S. Hrg. 101-653

NOMINATIONS OF DAVID W. MULLINS, JR., EDWARD W. KELLEY, JR., AND ROBERT H. SWAN

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

THE NOMINATIONS OF

DAVID W. MULLINS, JR., OF ARKANSAS, TO BE A MEMBER OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM FOR THE UNEXPIRED TERM OF 14 YEARS FROM FEBRUARY 1, 1982, VICE H. ROBERT HELLER, RESIGNED.

EDWARD W. KELLEY, JR., OF TEXAS, TO BE A MEMBER OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM FOR A TERM OF 14 YEARS FROM FEBRUARY 1, 1990 [REAPPOINTMENT.]

ROBERT H. SWAN, OF UTAH, TO BE A MEMBER OF THE NATIONAL CREDIT UNION ADMINISTRATION BOARD FOR THE TERM OF 6 YEARS EXPIRING AUGUST 2, 1995, VICE DAVID L. CHATFIELD, RESIGNED.

MARCH 23, 1990

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MARCH 23, 1990

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FRIDAY, MARCH 23, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10:00 a.m., in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Sarbanes, Dixon, Shelby, D'Amato, Gramm, Mack, and Pressler.

Also present, Senator Bumpers.

OPENING STATMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

Let me welcome all those in attendance. We have three important nominations to deal with this morning.

We are very pleased to have our colleague and good friend, Senator Bumpers, from the State of Arkansas, and he has asked to make some introductory comments on behalf of Mr. Mullins. We would be pleased to hear from you now, Senator Bumpers.

OPENING COMMENTS OF SENATOR BUMPERS

Senator BUMPERS. Thank you very much, Mr. Chairman, members of the committee. I will extemporize my introduction of David Mullins and ask unanimous consent that my statement be inserted in the record.

The CHAIRMAN. Without objection, it will be inserted in the record.

Senator BUMPERS. Mr. Chairman, members of the committee. David Mullins is a junior. His father came to the University of Arkansas as president in 1960 from Auburn, and he served with great distinction as president of the University of Arkansas from 1974, I guess it was, which incidentally—well, it was longer than that—no, through 1974, but that covered my tenure, the 4 years I served as Governor. I never knew Dr. Mullins before I became Governor, but he was an extremely intelligent man, a consummate gentleman, and I mistook—sometimes we have a tendency, I mistook his gentleness for a lack of resolve, and I crossed him a couple of times, and I found that he could be extremely firm and stood up to Governors very well.

I have had that same experience with this David Mullins. I have tried to beat him over the head two or three times to see my point of view. He has not yet seen it, and I don't know what I'm doing here this morning, to tell you the truth. [Laughter.]

The CHAIRMAN. Well, thank you for coming. Next witness. [Laughter.]

Senator BUMPERS. But through no fault of his own, he moved to the university, he moved to Fayetteville, Arkansas, when his father was named president. Graduated from Fayetteville High School. They came from Auburn. Actually, David, Jr., was born in Memphis, where his father was in the military, but his father was at Auburn, and they moved to Fayetteville. He graduated from Fayetteville High School, first started attending the University of Arkansas and through some kind of a dumb stroke then went to Yale, and graduated there and at M.I.T., where he received a master of science degree in finance and a Ph.D. in finance and economics.

He has worked as a financial consultant. He served on the faculty of the Harvard Business School where he taught finance in the M.B.A. Executive and Doctoral program. Recently he served as Associate Director of the Presidential Task Force on Market Mechanisms, and since October 1988, he has been the Assistant Secretary for Domestic Finance.

Mr. Chairman, I simply want to say to you that I have found this nominee to be a man of inordinate intellect, firmness, gentleness, all the qualities that I personally like in people as individuals, but qualities which I think will sustain him extremely well in the position to which he's been nominated.

It's a rare combination when you find a man with intellect, good sense of humor and good common sense, as well as a professional approach to the problems that he has to deal with.

I must say to you in all candor as a member of the loyal opposition, that all the nominees sent over here from the White House were even close to the quality of this one.

So it's my honor, not just to introduce a fellow Arkansan with deep Arkansas roots, who still owns a farm up in Poinsett County, but a man whom I think will serve with great distinction, serve his President and the country.

Thank you very much, Mr. Chairman.

[The complete prepared statement of Senator Bumpers follows:]

OPENING STATEMENT OF SENATOR DALE BUMPERS

Senator BUMPERS. Mr. Chairman, I am always honored to introduce a fellow Arkansan to my colleagues in the Senate. I am especially honored today to have the privilege of introducing David W. Mullins, Jr.

Dr. Mullins' ties to Arkansas are strong. Although he was born in Memphis, while his father was in the military and spent the early years of his life in Auburn, Alabama, he moved to Arkansas in 1959. His father distinguished himself as president of the University of Arkansas from 1960 through 1974—a term which partially coincided with my two terms as Governor of Arkansas.

Following his graduation from Fayetteville High School in 1964, Dr. Mullins attended the University of Arkansas. In 1968, he received his BS degree from Yale and then completed his formal education at MIT, where he received both a Master of Science degree in finance and a Ph.D. in finance and economics.

Dr. Mullins has worked as a financial consultant and served on the faculty of the Harvard Graduate School of Business Administration where he taught finance in the MBA, Executive, and Doctoral programs.

Recently Dr. Mullins has served as Associate Director of the Presidential Task Force on market mechanisms. Since October 1988, he has been the Acting Assistant Secretary for Domestic Finance.

Although his education and his work have not allowed him to live in Arkansas in a number of years, he continues to maintain his ties to our State and we still count him as an Arkansan. He jointly owns, with his sister and brother, a farm in Poinsett County which they inherited from their father. He returns to Arkansas when he can (that fact may be the best proof of his intellect). Just last June he was the keynote speaker at the annual meeting of the Arkansas Bar Association.

Above all, Mr. Chairman, Dr. Mullins possesses a rare combination of intellect, humor, and common sense, all of which enhance his professional approach to very big problems. He is a very able, articulate, and dedicated public servant.

It is my pleasure to recommend Dr. Mullins to you today for confirmation as a Governor of the Federal Reserve.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Bumpers. Your opinion, certainly carries weight with us here, and I appreciate your coming and making such an important set of comments.

I want to read into the record while you're here a letter from your colleague, Senator Pryor, who is unable to be here in person, but who very much wanted to have his views known. It's very brief, and I'll just read it to the committee.

"I regret that hearings in the Finance Committee will prevent me from joining my colleague from Arkansas, Senator Bumpers, in testifying in behalf of David Mullins, Jr."

And he notes that he's been nominated to the Federal Reserve. He goes on to say as follows:

"Mr. Mullins' father, David Mullins, Sr., served for years as president of the University of Arkansas, and his son carries on the father's commitment to intellectual integrity and responsibility. His record as a professor at Harvard and as an Assistant Secretary of the Treasury both testify to his ability, his impressive professional background and his dedication as a public servant.

"David is widely published in the field of public finance and is a recognized authority on banking and related matters.

"It is a pleasure to recommend a fellow Arkansan, particularly when it happens to be someone of David Mullins' experience and talent.

"I look forward to his tenure as Governor of the Federal Reserve and know that he will do a splendid job in this position."

Signed "David Pryor."

That's another very strong statement from another highly respected colleague. We will make that full letter part of the record.

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COMMITTEES:
AGRICULTURE, NUTRITION, AND FORESTRY
FINANCE
SPECIAL COMMITTEE ON AGING
SELECT COMMITTEE ON ETHICS

March 22, 1990

The Honorable
Donald W. Riegle, Jr.
Chairman, Committee on
Banking, Housing, and Urban Affairs
U. S. Senate
Washington, D. C. 20510

Dear Mr. Chairman:

I regret that hearings in the Finance Committee will prevent me from joining my colleague from Arkansas, Senator Dale Bumpers, in testifying personally on behalf of David Wiley Mullins, Jr. Mr. Mullins, a native of Arkansas, has been nominated for the position of Governor of the Federal Reserve, and I am pleased to second this nomination.

Mr. Mullins's father, David Mullins, Sr., served for years as president of the University of Arkansas. And his son carries on the father's commitment to intellectual integrity and responsibility. His record as a professor at Harvard and as an Assistant Secretary of the Treasury both testify to his ability, his impressive professional background, and his dedication as a public servant. David is widely published in the field of public finance and is a recognized authority on banking and related matters.

It is a pleasure to recommend a fellow Arkansan for this position, particularly when it happens to be someone of David Mullins's experience and talent. I look forward to his tenure as Governor of the Federal Reserve and know that he will do a splendid job in this position.

Sincerely yours,

David -

David Pryor

DP/dh

The CHAIRMAN. As I know you have other things that you may have to go to, let us excuse you.

Senator BUMPERS. Thank you very much, Mr. Chairman, for allowing me to be here today.

Senator GRAMM. Congratulations on the basketball game.

Senator BUMPERS. Gramm, we're going to finally get even with you tomorrow night. [Laughter.]

The CHAIRMAN. You may be meeting Michigan State down the road too, so don't lose sight of that.

Senator BUMPERS. Aren't you glad you're an Aggie? [Laughter.]

Senator GRAMM. Mr. Chairman, I'd like to ask unanimous consent that a statement by Senator Garn be put in the record in support of David Mullins.

The CHAIRMAN. We'll make it part of the record.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Every member of this committee has had the opportunity to get to know David Mullins well while he has served as Assistant Secretary of the Treasury for Domestic Finance. His understanding of the workings of both financial institutions and financial markets was of great value to the Congress as well as to the administration last year, in particular, during the development of legislation to address the problems in the Saving & Loan industry.

This demonstrated appreciation for the workings of the financial-services sector of our economy obviously will make Mr. Mullins a valuable asset to the Board of Governors of the Federal Reserve System.

Secretary Mullins' responsibilities at the Treasury also have included the following areas: Federal finance, Government-securities-market regulation, and corporate financial policy. The expertise he has demonstrated on all of these subjects, as well, will contribute to his value as a member of the Board of Governors.

The principle responsibility of a Member of the Fed Board, of course, is in the realm of monetary policy. To this aspect of the job, Mr. Mullins will bring a Ph.D. in finance and economics from M.I.T, an impressive list of academic writings in the area, and 14 years of teaching related subjects at the Harvard University Graduate School of Business Administration.

Mr. Mullins extended residence in Massachusetts and his shorter residence in Washington did raise a question in my mind as to whether he could be a proper representative of the St. Louis Federal Reserve District, from which he has been nominated. As I have often said in the past, as long as the Federal Reserve Act requires Governors to represent specific Federal Reserve districts, I believe that we should abide by the spirit, as well as the letter, of the law and choose Governors who have an appropriate tie to the Districts they are to represent.

I believe Mr. Mullins meets this test. He was born and raised within the St. Louis district. Not only was his father president of the University of Arkansas, but both sides of his family have long-term ties to the St. Louis district. While living outside the district, Mr. Mullins has maintained both close personal ties and business ties with the district. As we will hear this morning, prominent members of the business community within the district feel that Mr. Mullins is well qualified to represent it.

Secretary Mullins, I congratulate you on your nomination. I believe you will be an excellent Federal Reserve Governor.

The CHAIRMAN. Let me now make a few comments, and then I'll call on my colleagues to do likewise.

As I indicated earlier, we have three nominees for important posts here with us today: David Mullins and Edward Kelley for the Federal Reserve Board and Robert Swan for the National Credit Union Administration Board. We are, of course, starting with Mr. Mullins.

The Federal Reserve not only determines our monetary policy with substantial impact on our interest rates, employment and unemployment levels, and inflation, but it also has substantial regulatory responsibilities.

Mr. Mullins, your work over the past 2½ years, as a contributor to the Brady Report on the stock market crash and currently as Assistant Treasury Secretary, has clearly provided you with a good background for many of the issues that the Fed and this committee deal with regularly. Today's hearing will give us an opportunity to discuss, in addition to monetary policy, several areas where you have already played a large role and where the Fed will have an involvement of one kind or another in the future.

The Brady Report that you helped prepare recommended a number of changes in financial markets that have already occurred and some others that are still open issues. Chief among the open issues are questions of how regulatory authority should be allocated among the different agencies, particularly with regard to margins and new products.

You were a principal designer of the financing package for the administration's S&L reform plan which we enacted without major structural modification last year. As you know, serious questions have since been raised about the adequacy of that financing.

You did some notable research on the junk bond market, pointing out that the risks of that market had been underestimated by some. That market, of course, has since collapsed, threatening or destroying the solvency of some owners of those bonds. I personally think our information about this market is still very meager, although I don't get a great sense of concern about that issue in the Treasury Department at the present time.

Within your purview at Treasury, work is currently in process on possible deposit insurance reforms, and, I trust, on plans for financial modernization. Studies are also progressing on ways to improve corporate governance and evaluate the risks posed by Government-sponsored enterprises. This committee, of course, has a keen interest in these matters as well.

Finally, you are going to the Fed directly from the Treasury. There are some who think that the Treasury ought to have a seat of its own on the Fed Board, and some have expressed a concern that while that is not the present arrangement that you, in fact, may become the Treasury's man at the Fed. I can tell you my own very strong feeling is—without any reflection to the Treasury Department—I've great regard for Secretary Brady—that I certainly hope that you're going as your own man, with absolute independence of mind and thought in regard to the work that's to be done there. We'll discuss that in the course of our hearing this morning, and you may want to address that issue yourself in your opening comments. The Congress set up the Fed as a agency with considerable independence, and we want to make sure that that proper degree of independence is preserved.

With that, let me call on my colleagues and let me starting first with Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Well, Mr. Chairman, let me first say that I am in support of David Mullins. I believe that we have among the best Federal Reserve Bank Boards that we've had in the history of the Fed. I think only time is going to tell whether the provisions that Mr. Mullins is responsible for in the S&L bailout bill will work or not. I did not think highly of the provisions that related to high yield bonds being excluded from the portfolios of savings and loans, but I think it—we have acted, we have a program in effect, and we'll just have to see how all that works out.

I think the important thing is we did act, we do have a program, and we're a lot better off than we would have been had we been sitting around here talking about it for another 2 or 3 years. I think it was quite an achievement for the administration to come up with a package, and I don't have to tell you, Mr. Chairman, I think it was quite an achievement on your part providing the leadership to bring that package together on a bipartisan basis, and I continue to be impressed by that achievement, and I always will be grateful for it.

I don't really have any questions. I do not support the idea of the Executive Branch of Government exercising direct control over the Federal Reserve Bank. I think the history of Government directly controlling the money supply over 5000 years of recorded history is about as clear as history can be, and that is that politicians are poor stewards of financial matters, because they respond as the system is set up to respond to political pressures. I think it is part of the genius of the American system that as we started to move away from gold as a basic unit of account and as the anchor of our monetary system, that we moved toward an independent agency, and I think that while that basic approach does not have all the advantages of a commodity standard, I think it still has some insulation from politics. And my experience in making appointments in my own State and my region has long ago convinced me that anybody who thinks that they're appointing somebody who is going to be their guy when the person has independent tenure is probably foolish to begin with but is going to be destined to almost always be disappointed.

So I have no doubt that you will exercise independent judgment, and I commend you to that action, and I am happy to support your nomination.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Gramm. Thank you for your kind personal comment as well. Senator Sarbanes.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman. I'll be very brief. I'm anxious to hear from Mr. Mullins. I simply want to underscore the point which you made in your opening statement and is the importance of the position to which Mr. Mullins and Mr. Kelley have been nominated here this morning. We actually give the Governors of the Federal Reserve Board the longest tenure of anyone in the executive branch or in the executive or legislative branches of our Government, a 14-year term, although I understand this nomination is not for a full term but to complete the balance of a term, which is, in fact, an issue I will wish to explore in the question period, because in my perception there's now developed a unfortunate pattern of people going on the Federal Reserve Board for, in effect, short-term appointments.

It is obviously not the premise of the legislation which provided for a 14-year term, and you have people who sort of get on there and stay there a few years, and then they go off, perhaps having used the Board to enhance themselves, so to speak. That wasn't the concept originally, in my view, in establishing the Board and the Federal Reserve System, and it is a trend that has increasingly troubled me and one I will hope to explore with the witness.

I also will want to look into the geographical distribution of the Board members. I don't question Mr. Mullins' Arkansas origins, but I'm not sure this is exactly a nomination from Arkansas, given his intervening activities and locations over the years, and I think it is worth developing that point as well.

I am pleased to be here this morning. I look forward to the witness' testimony.

The CHAIRMAN. Thank you very much, Senator Sarbanes. Senator Mack.

OPENING REMARKS OF SENATOR MACK

Senator MACK. Thank you very much, Mr. Chairman. Let me just extend my welcome as well to Mr. Mullins, and we'll probably, when the time for questioning begins, want to pursue some of your thoughts with respect to the objective, true objective of the Federal Reserve and how you see monetary policy developing.

These are, in fact, difficult times as we see international changes, some arguing that lessening the ability of the Fed to direct monetary policy as we move into a global financial market. So again, we'll be interested in your comments and appreciate your assistance as we were working through the S&L bill. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Mack. Senator Pressler.

OPENING STATEMENT OF SENATOR PRESSLER

Senator PRESSLER. Thank you, Mr. Chairman. I look forward to the statements of the witness, especially since he was involved, as I understand it, in planning this structure regarding the Office of Thrift Supervision and the Resolution Trust Corporation, and so forth, and he is a Ph.D. and a professor and a thinker. I know you're not applying for those jobs, but we told that——

Senator GRAMM. And will never exhibit them again.

Senator PRESSLER. We are told they are not functioning as well, administratively, from a point of view of public administration as they might be, I would very much like to hear your views on what structural changes we need to make them function, if any, or if you're satisfied. Weren't you over at Treasury when these things were planned? So you probably drew the boxes, and so forth.

Mr. MULLINS. I didn't draw them.

Senator PRESSLER. You didn't? Well, somebody must have. But anyway, I'll look forward to hearing what you have to say.

The CHAIRMAN. Very good, Senator Pressler.

Let me make one other comment before I administer the oath to you, and then we'll proceed.

I appreciate the fact that you're prepared and willing to give important Government service. This is a challenging time in our national history, and this is a very important assignment that you're here for, and in a citizen government, we have to be able to see good people come forward and take on these important public duties for periods of time in their lives. I appreciate very much your professional background and training and the fact that you are willing to undertake Government service at a high level and accept all of the responsibilities and effort that requires. I salute that personal commitment.

Let me now note that Senator Dixon has joined us. Senator Dixon, did you have any initial comments you wanted to make?

OPENING STATEMENT OF SENATOR DIXON

Senator DIXON. Well, Mr. Chairman, I am pleased to be here this morning, of course, as the Senate Banking Committee considers the nominations of David Mullins and Ed Kelley, Jr., to be members of the Board of Governors of the Federal Reserve System and Robert Swan to be a member of the National Credit Union Administration.

Gentlemen, as we all know, the Federal Reserve is central in managing our Nation's financial stability and economic prosperity. The responsibilities of Governors of the Federal Reserve are, therefore, of the greatest importance with regard to monetary policy, safety and soundness concerns and the future of our banking system.

Although I'm interested in your views on these vital issues, as chairman of the Consumer and Regulatory Affairs Subcommittee, I'm interested as well in your views on issues before the subcommittee. These range from the Community Reinvestment Act and Government check cashing to risk-based deposit insurance, money laundering, the regulatory burden of section 20 firewalls and other regulatory affairs issues. Your backgrounds relate to macro-financial and macro-economic issues. I'll expect you, however, to take your consumer issue responsibilities just as seriously as the other macro and regulatory issues before you.

In the year 1990, it's unacceptable, in my view, that working people in this country are discriminated against in trying to get a mortgage. It's simply unacceptable. I believe we all have a responsibility to root out this discrimination, and we may need some creative new ways to do so.

Your leadership on the Board is needed, and gentlemen, I trust that I can count on all of you for your attention to and your cooperation with me on this issue, on regulatory affairs matters and on other consumer protection issues which are, after all, the law of the land. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Dixon.

Let me ask you now, Mr. Mullins, to stand, if you would, and raise your right hand.

[Witness sworn.]

The CHAIRMAN. Do you agree to appear and testify before any duly constituted committee of the Senate?

Mr. MULLINS. I do.

The CHAIRMAN. Very good. Thank you.

Let me now invite you to introduce any family members or others that may be with you that you'd like us to be aware of, and then I'd like you to proceed with any opening personal comment that you wish to make.

Mr. MULLINS. OK. My family is back in Arkansas. [Laughter.]

The CHAIRMAN. I'm sure they are watching C-SPAN at the moment. [Laughter.]

Mr. MULLINS. Probably. I do have a brief statement.

DAVID W. MULLINS, OF ARKANSAS, TO BE A MEMBER OF THE BOARD OF GOVERNORS, OF THE FEDERAL RESERVE SYSTEM

Chairman RIEGLE, members of the committee, it is a privilege to appear before you this morning as President Bush's nominee to serve on the Board of Governors of the Federal Reserve. I am deeply honored that the President has asked me to serve in this capacity. If confirmed, I will commit myself to carrying out the Federal Reserve's mission of preserving the stability and vitality of our Nation's economy and its financial system.

I'm also deeply grateful to the kind words of introduction by Senator Bumpers and Senator Pryor from my home State, and I'm sure we're all happy this morning with the impressive victory of the Arkansas Razorbacks over a regional team in the NCAA tournament last evening. [Laughter.]

Before turning to the particular issues confronting the Federal Reserve, let me briefly describe my qualifications that I would bring to this position. I received a Ph.D. in finance and economics from M.I.T, where I specialized in capital markets, banking and monetary economics.

During my 15 years as professor at Harvard, my research, teaching and consulting focused on banking, corporate finance and capital markets.

Following the 1987 stock market break, I served as Associate Director of the Presidential Task Force on Market Mechanisms chaired by Secretary Brady. In the fall of 1988, I came to the Treasury Department, where I currently serve as Assistant Secretary for Domestic Finance.

My Treasury responsibilities have included a broad range of financial issues. I was involved in the development of FIRREA, and the design and issuance of bonds of the Resolution Funding Corporation. I oversee the issuance of Treasury debt and serve as chief lending officer of the Federal Financing Bank. I also serve on the board of the Securities Investor Protection Corporation and have represented Secretary Brady on the boards of the Pension Benefit Guarantee Corporation and the Farm Credit System Assistance Board.

Other duties include attending the periodic meetings of the banking regulators and the meetings of the Working Group on Financial Markets. I also direct the Treasury studies of deposit insurance and Government-sponsored enterprises.

These experiences are, I believe, directly relevant to the responsibilities of a Federal Reserve Board Governor.

Let me now turn to two issues that I know are of direct concern to both the Federal Reserve and this committee: monetary policy and financial services reform.

I believe the Federal Reserve must engender the monetary and financial conditions that will allow the United States to maintain its position as the world's strongest, most successful economy. The payoff, of course, will be continued increases in the standard of living for every American. To achieve this, the Federal Reserve should seek to maximize sustainable growth within a context of price stability. Steady, credible policies with respect to the growth of monetary aggregates should contribute to this long-term objective, although fiscal policy, international influences and economic shocks will also play important roles.

Propelled by private initiative, the U.S. economy has demonstrated a remarkable capacity for growth, and the Federal Reserve should continue to follow policies that foster this growth. High and variable rates of inflation are fundamentally detrimental to this objective. While much progress has been made to reduce inflation in the past decade, more can and should be accomplished to remove inflation as a variable in business and individual decisionmaking.

More broadly, I feel we should use the 1990's to build a strong capital base for the 21st century. Reducing the budget deficit is the single most important step to achieve this goal, but we must also design and implement policies to increase personal savings and reduce the cost of capital to U.S. enterprises. The resulting increase in investment and productivity will provide the capital base we need for the coming decades. This is the only reliable path to sustainable economic growth without inflation.

Finally, let me emphasize that the Federal Reserve is in a unique position to establish policy focused on long-term objectives. This is, in part, because of its traditional independence. I believe this independence works.

If confirmed, I pledge to this committee that I will exercise my independent judgment on matters before the Board.

Let me turn now to the subject of modernizing our financial services system which I believe is long overdue. I appreciate the difficulties of enacting legislation in this area, although it seems to me that much progress was made in the last Congress, especially by this committee. Nevertheless, there has been no comprehensive modernization of the regulation of financial services in almost 60 years. The result has been a piecemeal approach by regulators to keep pace with changes in the marketplace. That has been positive, but in the end, inadequate.

Rapid technological innovation and increased competition, especially from overseas firms and markets demand that we adopt a comprehensive legislative solution. It seems to me that the key to this comprehensive approach is competitiveness, whether we measure it by domestic or foreign competition. Many of our financial firms have seen their traditional markets shrink. They have responded by building their expertise to expand into new markets only to find that obsolete rules block their path. We can no longer afford the luxury of this inefficiency.

But competitiveness is not the only concern we should address in comprehensive financial reform. Any significant changes must be made in the context of essential standards of safety and soundness. This would include a reexamination of the so-called "Federal safety net," which includes Federal deposit insurance, access to the discount window, access to the payments system and other less formal types of Federal benefits to financial institutions.

For example, I believe the "too big to fail" doctrine already represents a costly expansion of the Federal safety net. That should be fixed, and we must also address and adjust the relationship of the Federal safety net to the spectrum of financial activities. The thrift crisis illustrates that we should not make fundamental changes in the way financial institutions compete without corresponding changes in the Federal safety net.

Currently, there are a number of models of financial reform under discussion by Congress, the regulators and the financial community. At this stage of the debate, I would not advance a firm view on the way we should proceed. I do believe hearings scheduled by this committee and by the House will be important contributions to this debate and so will be the Treasury study on deposit insurance. With the proper foundation laid this year, I believe that a sound, comprehensive approach can be developed for legislative action in the next Congress.

In conclusion, what I have described today are only two of the important and difficult problems that will challenge the Federal Reserve Board in the 1990's. I can assure this committee that if confirmed, I will commit myself fully to this challenge.

Mr. Chairman, I would be happy to answer any questions the committee may have.

The CHAIRMAN. Thank you for your opening comments.

Senator Shelby has joined us.

Senator Shelby, did you have an opening comment that you wanted to make?

OPENING COMMENT OF SENATOR SHELBY

Senator SHELBY. Mr. Chairman, I had a chance to talk with Mr. Mullins and Governor Kelley yesterday, and the only issue I'm interested in is how they are going to solve the cost of capital to our businesses in America, and if he can show that here, he's surely going to have my support.

The CHAIRMAN. I'm sure he will.

Senator Sarbanes, I think, posed a very important question at the outset, in terms of your intentions as to length of service. You have been nominated to a term that has 6 years to run.

Is it your intention to serve the full time period?

Mr. MULLINS. Oh, Mr. Chairman, since I haven't been confirmed, I have not given a lot of thought to leaving [Laughter.]—but I certainly enter this position with every intention of fulfilling the term.

The CHAIRMAN. Just so we're clear on that, it is your intention, as you think about it——

Mr. MULLINS. It is absolutely my intention.

The CHAIRMAN. To stay for the entire 6-year term——

Mr. MULLINS. Yes. Six years remaining——

The CHAIRMAN [continuing]. That you have been named to.

Mr. MULLINS. 1996.

The CHAIRMAN. I think the independence question that I raised and you touched on it in your remarks is a key issue. On the face of it, you are a person who has been absolutely in the center of most major activities at the Treasury Department. I think it will not be easy, would not be easy for anyone, to be able to disconnect from the intimacy of that kind of central administration policy role and, in turn, go over to the Federal Reserve in an entirely separate and independent role. I would like you to talk a little bit more about your feeling about it, and your intention to be free of any kind of direct or indirect influence from anyplace, but very particularly the Treasury Department.

Mr. MULLINS. Yes, Mr. Chairman, as I mentioned in my statement, I believe the Fed's independence is crucial to its ability to focus on long-term policies, especially in difficult times. This is an issue which I feel very comfortable with. It is true that if confirmed, I will seek counsel from all quarters, including people I know in the administration, Members of Congress and people in the private sector. I think we ought to cast the net widely, although I can commit to this committee that I will exercise my independent judgment on matters that come before the Board, and I do believe that people who have known me in previous positions as well as the Treasury, would testify to my independence of mind and conviction.

The CHAIRMAN. And so, should an occasion arise where your views were at direct odds with the position the Treasury Department was advocating, you are fully prepared to face off against them without any reservation whatsoever?

Mr. MULLINS. Mr. Chairman, I would be happy to listen to anyone's views, but my view of the appointment is that I was appointed to exercise my judgment on these matters, and so I would have no difficulty in exercising independent judgment.

The CHAIRMAN. You devoted a fair amount of the time in your opening statement to your views about financial modernization or reform of the financial services system, and I want to ask you some questions about it. I realize you don't necessarily have finished views on it, but I would like to have a sense as to what your views are.

Do you think bank powers should be expanded and, if so, should that be done directly or through holding company affiliates?

Mr. MULLINS. Well, Mr. Chairman, again I think we're entering a period of debate and ought to consider a lot of models. I do firmly believe that financial institutions should be allowed to capitalize on their expertise and apply that expertise to a wide range of financial activities. I do also believe, though, that it is important to live up to standards of safety and soundness and limit exposure to the

Federal safety net. I think there is a lot of evidence that suggests from the thrift crisis and other recent events the need to have some sort of insulation for the Federal safety net, and I don't think that insulation need be complex and tedious and cumbersome firewalls but something on the order of interaffiliate 23A, and 23B restrictions. There are other analogies as well, the Investment Company Act of 1940, for example, prescribes the relationship between mutual funds and their investment advisers, and I think that worked pretty well, keeping investment advisers from selling securities into mutual funds.

I think we should look for a simple and direct way to assure ourselves that the Federal safety net is protected. I believe the basis of competition in new areas should not be access to cheap capital, made cheap by the Federal safety net, rather the basis for these institutions going out into new activities should be their own expertise.

The CHAIRMAN. Do you think it would be desirable for the Board of Governors at the Federal Reserve to play an active role in developing a comprehensive proposal to modernize or change the financial services system?

Mr. MULLINS. I do think that they might play a role; however, fundamentally, I believe Congress needs to enact a comprehensive legislative solution and essentially not leave it to the regulators. I also believe that Congress ought to think boldly and look widely on this and not get trapped into too many of the parochial concerns of particular regulators.

The CHAIRMAN. That is interesting. The Fed, of course, has taken some steps in that area, incremental steps to change the system in the absence of legislation. Is it your view that perhaps we have gone about as far in that direction as we can and we are now to the point where any further changes ought to be done legislatively?

Mr. MULLINS. I do believe Mr. Chairman, that by far the best approach is to look at the whole area and come up with a comprehensive solution instead of only continuing down the path of a piecemeal approach, and I think the Fed's work in this area has simply been because we have not had legislative solutions.

The CHAIRMAN. On the issue of separating banking from commerce, do you have a view on that? If so, what is it?

Mr. MULLINS. I have an open mind on that. While many countries do separate banking and commerce, it is true that some other countries do not have a separate of business and commerce. They also do not have the same sort of Federal safety net that we have. I might also add the countries that do have universal banking have years of experience with it and know how to make it work. I think we should look at it. I am concerned about conflicts of interest in the credit-granting process and potential damage and exposure to the Federal safety net.

In the thrift crisis we saw what happened when borrowers who had very little interest in being in banking as a business got control of financial institutions. They have an interest in cheap capital, made cheap by the Federal safety net, and that did not work out very well. That situation was different, because the capital standards were low, and they were allowed to do this without capital. With appropriate capital standards, some of these abuses may go away.

I think it is one of the issues we should put on the policy debate, but I think I approach it with some caution.

The CHAIRMAN. Senator D'Amato has joined us. Senator D'Amato, do you have an opening comment that you wanted to make?

Senator D'AMATO. Mr. Chairman, in the interest of time, I am just going to ask that my statement be submitted for the record.

The CHAIRMAN. We will make it part of the record.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. First, I welcome each of today's nominees to the Banking Committee and I would like to congratulate the President on each of these nominations.

As we all know, this Congress faces large fiscal problems that are very sensitive to overall economic parameters all of which are sensitive to the dicisions of the Federal Reserve Board. And the National Credit Union Administrative Board has a very crucial role as well.

Indeed, if we believe all of the stories of financial disaster that we hear, it may be that the credit unions and the Federal Reserve System may one day merge as the country's surviving financial system.

Seriously, Mr. Chairman, each of today's nominees faces a difficult and important task in the financial environment of the 1990's. I commend each of them for their public service and hope for their early confirmation.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Gramm.

Senator GRAMM. Mr. Chairman, I don't really have any questions for Mr. Mullins. I have a budget meeting at 11 o'clock, and I wanted to introduce Mike Kelley.

The CHAIRMAN. Do you want to do that now?

Senator GRAMM. Why don't I go ahead and do that now?

The CHAIRMAN. Yes.

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Mr. Chairman, I know Mike Kelley. He is from Texas. Has been a member of the Federal Reserve Board for 3 years. I think his service has been exemplary there. He has been involved in many of the areas of Fed that often don't end up in the papers, but they don't end up in the newspapers because he has done an outstanding job in his leadership in those areas. And those are areas related to the day-to-day management and administration of the Fed, to the oversight of the 12 district banks, to the oversight of the competitive and safety aspects of banks and finally, he was the leader at the Fed in changing their salary system to provide incentives and rewards for excellence. In fact, it was his work at the Fed that is now the model for the OPM recommendations that Congress will have the opportunity to deal with and to hear from all those who say incentive is an unproven concept, the same people who would reject perestroika if they were working in the Kremlin instead of the Capitol.

But in any case, Mr. Chairman, Mike Kelley is a top man. He's done an outstanding job, and it will give me great comfort to see him have a 14-year term on the Federal Reserve Board. He brought to the Fed practical business experience, and I think in the process has made a great contribution.

Maybe we ought to take a second lien on all these people's houses, and we take their house if they don't serve out their term or something. [Laughter.]

Fourteen years is a long time, but I'm strongly supportive of Mike Kelley, and I appreciate having the opportunity to introduce him here.

Finally, in my remaining time I will just ask David Mullins one question. As a general framework for the action of the Federal Reserve Bank, do you think the Fed ought to be primarily interested as a monetary indicator and target in looking at the rate of growth of the money supply and the monetary base, or do you think it ought to be primarily aimed at looking at the interest rate and having a target interest rate?

Mr. MULLINS. Senator Gramm, I will be the first to admit I am not absolutely intimately familiar with all the current details of macroeconomic policy. My opinions may change, but I can give you my opinion going into this process. That is, I think the evidence is persuasive that economic activity is related in direct and powerful ways to growth in monetary aggregates, and I think, in the first case, we should look to steady growth in monetary aggregates as the basic monetary policy tool. Interest rates give us indications of how that policy is working its way through the market, being received by the market, but most fundamentally especially over the longer term, I believe growth in monetary aggregates should be the guide.

Senator GRAMM. Well, I agree with that. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Gramm. Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman. Mr. Mullins, you are a bright and thoughtful person, and I want to ask just a couple of questions about the Board and its structure, which I indicated in my opening statement.

First of all, this trend that is developing of people not serving out their term, raises, I think, probably the legitimate question as to whether the 14-year term is still appropriate. Perhaps circumstances have changed in such a way since we first passed the legislation that 14 years just doesn't work any more. In other words, if we are picking people and only a few of them serve out their term and stay the 14 years and they leave after 2 years or 4 years or 5 years or 3 years or something, then perhaps we are living in a different environment, and we should think about revising the term.

Do you have any thoughts on that?

Mr. MULLINS. Senator Sarbanes, I think a 14-term is a good thing and helps support the Fed's independence. Even if people serve 8 years, that is longer than a lot of terms, and it helps fundamentally decouple the appointments from the political process. I do think it is difficult in a——

Senator SARBANES. Would you have accepted this nomination if it had been for the full 14-year term or would that have affected your thinking about it?

Mr. MULLINS. Well, it certainly is a consideration. I think that when you look at the 14-year term today, the financial side of it is difficult to deal with to commit for 14 years. Although I think in principle, it is a sound practice.

Senator SARBANES. Well, I take it from that answer that your decision on accepting this nomination was, in fact, made easier in the direction of accepting it because you were filling an unexpired term for 6 years rather an a full term for 14 years. Would that be correct?

Mr. MULLINS. Well, I haven't thought carefully about whether I would be willing to commit for a full term of 14 years, but it does bring a different nature to the decision.

Senator SARBANES. Although when you look at the length of this, you didn't have to spend as much time thinking about it as you would if it had been a full term.

Mr. MULLINS. Perhaps, although tenure at Harvard is forever or until you leave, and we have no difficult——

Senator SARBANES. You are about to give that up, I take it; is that correct?

Mr. MULLINS. Yes, Senator.

Senator SARBANES. Now what do you think of the requirement in the law that not more than one Member of the Board shall be selected from any one Federal Reserve District?

Mr. MULLINS. I support the provision.

Senator SARBANES. What do you see as the purpose of that requirement?

Mr. MULLINS. Diversity. Diversity in the Board members.

Senator SARBANES. Why aren't you and John LaWare essentially the same diversity then?

Mr. MULLINS. I think that——

Senator SARBANES. Let me lay the basis for that first of all.

How long have you been living in the First Federal Reserve District?

Mr. MULLINS. Approximately 15 years.

Senator SARBANES. Ever since you finished—I mean, all of your adult, post-school years have been in the First District; is that correct?

Mr. MULLINS. Yes, Senator.

Senator SARBANES. Well, how then is your diversity that different from John LaWare?

Mr. MULLINS. Well, because I think that I have a very direct relationship with my home State of Arkansas. I was born in the District, grew up in the District, my family still lives in the District, I own property in the District, I have maintained business contacts in the District and was a voting resident up through the finishing of graduate school. The only blemish on that record is having spent 15 years as a professor at Harvard. And no one's perfect, I suppose. [Laughter.]

Even during that time——

Senator SARBANES. Well, I don't see it as a blemish. I guess what I am really getting at is some thought as to whether we ought to just repeal the requirement. You are not the first to come before us in which the nomination has been made from a particular district, but the connection with the district is not—at least to me, it doesn't seem to reflect what the statute—I mean, we're going to be hearing Mr. Kelley soon, and of course, he's out of the Eleventh District, out of Texas, and in a sense, he is out of Texas. He was a businessman in Texas actually pursued his adult career in Texas, which seems to be is what the statute was trying to get at, and I would just be interested in your thinking on this. We get people, they get nominated out of California even though they've been on the East Coast, because they were born in California or they went to school in California for a couple years or something of that sort.

Perhaps we just shouldn't have this requirement.

Mr. MULLINS. I think it is a good requirement, Senator. I do think mine is a different case, because I have always considered Arkansas my home, and the connections I have had to the State have lasted even during my time in Boston. I feel very close to the District and comfortable in representing it and, indeed, honored to be nominated to represent it.

Senator SARBANES. How did this nomination come about, Mr. Mullins?

Mr. MULLINS. Governor Heller left and there was an open position. In talking about candidates, Under Secretary Glauber asked if I would like to be considered, and I said yes, I would be willing to be considered. I guess I had brief discussions with Secretary Brady and a few other people, and then I read it in the newspapers.

Senator SARBANES. Had you indicated an interest to Under Secretary Glauber or had he approached you about whether you would be interested?

Mr. MULLINS. Well, we were trying to find good candidates, and I——

Senator Sarbanes. You mean the two of you together were.

Mr. MULLINS. The two us together. And I suggested I would be willing to be considered and to consider the position.

Senator SARBANES. Did you get interviewed elsewhere about becoming a Member of the Board other than with Glauber and Secretary Brady?

Mr. MULLINS. Yes, Senator.

Senator SARBANES. Where was that?

Mr. MULLINS. I talked briefly with Michael Boskin, with Director Darman and with Governor Sununu.

Senator SARBANES. In that order?

Mr. MULLINS. I think that's an approximate order, and perhaps Deputy Secretary Robson as well.

Senator SARBANES. And particularly with Governor Sununu, what was the nature of—was it your views on economic policy that were being explored?

Mr. MULLINS. I don't know that I remember specifics, but it was, I think, the general philosophy and my background and what I might bring to the position.

Senator SARBANES. Did you feel in those discussions that you were being carefully vetted for your views on economic issues or economic policy?

Mr. MULLINS. Interestingly, Senator Sarbanes, I think I did not feel that. In none of these interviews did anyone ask me my opinion of the current situation or whether I felt the rates were too high or too low. Perhaps it was because I had worked with these people before, and they knew me, although they did not know my monetary views. What discussion of monetary issues there was, was more general, such as discussion on whether I felt monetary aggregate growth was best or whether I was a monetarist or whether I thought international consultation was a good thing. So they were very—very general discussions.

The CHAIRMAN. Senator Sarbanes, I think that is an important line of questioning, and it probably ought to continue. We are going by the time period, but one way or another, I would hope that we could fill out the rest of that discussion before we finish today. Senator Mack.

Senator MACK. Thank you, Mr. Chairman.

Mr. Mullins, I want to pursue some questions along the monetary policy line. I think maybe the first one would start us in a very broad general kind of question. I guess most of the time when people talk about the objectives of the Federal Reserve, it is, in fact, to maintain price stability and maximize economic growth, but as usual, when there are two objectives, you find yourself in conflict from time to time. I would appreciate it if you would help me understand your thinking as you kind of walk through how one balances the decisions that are necessary between those two objectives.

Mr. MULLINS. Senator Mack, my view is that fundamentally there is no conflict between growth and reducing inflation. The ultimate objective should be maximum economic growth, but high and variable rates of inflation are fundamentally detrimental to the growth potential of the economy. So I think reducing inflation and trying to eliminate inflation is an important prerequisite to maximizing growth. High and variable rates of inflation damage the economy in a variety of ways, most directly by increasing the real cost of capital to firms not just the nominal cost of capital, and this way it hurts growth. So I think ultimately the two objectives are not in conflict.

Senator MACK. It also sounds as though you might be putting the emphasis on price stability, that with price stability, one is going to get growth. And so let me just kind of look at, I guess a mini-debate that has been taking place within the Fed itself. Chairman Greenspan, I think, made it very clear at least through last year, and certainly the early part of last year that inflation, fighting inflation was the objective. And even when the Fed was following times of restraint with the money supply, we saw long-term interest rates decline, which I presume basically was because the market said there is some confidence about the future. With the Fed fighting inflation, inflationary expectations were not as great and, therefore, long-term interest rates were able to come down.

In December of last year, there was a debate within the Federal Reserve as to what the policy should be, whether further restraint was required or whether there should be a loosening of the money supply, an increase in reserves. The decision was, in fact, to increase reserves, drop interest rates a quarter of a point or so in December; however, it appears that the market's response was that the Fed was backing away from its commitment to fighting inflation and, therefore, long-term interest rates went up.

That is probably an oversimplification of—in fact, I know it is an oversimplification of the statement made by Wayne Angell during that December meeting.

I am sure you are familiar with that discussion, and I would be interested in whether your feeling is the Fed made the right decision in December or whether the analysis that I have expressed is an accurate one and any other thoughts you might want to add to that.

Mr. MULLINS. I am not intimately familiar with all the considerations which went into those decisions, so I wouldn't express an opinion on them.

I would question whether the increase in rates we saw at the end of last year was due primarily to inflationary expectations because there were a couple of other things going on.

The domestic economy was stronger than many people had expected and also, of course, there was the emerging investment opportunity in Eastern Europe which may have moved up interest rates.

I do believe, though, that we should be moving on inflation and I'm afraid if we don't it could get out of hand. So I do support the notion of continuing to try to reduce inflation. I think we should try to do it in the least costly manner, but if we fail to do it and we let it get out of control, I fear the ultimate cost will be much higher.

Markets have very long memories when you let inflation get out of control. For example, if you purchased a 4 percent Government bond in 1964, a 30-year bond, you're still suffering. That's why I think it's quite important that we continue to move on inflation and it's not clear to me that the movement of interest rates suggests that we're not continuing to have some success there.

Senator MACK. So you basically then would be siding with the majority on the Board in this decision in December?

Mr. MULLINS. I would find it difficult to vote, not knowing the full record, but I am generally, again, in favor of continuing to work on inflation.

It is true we don't fully understand all the lag structures and we've had high real rates for some time now, and at some time I would hope we would start to see real progress on inflation. I think it's not apparent that that time is at hand yet.

Senator MACK. I guess one of the traditional ways of continuing that fight on inflation is a fairly restrained growth in the money supply, which certainly we went through a period which I think many would have thought that, as a result of that, we would have seen inflation lower than what it is today.

Which raises a question in my mind as to whether—and I would be interested in your opinion—as to, do we really have a good measure of inflation today? Has the makeup of our economy so changed that we have an inadequate measure of inflation?

Mr. MULLINS. I think it is difficult to measure inflation, especially in a service economy, although you might recall that Michael

Boskin has undertaken a very large project to try to improve the quality of the statistics.

We do have a variety of differing statistics on inflation ranging from commodity prices through various price indices, and I think you couldn't depend on just one. You need to look at all of them to try to get a sense of whether inflation is accelerating or decelerating, but it's not a simple task of just looking at the CPI.

Senator MACK. Could you give me an idea of some of those indicators that you look at and which ones you place importance in?

Mr. MULLINS. I'd like to look at the full range. The Producer Price Indices are important. Labor cost indices are important. I think commodity prices are useful in that they provide direct market signals, but they are not such a big input to the value-added in the GNP. Labor is probably 60 or 70 percent of the value-added in the GNP and the industrial commodity prices are less, but they provide clues—they are subject to shocks. Essentially I think you ought to look at them all and then try to get a sense of the direction of inflation. Are we making progress or not?

I know it's also difficult when you have what we've had lately, which is a series of inflation results which in each case you could tie to one single special factor. Perhaps we are making more progress than some of the numbers show. But you get concerned even when there's a specific cause, because a series of specific circumstances may make up overall inflation. I do think we've made progress and I hope we will continue to make progress.

[The following information was subsequently submitted for the record:]

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

May 1, 1990

The Honorable Connie Mack
United States Senate
Washington, D.C. 20510

Dear Senator Mack:

I am responding to your request for comment on Governor Wayne Angell's statement explaining his dissenting vote at the December meeting of the Federal Open Market Committee. Without commenting on the specific decision reached at that meeting, I believe there is much to agree with in the general approach to monetary policy outlined by Governor Angell.

The financial structure of the economy has become increasingly complex in recent years. For monetary authorities, this has meant that the conduct of policy must employ an expanding array of economic information. Since monetary conditions change continuously, it is important that the information not only be relevant and reliable, but that it be available quickly and continuously.

For many years, quantity data on financial flows, including money supply measures, have played an important role in the formulation of policy. However, deregulation and the availability of many more financial instruments has raised definitional, measurement, and timing problems for such data and have weakened their reliability as forward looking guides for formulation of monetary policy. This is not to say that these measures should not continue to play an important role in policy discussions, only that it is important to consider other economic measures.

Price information from financial markets, commodity markets and the foreign exchange markets form a useful set of measures to consider in policy formulation. They are readily available with little or no time lag. They serve as summaries of the millions of economic decisions of market participants. Finally, they also embody the expectations of market participants about future inflation, an important input to monetary policy decisions.

However, market data are available for only a relatively small percentage of the important components of overall price indices. For example, industrial commodities are only a small fraction of the value added to GNP; labor is a much larger component and I know of no broad labor related auction market data. Therefore, price data cannot be relied upon exclusively in assessing inflationary conditions.

Moreover, like any data, movements in price indicators can mislead unless carefully interpreted. Recently, for example, sensitive commodity prices and the price of gold have declined substantially. Yet the question of the appropriateness of an easing of monetary policy continues to be a topic of considerable debate. Inflation has not declined and some argue that it may accelerate a bit this year. And, despite sluggish economic growth, there are signs that labor and wage pressures are likely to continue.

I feel we should continue to use a range of financial measures in arriving at its policy decisions. The weight given to one or another of these measures will necessarily vary as new circumstances arise. Price measures certainly can serve as a useful adjunct to more conventional data.

Like Governor Angell, I believe that the successful pursuit of price stability by the central bank will bring about lower interest rates and higher economic growth over time. Careful attention to forward-looking indicators can contribute importantly to the success of that effort.

Thank you for your kind words and good wishes.

Sincerely,

David W. Mullins, Jr.
Assistant Secretary
(Domestic Finance)

Senator MACK. Thank you.
The CHAIRMAN. Thank you, Senator Mack.
Senator Shelby.
Senator SHELBY. Thank you, Mr. Chairman.
Mr. Mullins, let's talk about your statement or get into your statement on expansion of bank powers, if you could focus on that.
In view of all the problems that we have had with the thrift industry and the deregulation that they could get into such as real estate and all these ventures, do you believe that banks ought to be in the real estate business, which is a high-risk business?
Mr. MULLINS. Senator Shelby, I would not put real estate development or investment on the top of my list of activities banks should be allowed to engage in.
Senator SHELBY. That's not necessarily a banking business, is it?
Mr. MULLINS. Not necessarily.
Senator SHELBY. Or necessarily related? I can understand an investment bank or a commercial bank in other things, but real estate with the attendant risks in real estate and what we have been through and obviously are going to continue to go through not only through Treasury but in this committee, I would—you say that's not high on your list there. Is it on the list at all?
Mr. MULLINS. Well, I think we ought to draw up a full and complete list and I think some people would put real estate on that list.
It is true, though, Senator Shelby, I would agree with your assessment of our experience in that area and indeed commercial banks have tended to increase their lending to real estate in recent years and even in the lending area, we are seeing we're paying some cost for that as well. So I would be very wary of going beyond lending to more direct real estate activities.
I do believe this is a time for looking at the full range of activities and not starting with preconceived notions.
Senator SHELBY. But you also start with your knowledge of what has happened recently in real estate where banking and real estate have been combined in the deals. And if we forget that, we've lost a valuable lesson.
Mr. MULLINS. I agree with that, Senator Shelby.
Senator SHELBY. The other subject that I talked with you a little yesterday in my office about was the interest rates. Where are we going? How big a role does the Japanese and the Europeans play in the Fed's regulation of interest rates through the discount window?
Mr. MULLINS. I think there's no question that the markets are internationally linked now more than they were in the past. But they are not tied together inextricably. They are not tied together in a way which can't be separated. We've seen in Japan recently rates rise and rates have been falling here.
Senator SHELBY. Could they be separated more if we had a larger savings rate or capital base?
Mr. MULLINS. I think that would help substantially. One of the reasons that our rates are so tied is because of our inadequate level of domestic savings which requires us to import savings from abroad.
Senator SHELBY. And that goes back to the deficit we create here, right?
Mr. MULLINS. Yes, Senator Shelby.

Senator SHELBY. Now how is American business—small business, large business, medium, whatever—going to compete in an international global competition that's with us now and going to be with us where our companies and our individuals are paying much more for capital than the Japanese, for example, and possibly the Germans?

Mr. MULLINS. I agree that that is a major problem with our competitiveness and what we need to do, we all know, number one, is reduce the deficit. I think we also need to design plans to increase personal savings. If you look at our policies versus other countries, you notice a couple of tax differences as well. For example, virtually every other industrialized country has an advantageous rate on capital gains, which is right at the margin of investment.

Senator SHELBY. What about the dividends tax?

Mr. MULLINS. Double taxation of dividends.

Senator SHELBY. What does Japan have and what does Germany have?

Mr. MULLINS. The other countries give some relief from double taxation of dividends and these work directly to reduce the cost of equity capital. It's important not to tax capital because ultimately the only real way long term to get growth without inflation is through investment and increases in productivity. We are at a very fundamentally competitive disadvantage because of our high capital costs and I think that's at the root of our competitiveness problem.

Senator SHELBY. Do you believe legislatively that we can come forth in the Congress with some inducements to the American people that would really generate savings, or would that just be a horizontal shift?

Mr. MULLINS. I think we can generate new savings and not have horizontal shifts. I think the IRA programs are not quite as powerful as they could be because you can't remove the money until retirement, although it's good to have retirement plans.

In the administration's family savings plan you can remove money after 7 years.

I guess I believe the studies that are coming out now are showing that even in the IRA plan generated substantially more new savings than people thought. I don't think we have much to lose here because most Americans don't have much savings to shift.

Fundamentally, on the personal savings side, I believe that saving is learned behavior and we need to give people the incentive to teach them how to save.

Senator SHELBY. Does the psychology of inflation that was with us so long play a role in the individual saving or lack of saving?

Mr. MULLINS. I think people forgot how to save and they learned how to borrow and they need an incentive. And one of the things about these tax advantage plans is they will activate the private sector to design savings instruments and market them very heavily. You need to stick with it though. I think if you do stick with it we will get the sort of thing that started to happen with the IRA plan.

Senator SHELBY. By stick with it, are you talking about Congress passing a law for inducement for savings and taking it away 2 years ago?

Mr. MULLINS. That's exactly what I mean, Senator Shelby. It needs to become a habit and a routine.

Senator SHELBY. Predictability?

Mr. MULLINS. And after a while I think people will see it as an opportunity and there will be pressure—people will say, "Have you put in your $5,000?" That happened with the IRA. You felt that you had to do it or you were not very smart. It takes a while for that behavior to get started, but it has the potential for creating savings behavior throughout the population and I think it's worthwhile.

Senator SHELBY. Have you written any papers dealing with the cost of capital? I know you have been teaching at Harvard for a long time.

Mr. MULLINS. I haven't written papers directly on the differential cost of capital between the United States and other countries.

I have written papers on estimating the cost of capital and how you estimate the cost of capital.

Senator SHELBY. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Mullins——

Senator SARBANES. Mr. Chairman, could I ask just a follow-up question to Senator Shelby's point?

The CHAIRMAN. Yes. I will yield to you for that purpose.

Senator SARBANES. You said we didn't have much to lose in this effort to induce savings, but what's your view on seeking to induce private savings through tax changes that cost revenue and therefore increase dissaving by raising the deficit?

Mr. MULLINS. I think it's important that it produce new savings and not just shift savings, although with the average American family at $6,000 in savings and with a $5,000 plan, it's sort of difficult—well, you would run through the shifting process pretty quickly I believe

Senator SARBANES. What do you mean by shifting?

Mr. MULLINS. Well, simply the shifting of the $6,000 in savings which is normally taxable to a non-taxed plan, that's a loss in revenue.

Senator SARBANES. That's not what I'm talking about. I'm talking about to provide the non-taxable plan you're going to have to provide some inducement and you're going to raise the Federal deficit, which is dissavings.

Mr. MULLINS. Well, I think you raise the Federal deficit if you take away the taxes on existing investment. If people simply save more, the new savings, savings they would not have saved before, invest funds they would not have invested before, it's not clear to me that would increase the deficit.

Senator SARBANES. All right.

The CHAIRMAN. Mr. Mullins, you were the principal architect of the administration's savings and loan reform package. I got a call yesterday from Secretary Brady asking if the committee would undertake to expedite the handling of the Ryan nomination for chairman of the OTS. I indicated that we would move as rapidly as we can and we hope to have those papers today.

But that request obviously relates to the problem that's arisen with the court test which is underway out in the State of Illinois, as you know.

I took a look today at the original proposal that you helped write, which was sent up by the administration and introduced by request on February 22nd of last year. I went to the provision that deals with this to find out exactly what the thinking of the administration had been.

It's found on page 186. And with respect to the chairman of the OTS, it says on that page, "Provided, however, that the individual serving as the chairman of the Federal Home Loan Bank Board on the date of the enactment of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 shall be the chairman until the date on which his term as chairman of the Federal Home Loan Bank Board would have expired, notwithstanding section a."

Are you familiar with that? Do you recall this?

Mr. MULLINS. Vaguely, Mr. Chairman, yes, sir.

It is true that our original proposal was different because originally we did not propose splitting out the Federal Home Loan Banks themselves and so the only change to the Federal Home Loan Bank Board in effect was the splitting off of FSLIC. So it was a less dramatic——

The CHAIRMAN. Well, I'm raising a different point. As I read this language—and I'll send it down to you so you can take a look at it—it is very clear that you envisioned that the sitting chairman would serve to the end of the term.

Now you're not saying you don't remember that, are you?

Mr. MULLINS. No, Mr. Chairman. I think that was the proposal.

The CHAIRMAN. It was my assumption then, and it's my assumption now, that that was the intention the administration had. Am I correct in that?

Mr. MULLINS. Yes, Mr. Chairman.

The CHAIRMAN. The issue of where that idea came from has been raised recently. It came right out of your bill, did it not—out of your proposal?

Mr. MULLINS. Yes, Mr. Chairman.

The leadership of the FDIC and the Bank Board would have past through the bill and stayed in place.

The CHAIRMAN. Did the question arise in the drafting group of which you were part as to whether a legal challenge could later be made with respect to the confirmation process? Do you recall it ever coming up?

Mr. MULLINS. Well, I think it probably was considered, Mr. Chairman, and looked into, but I thought people did not feel it was a serious possibility because you took an existing agency and took away one of its subsidiaries and passed it over through the bill and I think it was looked at—that issue was looked at, but I think the conclusion was that we thought we were on sound ground.

The CHAIRMAN. Did it relate also, I suppose, to the fact that you were bringing that office in under the——

Mr. MULLINS. Under the Treasury Department.

The CHAIRMAN. Under the Treasury Department?

Mr. MULLINS. Yes, Mr. Chairman.

The CHAIRMAN. Let me ask you about the estimates in terms of the cost of the package. I gather you had a role in that as well. The latest estimates we have indicate that the $50 billion provided in the legislation is not going to be enough and that we are looking at a figure that is probably going to exceed that by some significant amount. The estimates vary, but I think a lot of the educated opinion is to the effect that we are probably going to see something at least in the range of $20 billion higher than the $50 billion anticipated.

Beyond that, there was no provision in the original plan for working capital. I mean, there's nothing spelled out in the plan specifically as it was presented. You may want to respond to that, but the estimates that we are now looking at are in the range of about $50 billion for working capital.

Would that be the way you would see it at this point, or how would you adjust those figures to what you think we ought to be anticipating?

Mr. MULLINS. Mr. Chairman, with respect to working capital, the legislation did include a working capital note cap—a cap on the notes issued by the RTC. So it did envision some sort of interim financing backed by assets. It did not specify the specific form of the financing.

In terms of the size issue, I still think it's too early to tell. The RTC has spent only $8.5 billion the last time I checked to pay for losses of S&L's. That's $8.5 billion of the $50 billion. At that pace, they could go for some time before needing new funds. I hope they are going to accelerate the pace.

I should also point out that——

The CHAIRMAN. Let me just ask you at that point, are you saying then that you think—that it is your best professional judgment, as you sit here today—that $50 billion is going to do it, whatever the time frame, or should we anticipate that it's going to overrun that figure?

Mr. MULLINS. Well, it is true that we designed a plan which met the estimates of the FDIC and GAO and the Bank Board, as well as our own independent checks and subsequently, there has been a tendency to raise estimates, in part I think because of the softness of the real estate market.

It's not clear to me, though, that the total package is substantially underfunded because the $50 billion was never intended to pay for all future resolutions. The $50 billion was intended to pay for the current hole, the currently insolvent institutions that had been insolvent for years and those that would be insolvent under new capital standards. We put in additional funds which start to become available in the fall of 1992, up to $32 billion in additional funds, for marginal institutions which may ultimately fail and have to be resolved through the SAIF fund.

I think if you look at the $50 billion and the $32 billion together, it may mean that we need the $32 billion earlier or something of that nature. But if you look at the total package it's not clear to me yet that we have convincing, compelling, analytical evidence that we have a serious underfunding. In fact, currently, there's plenty of money available and I think we should focus on trying to get the process moving because one input to the total cost of the problem, perhaps the biggest one right now, is the speed and efficiency with which the resolution and asset disposition process proceeds. If that doesn't get moving, the costs will likely be higher.

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The CHAIRMAN. Well, on that point I agree with you that we've got to get moving. We thought we had provided all the machinery that had been asked for, including sufficient money to move. As you yourself say, there's enough money there now, and I'm strongly of that view as well.

What's taking so long?

Mr. MULLINS. Well, Mr. Chairman, I think there are a number of factors. The legislation involved a relatively large start-up burden and I think appropriately so, of producing a strategic plan, of bidding rules, an inventory of all properties, ethics and conflicts rules and the like, and certainly we had to get through that process.

I tend also to think that the major reason for delay just reflects the difficulty, the massive complexity of this task. This thing took 15 years to develop. I'm not surprised that it isn't solved in 7 months.

We could speed up the process. If we wanted to do a lot of fast resolutions, we could do them tomorrow by giving long-term Government asset puts, long-term Government guarantees, and we could do a very large number of transactions at relatively attractive prices. However, I think that would be the wrong approach because that would leave the Government exposed down the road.

We've been trying to do this the right way and that is to move these institutions and these assets into the private market and get us out of this mess once and for all. That's just a very difficult, complex process to get off the ground. It requires, by necessity, a very large bureaucracy at the RTC level. I am hopeful, though, that we are now at the real take-off stage and we will see a significant acceleration in the process.

The CHAIRMAN. Is that the same thing as saying you feel good today about the package that we enacted? Because it was in every substantial detail the package that you asked for.

Mr. MULLINS. Mr. Chairman, I feel that FIRREA is a good law. I think it's the right approach. I think the administration made a good proposal and Congress improved upon that proposal.

The implementation has not gone as quickly as many would have like and as I would have liked. But I think that really reflects the difficulty of the task rather than the legislation itself, which I think is basically sound and the right approach.

The CHAIRMAN. Senator Mack.

Senator MACK. Thank you again, Mr. Chairman.

I want to move maybe to another area and another apparent conflict I guess.

Some at Treasury I think would argue that through various methods the value of the dollar should be reduced, reducing the price of American goods making us more competitive, increasing the price of foreign goods, reducing imports.

However, when one goes through that process, I think you can argue that you have increased the supply of dollars and you have taken away restraints in the domestic market because of competitive goods from outside the United States, and at the same time, again if the Fed's objective is to fight inflation, there appears to be at least on the surface an apparent conflict there.

I would be interested in your reaction as to (a) whether it is a conflict and (b) what do you think Fed policy should be if the

Treasury at the same time is trying to drive down the value of the dollar?

Mr. MULLINS. Senator Mack, I believe there are times in which it is appropriate to have intervention in foreign exchange markets. The classic example would be a period of disorderly markets or if we became convinced that the dollar had departed substantially from underlying fundamentals because of speculative reasons.

However, in general, I believe it's not wise to try to manage the dollar at levels inconsistent with the economic fundamentals. I think the answer to our competitiveness problems are much more in dealing with the underlying causes of inadequate domestic savings and cost of capital, which is too high, and I think addressing those fundamental underlying causes are the way to improve our competitive situation rather than looking to dollar management.

Senator MACK. I agree with that, but let me just go back again to the specific. There are certainly indicators over the last several months that the intention is to try to push the value of the dollar down. Is that counter-productive from the Fed's point of view with respect to its fight against inflation?

Mr. MULLINS. Well, it is true that a lower dollar does tend to increase inflationary pressures. We haven't seen much of a fall in the dollar recently I might add.

Senator MACK. Would that indicate to you that the underlying economic fundamentals are supporting a higher dollar value?

Mr. MULLINS. I'm not so certain. In part of my preparation I received, unsolicited, purchasing power parity estimates of the dollar which range from 209 yen to 104 yen I believe. So I'm not certain exactly where it is, although there seems to be a lot of demand out there for dollars and it's not apparent to me that there's a convincing case that it's out of line with economic fundamentals.

Senator MACK. I'm sorry, when I asked you that question I got off the main point again that I'm trying to pursue.

That is, is it counterproductive with the Federal Reserve?

Mr. MULLINS. My general view, Senator Mack, is that we ought to let the dollar be based upon economic fundamentals rather than trying to manage it. If the dollar falls, based upon economic fundamentals, we would have to deal with that.

Senator MACK. Thank you, Mr. Chairman.

The CHAIRMAN. What you're witnessing—of course, you can't see it directly because you're facing this way, but any time a Fed Member or a near Fed Member or a pending Fed Member utters anything that touches in any way, shape, or form on interest rates and where they might be going——

Senator MACK. Mr. Chairman, I thought I asked a very offensive question. I thought maybe that's what caused it.

The CHAIRMAN. If it touches the right buttons over at the press table, there's a mad scramble out the door and everybody heads for the phone booth from the press corps, at least those that have to report on a real time basis. So that rush of noise you heard indicates that you apparently said something of sufficient importance that it sent at least five hurdling press bodies out the door to the nearest phone.

Mr. MULLINS. I hoped it was my comment on the thrift situation.

The CHAIRMAN. And I took a look at Senator Mack because I wanted to see if he had understood, because I missed the importance of whatever the comment was that sent part of the press corps out there. Most of the press corps is still seated over here, so they took it in stride. I'm not quite sure why it sort of rocketed five out the door and the rest are here.

Senator MACK. I refuse to answer your question on the grounds that it might incriminate me.

The CHAIRMAN. I see. [Laughter.]

Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

Mr. Mullins, had you served in Government before you came to the Treasury in I guess it was October of 1988?

Mr. MULLINS. No, Senator Sarbanes, except for my service with the Brady task force on market mechanisms.

Senator SARBANES. How did it develop that you came down to the Treasury? Did the Secretary ask you?

Mr. MULLINS. The Secretary called me and asked if I would be interested in coming down and working on the S&L problem. I jumped at the opportunity.

Senator SARBANES. Did these talks that you had with Boskin and Darman and Sununu, do you recall about when they took place as it was leading up to this nomination?

Mr. MULLINS. I don't recall precisely, Senator Sarbanes. I think it might have been in October perhaps.

Senator SARBANES. That far back?

Mr. MULLINS. Yes, Senator Sarbanes. The process is a long one.

Senator SARBANES. Are you familiar with the—some saw it as almost an unprecedented intervention by the White House spokesman, Marlin Fitzwater, in effect, attacking the Federal Reserve and its policies back in January? Do you remember when that took place?

Mr. MULLINS. I do I think vaguely remember the incident.

Senator SARBANES. What did you think about that?

Mr. MULLINS. Well, as I recall, the President was going down to speak at the housing conference at Atlanta the next day and it was not unusual for Presidents to call for lower interest rates.

Senator SARBANES. So you saw it really as Fitzwater transmitting a message from the President?

Mr. MULLINS. I really wouldn't know exactly how it took place, although it's not unknown for people in the administration to prefer lower interest rates.

Senator SARBANES. Well, now let me read you a comment that was—this is from the Wall Street Journal about that point. It says, "The statement"—referring to Fitzwater's statement—"reflected concern by White House Chief of Staff John Sununu, Chief White House Economist Michael Boskin, and Budget Director Richard Darman that the Fed is being too zealous in its battle to rein in inflation."

Now those three officials are all people that you spoke to, by your earlier testimony here this morning—in effect, were interviewed by them, I guess is not an unfair characterization, in the course of finally being selected by the administration to be nominated to the Federal Reserve.

In those discussions, did this concern reported here—was that reflected in the discussions you had with these people?

Mr. MULLINS. Absolutely not, Senator Sarbanes. There was no discussion of my views—I think it's kind of interesting that there was no discussions of my views on the current situation or this concern.

Senator SARBANES. You say there were discussions in these sessions as to whether you were a monetarist?

Mr. MULLINS. Mike Boskin asked if I was a monetarist.

Senator SARBANES. What did you tell him?

Mr. MULLINS. I told him I was a pragmatist.

Senator SARBANES. And did Sununu ask about that?

Mr. MULLINS. He generally asked about my philosophy on monetary policy.

Senator SARBANES. Did you see the reports that Budget Director Darman was angry with Mr. Greenspan because of his policy?

Mr. MULLINS. No, Senator Sarbanes, I didn't see that one.

Senator SARBANES. Back in the summer of 1989. You're not familiar with that?

Mr. MULLINS. I don't recall that one.

Senator SARBANES. Are you familiar with these reports—let me just quote the headline—"Bush insiders see no renewal for Greenspan."

Mr. MULLINS. Yes, Senator Sarbanes, I have seen that.

Senator SARBANES. I would hope you would be familiar with those because those reports are pretty contemporaneous, aren't they?

Mr. MULLINS. Come to think of it, Senator Sarbanes, I do recall that Director Darman on a TV program criticized the Federal Reserve.

Senator SARBANES. It's reassuring that your recollection is picking up on this issue because this very article says, "Last August, Mr. Darman said in a television interview that if the country fell into a recession it would be because the central bank erred on the side of caution. Mr. Darman subsequently explained that he had not meant to be so blunt and he has not spoken out publicly since. Although a top Office of Management and Budget official said that he had heard of Mr. Greenspan's future, Mr. Darman is known to feel strongly about the issue and has continued to discuss it in Administration circles."

Have you ever heard any such discussion?

Mr. MULLINS. No, Senator Sarbanes, and I think when those reports came out, the Treasury Department issued a statement confirming there had been no discussions.

Senator SARBANES. And you hadn't been anywhere where this issue came up and was talked about in your presence?

Mr. MULLINS. It was not talked about and, indeed, when I see the stories on a number of fronts, the differences between the Treasury and the Federal Reserve, from being inside some of these discussions, I think the differences have been exaggerated.

Senator SARBANES. Of course, Darman is not at the Treasury. He's at OMB. In your answer, is the use of the "Treasury" meant to differentiate out Darman and Sununu?

Mr. MULLINS. No, Senator Sarbanes. I think everyone denied the basis for the story on the reappointment of the chairman.

Senator SARBANES. There just wasn't anything to it; is that what everyone said?

Mr. MULLINS. I think that's what everyone said, Senator.

Senator SARBANES. No one had had any problems with the Fed's policies?

Mr. MULLINS. I think everyone would like lower interest rates and one way to get there is to reduce inflation, but I know of no discussions in that vein and I might add again, in my discussions in talking about this job, these issues of the current policy were never brought up.

Senator SARBANES. Did you talk with the President about this job?

Mr. MULLINS. No, I did not, Senator Sarbanes.

Senator SARBANES. I see my time has expired. Thank you, Mr. Chairman.

The CHAIRMAN. Just on that point, I take it that the highest ranking official that you spoke to when you were interviewed was Secretary Brady and, I suppose, Budget Director Darman and Mr. Sununu at the White House. Would that be it?

Mr. MULLINS. Yes, Mr. Chairman.

The CHAIRMAN. Who called you to tell you you were going to get the job?

Mr. MULLINS. Again, I read that in the newspaper, but Secretary Brady and Michael Boskin and Director Darman had indicated to me that they would support my nomination.

The CHAIRMAN. Let me go to monetary policy here.

Senator SARBANES. Mr. Chairman, I'm going to have to excuse myself. I'd like to ask the chair if he would ask Mr. Kelley when he comes before the committee—maybe not so much on his renomination but even his initial nomination, whether he went through the same screening process that Mr. Mullins went through.

The CHAIRMAN. I will ask that question. He's had the chance to hear the question, so he will be able to answer now.

Do you see policy actions available to the Fed right now that would enable the Fed to push interest rates down from where they are at the present time?

Mr. MULLINS. I think the Fed could do that. I don't know that that would be a good policy. I am not a believer in these concerns that the Fed has lost its discretion.

The CHAIRMAN. Suppose the Fed decided to lower interest rates—and I'm not asking you to endorse that action, let me make that clear—but what could the Fed do today that could materially take interest rates down from where they are?

Mr. MULLINS. Well, in terms of short-term interest rates, they can have a very direct effect by increasing the growth in monetary aggregates. I would think in the long run, to get the long rate down, the only way to do it really is to squeeze out the inflation premium and pursue policies which the market is convinced have inflation whipped.

The CHAIRMAN. Now I take it, following that logic, if they were to just try to right now push down short-term rates, it would probably have the effect of pushing up long-term rates, would it not?

Mr. MULLINS. I agree with that.

The CHAIRMAN. Now what's available to the Fed right now, actions that you see or policy options that the Fed could take to reduce long-term interest rates?

Mr. MULLINS. Well, to reduce long-term interest rates, I think the Fed needs to continue to work on inflation and reduce inflation.

The CHAIRMAN. How does the Fed do that?

Mr. MULLINS. Well, I would not disagree with the current policy. Current policy has relatively high real rates and I think that's having a moderating effect on inflation and ultimately I hope it would lead to lower rates, although it may take a little while.

The CHAIRMAN. But you're saying that you don't really have a different view, then, than what you see happening now. In other words, it sounds to me like you are pretty much in harmony with what you sense is being done with respect to efforts that could bring down long rates?

Mr. MULLINS. Mr. Chairman, I haven't dived in yet and my approach to any job is to sort of dive in and learn it from the inside out and I'm not in that position now. But I don't think there is compelling evidence that the current approach is not generally sound.

The CHAIRMAN. Now you're an academic, and you're a very thoughtful man, and you've looked at these issues and these relationships for a long period of time. Are there options that are available to the Fed, that if it wanted lower long-term interest rates, that somehow by sheer policy action of the Fed that they could somehow bring those rates down? Is that realistic or is that really not the way things generally work?

Mr. MULLINS. The markets set long-term interest rates and that's been true for a long time.

Now it is certainly true—and I certainly wouldn't support it—but you could conceivably have very contractionary policies and you could conceivably have a big recession and that would take pressure off long-term rates. But that would be enormously costly and I don't think we should pursue that.

The CHAIRMAN. Are you saying that's a policy option available to the Fed?

Mr. MULLINS. No, I'm not.

The CHAIRMAN. I wouldn't think so.

Mr. MULLINS. I say that it is conceivable that you could get long-term rates down.

The CHAIRMAN. I'm trying to get at the issue of what the Fed's ability is to move interest rates around as you see it, and it relates to a question that was raised earlier by Senator Shelby. That is the degree to which the internationalization of money flows and interest rates and capital flows may be and, I think, expressing my own view, is having the effect of reducing the ability of the Fed to unilaterally push rates up or down. And I make the same differentiation you do between short-term rates and long-term rates.

As we rely increasingly on international borrowing and as the world financial system is increasingly one system—and I know you hold that view to a large extent—aren't we in a situation where our ability to control long-term rates is probably less today than it was maybe 10 years ago or 15 years ago? If the same trends continue, aren't we apt to find that in the future that our ability, as one Nation separate and apart, to take down our long-term rates without reference to the rest of the world is something that we, by and large, are not able to do?

Mr. MULLINS. Well, I do think we can't do it without reference to the rest of the world, although from someone who deals a lot in the U.S. capital markets, the participants in those markets still believe the Fed has a lot of policy discretion. I also think that——

The CHAIRMAN. Do you believe that?

Mr. MULLINS. I believe they do.

The CHAIRMAN. That they can bring down long-term rates?

Mr. MULLINS. Well, now, let's talk about that one. I think in the past people have overestimated the ability of the Fed to control long rates except through inflation. I do believe that changes in rates in other countries which are primarily changes in inflation expectations do not have to affect our rates.

So if you have a situation in a specific country where inflation is expected to be higher and the rates go up for that reason, that doesn't have to be fed back.

It's also true that the exchange rates—some economists believe interest rates should be totally decoupled and all the arbitrage should take place in exchange rates. I don't believe that happens.

I do believe where we are tied together is in real rates and when we see an opportunity, a world class opportunity like Eastern Europe, where we've discovered an underdeveloped country of 100 million in effect, that in general will push up rates some. I believe this argues for consultation among the economic leaders of the world so everyone understands their goals, problems and targets.

The CHAIRMAN. I agree with your last point, and I want to just pursue it one more step.

We see a picture today where interest rates are rising in Japan, interest rates are rising in England, rising in Germany and rising in Europe generally.

As interest rates are rising other places, the United States is really not able, is it to disconnect itself from this world picture, and if we want long rates from 8.5 percent to 7 percent because we would rather have a 7 percent long rate in the United States? The Fed doesn't have the power today to do that, does it? Do you think it does? Do you see a way to make that happen if you're over there at the Fed?

Mr. MULLINS. I think it depends on why the rates are going up.

The CHAIRMAN. I'm talking about today and your assessment of the situation that's out there right now.

Mr. MULLINS. I think the increase in Japanese rates does not have to wash back to United States rates. To the extent that the German rates have gone up following the talk of the monetary union which might be an inflation spread, I don't think we've seen an increase. The real rate increase that we saw I think did wash back.

I also think that with the inadequate personal savings, we are always on the margin of dealing with capital flows from abroad and, for example, when there's an opportunity to invest, like in Eastern Europe, that's a competing opportunity for funds which we need to flow in to service our own investment needs. I do think if we could increase our domestic savings, we would have more insulation from these——

The CHAIRMAN. We all want to do that and it would be great if we can, but it seems to me that we're in a situation where rates are pressing up around the world for a variety of reasons. Because we are now the largest debtor nation and continue to require a large amount of foreign borrowing ourselves, we're not in a position to drive our long rates down as things stand today. The Fed doesn't have that power today and you're not going to be taking any power over there in the way of an approach or a theory—at least if you have one I haven't heard it yet, and if you do I would love to hear it—that's going to enable us to take long rates down in the face of these rising international interest rates.

I am not saying there's a one-for-one wash back and forth in real interest around the world, but we need to have a realistic expectation of what the Fed can and cannot do by itself with respect to long term rates.

Mr. MULLINS. I agree with that, Mr. Chairman, although again, I think if we can continue to reduce inflation, we would have a direct impact in lowering not only our nominal rates but our real rates, and I think the Fed has policy discretion to work on that.

The CHAIRMAN. Well, I want to hear what the Fed can do to reduce inflation. I don't know whether Senator Mack will ask that, but I will if he doesn't.

Senator Mack.

Senator MACK. Thank you again, Mr. Chairman.

I think we might as well continue the discussion. The sense that I have is that while we're all kind of focusing on the impact of changes in interest rates internationally, the bottom line, the level of inflation in this country really is what drives long-term rates. And it seems to me that if there were a stated commitment by the Federal Reserve that said price stability is the number one goal, we are committed to that, we realize that there may be some difficult economic times ahead of us but we are determined to bring down inflation and maintain price stability, and then Fed policy month after month after month following that was not only in line with that but seen by the markets as being in line with that, I would suggest that that would be a way that interest rates in fact would come down.

Do you agree with that?

Mr. MULLINS. I agree that it would be useful to set a steady, credible path to try to reduce and eliminate inflation as a factor in individual and business decision making.

Senator MACK. This kind of goes in full circle now to the first question that I raised really because that was what was stated by the Federal Reserve I think earlier last year, maybe even earlier than that, maybe when Alan Greenspan was first named as chairman.

I really believe that what happened in December of last year was a signal that the Fed was backing away from that commitment. As a result of that, we saw the long-term interest rates go up.

Now your response, if I remember correctly, was that basically, no, there were other conditions that affected it and I think you mentioned international rates as well in your response.

Mr. MULLINS. Yes, Senator Mack, and also the fact that the U.S. economy proved to be stronger than many analysts had estimated.

Senator MACK. I've only got one more question to ask and that has to do with—I, too, was kind of surprised by the lack of specific questioning on the part of the administration with respect to your views about monetary policy. So help me.

Are you telling me that the decision about who would be nominated to fill the balance of 6 years, that during that process that detailed discussions and very specific questions somewhat along the line that we've raised here this morning were not raised with you as to what your specific beliefs about your ideas with respect to monetary policy are?

Mr. MULLINS. Well, there was considerable discussion about my ideas with respect to monetary policy and the opinions I hold and the long-term issues.

There was no discussion of my analysis of the current situation or these issues of whether I felt rates were too high or too low or any of the sort of issues which Senator Sarbanes has been discussing.

Now it is true that I've worked with most of these gentlemen on a number of occasions since I've been here, so they are not strangers to me nor I to them.

Senator MACK. Is it fair for me to draw from that that maybe there were discussions during the last several months in the process of debates about other issues where you raised your points of view with respect to present monetary policy?

Mr. MULLINS. Absolutely not, Senator. It's just that they knew me as a person. They saw how I approached other problems. But I, in those circumstances, did not discuss monetary issues either. It's as if they were were focusing on the long-term characteristics and the overall philosophy, rather than any specific opinion on the current situation.

Senator MACK. Just a last comment. I appreciate that and I wish I could be here to carry on the discussion with Mr. Kelley when he has an opportunity to testify, but frankly I got a number of answers as I observed your head either going up or down on the responses. So I apologize for not being able to remain. Thank you.

The CHAIRMAN. Senator Sarbanes.

Senator SARBANES. Mr. Mullins, do you think it would have been wrong if they had asked you those kinds of questions? Why wouldn't it have been—in fact, what do you say if I say to you that I'm surprised you weren't asked those kinds of questions, just like you're being asked them here today. Why would they put you on the Federal Reserve Board and not have some idea of where you were going to be coming from once you got there?

Mr. MULLINS. Well, I think they certainly know me and we've worked together and they also talked a lot about my general philosophy on monetary policy and on——

Senator SARBANES. Do you think they talked enough about your general philosophy on monetary policy that one could deduce your specific views on monetary policy?

Mr. MULLINS. There was simply no detailed discussion on whether the current situation was good or bad.

Senator SARBANES. Well, obviously we've pressed this because it's an independent institution and its independence is important and you've been at the Treasury. I think essentially you're being nominated because you're on the same wave length as all these people who interviewed you. I think they ran you through a pretty careful vetting from the extent of the discussions apparently that were held, but I think someone earlier made the comment that people of substance often assert their independence when they get into positions.

I want to ask you a couple of substantive area questions here. One is, you were the Associate Director for the Brady Commission report on the stock markets, is that right?

Mr. MULLINS. Yes, Senator Sarbanes.

Senator SARBANES. The report of the commission concluded that stocks and stock futures and options were all part of one market and they recommended that one regulator be given responsibility for that market. Is that correct?

Mr. MULLINS. For the important cross-market issues, the issues that cut across markets.

Senator SARBANES. Do you agree with that report?

Mr. MULLINS. Yes, I do, Senator Sarbanes.

Senator SARBANES. Who should the regulator be?

Mr. MULLINS. Well, I think it's more important that we have coordination and end these sort of jurisdictional disputes and I think that's more important than the specific decision on who it should be. The Working Group on Financial Markets is currently looking at these issues directly. I wouldn't want to prejudge those deliberations. I simply think that it's time to solve the problems of lack of coordination and design a system which does put the appropriate issues under one regulator.

Some people have discussed full merger of the CFTC and SEC as an option. Others have suggested splitting off stock index futures from the CFTC and putting them with the SEC. Others have suggested simply moving margins for stock index futures over to the Fed. And I think it's worthwhile discussing all those options but doing something pretty soon.

Senator SARBANES. Do you think the margins should be handled by the Fed, setting margins on stock futures?

Mr. MULLINS. In the Brady Commission report we felt the most important thing is that margins should be at one place. They should be coordinated because stock index futures and stocks are related and when margins are out of balance you have problems.

Now we felt the easiest way to do it, since the Fed already had margins on stocks and on options, was to simply move over margins on futures.

That doesn't have to be the only way to do it. You can put it all at the SEC.

Senator SARBANES. But come, come, Mr. Mullins, now. I don't know why I have to get—it's a little bit like President Truman saying he wanted a one-armed economist so he didn't get this advice on the one hand and then on the other hand.

Now you were the Associate Director of that Commission. You made a report. As you've pointed out, margins on stocks and on options are in the Fed now. Why shouldn't margins on stock futures be in the Fed? Why shouldn't they be set by the Fed?

Mr. MULLINS. Well, they could be.

Senator SARBANES. Well, I understand they could be. Do you think they should be?

Mr. MULLINS. I think it would be a better solution to try to do what I think we are doing in this debate right now. And that is to find an overall solution not only to the placement of margins but the jurisdictional disputes on new instruments and also to the enforcement issues and I think margins are part of that.

Senator SARBANES. Do you envision taking from the Fed in order to achieve this consolidation that you think is an important premise—do you envision taking from the Fed its power to set margins on stocks and on stock options?

Mr. MULLINS. Well, it is conceivable that under a new structure it would make sense to move those to some other place.

Senator SARBANES. Where would you move them to?

Mr. MULLINS. Well, for example, you might move them to the SEC which currently has the other regulatory responsibility for stocks. The Fed already delegates its authority to set margins for options to the exchanges with oversight by the SEC. The Fed doesn't do it directly. The Fed hasn't changed stock margins since 1974 I suppose, and I think there's an argument that the original circumstances which led to the Fed having the authority to set margins are no longer present.

Senator SARBANES. So you would entertain moving them to the SEC?

Mr. MULLINS. That would be one possibility.

Senator SARBANES. Would you entertain moving them somewhere else other than the SEC?

Mr. MULLINS. Well, again, I think they should be under one agency and I think that the two choices would be to leave them at the Fed and consolidate them at the Fed or move them to the SEC.

Senator SARBANES. All right. Now if you move them to the SEC, what does that imply about consolidating other regulatory jurisdiction, particularly that of the CFTC?

Mr. MULLINS. Well, again, I think to solve the problems we have in jurisdiction, enforcement and market mechanisms, there are two ways you could do it. One would be to move the jurisdiction for stock index futures over to the SEC along with margins and then you would have the SEC doing stocks and stock index futures.

Another approach, which is somewhat more drastic, is simply to merge the CFTC into the SEC or create a new agency which has responsibility, as most other countries have—one agency that has responsibility for futures and stocks.

Senator SARBANES. Under any of your scenarios, you don't envision moving any of this jurisdiction to the CFTC, do you?

Mr. MULLINS. I don't think I would envision that.

Senator SARBANES. OK. Thank you.

The CHAIRMAN. May I ask a follow-up to this?

Senator SARBANES. Sure.

The CHAIRMAN. I'm not sure there's anybody in the Government that's thought about this any more than you have and I say that respectfully. I mean, this is your background and it's your interest and you've worked on it and you're highly knowledgeable and I have great respect for your intellect. I think you are one of the people around that really is able to fathom in a comprehensive way these issues and I say that as a genuine compliment.

I think you have an opinion because I think you have studied it enough to have, in all likelihood, reached a judgment about it and I'd like to know what your own opinion is. You're not speaking for anybody else. You're not here speaking for the Treasury Department or for a working group or anyone else. You're here as a nominee for the Fed and I would be interested in what your view is, your own professional view.

Mr. MULLINS. Mr. Chairman, the difficulty I have is, I still participate in the Working Group meetings on financial markets and we are literally—I don't know if I'm late for the meeting—but we are literally considering these issues and confronting them. They're in a stage of deliberation. I think I can outline what I feel are the two viable approaches—either moving the stock index futures which takes care of 90 percent of the problem, or the full merger; but because of the state of those negotiations—I think the principals are going to be here to testify next week on that. I do not believe it is appropriate for me to state a final conclusion.

There's no question that merger is the most direct and powerful way to deal with the problem and that's the way regulation is accomplished in most other countries. That is you have one agency dealing with these issues. However, there are some disadvantages to merger. For example, you create a large, bureaucratic organization which is less responsive to the market at a time we need competitive vitality. Moving the stock index futures would essentially solve the jurisdictional problems, the enforcement problems, I think, and the market mechanisms problems with less disruption than full merger. However, you would still have two separate agencies and the CFTC would have less to it than before.

The CHAIRMAN. If we confirm you next week in the Senate to the Fed, do you stay on the Working Group or do you come off the Working Group?

Mr. MULLINS. Well, I am on as a Treasury official and Chairman Greenspan represents the Fed, but he consults widely enough I feel confident I will stay in touch with the issues.

The CHAIRMAN. Is there no understanding as to whether you would remain on the Working Group as the Fed member?

Mr. MULLINS. Well, I would certainly be involved, and senior Fed staff, as well as some of the other Governors have been involved, so I think I will continue to be—I have every expectation that I would continue to be involved.

The CHAIRMAN. So I take it that your testimony on this specific question is, it's not that you don't have a point of view personally and professionally, but that you prefer not to state it right now because you're coming down the home stretch on the policy debate and you would prefer to keep it ambiguous until that issue is settled there. Is that correct?

Mr. MULLINS. I think we need to do something. For the first time, these foreign markets are viable competitive threats to us and we've not made the changes we need to make and I might add, the more time that passes when we don't make those changes, the greater the pressure just to put it all together in a merger and let them figure it out.

I wouldn't say that I would leave it ambiguous. I think it's presumptuous of me at this stage of what they're doing to state my opinion. I would prefer that the important opinion, those of the Working Group members who will be up here next week, be stated.

The CHAIRMAN. Tell me what you think the Fed can do at this point and the kinds of things you would try to endeavor to have the Fed do in the current circumstance to reduce inflation. You talked earlier about that being an important role for the Fed as you see it. What could be done? What more can be done as you see it now to bring down inflation by the Fed?

Mr. MULLINS. I think the Fed needs to show the willingness to stick with a firm policy of moving on inflation and, again, it's not clear to me that the current policy is not sound. But I do think we have to—in fact, I think it, in general, is the right approach. What we need to do is essentially break the back of inflation by continuing to have progress. I don't think we should—I am not a big believer in——

The CHAIRMAN. How does the Fed do that? You're saying you set it as a goal, let's get the inflation down further, but what does that translate to? What tools does the Fed have available to it, as you see it, that can enable the Fed to squeeze the inflation down further? What does that mean?

Mr. MULLINS. The basic tool is to keep the pressure on. Real rates will have to be somewhat higher than we would like them to be, and to maintain a stance that is not overly expansionary until we start to see some progress.

The CHAIRMAN. So in other words, it means a somewhat higher level of interest rates and then a lower level of interest rates. Is that right?

Mr. MULLINS. I think ultimately the way to get lower rates is to get rid of inflation, so temporarily we have to accept the cost of higher rates.

The CHAIRMAN. Senator Sarbanes.

Senator SARBANES. On this very point, I want to pursue this capital gains tax cut, which over time will cost us money and raise the deficit. Correct?

Mr. MULLINS. Well, I have not been involved in the revenue estimates, Senator Sarbanes. Those estimates do not include what I feel is the most important aspect of reduction in the capital gains tax, and that is a reduction in the cost of capital.

Senator SARBANES. Let's discuss the reduction in the cost of capital. That's exactly what I wanted to get to.

How much of the capital that is made available to corporations is raised by debt rather than equity and therefore not subject to capital gains taxation?

Mr. MULLINS. Pardon me?

Senator SARBANES. How much of the capital that is made available to corporations is raised by debt rather than equity and therefore not subject to capital gains taxation?

Mr. MULLINS. Well, a significant percentage is raised by debt.

Senator SARBANES. Some 40 percent?

Mr. MULLINS. That sounds about right.

Senator SARBANES. So that leaves 60 percent from equity.

How much of corporate equity is held by institutions not subject to capital gains taxation?

Mr. MULLINS. For institutions not subject to capital gains, I wouldn't know the exact number, although it——

Senator SARBANES. Does about half sound right to you?

Mr. MULLINS. I think it would be less than half, Senator. Maybe 40 percent I would estimate.

Senator SARBANES. Now that brings us down to where we're about 30 or 35 percent of the capital of corporations that would be conceivably touched by the capital gains tax. Correct?

Mr. MULLINS. Well, I don't think you should just look at flows and you can't look at static flows. I think if you offer people an opportunity to earn higher returns on investment, they will increase their investment. And I think that increase is most significant.

Senator SARBANES. How much of asset appreciation in the household sector is held until death in part to avoid any capital gains tax whatever?

Mr. MULLINS. Pardon me, Senator Sarbanes?

Senator SARBANES. How much of asset appreciation in the household sector is held until death in part to avoid any capital gains tax whatever?

Mr. MULLINS. I wouldn't know, Senator.

Senator SARBANES. That's a fairly significant percentage, isn't it?

Mr. MULLINS. I suppose so.

Senator SARBANES. Do you think that a 30 percent exclusion would induce many households to forego the 100 percent exclusion they realize at death?

Mr. MULLINS. I think, Senator Sarbanes, that the capital gains tax is absolutely at the margin of the decision to invest and virtually every other country has an advantageous rate on capital gains because they consider the benefits to outweigh the costs.

I think we are at a competitive disadvantage because we do not have such an advantageous capital gains tax.

Senator SARBANES. How far would interest rates have to fall to give the same reduction to the cost of capital as a 30 percent capital gains exclusion?

Mr. MULLINS. I wouldn't know, Senator.

Senator SARBANES. Would I be correct in saying that they would have to fall a very, very tiny amount—five-hundredths of 1 percent?

Mr. MULLINS. Again, if you were to look at the places where the capital gains tax would be most beneficial—investment in young growth companies, entrepreneurial activities—the equity investment is the prime risk capital which makes those organizations go. They are not highly-leveraged organizations.

Senator SARBANES. Well, Venture Capital Journal says that 90 percent of the new commitments to venture capital funds in 1986, when you still had a capital gains tax, came from entities other than individuals and families who benefitted from the exclusion. And then after it was repealed, they set new records.

Mr. MULLINS. I would argue that a reduced capital gains tax would benefit young growth companies and draw in——

Senator SARBANES. But a rather slight reduction in the interest rate would be more beneficial in reducing the cost of capital than a capital gains tax cut, would it not?

Mr. MULLINS. I think we should do both.

Senator SARBANES. I know, but they work at cross-purposes if reducing the capital gains tax raises the deficit which then provokes you to keep high interest rates, doesn't it? Isn't there a relationship between the deficit and the interest rates?

Mr. MULLINS. I think there is and it's not clear to me that when you take into account the dynamic effect of reducing the capital gains tax that debt revenues might well increase.

Senator SARBANES. That sounds a lot like Mr. Laffler. Are we back to that curve?

Mr. MULLINS. No, Senator. I do think it's not an unusual proposition that reducing the cost of capital increases investment and would benefit the economy, including tax revenues. And I do think the debt question——

Senator SARBANES. Well, that's my point. Don't you think it would help more to reduce—if in fact, as I have asserted here, a reduction of five-hundredths of 1 percent in the interest rate would equal the incentive of the reduction of cost of capital that would come from a capital gains tax cut, wouldn't it make more sense to try to get the interest rate down?

Mr. MULLINS. Well, again, I think the place where the benefits of the capital gains tax would be most directly applied would be in younger companies, in growth companies, in which the debt ratios are not especially high.

Senator SARBANES. Thank you, Mr. Chairman.

The Chairman. We've spent quite a bit of time here but I want to cover a couple of other things before we finish.

I want to have you take a look at a letter that I sent to Secretary Brady back on October 5th of 1989, and it was answered on December 12th. It deals with junk bonds. I think you're probably familiar with the letter. I think you will be when you see it, and I will send it down to the table in a minute.

When the response was sent back from the Secretary, there was attached to it—I assume by inadvertence—a routing slip that one would read to indicate that the letter had been assigned to you to draft something for the Secretary.

Mr. MULLINS. I'm glad we make those things public, Mr. Chairman.

My guess is that would have been handled in my office, by the Deputy Assistant Secretary for Corporate Finance.

The CHAIRMAN. Let me send it down to you because I want you to take a look at it, and I want to send down a copy of the Secretary's response. Let me just give you a minute to look at the letter and see if it rings some bells as you look at it.

The thrust of the letter, as you're studying it, and for others in the room, is to get at the question of what's the lay of the land with respect to junk bonds outstanding, who holds them, what kind of a market system is there, how does one assure that people are getting fair prices and full and adequate information and so forth. Now, this was some time back. Since these letters were exchanged, the junk bond market took the sharp drop.

Would you have been the one who would have drafted this response?

Mr. MULLINS. Mr. Chairman, I doubt that I drafted it. It was drafted somewhere in my office. I have an office of corporate finance and that's where it was probably produced. I am generally familiar with the letter.

The CHAIRMAN. Would the notations on the second page be your notations, or would these be somebody else's?

Mr. MULLINS. The notations on the second page?

The CHAIRMAN. On the second page of my letter to the Secretary.

Mr. MULLINS. No, Mr. Chairman, that is not my handwriting.

The CHAIRMAN. OK. I must say that when I got the answer back I was disappointed in the answer because I thought it didn't say much. This is no disrespect to the Secretary. I have great respect for the Secretary. But I thought that it really didn't engage very fully the issues and questions that were posed in the letter.

And I think the events in the junk bond market since point out why we ought to really know what we're doing here more than I think the Government presently does.

When you look at the response of the Secretary, you notice the attachments. Just take a look at those for a minute. You and I are both folks that spent time at the Harvard Business School and so we're used to seeing documents like these.

This constituted all of the information accompanying the reply to my questions. Do you notice down on the bottom of the attachments what the source of the attachments is?

Senator SARBANES. Drexel?

Mr. MULLINS. Yes, Mr. Chairman, Drexel Burham Lambert.

The CHAIRMAN. I must say I when we took a look at this and we saw that the documentation the Treasury seemed to have, the full extent of it because it was all that we were sent, was information that had been compiled by Drexel Burnham. I think it's obvious, at least from today's perspective, that we need information in the Government on something as important as this that is our own information, not derived from Drexel Burnham or any other outside private company.

I must say, the impression that I got from the response was that we really don't seem to know very much about what was going on in the junk bond area.

Do you know if we've got more independent information, self-generated information, now within the Treasury Department on the whole junk bond market and who holds the junk bonds, how the marketing system works whether people are getting accurate quotes, who has these instruments and wants to try to buy or sell them? Do we have more information today than we had then?

Mr. MULLINS. Well, I think this information is only illustrative, the Drexel information, and there is information from a variety of sources.

I am generally comfortable with the outlines of the aggregate information and feel that from a variety of industry sources and other sources we have a pretty good idea. However, the specific information is not very good.

I think we also tend to have pretty good information in the regulated investor sectors on mutual funds. On S&L's we have good information, a little less well on pensions and insurance.

In general, though, I think it would be useful to have a little more precision. For example, when doing research in this area you literally have to go back to SEC filings and pick them up bond by bond since there is no centralized system.

The CHAIRMAN. Shouldn't we have a centralized system? Why isn't it time, when you've got—if I'm not mistaken—about $200 billion worth out there, shouldn't we have a modernized quotation system so that people don't get cheated?

Mr. MULLINS. Let me just mention—to finish my earlier thought before I go on to that one. I do think the SEC is really the appropriate place to develop the detailed information on who holds the bonds and the like.

As for the market pricing system, I think that's worth looking at and examining. One of the reasons I'm not so optimistic on that is that to a certain extent it's like getting blood from a stone. These instruments are not very liquid and they never have been and they never will be. They are much more liquid than private placements, so they are a big advantage. But they are not continuous markets and there's a very real reason why they are not continuous markets.

In order to invest in one of these bonds, you have to do very detailed, fundamental analysis of the company, like you would have to do for equity. But more than that, you have to do detailed analysis of the indenture, where you stand in default, which is a significant possibility. That adds a big analysis burden and because of that you don't find a lot of investors standing by at all times ready to buy and sell. Even inside these investment banking companies, when you look at a screen and see prices for the high yield bonds, those are not market prices. They are what's called matrix pricing, which are hypothetical prices determined by interpolation. You look at the few bonds that have traded recently in volume and you try to interpolate a hypothetical price.

So I am not too confident, by the very nature of this market, it's not going to be a continuous market.

I would also be a little concerned if we had a system which tended to mislead individual investors into thinking the market was more liquid than it was.

The CHAIRMAN. How could they be any more misled than they are being misled now, when they can't basically get any kind of a realistic reading?

Mr. MULLINS. Well, I think to a certain extent it's the nature of these markets, that they are simply not liquid markets. People should know that going in and one thing we ought to think about is, when you have a new market which develops like this, how you can get full disclosure so people understand the liquidity risk and the price risk. Besides the default risk that the market I think probably underestimated, they also misperceived the price volatility of these instruments, the fact they tend to sell below par, and the liquidity risk. And indeed, articles in Barron's in I guess around May of last year really exposed the pricing and liquidity problems in this area.

But these are, again, more liquid than private placements, but they simply are not the type of instruments where you will typically find a lot of people ready to buy and sell at any time.

The CHAIRMAN. Let me ask you this. What specific lessons have you learned from the failure of Drexel as a professional? What lesson should be drawn from that?

Mr. MULLINS. The first is that large institutions can be allowed to fail without undue systemic damage. I think that's an important lesson for the coming debate in financial services.

The second is that the implicit firewalls in capital standards in the broker-dealer worked pretty well under the watchful eye of regulators and they were able to keep the broker-dealer solvent, which allowed the transactions to unwind without damage to the system. And in some sense, the firewall of the capital requirements worked in that case.

The third factor I would point to is the wisdom of the holding company risk assessment proposal in the market regulation legislation up here because if this had been a commercial bank, regulators would have known for weeks ahead of time where the soft spots were.

Here, when the Drexel situation became critical, regulators walked in with very little idea of where the landmines were because they didn't know what was going on at the holding company. And when you started to unravel what's going on in the holding company and see how funds are shifted around, you had basically each regulator looking at their little piece of the pie—the CFTC watching their margin and SEC looking at their capital—but no one had an overview of the full system.

That's why I believe in financial services reform we ought to think about the need for someone to have that overview.

Two other points I would raise hypothetically——

The CHAIRMAN. Doesn't that mean that affiliates have to be very carefully monitored and measured?

Mr. MULLINS. I think I would agree with that, Mr. Chairman. I would agree with that.

I would mention two other lessons. It's interesting as we enter financial services reform to think of the Drexel situation as a hypothetical situation under different models of Glass-Steagall reform.

Suppose Drexel had had a commercial banking affiliate. Would they have made the same decision that the private commercial banking—the non-affiliated commercial banks made not to fund the firm?

I think the difficulty is, if they had not, the problems of Drexel could have ended up in the Federal safety net, in an insured depository. This illustrates the need I think for some sort of insulation, if we do go to a structure allowing financial institutions to be in a wide variety of activities—some sort of insulation—simple, firm, direct—maybe like the inter-affiliate rules.

The second thing I would mention is the other form of the safety net. Some proposals you see today—and I'd keep an open mind on this—would give broker-dealers access to the discount window and that's part of the federal safety net. One would wonder how a Drexel situation would work if the broker-dealer had access to the discount window. We should be careful in thinking about the Federal safety net to realize it's not just deposit insurance but it includes other things as well. We may reduce it in one area and increase it in another area.

So I think the Drexel situation should be studied as we think about comprehensive financial services reform.

The CHAIRMAN. I have one final topic I want to raise with you that we touched on earlier. You're coming out of the Treasury Department and you've really been a key policymaker there and you've been right in the center of most every major issue in the Treasury insofar as I can tell.

You are now headed over to the Federal Reserve Board, which is, as we've talked about today, an independent body. It's one whose independence is particularly important I think.

Earlier, Richard Breeden, who also served in a key spot in the administration on financial policy issues, was named to go over to the SEC, confirmed by the Senate, and reported out favorably by this committee with the affirmative vote of this chairman.

Do you know of any other time in recent history where there would have been from an administration two central financial policy players that would be taken out within the first year or year and a half of that administration and appointed to major policy positions in independent regulatory bodies?

Mr. MULLINS. Mr. Chairman, I don't know of a circumstance. However, I don't know that if you looked back it would be so unusual. Manley Johnson, currently at the Fed, came from an earlier Treasury job as Assistant Secretary, and he had also been instrumental in a variety of things going on at that time.

The CHAIRMAN. The reason I ask the question is not to in any way challenge your statement that you intend to be independent. I take you at your word. By the same token, I think an appearance begins to take shape of a small group of policymakers coming out of an administration, going out into key spots in independent financial branches of the Government. I think a fair and appropriate and necessary question is whether these cases or any continuation of that pattern would give the impression of or start to have the effect of creating a policy nexus across boundary lines that are designed to separate parts of our Government and to establish independence?

Obviously, there needs to be a flow of ideas and give and take and so forth, but I think one of the safeguards of our system, and it is a very important safeguard, is that there be these divisions and that they be clean divisions, that separate bodies be charged with separate tasks, be free to carry them out, sometimes in direct opposition to some other part of the Government, whether it be the executive branch or another independent agency.

This is my 24th year in the Congress, and I've tried to recall any other time that would be parallel to this, where you've got a new administration, roughly a year old, two central policymakers came out of that administration and went out into two absolutely critical independent financial agencies. That doesn't necessarily mean there is anything to it, but it is unusual. I can't recall another time like it.

It causes me to ask with perhaps more than the normal sense of interest that we have an assurance that we're going to have independent decisionmaking and not some kind of de facto group decisionmaking that spills across these boundary lines.

Mr. MULLINS. Well, I am sensitive to that concern and, again, as I said before, Mr. Chairman, I would commit to exercise my independent judgment. I also think the agencies are set up to encourage independence, and I would hope and expect that appointments are made based upon expertise, and I look forward to the challenges at the Federal Reserve.

The CHAIRMAN. I have one question that Senator Sasser has asked me to raise with you. It runs as follows:

Now that the RTC has the Federal financing capital that is available, should we slow down our REFCORP borrowing? And would you estimate how much more REFCORP will borrow in 1990 and how much will be borrowed in 1991?

Mr. MULLINS. I don't think we should slow down the REFCORP borrowing. REFCORP funding is for hole—we've done $9.5 billion so far. We filled $8.5 billion of hole. I think it is worth while to keep it distinct. The payment of losses should be seperate from the working capital financing which is backed by assets. It is also true that the cheapest way to do REFCORP financing is to set up a steady predictable schedule calendar, and so it is costly to start and stop REFCORP funding. I would not predict exactly what levels we will be issuing in the future, although on the order of $3 billion to $5 billion a quarter till the borrowing authority is exhausted, it runs out, I think, is the order of magnitude.

The CHAIRMAN. So that projection would take us through 1990 and 1991?

Mr. MULLINS. Yes, Mr. Chairman. It may be that it could rise if the pace of resolution picks up, but I would generally see it tracking the payment of hole in the resolution process.

The CHAIRMAN. Let me conclude by saying to all of the Arkansans that are watching on television, members of your family and others that would be supporting your nomination, that I think you've been responsive to what we have presented you with today. There will be other questions, I think, for the record from other members that we would like you to respond to.

I appreciate the quality of the answers that you have given today. I am supporting your nomination because I think you bring the kinds of skills and the capacity to the Board that it ought to have. I think your independence is the most important asset you have, and you have told us that you intend to hang onto it, and I believe you when you say that, and it will be important that that be carried out.

Thank you very much.

Mr. MULLINS. Thank you, Mr. Chairman.

The CHAIRMAN. Let us excuse you now, and let me call Mr. Kelley.

Mr. Kelley, do you want to come forward, please. You, of course, are here for reappointment, and you feel as if you've gone through something of a hearing process already today sitting through that discussion with Mr. Mullins. We are pleased to have you before us. I am going to ask you, if you will, stand and let me administer the oath to you.

[Witness sworn.]

The CHAIRMAN. Do you agree to appear and testify before any duly constituted committee of the Senate?

Mr. KELLEY. I do, sir.

The CHAIRMAN. Very good. Be seated, please.

Do you have any opening comment that you would like to make to us? I am going to make a statement at the conclusion of any opening comments you want to make.

EDWARD W. KELLEY, JR., OF TEXAS, TO BE A MEMBER OF THE BOARD, FEDERAL RESERVE SYSTEM

Mr. KELLEY. Mr. Chairman, I do not have a prepared statement, but I would appreciate just a moment of your time, spontaneously.

First of all, I appreciate the kind words of Senator Gramm when he was with us earlier this morning by way of introduction. And I would like to say it's been a tremendous honor for me to have had an opportunity to serve on the Fed for the last almost 3 years. It has also been a great pleasure. The culture, the integrity, the level of skill and dedication that one finds across the country in the Federal Reserve staff and certainly in my colleagues on the Board make it a great pleasure to be there.

I think far more important than these considerations, I do want to say that I do understand and appreciate the fact that this is a very heavy responsibility that has been given me by the Congress and by the administration. As you know, and as you recited in your introduction this morning at the starting of this hearing, the Fed has a great many responsibilities. When people think of the Federal Reserve, they usually think of monetary policy and that certainly is a very important key responsibility, but quite beyond that, the Federal Reserve has a responsibility for administering and, indeed, operating a very large part of the payment system in this country which is, in effect, a very large and absolutely critical public utility function to enable a modern economy to operate.

We have responsibility for the supervision of bank holding companies which, in the aggregate, control on the order of 93 percent or more of the assets in the banking system. The Congress delegates a large body of regulatory authority over the banking system to the Federal Reserve Board and, of course, there are an increasing number with increasing complexity of international relationships that the Federal Reserve carries forward with other central banks.

So it is, indeed, a very important body. It is an honor to serve there, and I am very, very conscious of the heavy responsibility that it entails. I have given it my very best efforts to date and would intend to continue to do so. Thank you.

The CHAIRMAN. Thank you, Mr. Kelley. This is a reappointment, as you indicate, for a 14-year term. You have already, of course, served 3 years at the Fed. During that time the Fed has raised short-term interest rates close to a percentage point, lowered them by a similar amount after the stock market crash, raised them 3.5

percentage points to slow things down, and over the past year lowered rates 1.5 points to lessen the risks of recession.

There have also been some important regulatory decisions involving bank powers, and you make a passing reference to those other activities.

So you have been very busy in the 3 years that you've been there, and there are a number of areas that we would like to cover. Some I am going to cover here. Others I will ask you to respond to for the record.

I want to indicate that because you are presently a Board Member, the questions that I am asking you today are designed to elicit your own personal views and not necessarily the views of the Board, obviously.

Before I pose the first question, is there anyone accompanying you that you would like to introduce to the committee at this time?

Mr. KELLEY. Yes, sir, my wife Janet is here, and I appreciate the opportunity to introduce her to the committee. Thank you.

The CHAIRMAN. Janet, we welcome you.

Many of us on the committee are concerned about the short-term focus of many of our investors and business firms. As a former businessman and investment adviser, do you share these concerns and if so, what do you think we ought to be doing about it?

Mr. KELLEY. Well, I do, indeed, feel that we have slipped into a short-term mentality in this country in a great many ways, and I think it has manifested itself in a number of ways. As I have thought about how we came to this pass, it seems to me that the inflationary psychology which began to take hold of this country back, I suppose in the early 1970's or earlier, has a great deal to do with it. Inflation tends to put a premium on owning things, getting out of financial assets because it denigrates the integrity of the financial system and of financial assets, and as a consequence, I believe that people have, to some degree, some lack of confidence. I hope that that is diminishing, but they have had some degree of lack of confidence in the long-term stability of our financial system, and this has led them to feel that they must give short-term considerations much more weight in their decisionmaking than long-term, and I think that has, indeed, caused distortions in the operations of our companies in various ways and perhaps in individual households in many instances.

So I think that it is an important concern that we should have, and I think that the credible alleviation and ultimate elimination of inflation would be the most important single thing that we could do to restore the confidence that people will need to go back to a willingness to consider the longer term when they make commitments and when they make decisions.

The CHAIRMAN. I want to ask you the question that I asked Mr. Mullins.

What more can the Federal Reserve do or consider doing now to squeeze more inflation out of the economy?

Mr. KELLEY. Well, I believe that the policy we have been pursuing is the wisest policy. The long-term objective of economic policy in this country is sustainable long-term growth. In my view, an essential precondition for that to occur over time is to have a no-inflation or a very low- inflation environment in the economy and to have great confidence in our financial system that will grow out of that. Price stability, in short.

If achieved, this would, in my view——

The CHAIRMAN. Well, we are all for that, but let me be more pointed with you, what can you do about it? You've been over there 3 years. What tools are available now, today, at the Fed to squeeze more inflation out than you are presently squeezing out.

Mr. KELLEY. The Fed has the tools to tighten monetary policy which would tend to raise interest rates and tend to make credit scarcer. Those are tools that are available. But the Federal Open Market Committee is very conscious of the fact that while we seek a no-inflation environment and while we seek stability, to kill the economy, so to speak, which might achieve that, would obviously be counter to essential long-term growth over time. So the Board and the Committee finds itself walking a tightrope, if you will, between being overly tight, which would tend to drive out inflation quickly and put the expansion at some risk, or alternatively, being overly accommodating, which might allow inflation to break out again, which would, in our view, clearly be counterproductive in the long run and perhaps in the fairly short run.

The CHAIRMAN. Are you concerned about international events, higher foreign interest rates, foreign uses of capital and increasing U.S. reliance on foreign borrowing? Are these things having the effect of making us more susceptible to events abroad, and if foreign events drive interest rates up, doesn't that tend to pull our interest rates up now?

Mr. KELLEY. Well, we have, indeed, come more and more, and I am sure the trend will continue, to an integrated world economy, and there are transmission effects across borders that were not there a few years ago. As we pursue the national interest in monetary policy, a factor now is in our own national interest, what effect are events and conditions around the world having on our own economy. This is a new complexity that has to be dealt with. It is not something that in my view has rendered policy impotent.

The CHAIRMAN. If you thought the economy right now needed lower interest rates to stay out of a recession and you became convinced of that, do you think the Fed at the moment has the maneuvering room to lower interest rates?

Mr. KELLEY. Well, again, to repeat, I think——

The CHAIRMAN. Do you really have a policy tool open to you?

Mr. KELLEY. Those are certainly considerations that are there. The policy tool is open, of course, and any judgment that would be made would have to be made in the light of all those factors that I recited and that you recited that might be playing at the time, and there are always considerations that are cutting in both directions. It is simply necessary to make a judgment as to what is in the national interest both in the area of the objective of policy, namely, sustainable growth and also to maintain the integrity of our financial system and to reach toward price stability.

The CHAIRMAN. If we felt we needed to lower interest rates in order to stave off a recession here, do you think we would still be able to attract the same amount of foreign capital that we are now attracting?

Mr. KELLEY. Well, I think with the Government running a deficit the Government is going to be financed. As to how those rates may vary under different conditions, it is a little hard to predict, as was discussed by Secretary——

The CHAIRMAN. But it's not very hard to predict that if foreigners will lend you so much money at 8 percent and you take the rates down to 6 percent, they are probably not going to lend you as much, are they?

Mr. KELLEY. Well, the interplay there is going to be what other alternatives are available to them.

The CHAIRMAN. Well, I am assuming the other alternatives are the ones we see out there right now. I am asking about our ability to act unilaterally in today's situation, and it seems to me we really don't have much latitude to do that anymore, or are you telling me that we do?

Mr. KELLEY. Well, I think we do have latitude. Whether it's as much as it used to be or not is a value question that I'm not sure I know how to consider.

The CHAIRMAN. Yes.

Mr. KELLEY. But for example, there has been a decoupling, if, indeed, there ever was a tight coupling, of foreign rates and foreign exchange rates and the United States, witness the fact that Japanese rates have gone up very substantially over the last 6 to 18 months while ours are flat to down. Our currency relative to the yen has been strengthening.

These things—I would also mention the stock market. Their stock market has been declining rather radically recently and ours has held up quite well.

So I think that national conditions in every country continue to be predominant in that country, but there are certainly influences across borders, and those are considerations in our country's national interest as we consider it. I am sure as other countries consider theirs, they have to consider what is happening here and how that affects their national interest.

The CHAIRMAN. Are you concerned about the amount of foreign borrowing the United States is now having to do? Is that getting out to a point that concerns you, or do you think we can continue to rely as much as we have become accustomed to on foreign lending to meet our own shortfalls in savings?

Mr. KELLEY. Well, we have a shortfall in savings and we have a large Federal deficit that has to be financed and fortunately, there is an appetite in the world financial community for dollar assets. So we have been able to attract those assets which we must have while we are in this configuration economically.

I suppose that there is some point where there begins to be a diminution of interest on the part of financial interests in other countries to continue to invest in dollar assets. Where and when we get there, I don't know.

The CHAIRMAN. In terms of the debt instruments that the Government is issuing, roughly what percent over the last year, say, would the Japanese finance?

Mr. KELLEY. I'm sorry, Senator, I do not have that number in my head.

The CHAIRMAN. I think it is a significant fraction.

Mr. KELLEY. I think it clearly is significant, but I hesitate to quote a number because I'm not sure what that number is.

The CHAIRMAN. They have lost a lot of value in their stock market. There is some questions as to whether their real estate values are going to hold up and how wealthy they feel and whether or not they feel they can continue to lend money to us or anybody else. I suspect the Germans, as well, to the extent we have been relying on them to take down some of our foreign borrowing with their savings. They now have new needs and places to spend their money with the Berlin Wall opening up.

My surmise would be, that we are going to find that it is going to get tougher and is getting tougher right now to attract that foreign capital. This is not one-dimensional, of course, because, there are safety factors and other things, currency rates and what have you. But I would think that that will put an upward pressure on interest rates.

Do you not feel any of that yet?

Mr. KELLEY. Well, it could put an upward pressure on interest rates, but it does not necessarily mean that interest rates will go up. It will just be—if that occurs, it will be one of a number of factors. I think that one thing we may be seeing now, it's hard to be sure, is that as Japanese assets have declined in their stock market, and presumably that is beginning to show up somewhat in their real estate market, their interest rates have gone up, but at the same time we have seen our dollar go up versus the yen, which means that there are a number—or a very substantial quantity of yen-dominated assets that are still flowing into the dollar.

So our rates have essentially been flat. Theirs have been going up. But there still seems to be some attraction in holding dollar assets.

The CHAIRMAN. You come from a State that is a big, strong economic State. I mean, it has had its problems, and I come from a State, Michigan, where we are involved in the international economy, and I can tell you one effect of the dollar being at 1.55 or so against the yen, and that is that we are going to be seeing our trade deficit go back up. And the trade deficit going back up is not a helpful thing in many ways, including you folks managing monetary policy, where we have got to borrow more money from overseas to cover that shortfall in the trade accounts.

I would say that if the dollar stays at current levels, you are going to see the trade problem get worse.

How do you think the economy is doing right now? Are we chugging along pretty well, and are we going to stay out of a recession here? What is your view? We are seeing more and more pieces being written, including yesterday in The Wall Street Journal, where small businesses are saying they are finding there is a credit contraction, they can't get money, and they are having to draw back.

Are you concerned about your feel for how our domestic economy is doing at the moment?

Mr. KELLEY. Our feel, or I'll say my feel——

The CHAIRMAN. I want your feel——

Mr. KELLEY. Yes, sir.

The CHAIRMAN [continuing]. I don't want the Board's feel.

Mr. KELLEY. I understand. My feel is that the domestic economy is doing satisfactorily well. There was a progressive slowdown over the course of late 1989, and when you are getting that kind of a condition, it is hard to know for sure whether it is going to keep on going into the negative column or begin to stabilize. I think we have substantial evidence that it is stabilizing. In recent days, I have seen some projections by some economists that we are back into a takeoff phase again, but I think that it is far too early to make an assumption like that.

The employment numbers and others show that the deterioration has apparently stopped. We have stabilized and may be coming back somewhat. But we have had such an unusual number of one-shot events, some weather related, some strike-related, such as we had in Boeing and other things, that have distorted the numbers in the fourth and first quarters, that to some extent have rendered us unable to make a very strong judgment as yet as to how strong the underlying economy really is and to what extent are we being bolstered by events that won't follow through and keep going.

So I am confident that the economy has stabilized at a satisfactory level. I can't be sure of that. Obviously, it is still quite possible that this could turn down. It is quite possible that it could turn up also. But I am a little leery of making any projections in either one of those directions.

The CHAIRMAN. Let me ask you one other question here. There have been a number of studies produced within the Federal Reserve System showing that white homeowners receive a much higher proportion of mortgage loans even after taking into account homeownership rates, income levels, house values and so forth than, say, people of color. And I am wondering if those studies that have shown this now a number of times suggest a pattern of racial discrimination to you and, if so, what do you think we can do about it?

Mr. KELLEY. Well, I think that these studies have been valuable in that they have pointed up that we haven't gotten as far as we need to go in completely eliminating those kinds of distortions. Whether or not they show any overt racial discrimination, I am far from sure. I think they do show some patterns that need attention and are receiving attention.

The CHAIRMAN. Yes. Well, how are they receiving attention?

Mr. KELLEY. Well, I think that the very fact that it has been identified that we are still in a less than completely balanced position there will encourage our examiners and other regulatory examiners who are charged with overseeing CRA compliance to look in those areas where there will possibly be some imbalances that still take place.

Also, as I am sure you know, this summer the CRA ratings that are assigned to banks are going to begin to be made public.

The CHAIRMAN. Right.

Mr. KELLEY. And I have already seen a very greatly heightened sensitivity on the part of banking institutions over the past several years. I think many are—perhaps most—I am sure most are making a very serious effort to comply, but I think that will be an additional incentive.

The CHAIRMAN. Mr. Kelley, I want to thank you for coming today. We've got other questions that we are going to submit to you for the record, and we will send those to you forthwith, and we would like an early response. I know you will give us one.

Mr. KELLEY. Certainly. Thank you, sir.

The CHAIRMAN. Thank you.

Let me excuse this witness and now invite Mr. Robert Swan of Utah, a nominee for the National Credit Union Administration Board, to come forward at this time.

Let me ask everyone trying to exit the room as quickly as you can find seats, so others can, then we will proceed with the next witness.

Senator Garn has asked me to indicate to you that he is very much supportive of your nomination, and that he wished that he were able to be here in person, but he cannot be. He has submitted a statement for the record that expresses his knowledge of you and his strong support of you, and I am going to make that a part of the record at this point.

Mr. SWAN. Thank you.

STATEMENT OF SENATOR GARN

Senator GARN. Mr. Chairman, I would like to take this opportunity to welcome Mr. Robert Swan. I have known Bob for over 20 years. Robert and I have much in common. Not only are we both from the same State, but we are both former mayors. Bob served as mayor of Tooele, Utah from 1970 to 1974. Prior to that he was a member of the Tooele City Council. Bob has also had considerable financial experience as the Deputy Director of Finance for the State of Utah. Bob is currently the President of the Tooele Federal Credit Union and an active member of the Credit Union Executives Society. I am proud that Robert Swan has been nominated by the President for this position, and know that based on his qualifications and personal integrity that he will serve very ably.

Thank you, Mr. Chairman.

The CHAIRMAN. Let me just say, Mr. Swan was Mayor of his hometown of Tooele, Utah, at the same time as my distinguished colleague, Senator Garn, was Mayor of Salt Lake City. He went on to serve as Deputy Director of Finance for the State of Utah. Since 1983, you have been President and Chief Executive Officer of the Federal Credit Union in your hometown.

The NCUA Board is responsible for chartering Federal credit unions, for administering the National Credit Union Share Insurance Fund and protecting the safety and soundness of all Federally insured credit unions.

Credit unions, I think, are clearly a great asset to this country and that makes this position a very important one.

Let me now administer the oath to you and, then I am going to invite you to make any opening comments.

[Witness sworn.]

The CHAIRMAN. Let me invite you to introduce anyone that may be accompanying you and to make any other initial comments you would like to make.

ROBERT H. SWAN, OF UTAH, TO BE A MEMBER OF THE NATIONAL CREDIT UNIT ADMINISTRATION BOARD

Mr. SWAN. My family is in Utah. I have some friends in Washington that are here in support. And I think the only comment that I would make—I did not have a prepared statement—I appreciate your comment in regard to the significance of credit unions, and I just might say that although we only control about 6 percent of the deposits in financial institutions throughout the country, we are the lifeline financial services for millions of Americans.

In the aftermath of the saving and loan problems, I just feel that any regulatory position that can impact on the security of the American depositor is a significant position, and I approach the possibility of going into this position as one of challenge, and I think it is a privilege and honor to be considered.

The CHAIRMAN. Well, you bring a credit union background, so I take from that that you are a very strong supporter of credit unions and the credit union movement.

Is that a fair statement?

Mr. SWAN. That is a fair statement, and I might add that I was not a member of a credit union until 8 years ago when I did become part of the industry as a manager, and I have been excited, challenged and enjoyed and become very much a credit union supporter as well as being an officer in my credit union.

The CHAIRMAN. Now one of the NCUA's most important responsibilities is to protect the National Credit Union Share Insurance Fund, and obviously, we are highly sensitive to that with what we have seen in the savings and loan industry. That fund insures all Federal credit unions as well as thousands of State-chartered credit unions. My belief is that if the Federal Government insures the deposits of a State-chartered credit union, that credit union should not be allowed to jeopardize the Deposit Insurance Fund by engaging in risky activities that are off-limits for Federal credit unions. We made that correction in the savings and loan industry, and it was a central part of the problem that led to the collapse.

I want to ask you, will you work to make sure that NCUA has adequate controls on risk taking by State-chartered, but Federally insured credit units?

Mr. SWAN. I agree with that, Senator. I believe that—of course those State-chartered credit unions that are now part of the Federal system experience a Federal exam, and they are expected to adhere to Federal guidelines. Many States do do a good job in their examination process in the regulation of State credit unions, but I agree that it is incumbent upon the Federal agency and the NCUA to work and possibly monitor those States that might have weaknesses in their examination process and in the ability of their own insurance funds or in the case of privately insured credit unions, that they're adhering to Federal standards and the same things that we demand of our credit unions.

The CHAIRMAN. I want to ask you to do something specific on that, and that. We found that in 1988, 70 percent of the massive losses came from just two States: Texas and California. And they were State power problems in both States of a very severe sort.

I want to ask if you will undertake as part of your work, if confirmed, to examine that issue specifically. I would like to know that we would have an understanding that you will take a look at the State powers issue and assure yourself and be able to come back and discuss with me whether or not there are any outstanding problems in that area in any State, because it doesn't take many States having an exposure there to put the whole system at risk, as we have seen in this other instance.

So I would like to ask you if you would be prepared to spend some special time and effort on that as a new member able to take a fresh look and be able to come back and report to us later what your findings are.

Mr. SWAN. I would be very glad to do that if you consider it necessary.

The CHAIRMAN. Very good.

One of the hallmarks of the credit union charter has been the requirement that the members of a credit union share a well-defined common bond, but I think as we know that common bond requirement in the historic sense has been changed, and I think weakened in recent years to the point where some critics of credit unions question whether the requirement is still meaningful. They argue that the loosening of the common bond requirement tends to undercut the basis for treating credit unions differently from commercial banks.

How do you feel about this issue of maintaining a strong common bond requirement? You come out of a credit union experience, and how do you think we ought to do that at this point and treat it at this point?

Mr. SWAN. Well, I think the common bond idea is a good one. I think it is part of the credit union philosophy, and I realize that there have been a lot of membership expansions and some question about whether or not we're adhering to the old philosophy of the common bond; however, just by the nature of what has happened in the financial services industry, there have been some things that have weakened the common bond only because credit unions have had to do it to stay competitive, as they have had to grow and provide other financial services, become a part of the electronic age, computers, to stay in a competitive market and offer more services, it has just been natural that they have had to attract other people to survive.

And there have also been—in the credit union movement, rather than face losses, there have been a lot of mergers and acquisitions, and in doing so, that takes in also a larger field of membership.

The CHAIRMAN. Do you intend to serve the full term for which you are being appointed?

Mr. SWAN. Yes, I do, Senator.

The CHAIRMAN. Many of the regulatory agencies, including the NCUA, are often criticized for being too close to the institutions that they regulate, and of course, you have served as full-time credit union executive for the past 7 years. You have been active in the credit union trade associations, and I think that is very valuable experience that you bring, but at the same time I would like you to address the issue of your ability to maintain a healthy independence from the industry so that you are able to be in an oversight capacity and independent in your view so that you can make the hard calls when you think they are required.

Mr. SWAN. I think I would have no problem doing that. I can maintain my independence, I think, very well.

The CHAIRMAN. And you intend to do so.

Mr. SWAN. I intend to do so.

The CHAIRMAN. Very good.

We may have some other questions for you that we will send you to respond to for the record. I appreciate your being here today. You have been very patient sitting through two long prior witnesses. There is a certain virtue to that, however, and that is that if you are the last man in line and those have taken a long time, then your time sometimes isn't quite as long.

Mr. SWAN. Well, I might mention, my patience is well-tried, because I am now only one of five Democrats from Utah. [Laughter.]

And that's former Governor's Rampton and Mathesen, Congressman Owens, my brother—my wife is questionable.

The CHAIRMAN. I see. [Laughter.]

Mr. SWAN. She's noncommittal.

The CHAIRMAN. Well, that may be why they are appointing you, is to get you out of the State. [Laughter.]

Have you thought of that?

Mr. SWAN. It may be.

The CHAIRMAN. Anyway, it is good to have you here today, and we appreciate your willingness to serve.

Mr. SWAN. Thank you.

The CHAIRMAN. We thank you for appearing.

The committee stands in recess.

[Whereupon at 1:10 p.m., the hearing was adjourned.]

[Biographical sketches of nominees and response to written questions of the witnesses follow:]

STATEMENT FOR COMPLETION BY PRESIDENTIAL NOMINEES

Name: MULLINS (LAST) DAVID WILEY, Jr. (FIRST) (OTHER)

Position to which nominated: Governor of the Federal Reserve

Date of nomination:

Date of birth: 28 (DAY) 4 (MONTH) 46 (YEAR) Place of birth: Memphis, Tenn.

Marital status: Single Full name of spouse: N/A

Name and ages of children: N/A

Education:

Institution	Dates attended	Degrees received	Dates of degrees
Univ. of Arkansas	1963-1968	None	
Yale University	1964-1968	B.S.	1968
Mass. Inst. of Technology (MIT)	1969-1974	SM, Ph.D.	1972, 1974

Honors and awards: List below all scholarships, fellowships, honorary degrees, military medals, honorary society memberships, and any other special recognitions for outstanding service or achievement.

Sloan Fellowship, NSF Fellowships at MIT

Bates Prize for best Masters Thesis, MIT, 1972

AM (Hon) Harvard University, 1984

Smith-Breeden Award, American Finance Association for best Journal of Finance article, 1989 ("original Issue High Yield Bonds: Aging Analyses of Defaults, Exchanges, and Calls", Sept. 1989, co-authored with Asquith and Wolf).

Memberships: List below all memberships and offices held in professional, fraternal, business, scholarly, civic, charitable and other organizations.

Organization	Office held (if any)	Dates
Harvard Club of Boston	None	Present
Harvard Club of New York	None	Present
Yale Political Union	None	1964-1968
Society for the Advancement of Management	None	1964-1968

Employment record: List below all positions held since college, including the title or description of job, name of employment, location of work, and dates of inclusive employment.

See Attachment

28-952 O - 90 - 3

DAVID W. MULLINS, JR.

EMPLOYMENT RECORD:

3/89-Present	**Assistant Secretary for Domestic Finance** U.S. Treasury Department 15th Street and Pa. Ave., N.W. Washington, D.C. 20220
10/88-2/89	**Acting Assistant Secretary for Domestic Finance** U.S. Treasury Department 15th Street and Pa. Ave., N.W. Washington, D.C. 20220
9/74-9/88	**Finance Professor** Harvard University Graduate School of Business Administration Soldiers Field Boston, MA 02163
9/74-9/88	**Financial Consultant** Self Employed 10 Emerson Place - #20-A Boston, MA 02114
9/70-8/74	**Teaching Assistant** Sloan School of Management Mass. Institute of Technology (MIT) Memorial Drive Cambridge, MA
9/71-6/74	**Part-time Teacher** Bentley College Beaver and Forest Waltham, MA

Government experience: List any experience in or direct association with Federal, State, or local governments, including any advisory, consultative, honorary or other part-time service or positions.

- Assistant Secretary for Domestic Finance
  U.S. Treasury Department
- Deputy Assistant Secretary for Domestic Financy Policy and Acting Assistant Secretary for Domestic Finance
  U.S. Treasury Department
- Associate Director
  Presidential Task Force on Market Mechanisms

Published writings: List the titles, publishers and dates of books, articles, reports or other published materials you have written.

SEE ATTACHMENT

Political affiliations and activities: List all memberships and offices held in and services rendered to all political parties or election committees during the last 10 years.

None

PUBLISHED BOOKS, ARTICLES

Cash Management - Inventory Control Limit Approach (with R.B. Homonoff). Lexington, MA: Lexington Books, D.C. Heath, Inc., 1975.

Case Problems in Finance, 8th ed. (with Butters, Fruhan, & Piper) Homewood, Ill.: Richard D. Irwin, 1981.

"Restrictions on the Rate of Interest on Demand Deposits and a Theory of Compensating Balances." The Journal of Finance, May 1976.

"Applications of Inventory Cash Management Models" (with R. B. Homonoff) S.C. Myers, ed., Modern Developments in Financial Management. New York, N.Y.: Praeger Publishers, 1976.

"Regulated Rate of Return and the Double Leverage Controversy" (with Butters). Cambridge Research Institute, 1980.

"Does the Capital Asset Pricing Model Work?" Harvard Business Review, Jan.-Feb., 1982.

"The Impact of Initiating Dividend Payments on Shareholders' Wealth" (with Asquith). Journal of Business, Jan.-Feb., 1983.

"The Gains to Bidding Firms from Merger" (with Asquith and Bruner). Journal of Financial Economics 15 (1986):61-89.

Case Problems in Finance, 9th edition, Richard D. Irwin, Homewood, Ill., 1987. Mullins, D., Jr., Butters, K., Fruhan, W., Jr. and Piper, T., editors.

"Signalling with Dividends, Stock Repurchases and Equity Issues," Financial Management 15 (1986): 27-44. Mullins, D., Jr., and Asquith, P.

"Original Issue High Yield Bonds: Aging Analyses of Defaults, Exchanges, and Calls". The Journal of Finance, September, 1989; Mullins, D., Jr., Asquith, P., and Wolf, E.

"Merger Returns and the Form of Financing," in Proceedings of the Seminar on the Analysis of Security Prices 34 (May 1987). Mullins, D., Jr., Asquith, P., and Bruner, R.

"Convertible Debt and Corporate Call Policy," unpublished working paper, Harvard Business School, (May 1988). Mullins, D., Jr., and Asquith, P.

A variety of case studies and technical notes published through Harvard Business School Case Services, Harvard Business School.

Political contributions: Itemize all political contributions of $500 or more to any individual, campaign organization, political party, political action committee or similar entity during the last eight years and identify the specific amounts, dates, and names of the recipients.

None

Qualifications: State fully your qualifications to serve in the position to which you have been named. (attach sheet)

SEE ATTACHMENT

Future employment relationships:

1. Indicate whether you will sever all connections with your present employer, business firm, association or organization if you are confirmed by the Senate.

   Yes, except on leave from full Professorship at Harvard University through September 1990.

2. As far as can be foreseen, state whether you have any plans after completing government service to resume employment, affiliation or practice with your previous employer, business firm, association or organization.

   None

3. Has anybody made you a commitment to a job after you leave government?

   No

4. Do you expect to serve the full term for which you have been appointed?

   Yes

QUALIFICATIONS:

I feel my experience, training and knowledge in the field of financial economics qualify me for this position.

At the Treasury Department I was the Assistant Secretary for Domestic Finance. In that capacity I advised and assisted the Secretary, Deputy Secretary and Under Secretary for Finance on matters of Federal finance, financial institutions policy, government securities market regulations, corporate financial policy, and synthetic fuels projects. I played a major role in developing President Bush's plan to resolve the S&L crisis.

Prior to joining the Department, I was a Professor of Business Administration at the Harvard University Graduate School of Business Administration. I received a B.S. in administrative sciences from Yale University and an S.M. in finance from the Sloan School of Management at the Massachusetts Institute of Technology (MIT). After earning a Ph.D. in finance and economics at MIT, I joined the faculty of the Harvard Business School where I taught finance in the MBA, executive and doctoral programs.

I have published original research in leading academic journals on a wide variety of topics in financial economics. These include cash management and banking, as well as corporate finance and capital market topics such as cost of capital, dividend policy, mergers, stock issues and bond issues.

I have served as faculty chairman of Harvard's Corporate Financial Management program, an executive program for senior financial officers of major corporations as well as course head for the first year MBA finance course. I have also taught the advanced courses in Corporate Finance and Capital Markets in the MBA program.

I have been a consultant to a wide variety of firms and governmental agencies and have taught in numerous executive training programs in the U.S. and abroad, and have served as Associate Director of the Presidential Task Force on Market Mechanisms.

Potential conflicts of interest:

1. Describe any financial arrangements or deferred compensation agreements or other continuing dealings with business associates, clients or customers who will be affected by policies which you will influence in the position to which you have been nominated.

   None, except an outstanding account receivable from Citibank (approximately $40,000).

2. List any investments, obligations, liabilities, or other relationships which might involve potential conflicts of interest with the position to which you have been nominated.

   None

3. Describe any business relationship, dealing or financial transaction (other than tax-paying) which you have had during the last 10 years with the Federal Government, whether for yourself, on behalf of a client, or acting as an agent, that might in any way constitute or result in a possible conflict of interest with the position to which you have been nominated.

   None

4. List any lobbying activity during the past 10 years in which you have engaged for the purpose of directly or indirectly influencing the passage, defeat or modification of any legislation at the national level of government or affecting the administration and execution of national law or public policy.

None - other than as part of my official duties as Treasury Assistant Secretary

5. Explain how you will resolve any potential conflict of interest that may be disclosed by your responses to the above items.

N/A

Civil, criminal and investigatory actions:

1. Give the full details of any civil or criminal proceeding in which you were a defendant or any inquiry or investigation by a Federal, State, or local agency in which you were the subject of the inquiry or investigation.

None

2. Give the full details of any proceeding, inquiry or investigation by any professional association including any bar association in which you were the subject of the proceeding, inquiry or investigation.

None

STATEMENT FOR COMPLETION BY PRESIDENTIAL NOMINEES

Name: KELLEY JR. (LAST) EDWARD (FIRST) WATSON (OTHER)

Position to which nominated: Governor, Federal Reserve Board

Date of nomination: 4-27-87

Date of birth: 27 (DAY) 1 (MONTH) 32 (YEAR)

Place of birth: Eugene, Oregon

Marital status: Married

Full name of spouse: Ellen Louise Elizardi Kelley

Name and ages of children:
Kinsloe Kelley Queen (30)
James Micaiah Kelley (27)
Michael McIver Kelley (25)

Education:

Institution	Dates attended	Degrees received	Dates of degrees
Kinkaid	1942-1947	N/A	
Woodberry Forest	1947-1950	Highschool	1950
Rice University	1950-1954	B.A.	1954
Harvard Business School	1957-1959	M.B.A.	1959

Honors and awards: List below all scholarships, fellowships, honorary degrees, military medals, honorary society memberships, and any other special recognitions for outstanding service or achievement.

Memberships: List below all memberships and offices held in professional, fraternal, business, scholarly, civic, charitable and other organizations.

Organization	Office held (if any)	Dates
See Attachment A		

Employment record: List below all positions held since college, including the title or description of job, name of employment, location of work, and dates of inclusive employment.

9/25/81 to present -Investment Advisors, Inc., Chairman
Houston, Texas

6/30/81 to present -The Shoreline Companies, Inc., Chairman
Houston, Texas

2/1/73 to 6/30/81 -Kelley Industries, Inc., President and CEO
Houston, Texas

7/1/56 to 6/30/81 -Kelley Manufacturing Company, President & Chairman
Houston, Texas

Government experience:

List any experience in or direct association with Federal, State, or local governments, including any advisory, consultative, honorary or other part-time service or positions.

None

Published writings:

List the titles, publishers and dates of books, articles, reports or other published materials you have written.

None

Political affiliations and activities:

List all memberships and offices held in and services rendered to all political parties or election committees during the last 10 years.

Director of HOUPAC. Inactive.

Political contributions: Itemize all political contributions of $500 or more to any individual, campaign organization, political party, political action committee or similar entity during the last eight years and identify the specific amounts, dates, and names of the recipients.

See attached B

Qualifications: State fully your qualifications to serve in the position to which you have been named. (attach sheet)

See attached C

Future employment relationships:

1. Indicate whether you will sever all connections with your present employer, business firm, association or organization if you are confirmed by the Senate.

   Yes

2. As far as can be foreseen, state whether you have any plans after completing government service to resume employment, affiliation or practice with your previous employer, business firm, association or organization.

   None

3. Has anybody made you a commitment to a job after you leave government?

   No

4. Do you expect to serve the full term for which you have been appointed?

   Yes

Potential conflicts of interest:

1. Describe any financial arrangements or deferred compensation agreements or other continuing dealings with business associates, clients or customers who will be affected by policies which you will influence in the position to which you have been nominated.

None

2. List any investments, obligations, liabilities, or other relationships which might involve potential conflicts of interest with the position to which you have been nominated.

None

3. Describe any business relationship, dealing or financial transaction (other than taxpaying) which you have had during the last 10 years with the Federal Government, whether for yourself, on behalf of a client, or acting as an agent, that might in any way constitute or result in a possible conflict of interest with the position to which you have been nominated.

None

4. List any lobbying activity during the past 10 years in which you have engaged for the purpose of directly or indirectly influencing the passage, defeat or modification of any legislation at the national level of government or affecting the administration and execution of national law or public policy.

None

5. Explain how you will resolve any potential conflict of interest that may be disclosed by your responses to the above items.

I will make any divestment, as required; and alter or sever any relationships, as required.

Civil, criminal and investigatory actions:

1. Give the full details of any civil or criminal proceeding in which you were a defendant or any inquiry or investigation by a Federal, State, or local agency in which you were the subject of the inquiry or investigation.

None

2. Give the full details of any proceeding, inquiry or investigation by any professional association including any bar association in which you were the subject of the proceeding, inquiry or investigation.

None

Attachment A

Memberships:

Organization	Office held (if any)	Dates
Investment Advisors, Inc.	Chairman	1981-to present
The Shoreline Companies, Inc.	Chairman	1981-to present
Rally Club of Rice University	Vice President	1953-1954
Young President's Organization	Chapter Chairman	1962-1982
World Business Council		1982-to present
Houston Club	Board of Directors	1960-to present
Texas Industries, Inc.	Board of Directors	1976-to present
Distribution Systems, Inc.	Board of Directors	1977-1984
KI Holdings, Inc.	Board of Directors	1981-1983
Kelley Industries, Inc.	President & CEO	1973-1981
Kelley Manufacturing Company	President & Chairman	1956-1981
Westwood Commerce Bank	Board of Directors	1974-1982
West Belt National Bank	Board of Directors	1982-1984
Southern National Bank	Board of Directors	1961-1972
Rice University	Trustee & Governor	1977-to present
National Association of Independent Schools	Trustee Committee	1977-1982
St. John's School	Chairman, Bd. of Trustees	1972-1981
Metropolitan YMCA	Board of Directors	1970-1971
Harris County United Fund	Agency Operations Comm.	1966-1969
Better Business Bureau	Executive Committee Vice Chairman	1978-1981 1980-1981
Girl Scouts of America San Jacinto Chapter	Director, Treasurer	1964-1970
The Forum Club of Houston		1981-to present
Harvard Business School Club of Houston	Board of Directors	1959-to present
Houston Philosophical Society		1971-to present
St. Luke's Methodist Church Foundation	Vice Chairman	1978-to present

Attachment B

Political contributions:

1979		
2/13/79	George Bush for President	$ 1,000
9/19/79	George Bush for President	250
1980		
9/22/80	Fields for Congress	500
10/27/80	Harris County Republican Party	500
1981		
11/6/81	Jim Greenwood Campaign Fund	500
1982		
5/28/82	HOUPAC	1,000
1983		
3/4/83	HOUPAC	1,000
1984		
2/84	HOUPAC	1,000
2/24/84	Friends of Phil Gramm	2,000
8/8/84	Victory '84 (Reagan)	1,000
1985		
5/23/85	HOUPAC	1,000
10/31/85	Fund For America's Future (George Bush)	500
1986		
4/7/86	Fund For America's Future (George Bush)	500
4/11/86	HOUPAC	1,000

Attachment C

Qualifications:

The duties of the Governor of the Federal Reserve System can fairly be divided into three categories: technical central banking activity, policy setting based on macro and micro economic judgments, and institutional governance and management. In passing the various statutes that created and now control the System, Congress foresaw this broad variety of activity that would confront the Board, and instructed the President to nominate Governors with "due regard to a fair representation of the financial, agricultural, industrial and commercial interests."

Continually from 1959 to date, I have had primary profit and loss responsibility for corporations in (successively) distribution, manufacturing, and financial service. I have been a founder of two banks, and joined the Board of a third within several months of its opening. Additionally, I have been an active Director in other companies involved in aggregates, cement and concrete, distribution, real estate development, steel, terminaling, and trucking. These are among the most competitive and entrepreneurial industries in our economy. Most of these involvements have been in corporations with under $100 million in sales, the size category that includes virtually all of the net growth in employment that has occurred in our country in recent years.

As a manager of financial asset portfolios over the past five years, I have continuously studied and monitored the U.S. economy.

In the not-for-profit sector, I have served actively in nine institutions variously as Chairman, Trustee, Director or other officer.

In sum, it is my belief that experience in activities related to those in which the Board must act, and insight into areas in which the Board must make judgments, will enable me to make a useful contribution to the nation as a Governor of the Federal Reserve System.

28-952 0 - 90 - 4

STATEMENT FOR COMPLETION BY PRESIDENTIAL NOMINEES

Name: SWAN (LAST) ROBERT (FIRST) HARDY (OTHER)

Position to which nominated: NCUA BOARD MEMBER

Date of nomination: FEBRUARY 8, 1990

Date of birth: 19, JULY 1935 (DAY) (MONTH) (YEAR)

Place of birth: TOOELE, UTAH

Marital status: MARRIED

Full name of spouse: RUTH JANET SPENCER SWAN

Name and ages of children: NONE

Education:

Institution	Dates attended	Degrees received	Dates of degrees
Tooele High School	1950-1953	Graduated	
University of Utah	1953-1957	B.S. Accounting	June 1957
University of Utah	1959-1961		

Honors and awards: List below all scholarships, fellowships, honorary degrees, military medals, honorary society memberships, and any other special recognitions for outstanding service or achievement.

Merit Award for Achievement as Mayor of Tooele

Memberships: List below all memberships and offices held in professional, fraternal, business, scholarly, civic, charitable and other organizations.

	Organization	Office held (if any)	Dates
Civic -	Tooele County Chamber of Commerce	None	
	Tooele County Economic Development	President	1987 - 1989
Fraternal -	B.P.O.E. #1673	None	
	F.O.E. #164	None	
Professional -	Credit Union Executives Society	None	1983 - 1990

Employment record: List below all positions held since college, including the title or description of job, name of employment, location of work, and dates of inclusive employment.

6/57 to 1/58	U.S. Army Audit Agency	Pasadena, CA	Auditor
1/58 to 10/59	U.S. Army	Ft. Belvoir, VA	
1/66 to 10/75	Swan's Market	Tooele, UT	Owner - Operator
6/77 to 9/81	State of Utah	S.L.C., UT	Deputy Director/Finance
1981 to 1983	Western United Mines	S.L.C., UT	Vice President
6/83 to present	Tooele Federal C.U.	Tooele, UT	President/CEO

Government experience: List any experience in or direct association with Federal, State, or local governments, including any advisory, consultative, honorary or other part-time service or positions.

Tooele City Council	1964 - 1966
Tooele City Mayor	1970 - 1974
Tooele County Bicentennial Chairman	1975 - 1976
State of Utah Deputy Director of Finance	1977 - 1981
Tooele County Economic Development	1986 - 1990

Published writings: List the titles, publishers and dates of books, articles, reports or other published materials you have written.

None

Political affiliations and activities: List all memberships and offices held in and services rendered to all political parties or election committees during the last 10 years.

None

Political contributions:

Itemize all political contributions of $500 or more to any individual, campaign organization, political party, political action committee or similar entity during the last eight years and identify the specific amounts, dates, and names of the recipients.

None

Qualifications:

State fully your qualifications to serve in the position to which you have been named. (attach sheet)

See Attachment

Future employment relationships:

1. Indicate whether you will sever all connections with your present employer, business firm, association or organization if you are confirmed by the Senate.

Yes, I will sever all connections

2. As far as can be foreseen, state whether you have any plans after completing government service to resume employment, affiliation or practice with your previous employer, business firm, association or organization.

No plans

3. Has anybody made you a commitment to a job after you leave government?

No

4. Do you expect to serve the full term for which you have been appointed?

Yes

ATTACHMENT - PAGE 4

An educational and practical experience background in finance, accounting and management provides the basic qualifications for this position, plus the specific professional experience in the credit union industry will provide valuable input to the NCUA board's decision making process. The safety and soundness of the financial industry in America is of primary concern to everyone. I expect as an NCUA board member to contribute positively to decisions that will encourage credit union financial strength.

Potential conflicts of interest:

1. Describe any financial arrangements or deferred compensation agreements or other continuing dealings with business associates, clients or customers who will be affected by policies which you will influence in the position to which you have been nominated.

None

2. List any investments, obligations, liabilities, or other relationships which might involve potential conflicts of interest with the position to which you have been nominated.

Only Normal Loans, (Mortgage, Consumer) From Mountain America Credit Union and Tooele Federal Credit Union. To preclude any conflict of interest, a recusal letter will be signed in regard to these two credit unions.

3. Describe any business relationship, dealing or financial transaction (other than taxpaying) which you have had during the last 10 years with the Federal Government, whether for yourself, on behalf of a client, or acting as an agent, that might in any way constitute or result in a possible conflict of interest with the position to which you have been nominated.

None

4. List any lobbying activity during the past 10 years in which you have engaged for the purpose of directly or indirectly influencing the passage, defeat or modification of any legislation at the national level of government or affecting the administration and execution of national law or public policy.

None

5. Explain how you will resolve any potential conflict of interest that may be disclosed by your responses to the above items.

N/A

Civil, criminal and investigatory actions:

1. Give the full details of any civil or criminal proceeding in which you were a defendant or any inquiry or investigation by a Federal, State, or local agency in which you were the subject of the inquiry or investigation.

None

2. Give the full details of any proceeding, inquiry or investigation by any professional association including any bar association in which you were the subject of the proceeding, inquiry or investigation.

None

**QUESTIONS FOR DAVID W. MULLINS, JR.
FROM SENATOR DONALD W. RIEGLE, JR.
MARCH 23, 1990**

Q.1. In the financial estimates for the Administration's thrift proposal that accompanied Secretary Brady's testimony before the Banking Committee in February 1989, was there any allocation of funds for RTC working capital? How much? Was that part of the $50 billion supplied to the RTC, or in addition to it?

A.1. The $50 billion was provided to the RTC to pay for the net losses of the currently insolvent thrifts -- otherwise known as "filling the hole." In addition, the Administration's original thrift proposal provided the Resolution Trust Corporation (RTC) with the same borrowing and assistance authority that previously existed for both the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC). This included the authority to issue notes in order to raise the funds necessary for the temporary purchase of assets, which we refer to as working capital. Working capital amounts were extremely difficult to estimate at that time because of the many variables involved that affect the timing and amount of assets actually purchased and sold. In fact, these variables continue to make working capital projections difficult to estimate, even though there has been actual case resolution experience since the time of the Administration's original proposal.

Q.2. When did the Administration first publicly indicate that additional working capital funds would be needed?

A.2. My understanding is that the RTC's borrowing authority was specifically discussed in Senate Banking Committee hearings soon after the bill was introduced. I personally testified before the House Ways and Means Committee in connection with their markup of the thrift legislation in May of 1989. RTC borrowing authority was a specific focus of many of the questions asked at that time, and it was my understanding that the Committee subsequently sent a letter to Banking Committee Chairman Gonzalez expressing its concerns.

Chairman Gonzalez later successfully offered an obligation cap amendment on the floor of the House of Representatives to address this issue, and Congressman Wylie filed a different version of the same type of amendment with the House Rules Committee. In addition, Mr. Wylie specifically addressed the working capital issue in House floor debate on the Gonzalez note cap amendment.

On the Senate side, both Secretary Brady (June 23, 1989) and Chairman Seidman (June 26, 1989) sent letters to you, Senator Riegle, last June that specifically referred to the need for working capital.

Finally, during the Senate-House conference we worked closely with your staff and others to craft an obligation cap that would explicitly tie the amount of working capital obligations issued to tangible assets owned by the RTC. This is a concept that protects the taxpayer from additional exposure while at the same time providing the RTC with the flexibility to raise adequate working capital. The Administration had supported this concept for some time before the conference.

Q.3. The $32 billion of additional funds, that you referred to as available to the thrift industry after RTC funds run out, were meant to cover all losses through 1999 and to build up the thrift deposit insurance fund to $8.8 billion by the end of that time. If we use those funds earlier, what will we use for later losses and for building up the fund?

A.3. The $50 billion provided to the RTC was designed to cover the approximately 500 institutions that were thought to be tangibly insolvent at the time the original bill was introduced. The $32 billion was designed to cover future losses from other marginal thrifts that appeared likely to stay in business several years after the date of enactment of the legislation -- which would mean that any subsequent failure would be outside the RTC's jurisdiction.

If these same marginal thrifts fail sooner than expected and fall within the RTC's jurisdiction, then it may be necessary to reallocate funds from the $32 billion provided in the outyears. Regardless of when these marginal institutions fail and are resolved, the remaining solvent thrifts are healthier as a group and, therefore, less likely to require amounts of resolution funds in the outyears. Thus the $32 billion has always been earmarked for the same potential failures out of the marginal group of thrifts. The only difference is timing.

Finally, the Savings Association Insurance Fund would continue to grow from the premiums paid by these healthy thrifts. At the same time, the Administration's bill provided the FDIC with the authority to raise premiums if the industry experienced worse losses than expected. This, too, would help maintain the financial integrity of the fund even if federal assistance were reduced.

Q.4. The Administration's estimates, last year, of deposit insurance premiums assumed that S&L deposits would grow at a 7 percent annual rate over the next decade. Deposits have since declined. What do you see now as the likely future size of the thrift industry?

A.4. The rate of deposit growth has absolutely nothing to do with availability or adequacy of the RTC's $50 billion and the size of the problem the RTC faces.

The recent decline in deposit growth is in many ways a healthy sign. To a large extent it reflects intentional policies designed to improve the financial health of the industry rather than any loss of depositor confidence. It reflects in part the fact that the RTC has stopped insolvent thrifts from trying to grow out of their problems -- in fact, as required by the Oversight Board's strategic plan, these thrifts are shrinking to avoid higher operating losses. Other thrifts have been liquidated or have converted to banks as part of RTC case resolutions, which is obviously another positive development that often results in a reduction of thrift deposits. Finally, the shrinkage also reflects the fact that many thrifts are shrinking both their assets and their deposits in order to raise their capital ratios -- again, a very healthy trend. Many of these thrifts fail capital compliance because they grew their assets and liabilities faster than their capital. They are simply reversing this process now.

An examination of each of these factors leads me to believe that the current decline in deposit growth is probably a temporary adjustment. Once the industry stabilizes, it appears likely that aggregate deposits will resume growth at least to the extent of interest credited. Indeed, the deposits of the healthiest thrifts are growing even in the current climate.

Finally, even if deposits do not grow at the 7 percent rate over time, it will have little impact on the overall cost of the thrift cleanup. This is especially true if the shrinkage in thrift deposits is essentially matched by deposit growth at banks, since net budget collections would remain essentially constant.

Q.5. The Administration's thrift plan assumed that the RTC would sell all assets of thrifts under its control by the end of 1994. How long do you now think it will take?

A.5. Under the Administration's original proposal, the objective was to move the bulk of RTC assets out of the government and into the private sector by 1994 with any remaining RTC assets at that date transferred to the FSLIC Resolution Fund to be resolved by the FDIC.

Under FIRREA, the RTC is in operation until December 31, 1996. When the assets will actually be sold depends primarily on the asset disposition strategy of the RTC as well as the speed and efficiency with which that strategy is executed. Thus, the RTC is really in the best position to answer this question.

I would favor moving assets rapidly into the private sector in bulk transactions where possible. I am not talking about dumping assets on the retail market. Instead, I think the RTC should play the role of packager and in effect, "wholesale" assets to private sector entities with expertise in working the assets out over time.

With such a "wholesaling" strategy it should be feasible to sell the bulk of RTC assets by the mid 1990's. The alternative strategy of having the RTC own the assets, and work them out individually by selling them retail would involve much longer government involvement in ownership and management of these assets.

Q.6. The Brady report concluded that margins on stock futures were too low and may have aggravated both the rise and the fall of stock prices in 1987. Do you agree, and how high do you think they should be?

A.6. I agree that low margins on stock index futures played a part in the market disruptions in 1987. I do not think it would be appropriate for me to try to pick a specific level for how high stock index futures margins should be, but they do need to be harmonized with margins on stocks. The only way to ensure that margins are harmonized is to provide for a single regulator of margins on stocks and stock derivative products.

Q.7. There is considerable uncertainty among analysts about how low the unemployment rate can go before inflation begins to accelerate. Have we reached that point, or can we safely reduce unemployment a little further?

A.7. The level of the "natural rate of unemployment," also termed the "nonaccelerating inflation rate of unemployment," is an unsettled issue in economics. It is sensitive to shifts in the demographic composition of the workforce and to changes in institutional arrangements, such as availability of income support programs, competitive pressures from abroad, etc. Some previous work at Treasury suggests that the rate might be in the range of 5-1/4 percent, and the fact that inflation has been little changed over the past year or so while the civilian unemployment rate has held at about that rate would tend to corroborate that finding. However, some analysts place the figure at a higher level, while others believe it to be lower. As to current situation, there are some measures that suggest additional slack in labor markets and others that point to tightness. The fact that there is considerable uncertainty in this matter would argue against attempting to fine tune the economy to hit a particular target.

Q.8. What do you believe should be the goals of deposit insurance reform? What do you see as the most promising proposals for deposit insurance reform?

A.8. The broad goals of deposit insurance reform should be to reduce and limit the exposure of the federal government to loss; maintain depositor confidence to avoid runs and protect the financial system; and foster the competitiveness of U.S. financial services providers.

As I said in my testimony, I have not reached firm conclusions about specific changes that should be made. My initial impression is that certain proposals do appear worthy of study. These include the proposal to require early and certain resolution of failing depository institutions; the limitation of deposit insurance to individuals or to a single account (although there appear to be substantial administrative problems); and possibly the proposal to impose some kind of "haircut" on uninsured depositors in resolutions of failed institutions.

I also believe that it is important to examine other aspects of the federal "safety net" as well, including access to the discount window and the payments system. It seems to me that the fundamental question is how to reduce the scope of the federal safety net without destabilizing the financial system. This will require very careful study.

**QUESTIONS FOR DAVID W. MULLINS, JR.
FROM SENATOR ALAN J. DIXON
MARCH 23, 1990**

Q.1. What are your views on enforcement of the Community Reinvestment Act? Do you believe that redlining still occurs? How can this best be prevented?

A.1. While I am new to this area, I recognize that enforcing compliance with the Community Reinvestment Act in an effective manner is one of the important regulatory challenges facing the Federal Reserve today, especially in view of the vagueness of the statutory mandate. That challenge is made all the more striking by the added requirement for public disclosure of an institution's CRA rating, called for by the FIRREA amendments to the act.

As I understand it, the Federal Reserve's program for enforcing the Community Reinvestment Act includes monitoring banks' CRA performance and assisting them by disseminating information and technical advice on community lending. In reviewing applications, the Board can closely examine an individual applicant's CRA performance. Though I am not yet fully acquainted with all the various pieces of its program, I have the impression that the Federal Reserve has established a solid framework for encouraging state member banks to find sound and profitable ways of meeting the credit needs of their communities. This includes meeting the special needs of a low- and moderate-income neighborhoods that may present for a bank the greatest risk but, at the same time, a real opportunity to make a difference in its community. I support a continued strong emphasis in all of these areas.

As to redlining, while one cannot be totally certain that it no longer occurs, I have been advised that the Federal Reserve's examiners pay special attention to checking bank policies and practices (for evaluation of an applicant's creditworthiness, for example, or assessing the value of residential property) that might unfairly result in the denial of a mortgage or in the failure to serve the overall credit needs of low- and moderate-income neighborhoods. The recent amendments to the Home Mortgage Disclosure Act should further enhance the ability to identify lending patterns that warrant closer attention. Active enforcement of the CRA and the fair lending laws, it seems to me, is ultimately the best means available to us for preventing discriminatory lending.

Q.2. How should the Federal Reserve best address the problem of discrimination in home mortgage lending? Would use of testers be an effective enforcement tool?

A.2. I am familiar, of course, with recent reports on mortgage lending in Atlanta, Boston, and elsewhere. The inference of discrimination is an obvious cause of concern, although as I understand it the studies do not necessarily conclude that the disparities in neighborhood lending result from purposeful racial discrimination.

I believe that the Federal Reserve has in place procedures for examining state member banks to ensure compliance with the Fair Housing and Equal Credit Opportunity Acts. In addition, I understand it is seeking other ways to ascertain more effectively the presence of unlawful discrimination. Some measures under study would be taken independently, others in close collaboration with other agencies. I believe these measures will move us closer to finding effective ways to deal with the problems in the mortgage area highlighted by the studies.

As to using testers as an added enforcement tool, the concept is not one I would readily espouse. It raises very negative connotations in the minds of many, and I know there are technical problems in setting up such a program in the credit area. At the same time, I recognize that testing might be warranted in specific instances where there is a strong suspicion of unlawful behavior. But this is really a very complicated issue, on which I have no experience, and I would have to study the matter much more thoroughly before reaching a definitive conclusion. Beyond that, let me reiterate my own strong commitment to ensuring banks' compliance with antidiscrimination laws, and more generally to our reaching the goal of providing decent housing opportunities for all Americans, including the nation's low- and moderate-income citizens.

Q.3. Do you believe that low and moderate income Americans lack access to banking services? If so, what should be done about it?

A.3. I have not examined this issue in sufficient detail to provide a definitive answer. However, I will study it and develop a position on it in due course.

Q.4. Do you believe the firewalls around section 20 subsidiaries result in unnecessary inefficiencies? How do your views on these firewalls compare with your opinion of the firewalls included in the Proxmire Financial Modernization bill?

A.4. The firewalls between Section 20 subsidiaries and their bank affiliates, while similar, appear to be somewhat more restrictive than those in the Proxmire Financial Modernization bill. While some have recently been relaxed, and the Board has indicated its intention to review others this year, I think there is little doubt that these firewalls have produced inefficiencies in the delivery of financial services by bank holding companies and, in my view, we should study ways in which they may be relaxed. Bank holding company securities powers should provide the scope for these organizations competitively to deliver services to the public, consistent with the appropriate protection of Federal safety net. We need to explore whether or not the disclosure rules required by the securities laws, functional regulation of the securities subsidiary -- especially regulatory capital requirements coupled with mark-to-market rules -- and Section 23A and 23B limits on bank loans to, and asset purchases from, affiliates, would be sufficient for protection of the latter while permitting the former. I feel the design of a sufficient but not inefficient mechanism for insulating the Federal safety net from risky activities is an important part of financial services regulatory reform.

Q.5. What are your views on universal banking?

A.5. I believe that it is desirable to give commercial banking institutions the flexibility to engage in a broader range of financial activities. We need to ensure, however, that those activities are conducted in a sound manner, one that does not expose excessively parts of the institution that are protected by the federal "safety net" to risks associated with other operations. "Universal banking" can encompass a variety of specific organizational arrangements, and I believe that it is important to have simple, effective and efficient mechanisms to insulate the federal safety net. At this stage I have yet to be convinced that organizational forms of universal banking without such protections would be appropriate.

Q.6. What are the implications of Europe 1992 for the United States banking industry?

A.6. The issue of the Community's reciprocity policy in the banking sector appears to be settled. The EC Commission has stated that the standard to be applied under the Second Banking Directive will be national treatment and that no sanctions are contemplated against countries such as the United States that provide EC banks with genuine national treatment.

More generally, the EC internal market program may create new competitive opportunities within the Community for U.S. and other non-EC banking organizations. However, as competition within the EC market increases, it is possible that there will be declining profit margins on financial intermediation. While such an effect would not be regarded as beneficial by banks, it would benefit consumers of banking services. Indeed, that is a key objective of Europe 1992.

U.S. and other non-EC banks compete with Community banking organizations on a worldwide basis. Given the increasing internationalization of banking, the evolution of the structure of financial organizations in the European Community (including the relatively unlimited securities powers permitted under the Second Banking Directive) will likely be a factor in consideration of financial regulatory restructuring in the United States. Indeed, EC 1992 underscores the need to move forward as soon as possible with reform of our antiquated U.S. financial services laws.

Q.7. What are your views of the relationship between the Federal Reserve discount window, the deposit insurance system, and prospects for deposit insurance reform?

A.7. The Federal Reserve's discount window is used to provide liquidity to individual depository institutions unable to obtain such funding elsewhere, and the Congress has directed that such loans be fully collateralized. In effect, such liquidity support is part of the federal safety net. The deposit insuring agencies, in contrast, are authorized to actually inject capital into failing depository institutions, if that would be cheaper than liquidating their assets and paying off their insured depositors. Quite often, when a bank is under duress and uninsured depositors and other creditors are withdrawing funds, the Reserve Banks are called upon to provide collateralized discount window credit. If the institution is subsequently assisted by the FDIC, the discount window loan is repaid by the FDIC as soon as possible. Any deposit insurance reform that relies more on depositor discipline may increase the number of requests for -- and perhaps the size of -- such loans. While depositor discipline may limit deposit insurance exposure it might increase exposure via discount window liquidity support. Careful consideration should, therefore, be given to these issues in designing deposit insurance reform especially since discount borrowing is also a basic monetary policy tool.

Q.8. What are your views on risk-based deposit insurance premiums?

A.8 Finding more sensitive mechanisms for regulating risk-taking by depository institutions is important. The risk-based capital requirements now being implemented are a step in the right direction. Risk-based insurance premiums may also have a place in the regulatory structure, although there possibly would be some redundancy with the capital requirement mechanism. How these, or other regulatory changes, should be coordinated is a complex question. As you know, the issue of deposit insurance is being studied at the present time, as required by FIRREA. I believe the Congress should give high priority to reviewing that work, for it is clear that FIRREA left unresolved some of the most difficult problems of reforming our system of deposit insurance.

Q.9. What are your views on market-based accounting? Would this be desirable either for regulatory or for financial disclosure purposes? Is it practical?

A.9. The problems in our financial system over the last several years have focused attention on the considerable differences that often have been found to exist between accounting and economic measures of the earnings, assets, and net worth of financial institutions. Market value accounting has been proposed by some as a way to narrow divergences between accounting and economic measures of income, assets, liabilities, and equity capital positions. This suggestion is primarily based on the view that the market values of assets and liabilities are more reflective of their true economic values than are the historical cost amounts generally reported in financial statements under GAAP. Therefore, it is argued that the use of market value accounting might lead to more effective regulation and supervision of financial institutions and to the closure of problem institutions long before they would become insolvent on the basis of financial statements prepared under current GAAP.

While this proposition has considerable theoretical merits, a number of concerns have been expressed regarding market value accounting that should be considered. First, market values do not exist for a large percentage of a financial institution's assets and deposits and standards have not yet been developed for the estimation of reliable market values for these items. Second, even when independent market quotations exist, there are questions as to whether market values always reflect true economic values. Some suggest that this problem arises because markets may not always be informationally efficient (e.g., as evidenced by the excessive volatility in bond and stock prices). Third, the overall cost and reporting burden associated with market value accounting could be considerable, including the cost of verifying market value quotations and estimates during audits and supervisory examinations. Finally, there are questions of the relevance of market values for fixed income instruments that are to be held to maturity. Aren't well designed measures of default risk sufficient and appropriate in assessing such instruments?

In my view, these concerns should be thoroughly studied before dramatic moves toward market value accounting are made. The federal banking agencies are reviewing the use of market values in connection with the federal deposit insurance study mandated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). At the same time, the Financial Accounting Standards Board (FASB) is studying the need for greater use of market values in GAAP as part of a project to develop new comprehensive standards for all financial instruments. These studies should provide additional information regarding the appropriateness of market value accounting for purposes of bank regulation and financial reporting.

Q.10. What are your goals for this job? What are your goals for the first two years?

A.10. I would hope to contribute to the general goal of achieving high sustainable economic growth with negligible inflation. Maintaining and enhancing the health and vitality of the U.S. economy has to be the Fed's number one goal. The challenges are particularly evident in view of the recent experience of slow growth and persistent inflation. Maintaining and enhancing the health and competitiveness of our financial system is also an important goal. I would hope that comprehensive legislative reform of financial services regulation will be forthcoming, and I would like to contribute to the coming debate on this topic. In view of the competitive threats facing U.S. financial services firms, I think a two year time horizon for this goal is both realistic and necessary.

Q.11. If you were confirmed, how frequently would you expect to consult with Secretary Brady, Undersecretary Glauber, or Deputy Secretary Robson?

A.11. To date, I have made no plans for regular consultation with Treasury officials or others and have formed no expectations about the frequency of consultations. Fed Governors on a rotating basis have lunch weekly with Treasury officials and less frequently with members of the President's Council of Economic Advisors. Bob Glauber is a close friend and Secretary Brady is also a friend so I would expect to see them relatively frequently. But, I would not feel any special requirement for consultation with them on the decisions facing the Fed. Overall, I think it is useful to consult widely including friends and former colleagues at Treasury, in other parts of the Administration, in academia, in the private sector and with members of Congress. Consultation is important in view of the difficult problems facing us.

Q.12. Do you believe that banks, particularly community banks, are burdened by inefficient regulation? If this is a problem, what should Congress or the Federal Reserve do about it?

A.12. I think this is an issue worthy of extensive analysis.

Bank regulations can generally be placed into one of three categories: (1) those related to maintaining the safety and soundness of financial institutions; (2) those related to the efficient conduct of financial markets; and (3) those directed to accomplishing socially desirable goals. The first category includes regulations dealing with such matters as capital adequacy, insider loans, physical security, risk-diversification, and so forth. The second includes regulations such as those necessary to implement monetary policy and those facilitating bank payments. The last category would include regulations dealing with bank disclosure, the rights of consumers, and the reporting of large cash deposits.

Clearly, within this scheme, there is some minimum core of rules and regulations necessary to promote the soundness of our banking and financial system, to ensure the smooth and efficient functioning of financial markets, and to protect the legitimate interests of bank depositors and customers. Normally, when laws are written or rules formulated, those involved are seeking to achieve what they perceive as desirable goals in a manner that is not unduly burdensome, disruptive or inefficient. Nevertheless, rules or regulations that are not properly formulated, or that have not been subject to a reasonable balancing of the costs and the expected benefits, can result in an excessively burdensome or inefficient regulatory framework. In this regard, it is particularly important to keep in mind that while individual rules may not be unduly burdensome, the cumulative effect of all regulations taken together may indeed pose unnecessary or excessive restrictions and inefficiencies on certain classes of banking organizations.

I am concerned that regulations, rules and supervisory activities may not be structured in ways to impose the least burden on banks while still enabling regulators to carry out their responsibilities in accordance with the laws set down by the Congress. I certainly am not prepared at this time to provide a blanket endorsement or condemnation of every rule, regulation, or procedure. Indeed, if confirmed, I would most certainly give careful consideration to this very basic question.

More generally, I believe that all involved in formulating laws and regulations for our financial system -- including both the Congress and bank regulators -- must be very sensitive to the costs to banks of regulations, as well as the anticipated benefits, and must recognize that these costs are ultimately paid by society at-large. Accordingly, both the Congress and the regulatory agencies should move prudently in creating new laws and regulations and should periodically review their continued merits. We should redouble our commitment to find the most cost-effective way to achieve public policy objectives. Laws or rules that contain "sunset" provisions may be particularly appropriate, and we should always be ready to revise or rescind rules that no longer achieve their intended results.

Q.13. In last week's hearing on CFTC/SEC issues, Chairman Greenspan stated that:

> "the Board, as best I can judge, is unanimous on the question that the appropriate margins for stock index futures and for stocks should be prudential only....had we found such a relationship [between margins and volatility], I suspect we would be arguing that margins should be constructed in a manner which picked up not only prudential requirements but also an element of additional margin which would act to presumably suppress the degree of volatility in the system. All of the analytical tools we have brought to bear have failed to find any such relationship. As a consequence of that, we are unanimous on the issue that prudential margins are the realistically sole purpose of putting margins in place."

Do you share the unanimously expressed view of the Board that margins on either stocks or on stock index futures should be set for prudential reasons only?

A.13. I do not believe that margins should be set from the narrow perspective of the private interest of a clearinghouse. One reason is the potential for the failure of one clearinghouse to create a chain reaction leading to broader distabilization within the financial system. Since the cost of such systemic disturbances is borne by the public rather than the clearinghouse, this risk may not be adequately reflected in the private decisions of an individual clearinghouse.

Margins must be adequate to protect against this broader systemic risk. Moreover, inconsistent margins in two segments of what is really "one market" can, I believe, contribute to episodes of market wide disruption. These disruptive episodes also engender systemic risk.

Therefore, I think it is not inappropriate to say that margins should be set for prudential reasons as long as limiting systemic risk is included as a prudential reason, and so long as federal regulators have ultimate margin setting authority.

Q.14 Do you share the unanimously expressed view of the Board that the evidence does not show a link between margins and volatility?

A.14. There are studies which provide evidence on both sides of this issue. For example, a study by Gikas Hardonvelis ("Margin Requirements and Stock Market Volatility," Federal Reserve Bank of New York Quarterly, summer 1988) concluded that higher margins are statistically associated with a reduction in price volatility; while a study by Paul Kupiec of the Federal Reserve staff came to an opposite conclusion.

Having reviewed many studies on this topic, I feel the question is unresolved. I would agree that there currently exists no convincing consensus in the research that there is a link between margins and volatility. However, I am also not convinced that the research to date demonstrates convincing the absence of such a linkage. I am optimistic that improved research methodologies will provide more insight into this issue in the near future. As an aside I would also note that there is also no compelling evidence that stock market volatility has increased over the past twenty five years.

Finally, and mostly importantly, I believe the issue of the linkage of margins and volatility as modeled in the research is totally irrelevant to the current debate. Volatility, as defined in these studies, is a measure of average variance over some period of time, for example, the average daily volatility of the stock market. I would note two points. First, volatility measured in this manner has not increased in recent years and second, average daily volatility is not what concerns us in the current market environment.

It is not the volatility on average days which is a concern, but rather the infrequent periodic episodes of market disruption which we have experienced over the past several years. Such episodes are not simply draws from the average volatility distribution. These episodes are periods in which markets are simply not functioning correctly. For example, during the periods the pricing relationships between stocks and futures break down, markets in particular instruments experience difficulties in staying open, serious supply-demand imbalances develop, very large market moves occur in the absence of underlying fundamental information, etc.

Though infrequent, I believe the problem is these disruptive episodes, rather than simply days of major market moves in well functioning markets. Volatility is not the problem; market disruption is the problem. These market disruptions put inordinate strains on the clearance and settlement process and thus engender systemic risk. These disruptive episodes erode investor confidence and ultimately can produce adverse effects on the cost and availability of capital, and the competitiveness of our financial markets.

Though very damaging, such episodes are too infrequent to be amenable to large sample statistical studies such as those relating average measures of volatility and margins. Nonetheless, I think that a strong case can be made that inconsistent margins between stocks and stock index futures play a role in such disruptions.

Lowering margins in futures encourages highly leveraged participants to enter the futures market. This may increase liquidity on normal trading days with moderate price movements. But these highly leveraged participants cannot absorb a major negative market movement, and indeed, may fuel the decline by forced sales to meet margin calls. The acceleration in futures market decline can wash back to the stock market via index arbitrage and produce disruptions there as well.

There are many other scenarios under which highly leveraged participants in some market segments can result in market wide disturbances. While there may be no demonstrated linkage between average volatility and margins, I do think there is a strong case that margin levels play a role in the damaging episodes of market disruption.

Q. 15. Chairman Greenspan, at that same hearing, when asked abut the consequences if Congress failed to act on further CFTC/SEC related legislation, responded that:

> "On the issue of the change is structure which I would personally recommend, which is not a huge change but I think a desirable one, were that not done, I do not think that we leave the structure in total at risk. I think it will be more difficult to resolve certain issues, but I would scarcely want to argue that action is mandatory because if action fails that the system would be put in jeopardy. I don't believe that.
>
> "I think that if there is a major market reaction, it is likely to occur with or without changes that we're talking about and I'm not certain the extent to which the types of changes we're talking about would make all that much substantial difference in how the particular market break worked its way through the system."

Do you agree with the Chairman that, if jurisdiction over stock index futures is not shifted from the CFTC to the SEC, our regulatory system would not be put in jeopardy by the failure to take that action?

A.15. I think we need action now, and failure to resolve the critical issue of regulatory fragmentation leaves our financial system vulnerable to a wide range of potential problems. A major concern is the potential loss of business to foreign competitors' markets due to the jurisdictional disputes which hurt innovation in our markets. Other problems which would persist with inaction include the potential for cross-market abuses due to the difficulties in cross jurisdictional enforcement.

I do not think the implementation of the needed reforms will eliminate major market moves based upon fundamentals. But it would, in my view, reduce the probability of major market disruptions and the attendant systemic risks associated with such disruptions.

Implementation of a unified regulatory structure governing stocks and stock index futures would also facilitate the implementation of badly needed improvements in the coordination of clearance and settlement mechanisms, circuit breakers and the like. Without such reform, I do believe there remains a level of systemic risk which is unnecessarily high and which can be effectively reduced with these reforms.

Q.16. Do you agree with the Chairman that, even if jurisdiction over stock index futures is shifted from the CFTC to the SEC, that shift would not make much difference in the way any potential future market break worked its way through the system?

A.16. I would not agree with Chairman Greenspan on this issue. Transferring jurisdiction over stock index futures to the SEC will help to minimize both the likelihood and the impact of further market disruptions, although it seems likely that major market moves will, of course, occur from time to time anyway. Unified regulation could make an enormous difference in our ability to resolve critical intermarket issues like unharmonized margins, uncoordinated circuit breakers, inconsistent short selling rules, and unintegrated clearance and settlement systems. Establishing a framework for resolving these key issues, and others we have not anticipated, is the most important step we can take to reduce systemic risk and minimize the destabilizing effects of major market moves in the future.

Q.17. The Federal Reserve Board was divided on the question of whether stock index futures regulatory jurisdiction should be shifted from the CFTC to the SEC, and so the Fed took no official position on that question. What is your view on whether jurisdiction should be shifted?

A.17. Shifting the regulatory responsibility for stock index futures to the SEC would appropriately unify the regulation of stocks, stock options, and stock index futures under the agency with the greatest overall expertise. Such unified regulation would end the jurisdictional disputes over the regulation of new products that stifles innovation or otherwise drives them overseas. In addition, enforcement efforts to combat intermarket abuses would be enhanced and the market disruptions and heightened risk resulting from conflicting rules, such as unharmonized margin requirements and uncoordinated circuit breakers, would be eliminated.

This solution represents the minimum necessary to deal comprehensively with the most prominent problems our markets now face. Moreover, because index futures are only a small percentage of the transactions regulated by the CFTC, it would not be a radical departure from the existing regulatory scheme. If this minimum approach cannot be accomplished soon, I feel the pressure for a more complete merger of SEC and CFTC jurisdiction will increase and the arguments in favor of the more dramatic solution of full merger will be strengthened.

Q.18. Assuming that Congress decided not to transfer jurisdiction over stock index futures from the CFTC to the SEC, do you believe that coordination could provide many, if not all of the benefits, that transfer is thought to provide by those arguing for transfer?

A.18. I believe the evidence on this is clear. Interagency coordination has not worked. It has not adequately resolved intermarket problems. While in theory interagency coordination should provide many of these benefits, in practice the problems have remained unresolved even when they have been severe and evident to all observers. Jurisdictional reform, on the other hand, would ensure that intermarket problems are viewed from an intermarket perspective.

Q.19. Chairman Greenspan, in his recent appearance before the Banking Committee, argued that the real cause of increased volatility in our stock markets is technological change and the increased concentration of stock in institutional hands. Do you share the Chairman's views?

A.19. First, there is not, I believe, convincing evidence that volatility, as traditionally and appropriately measured, has increased in recent years. What has increased is the occurrence of periods of serious market disruption. It is certainly true that technological change and institutional trading have put new demands on our market mechanisms, and we need regulatory reforms to ensure that these mechanisms can handle increased demands in an efficient and orderly manner.

Q.20. Do you agree that it makes sense for us to have a sound understanding of the factors responsible for market volatility before we act in any way that could potentially harm our markets and our international financial leadership?

A.20. I think we have adequate understanding of intermarket problems and failure to implement reforms soon will adversely affect our international financial leadership.

We always must be careful not to make changes that do more harm than good, but I believe we have a sufficient understanding of these issues to warrant carefully designed measures to address them. Examples of such measures include coordinated circuit breakers and harmonized margins.

It has been 2-1/2 years since the market break of 1987, and in that time we have become much better informed about the markets' interaction, the forces underlying excess volatility, and ways to minimize market disruptions. Numerous studies have been conducted by regulatory agencies, SROs, market participants and academics. Congressional oversight committees have held comprehensive and informative hearings. Particularly during the mini-break last October, we have had an opportunity to observe how markets react to the regulatory changes that have been put in place. Most importantly, we have observed repeatedly how the linkages between markets confirm the reality of one market and thus the need for more unified regulation.

I believe we have sufficient information to act responsibly at this time on the crucial issue of regulatory fragmentation, as well as on uncoordinated mechanisms that are contributing to intermarket problems. The sooner we do so, the better prepared we will be for future market volatility.

Q.21. Chairman Greenspan expressed some concern that some actions carry a risk of driving stock index futures trading offshore. Do you agree that some actions, for example, raising futures margins beyond those required for prudential reasons, carry that risk, and can you elaborate on the potential adverse consequences for U.S. financial regulation and financial leadership if most stock index futures trading was to move offshore?

A.21. I feel the greater competitive risk is in inaction. I am concerned that failure to resolve intermarket problems will drive trading to foreign markets.

If stock index futures traders go to Tokyo markets they will find (1) stocks and stock index futures are traded on the same exchange, (2) ultimate margin authority is vested in one regulatory agency, MOF, (3) margins on stock index futures are likely to be higher than present margin levels in the U.S., (4) there is no jurisdictional dispute over who regulates any new product and thus, an absence of the sorts of problems that beset innovation in the fragmented U.S. regulatory system. This unified regulatory system is generally the world standard among all our major competitors.

Although we have the most free-market oriented regulatory philosophy of any major market, our fragmented regulatory system inhibits market participants and leads to intermarket problems that undermine the competitive attractiveness of our markets. Although other market systems such as those found in Japan are clearly less free-market oriented in intent, the efficiency of streamlined, unified regulation may make them more attractive to market participants.

Rather than drive trading offshore, I believe harmonizing stock and stock index futures margins will strengthen our markets and help to preserve U.S. financial leadership. Regulatory fragmentation can drive trading offshore by impeding innovation in the U.S., as we have seen with index participations. There are a number of reasons why it is important to preserve U.S. derivative market leadership by keeping these markets safe, fair, efficient, liquid, innovative and competitively priced. Perhaps the most important is to preserve our leadership in the underlying stock market and thereby promote U.S. capital formation. In particular, I think a unified regulatory system would strengthen the futures markets by eliminating intermarket problems and attracting new market participants.

Q.22. Given that the futures exchange clearing system successfully handled the 508 point drop in October of 1987, isn't that strong evidence that the margining system already in place is a good, workable system that provides the kind of prudential protection that is needed?

A.22. No. The system was under very severe strain in October 1987 and the fact we were fortunate enough to avoid major systemic damage does not mean the clearance and settlement system is sound. After the October 1987 break, the clearance and settlement system fell over 6 hours behind its normal settlement times, with Chicago clearinghouses owing over $1.5 billion to investment houses. Had these funds been missing for any significantly longer time, it would have unleashed a chain reaction of events where other payments to other creditors would not have been made. The result could have been very severe systemic damage. Regulators also expressed concern about the system in the October 1989 break. I do not think we should wait until it breaks to fix the system.

Moreover, the current system may have contributed to the severity of such declines. Low futures margins indirectly permit high leveraging in stocks. This leverage creates the potential for major market disruptions, starting in the futures market and washing back to the stock market. The active use of this leverage has the potential, when concentrated in short periods of time, to punch a hole in the fabric of the market.

I believe rethinking the existing margining system will help to ensure that our markets do in fact achieve the requisite level of systemic protection.

Q.23. Chairman Greenspan's testimony on the CFTC/SEC issues indicated his opposition to merging the CFTC and the SEC. He stated that this kind of approach would "concentrate a great deal of regulatory authority over the financial system in a single agency.....We should not lose sight of the fact that under the existing system of split jurisdiction over financial instruments, our financial markets have been the most innovative in the world with many of the new products spurred by the introduction of index futures and other futures." Do you share the Chairman's views in this area?

A.23. I agree that, in the past, regulatory competition has at times, promoted innovation. Competition between New York and Chicago spurred new product development, while the practices of different regulators often promoted diversity, experimentation, and creativity. However, today adequate competition comes from foreign markets and the disadvantages of regulatory fragmentation outweigh, in my view, any residual advantage from regulatory competition between the SEC and CFTC.

Since the market break of October 1987, we have all come to realize that the securities and futures markets behave as one. This has significant implications for the regulatory structure. Recent experience has seen this competition degenerate into jurisdictional squabbles, which can strangle innovation and drive new products overseas. Today, therefore, the globalization of financial markets provides us with all the regulatory competition we need.

Q.24. One of the criticisms of letting bank holding companies into the securities business is that it creates an unfair competitive advantage because of the existence of deposit insurance. The argument is that deposit insurance permits banking organizations to take more risk, secure in the knowledge that deposit insurance will provide protection if things go sour.

This argument is made with particular force with respect to money center banks, which some argue are too big to let fail. How do you respond to this argument?

A.24. I believe that deposit insurance and other aspects of the "federal safety net" do provide depository institutions with benefits that could conceivably be used to compete unfairly with other financial firms. Moreover, if firms are permitted to rely on such benefits rather than their own expertise alone, they may create additional risk to the system -- they may grow and increase market share while being less efficient and more vulnerable to failure. This could have the effect of increasing ultimate losses to the deposit insurance fund.

On the other hand, it seems clear to me that banking organizations do have substantial expertise in the securities business and other lines of financial services in which they are currently restricted from fully competing. This expertise should be used both to make these businesses more competitive and to make banks more competitive generally. I believe the basis for banks' entry into these new fields should be their expertise, not their access to cheap funding, made cheap through the federal safety net.

The goal should, therefore, be to allow banking organizations to capitalize on their expertise or "synergy" in non-traditional lines of business without permitting them to take advantage of federal safety net benefits. I think this can be accomplished through appropriate insulation of the insured depository, although I have not reached any firm conclusions on the best specific ways to accomplish this. Obviously, structural separation is one method, whether by using subsidiaries or affiliates. Another is restrictions on transactions between the insured depository and its subsidiaries or affiliates. These are exactly the kinds of questions that should be addressed in efforts to reform the financial services industry.

Q.25. It is also argued that deposit insurance makes it possible for banking organizations to raise money more cheaply than their securities industry competition can. If banking organizations are only allowed into the securities business through an affiliate of the holding company, and the bank is not permitted to lend to its securities affiliate, is this argument adequately addressed?

A.25. I believe we can design a system to address adequately this concern. If appropriately designed structural requirements and firewalls are successfully enforced and if the protection of deposit insurance is not extended beyond its intended scope, then there should be an essentially level playing field for bank and nonbank securities firms.

Q.26. Another major criticism made of letting banks into the securities business is that it creates a real opportunity for tying services, and that this tying would disadvantage customers of the banks and the banks' competition in the securities business. Many securities firms are affiliated with insurance, real estate, or other kinds of companies. That leads to two questions:

a) How is the potential for tying in these situations dealt with under existing laws?

b) Is the problem any more serious when a bank is involved and is any additional special protection necessary?

A.26. This question deals with complex issues associated with both banking law and antitrust law, and I have not studied this area sufficiently well to give a definitive answer at this time. I do think it is an important issue and will examine it as we consider financial services regulatory reform.

Q.27. Some insurance companies are involved in corporate lending. I understand that at least one even has loan production offices in various locations around the country. Insurance companies are already the biggest long term lenders to agriculture. While insurance companies or securities companies cannot offer demand deposits, on the asset side of the balance sheet, is there anything that a bank holding company can do that a financial conglomerate such as Prudential/Bache, Sears, or American Express cannot do?

A.27. The only asset that a bank holding company may own that is not permissible for commercial companies is a controlling interest in a bank or bank holding company (except for so called "nonbank banks" which were grandfathered by statute). On the other hand, bank holding companies are limited to owning shares of banks, companies engaged in activities that are closely related to banking, and certain other authorized companies.

Thus bank holding companies have less authority and stricter regulation than insurance companies or securities firms. In fact, bank holding companies are disadvantaged vis-a-vis the three firms noted in your question, because each of them owns a

CEBA-grandfathered nonbank bank. This permits the combination of commerce, finance, and banking. I would also point out that to my knowledge none of the more than 160 grandfathered nonbank banks, which permits such business combinations, appears to have faced any difficulties because of its broader range of activities.

Q.28. The Federal Reserve has provided liquidity support for troubled banks in the past, and is doing large amounts of such lending to at least one bank with financial problems now. Under a risk-based deposit insurance premium system, would the Federal Reserve lending practices have to change in any way, and what factors would the Fed have to consider before making a loan?

A.28. I do not see a rigorous connection between a change to a risk-based deposit insurance premium system and Fed lending except that the discipline imposed by such an insurance system might reduce the chances that a bank would get into trouble and need liquidity support.

The one thing that does need to be considered carefully in any effort to reshape the insurance system is whether the changes being proposed would increase the propensity of holders of uninsured claims to "run" when an institution has suffered a reversal but actually is still solvent and viable. In this respect, the insurance system may have significant implications for the stability of the banking system and for the Federal Reserve in its role as lender of last resort.

QUESTIONS FOR DAVID W. MULLINS, JR.
FROM SENATOR PHIL GRAMM
MARCH 23, 1990

Q.1. The last twenty years have seen a dramatic growth in foreign exchange markets. This growth has diminished almost to insignificance the role that governments can play to influence those markets by direct intervention. The market volume each day could easily absorb any financial position taken by a central bank. And yet, international developments are having a growing influence on the conduct of domestic monetary policy. In this new international environment, how can the Federal Reserve effectively conduct monetary policy?

What are the restraints on its action?

What effective tools remain in the possession of the Federal Reserve?

How long can we count on such tools?

What additional tools would you envision or recommend?

A.1. In my view, intervention in the foreign exchange markets has never been an especially important tool of United States monetary policy. Intervention has at times been used to calm disorderly markets, or as a complement to monetary or fiscal policies that were appropriate to domestic objectives. Still, I believe it is no substitute for such policies, nor is it necessary for their success.

Instead, monetary policy is implemented either by adjusting the quantity of reserves available to depository institutions through open market operations or by changing the price of reserves at the discount window. These actions affect the volume of money and credit as well as domestic short-term interest rates. In turn, those changes ripple through the financial markets, altering the cost of credit and influencing decisions about prices, production, and spending. Of course, this process has always been subject to significant uncertainties about the magnitude and timing of policy effects on the economy.

The increasing globalization of the world's economies and financial markets has opened up new channels through which monetary policy operates. For example, with exchange rates free to vary, a change in monetary policy can change not only domestic interest rates, but also the value of the dollar on foreign exchange markets. Such fluctuations in the exchange rate alter the relative prices of domestic and foreign goods, influencing our economy by shifting demand -- both domestic and foreign -- toward or away from U.S. producers. At the same time, with funds flowing freely across our borders, developments in foreign financial centers have a greater capacity to affect both the exchange value of the dollar and conditions in domestic financial markets.

Nonetheless, while international factors do alter the precise channels through which a given monetary policy action affects our economy, they do not change the fact that, in the long run, our economic circumstances depend on our own monetary and fiscal policies. Policy makers must take into account the effects of developments abroad, and be aware of the impact of our actions on the rest of the world, and how that feeds back to domestic conditions. I feel international consultation among policy makers is also useful. Still, participants in financial markets feel that domestic conditions and Fed policy are very important influences on our economy, and I agree with this view. Domestic factors remain the most important influences on our economy and on our financial markets, and existing policy tools remain well-suited to pursuing our goal of sustainable, noninflationary growth while supporting stable international economic relations. We need to think carefully about how we deploy our instruments of policy, but at this time I do not see the need for new methods of implementing monetary policy.

Q.2. Describe what you see as the appropriate division of responsibilities for international monetary policy between the Federal Reserve Board and the Federal Reserve Bank of New York.

What problems have there been in the past?

A.2. The Federal Reserve has a role in formulating international financial policy through a process of consultation with the Administration and Congress. The Board of Governors itself is required to exercise special supervision over all foreign relationships and transactions of any Federal Reserve Bank.

With respect to international monetary policy, the relevant policy-making body of the Federal Reserve System in this area is the Federal Open Market Committee, composed of the Board members, the President of the FRBNY, and four other Reserve Bank presidents.

The Foreign Department of the Federal Reserve Bank of New York headed by the FOMC's Manager of Open Market Operations, Foreign Exchange, conducts actual foreign exchange operations as agent for the FOMC and for the Treasury. Its responsibilities are operational rather than policy making, though by virtue of its close contacts with the market it is in a position to offer constructive suggestions on strategy and policy. The Manager also frequently acts as a facilitator for communications between the Federal Reserve and the Treasury.

I know of no serious problems between the Board and the New York Federal Reserve Bank in this area in recent years, and I feel the respective areas of responsibility are well defined and well understood.

Q.3. What do you see as the appropriate division of responsibility for international monetary policy between the Federal Reserve and the Treasury?

Who sets U.S. exchange rate policies?

What happens if the Federal Reserve and the Treasury disagree over exchange rate policies?

A.3. As the chief economic officer of the United States, the Secretary of Treasury, acting for the President, should have ultimate responsibility for the international financial policies of the United States. However, since exchange markets are integrally linked with money markets and questions of monetary policy, over which the Federal Reserve has independent authority, it is imperative for the Federal Reserve and Treasury to work in close consultation and coordination in this area to ensure consistency of overall U.S. international monetary and financial policy.

The Secretary of Treasury, in close consultation with the Federal Reserve, sets U.S. exchange rate policies. In most international forums where these policies are discussed, both agencies are represented. The Secretary of the Treasury and the Chairman of the Federal Reserve both participate in meetings of the Group of Seven finance ministers and central bank governors. The Secretary of Treasury serves as the U.S. Governor of the IMF, and the Chairman of the Federal Reserve serves as his alternate.

Differences between the Federal Reserve and the Treasury over exchange rates policies always have been worked out in the past through the process of reasoning and deliberation. If irreconcilable differences should arise in the future, which is highly unlikely, I would suggest that the appropriate Committee of Congress should be notified immediately.

Q.4. How closely should the State Department be involved in the conduct of foreign exchange policies?

What weight should be given to foreign policy concerns?

A.4. The Secretary of Treasury, acting for the President, has responsibility for U.S. international financial policy. To the extent that international financial issues are related to other issues confronting the U.S. government, as is often the case, the Treasury Department should consult with other relevant agencies both informally and in interagency meetings.

With respect specifically to foreign exchange policies, the Treasury works especially closely with the Federal Reserve. Finance ministries and central banks throughout the world are the agencies most involved with exchange rate matters. Broad foreign policy concerns provide a context in which foreign exchange policies are formulated, and the State Department makes its views known to the Treasury Department and, on occasion, to the Federal Reserve. Moreover, I believe the State Department -- along with its counterparts in other countries -- participates in some international forums where foreign exchange policies are discussed. However, I think the State Department in the past has not been closely involved in specific aspects of foreign exchange policy, and this is an appropriate division of responsibility.

Q.5. Should the United States promote the international convertibility of the Soviet currency? Why or why not?

A.5. Currency convertibility helps integrate a country into the international economy. The primary benefit of convertibility is that it facilitates the free movement of goods and capital internationally, thereby contributing to the efficient allocation of economic resources. As such, there is a clear connection -- and interdependence -- between convertibility, on the one hand, and international capital mobility, free trade, and free markets in general, on the other. Indeed, it would seem that the full benefits of a market economy would not be realized without a convertible currency. Without convertibility, the costs of certain transactions (involving foreign currency) are affected, thereby altering some allocative decisions.

However, convertibility need not be, and often has not been, an all-or-nothing proposition. Various forms of limited convertibility have been employed by many countries. However, as long as there are some distortions owing to the remaining restrictions on convertibility, there are, in principle, economic costs to partial convertibility. In some cases, these costs might be small and/or outweighed by other considerations.

I feel that it is for the Soviet authorities to decide the pace at which they move toward convertibility of the ruble. The clearest active role that the U.S. authorities can play in this process is in the area of what might be called "technical assistance," that is to say, advice and information on how a market economy operates and how policy is made in such an economy. This assistance could be brought to bear on all aspects of economic reform, not just the narrow question of currency convertibility.

Q.6. If you were appointed to the Soviet central bank rather than to the U.S. central bank, what program would you outline to move the Soviet economy to the condition where the ruble was fully convertible internationally?

A.6. It is somewhat difficult for me to project myself into the premise of this question, but I'll give it a shot.

The key conditions required for a successful implementation of ruble convertibility would be an economy organized along the lines of a market-oriented economic system and exhibiting a reasonable degree of macroeconomic stability. Many elements are involved in a successful reform along these lines. However, the Soviet central bank would be responsible for helping to achieve macroeconomic stability. For such stability there are two essential ingredients: a central bank that is effectively independent of the fiscal authorities -- and the pressures to finance the government through the creation of money -- <u>and</u> a commitment to some type of monetary discipline that would limit any upward drift in the general level of prices. I do not feel sufficiently expert on the topic to comment on the details of such a program within the Soviet context.

Q.7. The Federal Reserve shares responsibility for United States participation in the International Monetary Fund. Under what conditions would you favor Soviet membership in the IMF?

A.7. While I have not studied this issue in detail, I would favor membership of the Soviet Union in the IMF if the Soviet Union could meet the obligations of membership as described in the IMF Articles of Agreement and if Soviet membership appeared to be in the best interest of the international community.

Q.8. It has been said that the single most important factor in bringing on the Third World debt crisis was the rapid rise in interest rates and that the single most important factor in defusing the crisis was the fall in interest rates in the mid-1980s. To what extent, do you believe, are such assessments valid?

A.8. I have not studied this topic extensively, but I would make a few points in response to your question. The rapid and large rise in interest rates in the early 1980s was needed to contain inflationary pressures in industrial countries. The rise in interest rates and the related slowdown in economic activity and weakness in commodity prices contributed to the debt problems of heavily indebted developing countries. Obviously, oil price volatility also played an important role. However, some heavily indebted countries did not encounter debt problems. This suggests that the policies followed in the indebted countries were also important determinants in whether or not a crisis was encountered. The subsequent decline in interest rates and pick-up in world economic activity, as well as ongoing adjustments in the developing countries, all helped to ease the debt problems of developing countries. Those countries that implemented sound policies benefitted the most from these developments, whereas those countries that failed to address the fundamental problems facing them did not derive lasting benefits from the lower international interest rates and the resumption of growth in industrial countries.

Q.9. What do you see as the fundamental causes of the international debt problems of Latin America?

A.9. In my view, the fundamental causes of the international debt problems of Latin America include the failure on the part of borrowing countries to recognize that the relatively low rates of interest that prevailed in the 1970s would not be maintained and that the extent of their indebtedness therefore would become a burden; the overeager lending by commercial banks; oil price volatility played a role as well; and the inappropriate macroeconomic and microeconomic policies that many of the borrowing countries had been following prior to encountering debt problems, including the ineffective use of external borrowing.

Q.10. Why, do you believe, have the debt problems in Latin America and Africa not been found similarly in many of the countries of the Pacific Rim, such as Thailand, South Korea, Malaysia and Taiwan?

A.10. This is not a topic I have explored in detail, but I would note a few points. The recent debt problems of many developing countries resulted from a combination of adverse external shocks and the failure of these economies to adjust rapidly to these shocks. All indebted developing countries, including those of the Pacific Rim, were affected in the early 1980s by the rise in real interest rates and by the recession among the industrial nations. On the other hand, many Pacific Rim countries entered the 1980s with smaller debt ratios than did the African and Latin American countries. Moreover, the declines in commodity prices during the 1980s generally affected the African and Latin American countries more strongly than they affected the Pacific Rim economies, where manufactured products represented a greater share of total exports. Finally, the stronger outward orientation of the Pacific Rim economies allowed them to generate higher trade surpluses by increasing exports and hence preserving high levels of economic activity. By contrast, economies with an inward or import-substitution orientation, which was the more normal pattern in Latin America, found it difficult to implement the reforms necessary to encourage export expansion, and had to finance higher debt-service payments through import contraction instead. This, in turn, necessitated reductions in long-standing fiscal deficits, which political considerations often made difficult to achieve. As a result, many countries failed to make the fiscal and economic adjustments necessary to meet their debt-service obligations.

Q.11. Would you provide for the Committee your evaluation of the recently announced Brazilian economic plan? Do you believe that it will be successful in achieving its announced goals? What do you see as its strengths? It weaknesses?

A.11. I have not analyzed the plan in detail, but I have a few comments based upon a preliminary look at it. President Fernando Collor de Mello's economic program, announced when he took office in mid-March, is Brazil's most ambitious anti-inflation program to date. The plan proposes to increase tax revenues, sell public sector firms, reduce government expenditures on personnel, and liberalize trade, and includes other structural reforms. The plan also includes an 18 month freeze on large domestic deposits. In addition to greatly reducing the amount of liquidity in the economy, the government also reduced interest payments on government debt. Most of the measures require legislative approval.

The strength of the plan is in the inclusion of concrete tax increases and spending cuts designed to reduce the fiscal deficit. The Brazilian government's goal is to make fiscal adjustments equivalent to 10 percent of GDP. It remains unclear at this early stage whether the government can achieve this goal. If it does, I am hopeful that the program will be successful in eliminating the threat of hyperinflation.

The future management of the freeze on deposits (affecting about $100 billion out of $150 billion in deposits held with financial intermediaries) will be another key to the plan's success. The large fall in liquidity has made it difficult for firms to pay employees and other creditors. A challenging problem for the government will be to relax the liquidity squeeze in a manner that is consistent with price stability, while avoiding an excessive decline in economic activity.

Q.12. Do you favor involuntary, government-mandated forgiveness of international debt of troubled Third World debtors? Why or why not?

A.12. Involuntary, government-mandated forgiveness of international debt of troubled Third World debtors would harm the growth prospects of developing countries and would not be in the U.S. policy interest. Dictating terms of debt relief unilaterally is likely to fail, and even if enacted might be detrimental to the long-term interests of creditors and debtors alike. In particular, countries run a high risk that access to trade credits and other private capital inflows would be curtailed for an extended period of time. In addition, I believe that it is not the proper role of government to impose specific terms on private bank creditors that essentially serve to reduce the value of their assets.

In contrast, the Brady initiative emphasizes a cooperative approach balancing official support for debt and debt service reduction with new money flows where necessary for those countries that agree to adopt sound policies and to continue the process of structural reform. Positive results have been achieved under the initiative in a number of countries to date, and several other countries are beginning negotiations with the banks on financing packages.

Q.13. In your view, what role does the IMF currently have in the post-Bretton Woods era of flexible exchange rates?

The current Managing Director of the IMF has stated that he would like to see the IMF given the resources to play a greater role in the management of exchange rates. Do you believe that the IMF should have an increased role in this area? If so, what should that role be? If not, why not?

Do you believe that the IMF should be given increased resources at this time? Why or why not?

A.13. As I understand it, the IMF has a defined role in current foreign exchange market arrangements. Article IV of the IMF's Articles of Agreement, governing exchange arrangements, was revised in 1976 to take into account the changes in foreign exchange market policies and practices in the post-Bretton Woods period. Article IV specifies the general obligations of Fund members. It includes a provision for Fund surveillance over the exchange rate policies of its members, and it calls for the Fund to "adopt specific principles for the guidance of all members with respect to these policies." These principles are spelled out in more detail in the 1979 Fund decision on "Surveillance over Exchange Rate Policies."

Over time, the Fund's role in exchange market arrangements has evolved further. The Managing Director of the Fund participates in multilateral surveillance discussions of the Group of Seven, as well as in the discussions of the semi-annual meetings of the Interim Committee. In its various roles, therefore, the Fund is actively involved in monitoring foreign exchange market developments, and the Managing Director has ample opportunities to voice his views on these matters.

The Fund's role in exchange market arrangements, however, does not require the Fund to be a party in foreign exchange market intervention activity. There, thus, is no need to increase the Fund's resources for this purpose. Current discussions regarding an increase in Fund quotas relate primarily to providing the Fund with adequate resources to support the stabilization programs of its members that require additional external finance. In light of recent developments in Eastern Europe, the purview of the Fund's activities, and calls on its resources, has widened. This larger Fund role provides an additional justification for the consensus for an increase in Fund quotas that is now emerging.

Q.14. What purpose, if any, do you believe that IMF gold reserves serve?

If an increase in IMF resources is required, why should the taxpayer be called upon to provide that increase before these gold reserves are used?

A.14. Gold is an important asset of the Fund even though gold is not now normally used in the Fund's transactions and operations. Gold provides additional confidence to creditors of the IMF, including the United States.

Gold sales would only substitute one type of asset for another, assuming the Fund were to retain the proceeds from the sales, and would only raise liquid resources on a one-time basis. In contrast, an increase in quotas enlarges the assets of IMF, and can be repeated as appropriate.

While a quota increase means that the United States and other creditors will be providing more resources to the Fund, the United States does receive interest on the resources when they are used. Moreover, a quota increase enlarges the size of potential drawings on the Fund by the United States and other countries. The United States did draw on its reserve tranche in the Fund in 1978.

Q.15. What problems do you believe are presented for U.S. foreign exchange policy if the proposed European Bank for Reconstruction and Development bases all of its transactions, contributions, and so forth on the ECU?

A.15. In my view, the choice by the European Bank for Reconstruction and Development of a currency or currencies in which to denominate its transactions and contributions would have very little, if any, effect on exchange rates or, therefore, on U.S. foreign exchange policy. Even if that choice influenced ultimate demand for assets denominated in various currencies on the part of individual holders of wealth, the magnitude of the effect would likely be trivial relative to total wealth.

Q.16. Do you support the view that a bank holding company and its subsidiaries should be considered a source of strength for the insured bank subsidiaries?

Is the perpetuation of this doctrine, in your view, an impediment to restructuring the relationships between banks, securities, and insurance industries, since it would discourage securities and insurance corporations from seeking to acquire banks (should such acquisition become allowable by law)?

A.16. I have not yet reached a definitive conclusion on this issue, but it is an important issue to explore as we move toward financial services reform.

The Federal Reserve Board (FRB) has long contended that bank holding companies should act as a source of managerial and financial strength to their subsidiary banks "by standing ready to use available resources to provide adequate capital funds to subsidiary banks during periods of financial stress or adversity" (12 C.F.R. Part 261). The FRB developed the source of strength doctrine pursuant to its authority under the Bank Holding Company Act of 1956 (BHCA), the Federal Deposit Insurance Act, and the International Lending Supervision Act. However, the doctrine per se has never been codified under current law. Of course, FIRREA provided for corss-guarantees for banks within the holding company structure, but it is too early to assess the impact of this provision.

The source of strength doctrine is based in large part on the rationale that a bank holding company derives certain benefits at the corporate level through its ownership of a commercial bank. Specifically, the subsidiary bank can obtain federally insured funds and has direct access to Federal Reserve credit. These are alleged to be unique franchise benefits in return for which the holding company ought to serve as a source of strength and support to its subsidiary banks. As a practical matter, this policy is intended to prevent a holding company from "walking away" from a failing or failed bank subsidiary.

It is true, however, that from both a theoretical and policy standpoint, the source of strength doctrine is in conflict with the principle of corporate separateness which has served as the cornerstone of many proposals to restructure the commercial banking system, most notably in the area of Glass-Steagall reform. This is so because the doctrine can be interpreted as requiring a failing bank's non-depository affiliates to provide financial assistance, effectively negating the purpose of constructing "firewalls" and presumably "insulating" insured depositories from their holding company parents and affiliates. In this respect, the source of strength doctrine may tend to impede an efficient, balanced and equitable restructuring of our financial services markets, and this is why we need to rethink this issue in the coming debate on financial services reform.

Q.17. What are your views on the Qualified Thrift Lender test in the FIRREA?

To what extent does this QTL test increase the cost of resolving the S&L crisis, either by disqualifying or discouraging potential acquirors or by increasing the amount that the Government must provide in an assisted acquisition in order to attract an acquiror?

A.17. The Administration did not support the 70 percent QTL test in FIRREA because it may be too restrictive, and instead supported a 60 percent QTL test. It is true that the test in FIRREA may tend to increase the risks inherent in a non-diversified portfolio. Nonetheless, very many successful thrifts currently prosper within the 70% QTL test. There are many techniques for dealing with the problems associated with it (e.g. hedging, ARMs, originating and selling off MBS).

Thus, it is still unclear exactly how much the QTL test in FIRREA might increase the cost of resolving thrifts.

Q.18. Do you support Chairman Greenspan's view that regulatory authority over securities margins should be transferred from the Federal Reserve to the SEC?

A.18. I believe a single agency should have authority over all stock related margins. There are several possibilities for the single regulator. The Federal Reserve currently regulates margin on stocks and stock options, so it is a logical choice for stock index futures margin authority as well. Of course, Chairman Greenspan has said that the Federal Reserve does not want to be the single regulator of margins.

The SEC also is a logical choice because of its expertise and regulatory authority in the securities markets. The Fed has also delegated its stock option margin authority to SROs with SEC oversight. If jurisdiction over stock index futures were transferred to the SEC, it would seem all the more appropriate to give the SEC authority over securities and stock index futures margins.

If futures margins remain unregulated at the federal level, however, I see no compelling need for the Fed to relinquish its current authority over securities margins. Nonetheless, the basic rationale for margin authority at the Fed may need re-examining and there is merit in the notion that regulation should be unified under one regulator rather than fragmented among several. Overall, I feel this issue should not be dealt with in a piecemeal manner but as part of a coherent, comprehensive solution to the problems caused by regulatory fragmentation.

Q.19. What do you see as the difference, if any, between margins on futures, options, and stocks?

What changes, if any, would you recommend in the regulation of these margins?

Do you support the conclusion of the Brady Commission that the Federal Reserve should be given authority over futures margins?

A.19. Margins on stocks and futures are different in some respects due to differences in the extent of daily marking to market, different settlement periods, and the like. But margin requirements on stock and futures share a fundamental characteristic -- they control leverage, and leverage determines how much securities or futures can be bought or sold with a given amount of collateral.

Leverage in the futures markets has several consequences. It obviously affects the prudential interest of the clearinghouse. But if the clearinghouse sets margin too low for its own private purposes, as I believe they have in some cases, there is a systemic risk that a failure of one clearinghouse could cause a chain reaction that destabilizes the system. That systemic risk, which really is a cost to the public, goes beyond the private, prudential interest of the individual clearinghouse. This is one very important reason why I believe some mechanism for governmental oversight of futures margins is needed. Moreover, inconsistent margins in two segments of what is really "one market" can, I believe, contribute to episodic periods of market wide disruption. These disruptive episodes erode investor confidence and ultimately can affect the cost and availability of capital. Such periods of market disruption also put inordinate strain on the clearance and settlement process and thus, engender systemic risks as well.

I believe the margins on stocks, stock options, and stock index futures should be harmonized, not equalized, so that the leverage effects in the "one market" are consistent. To ensure consistency, and given that futures margins have a public purpose, there also should be, I believe, a unified system of federal oversight of margins on stocks, stock options, and stock index futures. The Federal Reserve is one of several possible choices for unified regulation of margins, as I explained at questions 18.

Q.20. Do you favor the merger of the SEC and the CFTC?

Several proposals have been made to transfer jurisdiction for some or all of the regulatory authority over financial futures to the SEC. Which, if any, of these proposals do you favor, and why?

A.20. I believe we must find a solution to the problems associated with intermarket regulation. These include the jurisdictional conflict associated with new products which hurt U.S. innovation and competitiveness; cross market enforcement issues; and inconsistent regulations in different markets which contribute to market disruptions. The latter two problems in my view undermine the confidence of investors in our markets and may add to systemic risks. It is important we solve these problems soon because, for the first time, we have serious, viable competition from foreign markets.

Merger of the SEC and CFTC is one of several possible solutions that I believe merit serious consideration. A merger would be the most direct and broadest solution, and it would make our regulatory system similar to many of our major foreign competitors. By unifying all regulation we could address not only the intermarket issues we now recognize, but new ones that are bound to arise as innovation continues.

A different solution would be to unify regulation only of those markets where problems have been acute. This could range from unified regulation of all financial products and their derivatives to unified regulation of stock-related products.

In my view, the minimum course of action would be to unify regulation of stocks, stock options, and stock index futures under the agency with the greatest overall expertise in stocks, the SEC. Margin authority over each of these products would also require consolidation in a single regulator. In addition, it is imperative that we end the jurisdictional disputes over the regulation of new products that simply drive them to overseas markets (this would require elimination of the "exclusivity" clause in the Commodity Exchange Act, which currently requires exclusive CFTC regulation of <u>any</u> instrument that has <u>any</u> element of "futurity").

This minimum solution would deal comprehensively with the most prominent problems we now face. Moreover, because index futures are only a small percentage of the transactions regulated by the CFTC, it would not be a radical departure from the existing regulatory scheme.

Indeed, any more limited approach will only delay the resolution of intermarket problems that must be addressed. If this minimum approach cannot be accomplished soon, it seems very likely that the pressure for the complete merger approach will increase as the problems continue unabated.

Q.21. Who should have jurisdiction in the United States for the regulation of foreign exchange futures markets?

A.21. I know of no particular problems in this area and, therefore, feel currency futures should be dealt with in the broader context of a solution to problems of regualtory fragmentation.

As you know, the cash market for foreign currency is a large, international market that is not subject to direct government regulation, though many of the major players in this market, such as commercial banks, are regulated. In contrast, in the case of stock index futures one regulator, the SEC, regulates the cash market and certain derivatives, while another regulator, the CFTC, regulates futures on the cash market. In the case of foreign currency futures, we have an unregulated cash market and a regulated futures market. This is also the case with many other futures contracts.

While I have not studied this area, I do not see a particular reason for transferring to a different agency regulation of foreign currency futures. However, this does not mean that aspects of their regulation might not be altered. For example, the exclusive jurisdiction clause of the Commodity Exchange Act could be modified to allow useful hybrid products, including those involving foreign currency to be traded. In this regard, because the CFTC seems to have a narrow view of the Treasury Amendment, which exempts from their jurisdiction transactions in foreign currency unless conducted on a board of trade, modifications could clarify that debt instruments with some aspects having similar risk characteristics to foreign currency futures are not precluded by the Commodity Exchange Act.

Moreover, I would not rule out a general solution to the continuing jurisdictional issues between the CFTC and the SEC, such as merger of the two agencies, but I do not favor transferring the jurisdiction of exchange-traded foreign currency futures separately from a more global solution to jurisdictional conflicts involving futures markets.

Q.22. Under what conditions, if any, would you support the imposition of wage and price controls upon the economy?

A.22. Wage and price controls are a distinctly inferior way of dealing with inflationary problems; they are costly and distortive, and usually prove to be at best temporary palliative. One perhaps should "never say never," but I am inclined to do so. It clearly is the central task of the Federal Reserve to pursue policies that obviate any consideration of such measures.

Q.23. What are your views on Senator Moynihan's proposal to reduce Social Security taxes, or proposals to take Social Security out of the unified federal budget for deficit calculation purposes?

A.23. Many of these proposals have their roots in concern about the progress we are making toward the elimination of the federal budget deficit. I share those concerns. However, it should be possible to address the fundamental issues of deficit reduction without tampering with the substance or the accounting of Social Security, which I do not think would be constructive in itself. Fundamentally, we need to rein in the non-Social Security deficit and, thereby, secure the benefits of greater national saving and capital formation that the Social Security surpluses could provide.

Q.24. Do you believe that the Gramm-Rudman-Hollings deficit reductions goals can be reached without an increase in taxes, or do you favor a combination of spending reductions and taxes to meet these goals?

A.24. I believe that the goals can be reached without additional taxes, and I would hope that decisionmakers will find the political will to achieve that objective.

Q.25. Would you favor legislation providing for an independent, perhaps GAO, audit of the Federal Reserve on a regular basis? Why or why not?

A.25. It is my understanding that the Federal Reserve is already subject to both independent and GAO audits on a regular basis. Outside independent auditors perform several functions. Under the Board's Inspector General, a private accounting firm conducts an annual financial audit of the Board of Governors, which is publicly available. In addition, this outside firm is responsible for review of the examination procedures used by the Board in its audits of the Reserve Banks.

The General Accounting Office also has authority, under the 1978 Federal Banking Agency Act, to audit the Board, the Federal Reserve Banks, and the branches and facilities of the Reserve Banks. The GAO has initiated numerous audit projects since the law's enactment covering a whole range of Federal Reserve operations including bank supervision, check clearing, wire transfers, and Federal Reserve expenditures.

The law does, however, exempt monetary policy from the purview of GAO audits, which I fully support because a GAO examination of the monetary policy process, I think, would constitute a step toward compromising the independence of the Federal Reserve. Indeed, in exempting monetary policy from the purview of a GAO audit, Congress recognized that the purpose of an independent monetary authority is that, subject to the oversight of Congress, that authority should be free from political pressure to determine and put into effect the most appropriate monetary policy.

Rather than GAO, Congress, in effect, audits the Federal Reserve's monetary policy. Indeed, the semi-annual Humphrey-Hawkins hearings were established so that Congress could oversee Federal Reserve monetary policy.

Q.26. Would you support immediate publication of the minutes of the Federal Open Market Committee meetings? Why or why not?

A.26. While there are arguments on both sides, I feel the current approach works well, and I do not support immediate publication of the minutes of the meetings of the Federal Open Market Committee. I recognize that, in general, the more information available to the market, the more efficiently the price mechanism can operate. And, in the case of financial markets and the pricing of financial instruments, monetary policy decisions and the intentions of the monetary authorities are certainly key information variables. The current stance of policy, however, is seldom a source of uncertainty for the market. Through its open market transactions, the Federal Reserve makes that stance quite clear. It is these actions that matter. Hence, immediate announcement of changes in the operating stance would add very little to information already at the market's disposal. Indeed, accompanying open market transactions with interpretative announcements could increase the potential for misunderstanding and market disruption.

Moreover, uncertainties about monetary policy involve the prospective course of policy; here prompt release of the minutes -- or the directive to the Open Market Desk -- may add to volatility, rather than damp it. The directive contains some forward-looking language, in the form of contingency plans for policy should events not accord with the FOMC's expectations. Publication of that portion of the directive could elicit price movements in financial markets, despite the fact that the contingency plans rarely are implemented. Concern about market reactions, in turn, might cause the FOMC to restructure the directive in ways that made it less informative and less useful as a guide for implementing policy. Partly as a result, the requirement to release the minutes might interfere with the efficient pursuit of policy goals.

On balance, I would prefer to confront the possibility of some minor efficiency losses to the financial markets than to risk a loss of flexibility, efficiency, and effectiveness in the operation of monetary policy.

Q.27. Are U.S. banks in decline vis-a-vis their international competitors?

If so, what are the causes and what can be done to address these causes? If not, then why do the major U.S. banks complain that they are?

A.27. The large U.S. banks involved in international activities clearly have been losing shares in some traditional banking markets, and individual U.S. banks are no longer the world's largest. However, in some other markets, notably those involving more sophisticated instruments and services, which do not show up on banks' balance sheets, U.S. banks remain among the world's leaders. Moreover, the profitability of U.S. banks has been relatively good.

In any case, the competitive position of U.S. banks would improve if the cost of capital facing U.S. banks were lower. U.S. banks would benefit also from a removal of the limitations on securities activities and interstate branching, which would permit greater geographic and product diversification and would enable U.S. banks to achieve the synergies from additional activities that banks from some other countries already enjoy.

Q.28. Do you support the concept of using the Federal Reserve's regulatory powers as a tool in a trade war, that is, to base decisions on petitions from foreign-owned applicants not on the merits of the particular application alone, but on the treatment given to U.S.-owned banks in foreign countries?

A.28. No. The Federal Reserve has always taken the position, with which I am in agreement, that national treatment applied without any conditions of reciprocity facilitates a more efficient, a more innovative and dynamic, and a more prudent financial system in the United States. Moreover, a reciprocity policy could have the effect of discouraging foreign investment in the United States at a time when such investment is needed.

Supporters of reciprocity argue that, whatever the economic merits of a policy that is based on free trade, an important strategic consideration is that foreign countries such as Japan take liberalizing measures only when under the pressure created by a reciprocity policy. However, I would be concerned that a U.S. policy of reciprocity in the banking sector could be viewed as an endorsement of the tendency of EC policy toward reciprocal national treatment and could encourage other foreign countries to adopt reciprocity policies that would be applied on a bilateral basis. The standards used in such policies and their implementation would be likely to vary considerably, with considerable potential for restricting international trade in financial services and for restricting opportunities for U.S. banks. I, therefore, believe that it is more appropriate and less risky to continue to work cooperatively on a bilateral basis with those countries in which U.S. banks see the greatest benefits from some relaxation of restraints on entry and operation of foreign banks, or through a multilateral forum such as the GATT.

Q.29. What, if any, monetary role would you support for gold?

A.29. The price of gold can be sensitive to changes -- actual and expected -- in the monetary environment. Specifically, gold prices often react to variations in the expected rate of inflation, as well as to returns on financial assets. Changes in gold prices for these reasons can give information to policymakers about economic and financial conditions, which may be especially valuable in the pursuit of price stability. However, gold prices also respond to a number of other influences, including variations in supply and changes in demand unrelated to underlying monetary conditions. In today's complex economy, tying monetary policy directly to the price of gold likely would introduce undesirable fluctuations in output and prices. The price of gold should be one indicator, among others, that policymakers monitor to judge whether policy is on track and converging toward their objectives.

Responses of Governor Kelley to
Questions from Chairman Riegle

Q.1. What are your views about how our financial services system should be reformed?

- **Should bank powers be expanded, either directly or through holding company affiliates?**

A.1. I support the general expansion of financial powers through the bank holding company structure. Global financial markets are changing so rapidly under the constant pressures of technological change and innovation, that to freeze any set of institutional powers as of those of some past date is to create the likelihood that those institutions could atrophy and weaken. It is not, however, just concern about banks that is relevant. Bank customers should have the benefit of the most competitive markets possible and I see no reason to force individuals and institutions to migrate from the banking system to other financial institutions to obtain vital financial services, unless some essential public purpose so requires.

The holding company structure is best suited to assure competitive equity and guard against misuse of the safety net. It facilitates functional regulation and permits special safeguards for insured deposits and the payments mechanism. But market realities suggest to me that all affiliates will seek to operate as one whole and that problems in one affiliate can cause problems for others. For this reason, we should be cautious of the risks of certain financial businesses. I would, for example, exclude fire and casualty insurance underwriting from the list of acceptable financial affiliates for this reason and I have not yet made up my mind about life insurance underwriting.

- **Should the current regulatory structure be simplified or otherwise reorganized?**

The present structure is working well and one should be cautious, therefore, about modifications. It could, of course, be simplified and thereby reduce the costs imposed on the institutions regulated. However, modifications to the regulatory structure should only be contemplated seriously when the other structural questions have been successfully addressed, and Congress has available for its deliberations an up-to-date profile of the financial services industries.

Q.2. Do you believe it would be desirable for the Board of Governors to play an active role in developing a comprehensive proposal to modernize the regulation of financial services?

A.2. Congress, which must make the final judgments, should draw on all of the special expertise available. I think the Federal Reserve experience does provide a useful point of view that could be helpful in developing modifications to the regulatory structure. For example, in administering both the Bank Holding Company and International Banking Acts, the Board has learned a considerable amount about the dynamics of affiliation among financial entities and the interrelationships among financial markets domestically and internationally. Moreover, its focus on the risks to financial and real economic activity associated with regulation and supervision also offers insights which Congress might find useful.

Q.3. What do you believe should be the goals of deposit insurance reform? What do you see as the most promising proposals for deposit insurance reform?

A.3. The original goal of protecting the small, unsophisticated depositor still seems to me to be first on any list. Our federal deposit insurance now does this reasonably well, but we should try to develop reform to limit its misuse through multiple accounts. The goal of contributing to macro financial stability through avoidance of deposit runs and the insulation of failing banks from healthy banks remains vitally important. Any proposal which could weaken that goal should, in my view, be considered very carefully.

The deposit insurance problem today is that, in our desire for systemic stability, we have insulated bank management from the risks of their own bad policies. Depositors--both large and small--look to the government rather than the depository institutions' assets to protect their funds, knowing of the insurer's and regulators' sensitivity to bank runs. In its most extreme case, this has led to a perception of a too big to fail policy that many feel means 100 percent deposit insurance at large banks. This is a perception we cannot maintain without either overly regulated banks or large taxpayer costs.

In balancing the need for stability with the need for market forces to help the regulators discipline bank management, I think that we should give serious attention to a policy designed to harness management and stockholder self-interest to limit the potential misuse of the deposit insurance subsidy. That policy would call for early intervention with progressively more stringent limitations and constraints on the growth and dividends of banks whose capital declines below minimum regulatory levels. If a bank cannot recapitalize reasonably soon, this policy should call for conservatorship, shrinkage and/or sale to others, capped if necessary by closure while there is still some capital in the institution.

Beyond prompt resolution, we should consider some coinsurance above $100,000, and perhaps risk-based insurance premiums. I would be interested in seeing how some use of private insurance might compliment federal insurance.

Q.4. Do you believe that the wall separating banking and commerce should be eliminated?

A.4. In principle, I would like to see it happen, so that banks had wider access to capital and management. However, the feasibility of doing so depends critically on the nature of the regulatory and insurance reform addressed in the previous question. If, for example, we adopted a universal bank approach, with all powers exercised in one corporate unit, I would be opposed to banking-commerce combinations. In such a structure, it would be impossible to see where one entity began and another ended, which had access to the safety net and which did not, which was the lender and which the borrower. If we retain the holding company form and adopt rules that require all bank affiliates, as well as the parent, to use all their resources to maintain the capital of the bank--on pain of divestiture of the bank and compensation to the insurer for any of its costs--one has to worry less about misuse of the bank safety net. The critical element is to develop ways to ensure that the safety and soundness of a bank unit will not be compromised by a commercial affiliate. If that can be accomplished--and that depends heavily on the holding company structure and on rules on bank support by affiliates and the parent--the end of the separation of banking and commerce can be considered in a serious way.

Q.5. Last Fall, the Federal Reserve and the Treasury had a difference of opinion about whether to push the dollar down by intervening in currency markets. What side did you support? Since then, the dollar has fallen against the mark and gained against the yen. Are current rates sustainable?

A.5. Differences of opinion between the Federal Reserve and the Treasury with respect to U.S. intervention in foreign exchange markets are infrequent and should not be exaggerated. Last fall, the difference was largely one of scale and tactics not whether there should be any foreign currency operations at that time. On that occasion, as on most others, I found myself within the Federal Reserve consensus which is generally one in which concern about the inflationary effects of an excessive decline of the dollar are given significant weight. I favor exchange stability, which has been broadly achieved over the past several years. This would include current rates, and I see no reason why they should not be sustainable.

Q.6. There is considerable uncertainty among analysts about how low the unemployment rate can go before inflation begins to accelerate. Have we reached that point, or can we safely reduce unemployment a little further?

A.6. I should begin by emphasizing that the level of unemployment is but one of many factors that may influence the rate of inflation at any given time. Exchange rate movements, industrial capacity utilization, agriculture supplies--these are just a few of the forces that have been important in determining the pace of inflation in recent years.

One critical determinant of inflation is the prevailing expectation about the intentions of the monetary authority. Inflation cannnot persist over the longer run unless there is an accommodating expansion of the money supply, and inflation expectations therefore are importantly affected by whether or not it appears that the Federal Reserve is willing and able to adhere to a policy that is conducive to the achievement of price stability. Credibility on that score will be enhanced if the federal government is not consistently issuing large amounts of debt, raising the specter of possible inflationary monetization, and if there seems to be political support for the Federal Reserve's policy.

I would suggest that the experience of recent years is illustrative of the points just made. The fact is that inflation has remained in a fairly narrow channel (apart from the period when oil prices collapsed), as the rate of unemployment trended downward--repeatedly piercing levels that many analysts were suggesting were floors beneath which the jobless rate could not fall without grave consequences. I would assert that the clear commitment of the Federal Reserve to fighting inflation was one reason for this success.

As for the current circumstances, it does appear that the labor markets are fairly tight overall, with the usual geographic, occupational, and industrial variations. Given the recent behavior of wages and prices, I would have to say that, at this juncture, prudence would dictate that lower levels of unemployment be tested cautiously, lest there be any overshooting that would give additional momentum to the inflation process that would be costly to reverse later.

Responses of Governor Kelley to
Questions from Senator Sarbanes

Q.1. Before your original nomination to the Federal Reserve Board, what was the screening process you went through? Who interviewed you, and what subjects were discussed? Were you reinterviewed before your renomination? If so, by whom and on what issues?

A.1. I was originally contacted by the Office of Presidential Personnel in mid-November of 1986 and came to Washington for interviews on approximately December 1, 1986. Four interviews were conducted on that date. I met with Robert H. Tuttle, Director of Presidential Personnel and, subsequently, with his Deputy, Mark Sullivan. Both of these interviews were designed to gain an impression of my background and personal characteristics, and involved no questions of policy or political position. I visited with John Rogers, Assistant Secretary of the Treasury, where the agenda was similar. The final interview was with Beryl Sprinkel, Chairman of the Council of Economic Advisors, where in addition to the above, he also inquired into my views concerning monetary policy and its impact on economic growth and inflation. We also discussed the possible restructuring of the banking industry to allow a greater degree of commerce participation in banking.

It has been my understanding that then Secretary of the Treasury, James A. Baker, III, worked for my selection. I have known Secretary Baker all of my life and had occasional discussions of policy matters with him over the years. In late 1985, as best I recall, I expressed to him my interest in becoming a Governor of the Federal Reserve. He replied that he would keep it in mind. Subsequent to being contacted by Presidential Personnel in November of 1986, I have had no further discussions with Secretary Baker on Federal Reserve policy-related issues up to the present time.

In none of the above discussions was I asked to take any policy position and volunteered none.

In late summer of 1989, I met individually with Michael Boskin, Chairman of the Council of Economic Advisors, Treasury Secretary Brady, and Under Secretary Robson. Each of those meetings followed the same general line of discussion. We discussed the progress of the economy generally, and they inquired into my views on economic growth, inflation, and monetary policy. I replied that I fully supported the goal of sustained economic growth but I believed that this could not be achieved without considerable reduction in inflation over time. I have supported policies designed to achieve that end since I have been on the Board and would continue to do so. No other policy issues were discussed. No policy positions were requested, or volunteered by me.

Responses of Governor Kelley to
Questions from Senator Dixon

Q.1. What are your views on enforcement of the Communty Reinvestment Act?

A.1. I believe that appropriate enforcement of the Community Reinvestment Act calls for the federal enforcement agencies to encourage the institutions they supervise to lend in all parts of their communities, to assess the institutions' records of doing so in examinations, and to consider applicants' records of community lending in connection with certain applications to expand.

I support the programs that the Federal Reserve now has in place to address each of these. The Board has a community affairs program which gives information and technical assistance on how to do productive community development lending. It has a specialized compliance examination program that conducts Community Reinvestment Act examinations of state member banks. Its applications processing system is set up to review in depth any issues presented in a case involving a protest based on the Community Reinvestment Act or a low Community Reinvestment Act examination rating.

The policy statement on the Community Reinvestment Act issued by the agencies last year, I believe, will be helpful in achieving the objectives of the Act. In essence, the statement stresses that the agencies expect the institutions they supervise to manage their process for addressing their responsibilities under the Act like any other corporate activity, to market their products in all parts of their communities, to undertake outreach to all parts of their communities in order to ascertain what the credit needs are, and to lend in all areas in a safe and sound manner. The statement encourages communication between the institutions and members of their communities on a routine basis, rather than waiting until a time-critical application has been filed. I believe this approach fosters the kind of long term sustainable lending programs in all neighborhoods that will further the purposes of the Act in the years to come.

Q.2. How should the Federal Reserve best address the problem of discrimination in home mortgage lending?

A.2. The Federal Reserve examines all state member banks on a regular cycle, and has found them to be in substantial compliance with the Equal Credit Opportunity Act (implemented by the Board's Regulation B) and the Fair Housing Act. The policies and practices of the banks examined do not suggest that individual banks take the race of an applicant into account when making a credit decision. Nonetheless, I find the various studies of mortgage lending in metropolitan areas, identifying different lending patterns across minority and nonminority neighborhoods, to be a source of major concern. While these issues may offer only limited insight into the issue of discriminatory conduct and make no definitive statement about the presence of racial discrimination in lending, they establish quite clearly the need to look behind the statistical data for answers to the problems that produce these results.

In addressing this mortgage lending problem, I believe we should continue to place major emphasis on a strong compliance program of consumer examinations by specially trained examiners. I expect us to make maximum use of the data about the racial characteristics of applicants that will be newly available under the changed requirements of the Home Mortgage Disclosure Act. These data will provide information not only about loan originations but also about applications that do not result in the granting of a loan. I believe our examiners will be better able to assess whether a bank's credit standards are being fairly applied.

Together with the other agencies comprising the Federal Financial Institutions Examination Council, the Federal Reserve is also working with the U.S. Department of Justice and the Department of Housing and Urban Development, to share information about our respective efforts in regard to lending dscrimination and to find ways in which we might improve our effectiveness through joint efforts. I support these efforts.

Q.3. Do you believe that low and moderate income Americans lack access to banking services? If so, what should be done about it?

A.3. The Federal Reserve has data showing that account ownership tends to be lower among low and moderate income individuals, and it has apparently not declined. We do not, however, have data regarding the number of institutions offering low-cost deposit account services. Surveys conducted by the banking industry indicate that a high percentage of banks, particularly larger institutions, offer such services. On the other hand, consumer group surveys conclude that the percentages are much lower.

Based on these disparities, I am not persuaded that a clear problem regarding access to banking services has been demonstrated. Individuals may choose, for a variety of reasons, not to maintain an account relationship. Moreover, even if every institution does not offer low-cost account services, low and moderate income consumers are not necessarily shut out of the banking market; such services could still be obtained by persons who are willing to shop for them.

I think the financial services industry has become increasingly sensitive to the need of low and moderate income individuals for low-cost services. As you know, the Board joined other regulators in issuing a policy statement encouraging institutions to recognize this need, and industry trade associations have been active in this area as well. In my view, the voluntary efforts by institutions that have resulted represent the best solution to any problems that may exist in this area. In addition, other promising developments such as electronic delivery of government benefits should also address many of the concerns that have been raised.

Q.4. Do you believe the firewalls around section 20 subsidiaries result in unnecessary inefficiencies? How do your views on these firewalls compare with your opinion of the firewalls included in the Proxmire Financial Modernization bill?

A.4. By design, the Board began its regulation of section 20 subsidiaries with very tight firewalls in order to assure that no unnecessary risks were taken and that unfair competition and conflicts of interest did not result. These firewalls are substantially the same as those contained in the Proxmire bill. In adopting the firewalls, the Board indicated that it would review the firewalls based on its experience. The Board has modified certain of the firewalls based on experience, and has indicated it intends to review other firewalls later this year. I would hope that ultimately securities powers for bank holding companies could be operated with more flexible insulating firewalls, but that would depend on the structural form and deposit insurance reforms ultimately adopted by the Congress.

Q.5. What are your views of the relationship between the Federal Reserve discount window, the deposit insurance system, and prospects for deposit insurance reform?

A.5. The focus of the discount window is to assure the liquidity of our payments system and financial markets. It does so by acting as a lender of last resort to solvent insured depository institutions. As deposit insurance reform goes forward, I would expect our need to act as a lender of last resort would remain unchanged. However, insurance reforms that run the risk of inducing deposit withdrawals and runs, by relying too much on depositor discipline, could increase the need for insured institutions to use the discount window.

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