

Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance & Urban Affairs

House of Representatives

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I am pleased to have the opportunity to present the views of the Board of Governors on H. R. 7001, the proposed "Federal Reserve Modernization Act" introduced by Chairman Reuss for himself and Chairman Mitchell and Mr. Cavanaugh.

As Chairman Reuss indicated in his introductory statement, this bill was introduced the day after the Depository Institutions Deregulation and Monetary Control Act of 1980 was signed into law. I cannot let this opportunity pass without expressing for myself and all the Members of the Board of Governors our deep appreciation for the dedicated work of your Committee, Chairman Reuss, Chairman St Germain and the other members of the full Committee which resulted in this major legislative achievement. This Act, particularly Titles I and II, the Monetary Control Act of 1980, and the Depository Institutions Deregulation Act of 1980, will undoubtedly take their place among the most important pieces of financial legislation enacted in this century.

The Monetary Control Act of 1980, strengthening the Federal Reserve's ability to implement monetary policy by providing an equitable universal system of reserves for depository institutions, affords the Board tremendous challenges and opportunities. Although these provisions are of overriding importance, they are only a few of the many changes made by the new act that will require the careful attention of the Federal Reserve Board.

Precisely because of the significance of these many amendments, which involve new relationships among the Federal Reserve and depository institutions, we would suggest first of all that it would be both appropriate and highly desirable to allow a period of time to digest and assimilate

these changes before other legislative proposals to change the operations or structure of the Federal Reserve System are pressed. In particular, we do not believe that the provisions of the Federal Reserve Modernization Act can be of such urgency that they need to be considered by the Congress on a priority basis while the Federal Reserve and the financial system in general are involved in the orderly implementation of the Depository Institutions Deregulation and Monetary Control Act of 1980. Indeed, a measure of experience under the legislation just passed would be helpful in making any final legislative judgment.

More generally, our judgment is that the more radical changes proposed in H. R. 7001 for the governance of the Federal Reserve would have an undesirable and unsettling effect on the carefully constructed structure for the implementation of monetary policy which has worked well over the years. Indeed, looked at not just section by section but as a whole, we believe the net result, intended or not, could be substantially to dilute both the independence of judgment and the regional attributes that have, through the years, been characteristic of the Federal Reserve System.

I would now like to turn to a discussion of the specific proposals in H. R. 7001, beginning with the provisions of Title II.

Title II contains significant provisions dealing with structural changes in the Federal Reserve System. Sections 201 and 202 are interrelated. Section 201 would abolish the Federal Open Market Committee and give sole authority for the conduct of open market operations to the Federal Reserve Board. It would remove the presidents of the Federal Reserve

Banks from having any policy-deciding role in the formation of monetary policy. Section 202 would revise the Federal Advisory Council, by changing the membership from each Federal Reserve district from a representative of private industry selected by the board of directors to the president of the Federal Reserve Bank for each district. This would place the presidents of the Federal Reserve banks in an advisory role to the Board so far as open market policy questions are concerned.

The Board believes that both of these changes would detract from the effective functioning of the Federal Reserve System. From its inception the Federal Reserve System has been based upon a combination of central and regional elements and from a desire to insulate the System from short-term and partisan political pressure. Twelve Federal Reserve Banks were established and given a significant role in the operation of the System in order to assure a proper consideration of viewpoints and needs from all sections of the country. The premise was that all wisdom does not reside in Washington, and that a degree of insulation from immediate political considerations would be enhanced by an important role for the Reserve Banks.

Removing the Reserve Bank presidents from membership of the Federal Open Market Committee would inevitably erode these objectives. The Reserve Bank presidents and their research staffs not only bring to the Federal Open Market Committee an element of experience, continuity, and insight that might be lacking in a purely Washington based policy-making organization. They also are an important source of knowledge and informed opinion about regional interests and needs.

Inevitably, there would be a profound difference between an advisory role, as contemplated by H. R. 7001, and the role of a participant sharing responsibility for policy making. Removal of the presidents from the Federal Open Market Committee could only have the effect of making the Federal Reserve more "Washington" oriented, less sensitive to regional concerns, and potentially without the same professional, career commitment now characteristic of many of the Bank presidents. I should note in this connection that Members of Congress have recently expressed the view that the composition of the Board itself should be more representative of regional and sectoral interests. The proposal in H. R. 7001 to reduce the role of the regional Reserve Bank presidents in the conduct of monetary policy seems quite contrary to meeting that overall concern.

The Federal Reserve System has also benefited from a unique capacity within its structure to benefit from informed and constructive criticism from those concerned with its operations and policies. This capacity would be weakened, in effect, by abolishing the Federal Advisory Council as presently constituted. That Council, consisting of leading commercial bankers from each Federal Reserve district, provides an opportunity for the Board of Governors to obtain a considered point of view of the economy and the credit conditions of the country. It provides a channel for criticism and suggestions, ranging from broad policy to operational concerns. The insights gained have helped the Board to implement policies and operations with more knowledge of their implications than would otherwise be possible.

We recognize the same purposes could be approached in other ways. But, the question arises -- why change an arrangement that is functioning well and which the participants understand? Is the purpose to weaken the regional elements or the consultative processes in the System? If not, what is it?

Section 203 would revise the provisions for the appointment of Federal Reserve Bank presidents by removing the requirement of approval by the Board of Governors of the Federal Reserve System and by requiring that the presidents shall be bona fide residents of the district involved.

The Board appreciates the importance of independent minded people serving as Bank presidents, individuals able to participate in policy and operations alongside Board members. We also believe that while the initiative and choice lies with the regional boards, some review of the appointment by public officials is an essential part of the appointment process given the nature of the duties. We know of no better way to accomplish that result than the arrangements embodied in the Federal Reserve Act for almost 70 years. In that connection, we note the importance of mutual respect and an ability to interact harmoniously between the Board and the presidents of the Federal Reserve Banks.

With respect to residency, the Board agrees that, and it has been a practice for, the president of the Federal Reserve Bank to be a bona fide resident of the district. However, we would oppose a requirement for residency prior to employment because it would detract from the ability to obtain individuals of the highest caliber for the posts,

including our ability to attract career people to the Federal Reserve who might conceive of moving from one district to another as an avenue for promotion and development.

Section 204 provides that the Federal Reserve System shall utilize its resources, and generally conduct its affairs, to foster the policies and purposes of the Employment Act of 1946, and the Full Employment and Balanced Growth Act of 1978, particularly the nation's effort to achieve a stabler price level and an improved economic structure.

The Board is unclear on the intent of this section. The Board now accepts the Employment Act and the Full Employment and Balanced Growth Act as guiding principles. We are, of course, concerned with price stability. In these respects, the addition of this section would not appear to be necessary. However, the section speaks specifically to the System using its resources to improve the nation's economic structure. We are uncertain as to the meaning, and would desire further clarification, of this proposed charge to the System.

I would now like to address the provisions of Title I which would provide for the retirement of Federal Reserve stock and substitute a certificate of membership for stock ownership. In connection with previous proposals for retirement of Federal Reserve stock, the Board has advised this Committee that on balance it believed that ownership of Reserve Bank stock is desirable because of the tangible indication it provides of the interest of its members in the operations and efficiency of the System.

Chairman Reuss has suggested that the provisions of the Monetary Control Act of 1980 make the present stock requirements for member banks anachronistic. While it is true that the rights attached to ownership of stock in a Reserve Bank are, in fact, extremely limited, that does not dispose of the question. Voluntary membership still has an important role to play in the Federal Reserve System. Members elect some of the directors of the Federal Reserve Banks who, in turn, elect the Bank presidents and maintain surveillance over the efficiency and effectiveness of Reserve Bank management and operation. In those respects, the public and private interest broadly coincide, and the participation of able men and women as directors, included among them persons chosen by stock-holding members, I believe contribute importantly to our efficiency and operational effectiveness. The Board would not wish to see any changes made that would weaken either its ability to attract outstanding individuals as directors of the Federal Reserve Banks and branches, or their continuing dedication to their work. However attenuated the rights of a stockholder may be compared to a normal corporation, that tangible evidence of continued interest we believe helps enhance our ability to obtain qualified independent minded directors concerned and interested in the effectiveness of the System.

In this connection, the provisions of H. R. 3257, a bill you have sponsored, Mr. Chairman, would increase the number of Class C directors appointed by the Board and thus permit the Board to increase the representation on the boards of directors of consumers, labor and service interests. We believe this approach is appropriate.



I recognize that some directors could continue to be elected by members holding only a "membership certificate." But the Reserve Banks are corporations, and do have capital. The alternative, presumably, would be in effect to transfer the stock evidence of that capital to a government agency. But what would be achieved by such a change? Would it not, whatever is intended, lead to an implication or allegation of Treasury control? Would it not, again whatever is intended, weaken the healthy concerns of banks with how the Fed is managed?

We do believe that consideration also needs to be given to the participation of nonbank financial institutions on the boards of the Federal Reserve Banks; whether they should participate in the election of directors, and, if so, how this should be accomplished. We also recognize that limiting payment of the dividends to 6 per cent on Federal Reserve stock can be a small disincentive to membership, and if it is concluded that membership should be broadened and stock retained, consideration might also be given to providing a rate of return on that stock more comparable to that on government securities. Considerations of this sort lead us to the conclusion that elimination of Federal Reserve stock would be undesirable, but that consideration of which institutions might be eligible for membership, the formula for acquiring such stock, and the rate of dividends will be in order as we gain experience with the Monetary Control Act of 1980, and its impact on the Federal Reserve System.

The provisions of H. R. 7001 do not change the role of the Federal Reserve System with respect to the supervision and examination

of member banks. However, in Chairman Reuss' introductory statement, he said "Chartering and examination of State banks, member and nonmember alike, would reside in the State regulatory agencies rather than the Fed." In view of this statement, I would be remiss if I did not address the subject of the role of the Federal Reserve in the supervision and examination of member banks.

The Board has stated on a number of occasions that it believes that the condition of the banking system and information about individual banks is an important input for monetary policy formulation which would be lost or substantially reduced if the Federal Reserve had no role in the regulation or examination function. Our experience in recent years has only served to strengthen the conviction that information which the System obtains in the course of exercising its supervisory functions provides key insights into such matters as the state of liquidity and viability of the nation's banking institutions, indispensable elements in the formulation and implementation of monetary policy. The borderline between monetary, regulatory, and supervisory powers is sometimes indistinguishable. We believe all would be weakened by trying to enforce a strict separation. Obviously, there are a number of issues in the relationships among supervisory agencies, some of which have been addressed in recent legislation. As we gain experience under that legislation, we may have further proposals. But the Board strongly recommends that it continue to have a role in this area, and that the Board retain responsibilities for supervision and examination.

In summary, Mr. Chairman, the Board is concerned that the proposed structural revisions would weaken certain traditional elements in the Federal Reserve structure that significantly and substantively have contributed to the independence, the regional balance, and the efficiency, effectiveness, and integrity of our operations.

However, we do agree further consideration of the nature of membership and eligibility and terms of stock ownership in the Federal Reserve System will be needed in light of the enactment of the Monetary Control Act. Attention should be given to the participation in the operations of the Federal Reserve Banks by nonbank financial institutions that will maintain reserves with the Federal Reserve, as well as their representation on the boards of directors of those banks. And we continue to feel that those boards should be expanded in size in order to accommodate a broader representative segment of the public as a whole.

As experience has been gained under the Monetary Control Act of 1980, we will be happy to work with you and your Committee and its staff in evaluating and developing possible legislative proposals that might accommodate these needs.