For release on delivery
September 26, 10:00 AM (E.D.T.)

Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

September 26, 1979
I am pleased to be here today to testify on several bills designed to assure the capacity of the Federal Reserve to conduct effective monetary policy over the years ahead. Each of these bills aims to achieve that objective in a manner consistent with fair and equitable ground rules for financial institutions competing in providing depository services to the public.

The issues involved are old ones. There have been many proposals to deal with the so-called Federal Reserve membership problem and to restructure Federal reserve requirements through the years, going back in my personal experience on the Commission on Money and Credit twenty years ago. The matter has been under active, and sometimes contentious, consideration in the Congress for more than three years, as the need has become more evident. Financial innovations, shifting competitive patterns, strong inflationary pressures and related high interest rates have all exacerbated existing competitive inequities, have led to declines in membership in the Federal Reserve, and ultimately threaten our ability to conduct effective monetary policy.

Now, it is time to act. Moreover, it is possible to act with a minimum of controversy and maximum effectiveness.
I reach that conclusion in large part because of the substantial progress that has been made in the past year, through hearings and debate in the Congress and through discussions among interested parties, in achieving a consensus on the essential elements of a solution. As I will discuss later, that solution can be reached within acceptable limits of cost to the Treasury; indeed, failure to act would also cost revenues, and in cumulating amounts as attrition of Federal Reserve membership continues. Those issues which remain are being addressed by virtually all parties in a constructive atmosphere, with awareness of the central need to maintain a strong Federal Reserve, equipped with adequate tools to do its job.

It is my judgment, and that of many others, that only expeditious handling of this legislation can forestall a new wave of withdrawals from Federal Reserve membership. Many banks understandably have been willing to carry the burden of voluntary membership only so long as they felt that legislation could be foreseen that would provide more equitable competitive conditions. Failure to act now will not make the issue go away; we would only be forced to return to it in still more urgent, and potentially more contentious and divisive, circumstances.

All the legislative proposals need to be judged first of all against the central objective: We need to strengthen our ability to implement monetary policy in a variety of possible
circumstances -- not just in the immediate future, but for decades ahead. This legislation would provide the most important structural change in the Federal Reserve since its foundation; once passed, it will not be lightly amended. As we look ahead in that long perspective, effective monetary control will significantly benefit from broad coverage of competing depository institutions and a reserve base sufficient to support and transmit the effects of Federal Reserve monetary actions through the financial system.

At the same time, we need to work toward evenhanded treatment of all depository institutions insofar as they compete directly and bear a reserve burden. It is not only a matter of fairness. Evenhanded treatment, including broader access to System services, rationally priced, can bring about greater efficiency and more effective competition in financial markets. We should also assure that institutions bearing the implicit cost of reserves do not gradually lose, for that reason, business to others, thus narrowing the scope of Federal Reserve control.

The manner in which reserves are presently applied is the source of our present problem. Members of the Federal Reserve System are currently subject to a special burden -- from their point of view, the equivalent of a special tax -- because they must maintain substantial levels of reserves in non-interest bearing balances at Federal Reserve Banks. Nonmember commercial banks or other depository institutions -- even when their
business overlaps -- have no comparable requirement. Member banks receive some offset to this burden due to their access to System services, but all studies that have been made indicate the value of these services is, for the bulk of members, not sufficient to compensate for the earnings foregone on required sterile balances. In these circumstances, members leave the System, narrowing our base of control.

The specific bills before you originating with members of this committee have very different points of departure in dealing with these issues. S. 85, proposed by Chairman Proxmire, would place mandatory reserve requirements on all depository institutions, at the same time opening access to Federal Reserve services to all depository institutions. S. 353, proposed by Senator Tower, would instead preserve a fully voluntary system, but would attempt to remove the burden of membership by mandating that all balances held with the Federal Reserve to meet such requirements earn interest at nearly a market rate; access to System services would remain restricted to members and other depository institutions voluntarily maintaining reserves. The legislation passed by the House, H.R. 7, is a hybrid, initiating a mandatory reserve structure and open access to services if a revised voluntary structure fails to stem membership attrition.
This threshold question -- mandatory against voluntary -- has been at the center of much past debate. The voluntary approach has always had a certain appeal to me and others -- it is the way the Federal Reserve has operated, and I suspect it has helped encourage professionalism and efficiency within the Federal Reserve.

I would not want to see those attributes lost. But a purely voluntary approach toward reserve requirements does not seem to be practicable or possible at this time. The cost of eliminating the burden of reserves -- as would be necessary in a voluntary system -- would be relatively high -- apparently higher than the Administration or the Congress would find tolerable. Full pricing and open access to our services -- a key consideration to many in Congress and elsewhere -- would not be feasible. Consequently, I believe it is more fruitful to concentrate attention on the mandatory approaches to reserves: S. 85, and the basic provisions of H.R. 7. That is consistent with the preferred position of the Federal Reserve Board over a long period of time.

These two bills have consistent common elements. Those common elements, with one important exception, provide an appropriate framework for speedy resolution of the remaining issues.
To the extent reserves are required, both bills would apply them on a consistent basis against comparable deposits or other accounts in competing depository institutions.

The reserve structure would focus mainly on transactions balances, the central element in the money supply and monetary control.

Access to Federal Reserve services would be open to all depository institutions, and the Federal Reserve would be expected to recover the full cost of those services from pricing.

Voluntary membership in the Federal Reserve System, which would continue to have implications for certain supervisory and regulatory matters and for election of Federal Reserve Bank directors, would remain.

My own understanding is that these basic, common approaches have wide support among affected institutions. What remains to be done is to reconcile remaining differences and to provide assurance that the Federal Reserve will in fact have an adequate base of reserves in all foreseeable circumstances for the effective conduct of monetary policy.
The Treatment of Transactions Balances

Both bills would extend reserve coverage of transactions balances to all established depository institutions. The change is clearly consistent with the emergence of transactions accounts at thrift institutions, the growth of which can be expected to accelerate as the powers of those institutions to operate such accounts are enlarged. Such coverage assures, first, that larger and larger portions of the basic money supply of the nation will not escape direct Federal Reserve influence; and second, that future competition in markets for transactions deposits will be conducted without one institution or another enjoying an unfair competitive advantage. I would note in that connection that financial technology does not stand still, and the definition of a transactions balance -- in principle, an account from which payments to third parties can be made -- is critical. For instance, we can now observe burgeoning growth of money market mutual funds, many of which now offer facilities for transfer by draft, raising the question of whether such funds do not perform the economic function of a transactions account.

Providing the Federal Reserve has authority to define transactions balances, I believe concentrating the focus of reserve requirements on those accounts is appropriate. They
are, together with currency, the most active element in the nation's money supply. However, we need to remember that non-interest bearing reserves do have the characteristic of a tax on those deposits; a high tax will discourage use of transactions accounts over time relative to other outlets for liquid funds, lead to innovations in payment mechanisms outside the perimeter of the definition of defined transactions accounts, and promote the growth of money substitutes entirely outside the traditional domestic banking system, gradually impairing the base upon which the Federal Reserve operates. For that reason we should be wary of setting the requirement too high. The 12 percent ratio initially set in S. 85 is slightly higher than the 11 percent of H.R. 7. Even if the initial ratio were to be set as high as provided in S. 85 in the interests of preserving Treasury revenue, I believe that should also be the top of the permissible range, as already specified in the House bill.

An important difference in the two bills lies in exemption levels. In S. 85, the reserve requirement would apply to all transactions deposits regardless of the aggregate size of the balances in an institution, although the reserve ratio is set at only 3 percent for the first $5 million of such deposits. In H.R. 7 the first $35 million of transactions deposits in an institution are exempt from reserve requirements, and that
exemption would be ratcheted upward as deposits grow. The universal, virtually uniform ratio of S. 85 seems to us in the Federal Reserve more congenial to the basic thrust of both bills toward placing competing institutions on an equal footing. In practice, monetary control would not be significantly impaired by exemption of a very small amount of transactions balances for each institution. However, at some point, an exemption does have adverse implications for the reserve base and effective monetary control.

This Committee and the Congress will need to resolve this practical and philosophical question about the exemption level; a requirement graduated downward for small balances is one obvious possibility. I would emphasize that most institutions holding relatively small amounts of transactions balances -- for commercial banks up to $10 to $15 million -- will in practice be able to use cash held in their vaults to satisfy the requirements of S. 85 without cost; a more smoothly graduated reserve ratio would in practice exempt even more.

**Treatment of Time and Savings Deposits**

Both bills would exempt all savings and personal time accounts from reserve requirements. Because of the strong competition from other savings outlets outside the banking system, that approach is strongly and understandably urged by both banking and thrift institutions and is acceptable to
the Federal Reserve. Both bills also provide authority to apply such reserves against nonpersonal time deposits, but there are important differences.

S. 85 seems to envisage a more or less permanent requirement on nonpersonal time deposits, starting at the substantial initial level of 6 percent. Such a permanent requirement poses an important substantive problem. Competition for funds flowing into nonpersonal time deposits is intense and growing. The competitive handicap for covered institutions would be significant, as it is today, when the commercial paper market, the Euro-dollar market, and money market funds are growing rapidly. A substantial permanent reserve requirement would also place new burdens on thrift institutions.

For these reasons, the more practicable and desirable approach would be to maintain limited authority for the use of reserve requirements on short-term nonpersonal time deposits on a standby basis as seemed to be contemplated by H.R. 7. The circumstances for use should be exceptional, but not so extreme as stated by a colloquy on the House floor which would confine such use only to circumstances in which other countries agreed with the U.S. to impose parallel requirements on Euro-dollars. For instance, there may be occasions when such authority would be extremely useful to restrain excessively rapid growth near-money and of bank credit, particularly by large institutions. Moreover, the borderline between a transactions balance and a very short-time deposit may become so fuzzy as to suggest more equal reserve treatment.
The Question of Monetary Control and the Reserve Base

The key problem I have with the reserve structure specified in H.R. 7 or in S. 85 (assuming, in the latter case, no initial requirement on time deposits) concerns the volume and distribution of reserve balances that would be held in Federal Reserve Banks. It is these balances, and only these balances, that provide the "fulcrum" for the efficient conduct of monetary policy.

A few numbers will give you a sense of the potential problem. Today, some 5,600 banks hold about $30 billion of reserves at the Federal Reserve Banks, and those banks account for some 70 percent of all commercial bank deposits. Under H.R. 7, only 450 banks would keep any required reserves with the Federal Reserve; reserve balances would total only about $7-1/2 billion; and those 450 banks, while the largest in the country, would account for only 54 percent of total commercial bank deposits.

While S. 85 would provide much higher coverage, it would achieve that result in large part by extending substantial reserves to time deposits. That arrangement, as I have just noted, would create other serious problems if contemplated as permanent.

Viewed in another light, the ratio of reserve balances at the Federal Reserve Banks to the total of deposits at all commercial banks would drop to well below 1 percent under H.R. 7, and to about 1-1/2 percent under S. 85 (without time deposits
reserves). These percentages are uncomfortably low, even on operational grounds, considering the enormous volume of clearings that go through the Federal Reserve Banks every day. Large and erratic day-to-day fluctuations in such operational factors as currency in circulation or "float" arising from check clearings could, with a relatively low reserve base, have magnified effects on the money supply and weaken monetary control.

I know that the Committee has already heard theoretical debates about whether reserve requirements are essential at all to the conduct of monetary policy -- indeed I have engaged in such theorizing myself. But we in the Federal Reserve have the practical responsibility of operating monetary policy, and you will properly hold us accountable. We are not interested in committing ourselves to the conduct of monetary policy on the basis of untested and controversial theorizing.

In that connection, foreign experience has often been cited, including the fact that some industrial countries do not impose legal reserve requirements. A few of those countries approach monetary control either by keeping their banks continuously in debt to the central banks, and maintaining close control over the level of indebtedness as a method of control, or by relying heavily on direct, quantitative controls on bank liabilities on assets. Both methods are foreign to our experience and traditions. Other leading countries, whether by statute, convention, or tradition, de facto maintain a significantly higher proportion of total commercial bank deposits in central bank balances than would be provided by
the transactions account requirements of either H.R. 7 or S. 85.

We cannot be certain precisely how large reserve balances need to be to assure effective monetary control and a well functioning banking system. I feel quite sure we can do with a smaller reserve base than we now have. It is conceivable that the reserve requirements implicit in a modified S. 85 or in H.R. 7 may be sufficient, but I have grave doubts. Under H.R. 7, 97 percent of the nation's banks would either be exempt entirely or hold more than enough reserves in the form of vault cash to meet their requirements. Some technically covered banks would voluntarily wish to hold more reserves than required, and that uncertain "excess," differing from bank to bank and varying over time, would loosen the relationship between reserves and deposits. As a consequence, the ability of the Federal Reserve to control deposits by adjusting the reserve base could deteriorate, perhaps severely.

I have discussed both with members of this Committee and with representative industry leaders a practical approach for dealing with this problem. This approach would provide the Federal Reserve with the assurance we need that reserve balances will be adequate for monetary control and to support the nation's depository system, while not significantly adding to costs of banks and other depository institutions, disturbing competitive relationships among them, or draining revenue from the Treasury.
More specifically, I propose adding a provision to the legislation for **standby** authority to the Board to call for "supplementary deposits" to be held at Reserve Banks by all depository institutions up to a specified maximum. The Federal Reserve would be required to provide banks with a market yield on those deposits, the formula for which should be fixed in law to be comparable to the yields on U.S. Government securities. One simple way of providing such a return would be to provide that the supplementary deposits be invested in earnings participation certificates in the Federal Reserve's own portfolio of U.S. Government and agency securities.

I would not expect this authority to be used unless the Federal Reserve found that, in practice, monetary policy could not be effectively implemented with the reserve balances required under the other provisions of the legislation. Consequently, the authority should be viewed as an "insurance policy" or "safety net," to be used only in the event experience demonstrates the need for a larger reserve base than would be produced by other provisions of the bill. Thus, the percentage of deposits to be held as supplementary deposits probably would change infrequently, if at all, over time, if the authority were used at all.

As further assurance that the supplementary deposits would not be introduced lightly, I would suggest that the Board not be permitted to call for such deposits unless five members of the Board vote affirmatively, a report is issued to this
Committee, and the determination by the Board is renewed at, say, 2 year intervals.

Arrangements would be made for nonmember banks and thrift institutions to respond to a call for supplementary deposits by dealing through established banking correspondents. The law should, for instance, specify that such supplemental deposits could be held with the Federal Home Loan Banks, in the case of their member institutions, or the Central Liquidity Facility of the credit unions. The thrift institutions could, in turn, be permitted to count these deposits toward meeting their existing liquidity requirements, but the deposits would be "passed through" to the Federal Reserve Banks so the funds could become part of the reserve base. Possible arrangements of this kind have been reviewed with, and in principle are supported by, the Federal Home Loan Bank Board and the National Credit Union Administration Board.

It would make relatively little difference from the standpoint of monetary control whether these supplementary deposits are determined as a percentage of transactions balances or of all deposits held at institutions. The maximum percentage requirement would, of course, have to be judged against the base of deposits to which it applied. For instance, a limit as low as 2 percent would be adequate if the base were to be total deposits, transactions and time. If transactions balances alone are covered -- which account for only about 20 percent of the whole -- the upper limits would need to be proportionately
higher, depending on exemptions and the level of requirements
determined elsewhere in the legislation, to assure an equivalent
reserve base. We would be glad to work with the Committee in
developing precise legislative language to meet the need in
the way best suited to all interests.

I would emphasize the receipt of earnings on the sup-
plementary deposits at a market rate will, over time, mean
that institutions should suffer very little, if any, loss in
earnings from any call for such balances. If earnings are
determined by the return in the Federal Reserve portfolio,
those earnings will reflect a mix of long- and short-term
securities. Yield fluctuations would be less volatile than
the yield on shorter-term securities alone because the port-
folio yield varies less over time than does, say, the 3-month
bill rate. In years of relatively high short-term rates,
banks would be able to earn more by investing in the market
short-term, but the reverse is likely to be true in years of
relatively low short-term rates.

I must also emphasize a call for supplementary deposits
would have no effect on Treasury revenues. In effect, the
Federal Reserve would simply add to existing security holdings
to match the increased liabilities to banks and other depository
institutions incurred from supplementary deposits held at
Reserve Banks. These new security purchases would provide the
income to be transferred to the banks. And, the banks would
pay taxes to the Treasury in about the same amount as if there
had been no supplementary deposits.
Provision and Charge for Services

Both S. 85 and H.R. 7 provide broadened access to System services, including the discount window, and a mandate to charge for those services at prices adequate to cover costs, including imputed capital costs and taxes. In principle, these provisions are acceptable to the Federal Reserve. Intelligently implemented, we believe this approach can contribute to the efficiency, competition, and safety of the financial system. I would emphasize, however, that open access and pricing is practicable only after reserve requirements are restructured and applied to all depository institutions if we are to avoid exacerbating the cost burdens now placed on member banks.

Substantial progress has been made within the Federal Reserve toward developing pricing policies and schedules for Reserve Bank services. Those efforts will be pursued with vigor. I should note that in this process, a number of difficult technical and policy problems -- problems familiar to those engaged in the pricing of other public services where there is an obligation not only to cover costs but to maintain a minimum service level -- are apparent. For that reason, I would urge that the legislative language not unduly limit our flexibility in pricing particular services, while retaining the goal of full cost coverage.

Open access and pricing of System services likely will induce major changes in existing banking relationships. It may have differential effects on large and small, or city and rural,
institutions. Moving too precipitously to put this new system into place could cause disruptions in banking markets. Consequently, I would urge that the pricing provision allow some flexibility in timing and implementation. Moreover, it should be clear that the Federal Reserve need not precisely match costs and revenues for every service. Indeed, the Board questions whether a charge for the receipt and disbursement of currency is appropriate at all. The Government might normally be expected to provide that service, and in any event, the Treasury already earns some $7 billion per year from the provision of currency through securities held by the Federal Reserve as collateral.

Collateral for Federal Reserve Notes

A technical problem regarding collateral against Federal Reserve notes does arise in the bill. Under existing law, currency issued by the Federal Reserve must be secured by certain assets of the Federal Reserve specified in the Federal Reserve Act. If no changes were to be made in this requirement, the reserve reductions implied by the bills before you could be technically unworkable for they might result in insufficient amounts of government securities and other eligible financial assets to meet the collateral requirements against these notes. In mid-1979, for instance, collateral in excess of currency was only $13 billion. In terms of deposits outstanding at that time, balances at Federal Reserve Banks would be reduced about $24 billion under H.R. 7 and roughly $14 billion under S. 85
without the reserve requirement on time deposits. The reduction in government security holdings in the Fed portfolio that would have to accompany the decline in reserve requirements would leave the System with too few eligible securities to meet the legal collateral requirements.

S. 85 would meet this collateral problem by permitting all financial assets held by Federal Reserve Banks to stand behind the Federal Reserve's currency liability and by eliminating the requirement to collateralize notes remaining in the vaults of Federal Reserve Banks. This approach, while clearly meeting the need, was rejected by the House apparently on the grounds that it might open the way to the Federal Reserve acquiring a broader range of assets. To meet that objection, assets eligible for collateralizing currency might be confined to certain enumerated market-type assets that may already be held by the Federal Reserve.

I would suggest adding to the present list only assets acquired abroad arising from time to time out of our foreign currency operations -- a relatively small but fluctuating amount -- while removing the requirement for collateral against notes held by the Federal Reserve itself. In that connection, the Federal Reserve Act already permits us to hold foreign bank deposits and bills of exchange; it would be helpful to us operationally if short-term foreign government securities could be added to our authorized holdings -- an omission at the time of the original Federal Reserve Act when such securities were not widely available.
The Phase-in

S. 85 and H.R. 7 differ substantially in phase-in time for the application of reserves to transaction balances of nonmember institutions: 4 years for the former, 10 years for the latter. The Board feels the S. 85 approach -- which itself provides considerable time, is more in keeping with the purposes of the legislation, particularly for institutions newly entering or rapidly expanding transaction account business. At the same time, we are aware that this Committee and the Congress may be in a better position to appraise the equities of particular situations and develop an appropriate compromise.

Effect on Treasury Revenue

There is understandable sensitivity to the implication for Treasury revenue from alternative monetary improvement plans, particularly in these inflationary times when the budget is under pressure. An attachment to this statement shows the revenue input from H.R. 7 and S. 85. As can be seen, the bill acceptable to the House had a cost of around $300 million, using 1977 data. S. 85 would not cost the Treasury any revenue, but at the cost of increasing the reserve burden of many depository institutions. Without a reserve requirement on time deposits, as I have suggested, the revenue loss would be significantly smaller than in the House bill.

I would emphasize these calculations are artificial because, contrary to all expectations, they assume no revenue loss from rapid attrition of Federal Reserve membership, if no bill is passed. The net drain on Treasury revenues from H.R. 7 or
S.85 as modified would be quite moderate, if there were any drain at all, after account is taken of the losses that would be incurred by the Treasury due to that attrition. Indeed, the modification I have proposed to S. 85 would probably still leave the Treasury with a net gain in revenue over a reasonable period of time. Moreover, I would also note that the Federal Reserve has indicated its willingness to transfer to the Treasury part of its $1 billion surplus to cover revenue losses during the transition period.

Conclusion

This Committee has before it, in S. 85 and H.R. 7, nearly all of the essential elements of constructive legislation. I hope you will agree that the major new provision I have proposed today -- standby authority for "supplementary deposits" -- is a useful and possibly essential "insurance policy" for monetary policy. I do not believe it should be controversial.

Consequently, the way seems to me clear for promptly enacting legislation with the following main features:

First, reserve requirements should be placed on transactions balances at all depository institutions. Both S. 85 and H.R. 7 adopt this principle; what remains is only satisfactory resolution of exemption levels and the price level of the requirement.

Second, to assure an adequate reserve base for monetary control and to support the nation's depository
system, legislation should provide an insurance policy in the form of standby authority for "supplementary deposits" at Federal Reserve Banks, with those deposits earning a market rate of return.

Third, initial reserve ratios on nonpersonal time deposits should be set at zero, as in H.R. 7, but with the understanding that the Federal Reserve would have some flexibility to apply reserves to short-term nonpersonal time deposits if needed to "protect" the dividing line between transactions and time accounts or for cyclical purposes. There should be no reserves on personal or long-term time deposits.

Finally, there should be full pricing and open access to Federal Reserve services, with adequate flexibility, in timing and application, to minimize the risk of disruptions in banking markets and to protect the availability of a basic level of payments services to all institutions.

In passing through the lobby of the Federal Reserve Building recently, I read again a quotation from Woodrow Wilson on the wall referring to the original Federal Reserve Act:

"We shall deal with our economic system as it is and as it may be modified, not as it might be if we had a clean sheet of paper to write upon, and step-by-step we shall make it what it should be."
A constructive blending of S. 85 and H.R. 7, combined with the safety valve I have requested, can take a big step toward developing a reserve structure as it should be. The basic issue is preserving a strong and effective central bank able to discharge its responsibilities for monetary policy. The questions have been long debated, and I sense a convergence of views. Now, this Committee has the chance to bring the long process to the edge of conclusion. I urge you to seize that chance.
APPENDIX A

RESERVE COVERAGE AND TREASURY REVENUE EFFECTS OF MONETARY IMPROVEMENT PROGRAM PROPOSALS
(Based on December 1977 deposits; does not include effect on Treasury revenue of halting membership attrition)

**Exemptions:**

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<th>35/0</th>
<th>5/5</th>
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**Ratios:**

- **Transactions:**
  - H.R. 7
  - H.R. 7

- **Savings:**
  - H.R. 7
  - H.R. 7

- **Nonpersonal Time:**
  - H.R. 7
  - H.R. 7

- **Other Time:**
  - H.R. 7
  - H.R. 7

**Actual 1977 Plan Mandatory Voluntary S. 85 Mod. 85**

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<th>Reserves (billions)</th>
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<th>Nonmembers</th>
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<td>7.6</td>
<td>17.2</td>
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<tr>
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<td>3.5b</td>
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<td>1307</td>
<td>1315</td>
<td>428</td>
<td>874</td>
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| Revenue from Service Charges | (410) | (410) | (410) | (410) |
| Revenue from Float Charge | (247) | (247) | (247) | (247) |

<table>
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<tr>
<th>Total</th>
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<th>Percent of Total Deposits</th>
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<table>
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<th>Percent of Transactions Deposits</th>
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<td>73.5</td>
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a/ Members only.
b/ Includes $300 million of reserve balances of thrifts.
c/ Includes vault cash shift for members.
d/ Based on float outstanding of $3.8 billion in December of 1977.
e/ Cost estimate does not include offsetting benefit of halting membership attrition which would result in a loss of Treasury revenues of about $200 million annually by 1985, assuming attrition at midway between that experienced in the nation and that in New England during 1974-1978.

September 25, 1979