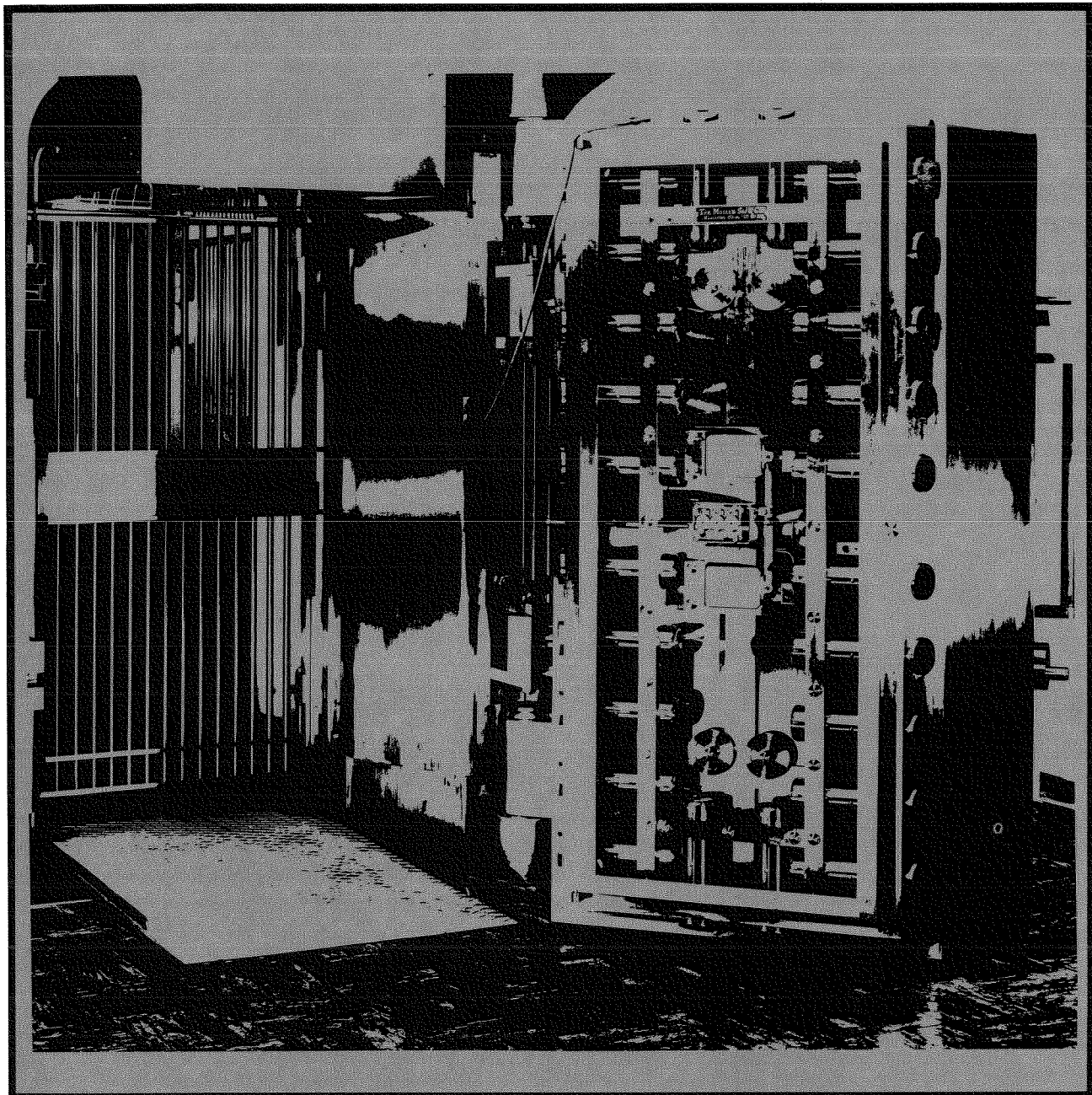


# FEDERAL RESERVE BANK OF SAN FRANCISCO

## ECONOMIC REVIEW



## MONEY AND THE MONETARY CONTROL ACT

**WINTER 1981**

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# Money and the Monetary Control Act

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Congressman Reuss called it the most significant piece of financial legislation since the 1930's, and Senator Proxmire went even further and called it the most important piece of legislation since the Federal Reserve Act of 1913. But that disagreement aside, few observers would deny that the Depository Institutions Deregulation and Monetary Control Act of 1980 — the MCA — will strongly influence the direction of banking and financial activity in coming decades.

Through the MCA, Congress promoted greater competition in financial markets, primarily by providing for the phase-out of deposit interest-rate ceilings and a broadening of asset and payment powers of banks and thrift institutions. Congress also promoted greater equity and improved monetary control by extending reserve requirements (following a phase-in period) to all depository institutions with transaction (check-type) accounts and nonpersonal time deposits. This step helped to solve the problem of declining Federal Reserve membership, by reducing the cost of reserve requirements for member banks and imposing similar reserve requirements on all insured depository institutions. Moreover, Congress promoted greater efficiency in correspondent-banking markets, by providing access to Federal Reserve services, at explicit prices, for all depository institutions subject to reserve requirements. To highlight the importance of the legislation, this issue of the *Review* considers its implications in two major areas — monetary policy and pricing of Federal Reserve services.

On the monetary control issue, Michael A. Klein analyzes several sweeping changes arising from the MCA — including those sections that don't directly address that specific issue. First, he discusses the role of reserve requirements in facilitating money-stock control

when the Federal Reserve uses an aggregate-reserves measure as its control instrument, as it has done for the past year and a half. (In October 1979, the Fed changed its open-market operating procedures to place more emphasis on the control of bank reserves and less emphasis on tightly pegging the cost of bank reserves, the Federal-funds rate.) He presents criteria for evaluating reserve-requirement systems, and develops an argument for uniform required reserves on all accounts included in the monetary aggregate targeted by the authorities, within the context of a simple deposit-multiplier model that includes both member and nonmember banks.

Klein shows that such a regime serves to reduce the number of disturbances that impinge on the money stock, and thereby facilitates monetary control. In other words, the imposition of uniform required reserves reduces the extent of multiplier uncertainty. His analysis also indicates, however, that two provisions of the legislation — a sharply higher reserve requirement on transaction accounts exceeding \$25 million than on smaller amounts, and the imposition of required reserves on nonpersonal time deposits — are inconsistent with the logic of a regime of uniform required reserves when the authorities' aim is to control a transactions aggregate.

Klein next examines the effects of the new law on the monetary-control problems caused by the process of financial innovation. Two forms of bank regulation — differential reserve-requirements on alternative deposit accounts, and deposit interest-rate ceilings — have induced a number of innovations in recent decades. Klein's analysis supports other criticisms of interest-rate ceilings, by showing that such ceilings tend to induce shifts of funds among different deposit liabilities in response

to interest-rate fluctuations. But the same analysis shows that deregulation will significantly improve monetary control by reducing the degree of multiplier uncertainty caused by such shifts of funds.

More importantly, deregulation will significantly retard regulation-induced financial innovation, by allowing depository institutions to compete for funds by paying market-determined interest rates. However, the differential between transaction-account and time-account reserve requirements will continue to encourage innovation, although less so than in the past.

Klein argues that the new types of transaction accounts developed in recent years clearly exemplify the innovations generated by regulations. "Such innovations have considerably complicated the task of monetary control by altering the relation between the (old) targeted monetary aggregates and nominal GNP and inflation. Thus in an environment of deregulation, the definitions of the aggregates should be more meaningful economically and, therefore, should be more useful for the conduct of monetary policy."

Turning to the pricing issue, Gary Zimmerman examines the impact of MCA pricing and access provisions on the market for correspondent-banking services. In the pre-MCA environment, Federal Reserve Banks provided correspondent services to member banks free of charge. But nonmember banks, being denied direct access to these services, had to produce them internally or rely on (member) private correspondents.

The passage of the MCA was a major breakthrough in the rationalization of the correspondent-banking system. As Zimmerman argues, it opens the door to equal treatment of all institutions with respect to pricing of (and access to) Federal Reserve services.

Zimmerman argues that, in the pre-MCA environment, free Federal Reserve services represented a major source of inefficiency in the correspondent-banking system. "First, this situation led to overconsumption of Fed services by member banks. Also, by causing

the overproduction of publicly produced correspondent services, this pricing policy resulted in an inefficient allocation of resources."

He thus raises the questions: to what extent will MCA provisions enhance competition and improve market efficiency? Also, after the implementation of MCA, will Federal Reserve Banks be able to compete with private banks offering these services? He presents evidence suggesting that Federal Reserve Banks do not have a natural monopoly in providing any correspondent services (except possibly automated clearinghouse services) — and that in many cases, Reserve Banks produce higher-than-optimal levels of such services.

In Zimmerman's view, " 'Full cost' pricing as implemented under the MCA will not eliminate all of the subsidies to institutions using Fed services. However, it will provide Reserve Bank customers with market signals concerning the true cost of the services they consume, providing strong incentives for more efficient use of the services produced."

Zimmerman argues that the post-MCA world will be more competitive and efficient as a result of the partial or complete elimination of Federal Reserve subsidies to depository institutions. He notes that removal of check-processing subsidies will allow private producers to compete on a more equal footing with Reserve Banks. On the other hand, he points out that cash-handling services will continue to be subsidized, but will be available to all depository institutions rather than just member banks.

Zimmerman notes, however, the special nature of automated clearinghouse services. The Federal Reserve's published pricing schedule indicates a short-run willingness to continue subsidies, so that the market grows sufficiently for Reserve Banks to take advantage of their economies of scale in this area. "This would permit lower ACH transfer costs, making them more competitive with check-clearing costs, and thereby helping to reduce the burden on the nation's check-payments system."