the contribution of balances from new participants in the system.

S. 353: The Voluntary Reserve Approach

S. 353 would rely on the payment of interest on reserves to induce depository institutions to keep balances with the Federal Reserve System. The interest payments would be set 1/2 percent below the yield on the System's U.S. Government securities portfolio. The problem with this approach is that, depending on a banker's preference toward risk, the banker might still opt to withdraw from the Federal Reserve System in order to gain a higher yield on his reserves elsewhere. In 1979 the average yield on the Federal Reserve's portfolio was 8.6 percent; hence the interest payments to reserve holders would have equalled an annual rate of 8.1 percent if this legislation had been in force last year. This compares with an average prime rate for commercial bank loans during 1979 of about 12-1/2 percent. Given this disparity in yields it is unclear how many depository institutions would keep interest-bearing reserves in the System in lieu of using the funds to make loans or purchase other earning assets. Moreover, with the proposed amendment mandating the pricing of Federal Reserve services added to S. 353, the benefits to banks of receiving interest on reserves would be substantially reduced.

Access to and Pricing of Services

Both amended S. 85 and H.R. 7 would require the Federal Reserve to price its services and make them available to all depository institutions. No longer would access to the Federal Reserve System's services be used as an inducement to membership and thus to hold reserves -- and the universal availability of Federal Reserve services should benefit the banking system as a whole. Moreover, requiring that the Federal Reserve price services on a basis involving full allocation of cost, with appropriate allowances for costs unique to private organizations, such as capital and taxes, should allow other vendors to compete with the Federal Reserve more effectively. Traditional market mechanisms will then become more important in establishing the prices of services and the relative roles of the competing vendors. Thus, we are in full agreement with those proposals which would lead to full access to and pricing of System services.

Conclusion

In conclusion, Mr. Chairman, we believe that the reserve structure ultimately chosen by the Congress needs to have a fairly universal, uniform coverage of deposits and depository institutions. Such coverage should be sufficient to ensure that the Federal Reserve has adequate tools with which to conduct monetary policy, and should be structured to hold the cost to the taxpayer to an acceptable level. At the same time, the legislation should provide for a more universal access to the Federal Reserve's services, and at a realistic price.

This concludes my formal testimony, Mr. Chairman. I would be pleased to answer any questions the Committee may have.

o O o