Federal Reserve Bank of San Francisco

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FRBSF Weekly Letter

New Deposits

Far-reaching changes have occurred in recent years in the laws and regulations governing financial institutions. Many of these changes have important implications for the Federal Reserve's conduct of monetary policy. The most recent example is the Garn-St. Germain Depository Institutions Act, passed in October 1982. This law required federal regulators to authorize a new deposit for commercial banks and thrift institutions that would be "directly" equivalent to and competitive with money market mutual funds..." The resulting Money Market Deposit Account (MMDA), which banks and thrifts began issuing on December 14, 1982, is free of interest rate ceilings, has a $2,500 minimum denomination, and allows six transfers to third parties per month (three of which may be checks).

In addition to authorizing this account, the Depository Institutions Deregulation Committee went one step further and permitted depository institutions to issue the so-called Super-NOW account beginning January 5, 1983. This deposit (which is not available to businesses) is also subject to a $2,500 minimum denomination and is free of interest rate ceilings. An important distinguishing feature is that it has unlimited check-writing privileges.

Taken together, these two accounts mean that for the first time since the Great Depression, depository institutions are permitted by law to offer checkable deposits that are not subject to interest rate ceilings. This deregulation of deposit interest rates should have a number of important effects on the U.S. economy. For example, it should affect the efficiency of the financial system, the interest earnings and savings of some individuals, and the profits of some depository institutions. This *Letter* focuses on yet another impact. The new deposits raise uncertainty, at least in the first half of 1983, for the Federal Reserve in choosing monetary policies that are consistent with its goals of promoting full-employment and price stability.

Monetary targeting

The main problem for monetary policy is that the new accounts are likely to generate difficult-to-predict flows of funds that will affect growth in the various monetary aggregates used in Fed policy. The Fed sets targets for the monetary aggregates because movements in them are expected to bear a close relationship with economic activity and inflation in future periods. Thus, if these relationships held up, the Fed could tell what effect its *current* actions would have on its economic goals in the *future* by studying the current behavior of the aggregates.

The Fed has most often focused its attention on the monetary aggregate called M1, which includes currency in the hands of the public, traditional checking accounts, NOW accounts (including the new Super-NOW), travelers' checks and other miscellaneous checkable deposits. This monetary aggregate is meant to measure balances held by the public for making transactions. It has been given the dominant role in monetary policy in recent years because it has historically had a closer relationship with GNP and prices than have other broader aggregates. However, the Fed has also focused from time to time on the broader aggregates, especially M2, which includes the new MMDA. M2 covers savings deposits, small denomination time deposits, overnight repurchase agreements and Eurodollars, and non-institutional money-market mutual fund shares in addition to M1.

The introduction of the new accounts will cause problems for M1 and M2 targeting because the accounts carry unregulated and highly competitive yields that will draw funds away from other financial instruments. These flows of funds will affect growth in the monetary aggregates during a transition period of uncertain length. It is difficult to tell

Research Department
Federal Reserve
Bank of
San Francisco
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in advance whether these flows will induce temporarily faster or slower growth in M1. But, in either case, changes in M1 growth from this source would merely signal a portfolio adjustment by the public, not a future change in income or prices. Because of this, the value of M1 as a policy indicator can be questioned during the transition period following the introduction of the new accounts.

Uncertain flows

The effects of Super-NOWs on M1 growth will tend to be the opposite of the effects of MMDAs. The Super-NOW has the potential to induce positive flows of funds into M1, from unregulated instruments and especially from accounts that carry interest rate ceilings. For example, yields on Super-NOWs may be attractive relative to passbook savings accounts that carry maximum rates of 5 to 5¼ percent. Other funds may be transferred from time deposits that carry interest rate ceilings and also from money market funds and other instruments. The incentive to transfer funds to Super-NOWs from non-M1 sources is greater because of the $2,500 minimum balance requirement which must be met to gain access to the interest bearing checking services. All of these flows would tend to accelerate temporarily the growth in M1, giving the false impression that monetary policy had become more expansionary.

In contrast, the introduction of the MMDA should temporarily depress M1 growth. Depending on the spread between yields on MMDAs and those on Super-NOWs, some funds may be shifted *out* of the checkable deposits in M1 into MMDAs. Such a shift of funds would arise if the public used the MMDA as a cash management tool to reduce holdings of true transaction balances. Within the regulatory limitations on transferability of MMDAs stated earlier, regular transfers of funds each month between this account and the fully checkable deposits in M1 would allow the public to reduce the level of M1 needed to conduct a given volume of transactions. Another reason for shifts out of M1 into the MMDA is that this new account is, to a limited extent, a transaction instrument itself. Use of the MMDA to write a few large checks, such as mortgage or credit card payments, would mean that some transaction funds deposited in the new account never have to pass through an M1 balance.

Finally, M1 presumably contains some savings-type balances that are not actually used by the public for making transactions. These savings-type funds probably are lodged in traditional NOWs, which carry maximum yields of 5 to 5¼ percent, and thus are competitive with passbook savings accounts. The higher yields and liquidity of MMDAs, however, should attract some of these funds away from M1.

In sum, shifts into MMDAs add up to a potentially significant but highly uncertain *reduction* in the public's demand for M1. The extent to which these shifts will depress M1, and thereby offset the expansionary effects of the Super-NOW account, depends on the pricing policies institutions adopt for the two accounts. If the institutions make yields on MMDAs considerably more attractive than those on Super-NOWs, then there will be a net outflow of M1 funds into MMDAs. Of course, it is also possible that Super-NOWs will be priced attractively enough to offset the outflow from M1, or even to cause a net inflow.

Pricing policies

There are a number of reasons that yields on Super-NOWs will be permanently below those on MMDAs. First, the Federal Reserve requires that depository institutions hold 12 percent of funds obtained through Super-NOWs in the form of non-interest-earning reserves, but MMDAs have a reserve requirement of zero to three percent depending on whether the account is classified as personal or non-personal. Thus, institutions will pay lower yields on Super-NOWs to compensate for the loss in earnings on the reserves that must be held against them.

Second, depository institutions may choose to charge for some of the expenses they incur in servicing high-turnover Super-NOWs by

reducing the interest rates offered. This approach to pricing transaction balances has certain tax advantages. By reducing the interest rate in lieu of "free" services, the institution offers the depositor part of the yield from Super-NOWs in the form of in-kind transfers, which are not subject to income taxes. However, the depositor can take advantage of such tax-free yields only through true transaction balances that generate substantial service costs. Thus, this method of pricing would reduce the incentive to hold (low turnover) savings-type balances in Super-NOWs.

The preceding discussion explains why Super-NOWs pay lower returns than MMDAs. However, the immediate question for the Fed is, how much lower? This is an empirical question that cannot be answered with any certainty in advance of the results. It is still too soon after the new accounts became available to draw any firm conclusions. However, very early evidence suggests that the marketing strategies of institutions are highly aggressive for MMDAs as institutions compete for shares of the market. These strategies have included heavy advertising and an initial offering of above-market rates of return. As a result, MMDAs have been extremely popular so far, having grown to $111 billion in the first three weeks they were available. Although some institutions are advertising above-market yields on Super-NOWs, many have also instituted high minimum balance requirements and fees. It is not yet possible to tell how attractive these terms will be to depositors.

Long-run problems?

The problems described above are all of a transitory nature. They will last as long as it takes the public to adjust its portfolio of financial assets to the new investment opportunities provided bySuper-NOWs and MMDAs. A somewhat comparable type of adjustment took place in 1981 when NOW accounts (with ceiling rates of 5 to 5¼ percent) were introduced on a nationwide basis. Available evidence suggests that it took the public somewhat less than half a year to make most of its portfolio adjustment in 1981. This experience suggests that the transitional problems with the new accounts may be substantially over by mid-1983.

However, this transition will not necessarily spell the end of the difficulties for policy caused by interest rate deregulation. First, federal regulators are considering authorizing a Super-NOW account for businesses, and have requested public comment by February 1, 1983. Should the proposal be approved, it would set off another period of portfolio adjustment.

Second, there are a number of potential problems that may affect M1 even after the transition is over. These problems will be discussed in a subsequent *Weekly Letter*. At present, it suffices to mention the most fundamental one. Interest rate deregulation could contaminate the character of M1 as a measure of transaction balances by inducing the public to shift *savings-type* funds into M1. This could occur if institutions were to price Super-NOWs very attractively in comparison to MMDAs. Rapid growth in Super-NOWs would then attract savings-type funds from passbook savings deposits, small time deposits, and other sources, and change the character of M1. There has been good reason to believe that M1's role as a measure of transaction balances has made it a more reliable indicator for monetary policy than other aggregates, but if its character were to change, its unique advantages for policy could be compromised.

On the other hand, if MMDAs were priced attractively in comparison to Super-NOWs, the transactions character of M1 might be preserved. In this case, savings balances would flow into the MMDAs, which are not counted in M1. From the point of view of monetary policy, then, there is an advantage to the MMDA becoming more popular than the Super-NOW. If this happens, the major uncertainties raised for monetary policy by the recent deposit-rate deregulation may be primarily transitory.

John P. Judd

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/5/83	Change from 12/29/82	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	164,450	161	7,360	4.7
Loans (gross, adjusted) — total#	143,564	− 226	7,675	5.6
Commercial and industrial	45,727	− 99	4,058	9.7
Real estate	57,585	− 148	1,439	2.6
Loans to individuals	24,017	8	233	1.0
Securities loans	2,741	− 76	772	39.2
U.S. Treasury securities*	7,404	397	1,611	27.8
Other securities*	13,482	− 10	− 1,926	− 12.5
Demand deposits — total#	44,867	1,731	− 1,375	− 3.0
Demand deposits — adjusted	30,154	429	− 635	− 2.1
Savings deposits — total	49,817	5,326	18,525	59.2
Time deposits — total#	84,824	−3,797	− 4,931	− 5.5
Individuals, part. & corp.	75,170	−3,503	− 5,676	− 7.0
(Large negotiable CD's)	29,141	−1,362	− 6,684	− 18.7

Weekly Averages of Daily Figures	Week ended 1/5/83	Week ended 12/29/82	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	144	115	64
Borrowings	20	9	34
Net free reserves (+)/Net borrowed(−)	124	106	30

* Excludes trading account securities.

Includes items not shown separately.

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