

TO: Federal Open Market Committee

DATE: November 3, 1976

FROM: Stephen H. Axilrod



Attached is a memorandum evaluating the effects of recent regulatory changes and financial innovations on growth rates of the monetary aggregates. The table on page 5 gives our estimate of the dollar effect of these changes on M_1 during the past year and projected for the year ahead. The table on page 14 shows the effect on M_1 growth rates.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date November 2, 1976

To Federal Open Market Committee

Subject: Recent Regulatory Changes
and Financial Innovations Affecting
the Growth of the Monetary Aggregates

From Messrs. Paulus and Axilrod

Over the one-year period from the third quarter of 1975 to the third quarter of 1976, M_1 expanded at an average rate of about $4\frac{1}{2}$ per cent, while GNP increased by $10\frac{1}{2}$ per cent. The modest growth of M_1 relative to economic activity is reflected in the comparatively rapid advance of M_1 velocity-- V_1 --over this period. As shown in Chart 1, V_1 increased by about 6 per cent in the last four quarters, and by $8\frac{1}{2}$ per cent in the five quarters since the trough of the 1974-75 recession. In contrast, the average growth of velocity in the first five quarters following the four earlier cycle troughs since 1954, also shown in Chart 1, is about 6 per cent.^{1/} The rapid growth of V_1 has occurred even though short-term interest rates have declined from trough values, a departure from the experience of most previous recoveries. Chart 2 compares percentage changes in 3-month bill rates in the current recovery relative to average changes in the four previous recoveries since 1954.

The modest growth of M_1 has occurred against a background of legislative actions and regulatory changes that have increased the liquidity of savings deposits, or have extended such deposits to new classes of customers.^{2/} For example, in late 1974 commercial banks were authorized

^{1/} There has not yet been an official (NBER) designation of the reference trough for the latest cycle. We have used the second quarter of 1975. Had the first quarter been used instead, the figures above would have been changed slightly. For example, the increase in V_1 for the current recovery would be 9 per cent over six quarters, compared to a 7 per cent average increase over six quarters in the four earlier recoveries.

^{2/} For a chronology of the development of money substitutes, see Appendix A.

Chart 1
AVERAGE PERCENT CHANGE IN V1 FROM CYCLICAL TROUGHS

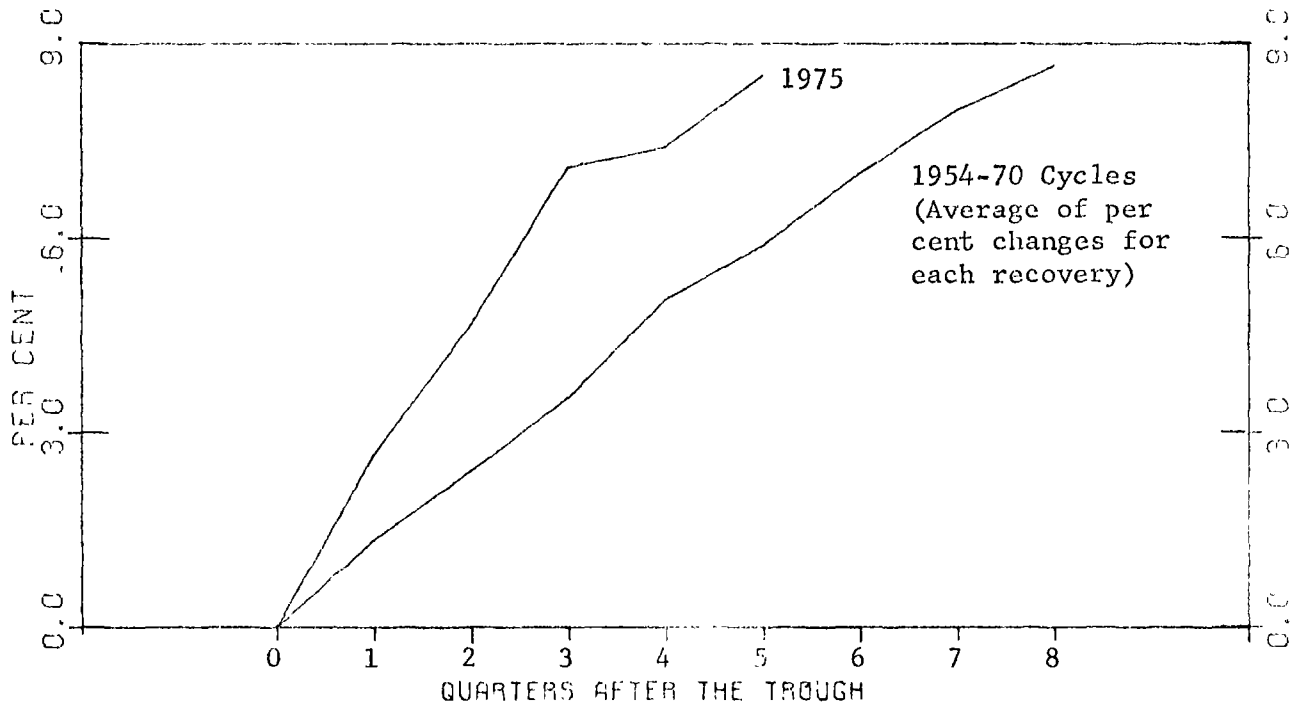
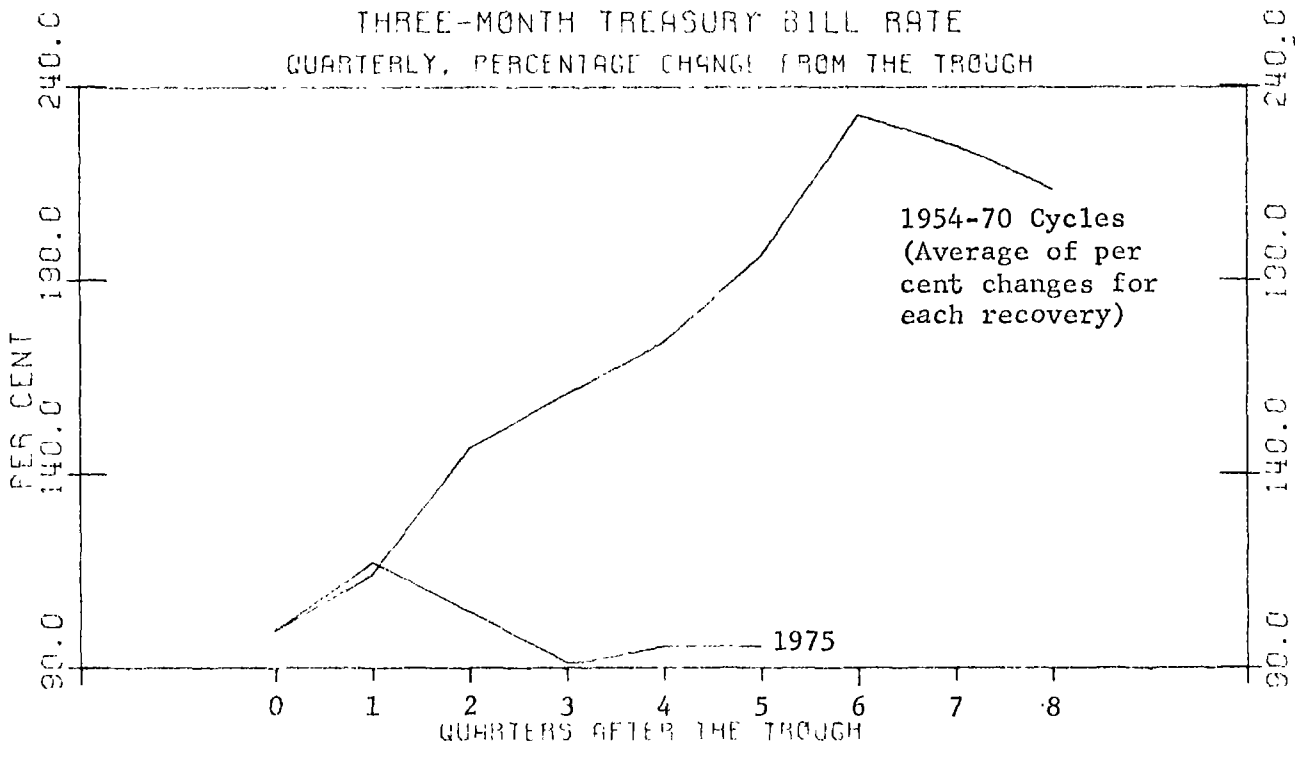


Chart 2
THREE-MONTH TREASURY BILL RATE
QUARTERLY, PERCENTAGE CHANGE FROM THE TROUGH



-3-

to offer savings accounts to State and local governments, and in November 1975, commercial bank liability powers were expanded further to permit the issuance of savings deposits up to \$150,000 to businesses operated for profit. In addition, the Congress authorized all depository institutions in Massachusetts and New Hampshire to begin issuing NOW accounts to individuals and sole proprietorships in January 1974. Growth of these deposits was modest in 1974, but accelerated appreciably in 1975.

The possible constraining effects of these and several other factors on the growth of M_1 are examined in Section I. Estimates are presented for the degree to which each factor, and all factors combined, may have reduced M_1 growth in the last year, as well as over the next year. For the year just ended (1975-III to 1976-III) we have estimated, on what we believe is a conservative basis, that M_1 growth has been reduced by perhaps 2 percentage points by the factors considered. Moreover, in the coming year M_1 growth is expected to be reduced by another $1\frac{1}{2}$ percentage points as consumers and businesses continue to adjust to new payments devices. In Section II the effects on M_2 growth of the factors constraining M_1 are briefly considered. It is suggested that while reducing M_1 growth, the factors, on balance, have probably stimulated M_2 growth at least marginally. Concluding remarks appear in Section III.

I. FACTORS CONSTRAINING M_1 GROWTH

M_1 growth may have been reduced in the last year by a wide variety of demand deposit substitutes, and by other factors, including devices which have generally facilitated the use of interest bearing

-4-

deposits and money market assets for payment purposes. Outstanding amounts and estimated impacts on M_1 of the first class of factors-- demand deposit substitutes--are shown in the top half of Table 1. Estimated reductions in M_1 arising from the second class of factors-- including compensating balances and telephone transfers from savings to demand deposits--are shown in the lower half of Table 1.

Substitutes for Demand Deposits

Of the possible substitutes shown in the top half of Table 1, business savings accounts are thought to have contributed the largest reduction in M_1 growth. These deposits had grown to \$6.6 billion by the third quarter of 1976. The \$2.5 billion estimated reduction resulting from business savings accounts is based on the following considerations. According to a universe survey taken by the Board, \$1.2 billion of the \$2 billion in business savings at all banks in early January were estimated to have been converted from demand deposits. Since then, business savings expanded by another \$4-1/2 billion through the third quarter of this year. Based on results from an October sample survey of usage of business savings accounts,^{3/} we have assumed that a little over one-fourth of the \$4½ billion growth since January has been diverted from demand deposits.^{4/} Adding another \$1.3 billion to the stock of business savings thought to have come from demand balances

^{3/} See Appendix B for details.

^{4/} Thus, in the first two months after business savings were first offered, businesses converted about \$600 million per month in demand balances to such deposits. In the last eight months, the rate of conversion has declined to about \$150 million per month. Thus, the stock adjustment from demand to business savings deposits is assumed to have slowed considerably since the beginning of the year.

Table 1

DEMAND DEPOSIT SUBSTITUTES AND OTHER FACTORS CONSTRAINING M₁ GROWTH
(\$ billion)

	Outstanding Amounts (Quarterly Average)		Change over 1-year QIII 75-QIII 76 Period	Estimated Effect on M ₁ Projected	
	1975 QIII	1976 QIII		QIII 1975- QIII 1976	QIII 1976- QIII 1977
SUBSTITUTES FOR COMMERCIAL BANK DEMAND DEPOSITS					
Business savings accounts	0.0	6.6	6.6	-2.5	-1.2
NOW accounts	.7	1.6	.9	-.7	-1.2
State and local government savings accounts	.5	3.1	2.6	-.5	-.3
Demand deposits at MSBs ^{1/}	.2	.4	.2	-.2	-.4
Check credit (overdrafts at banks)	2.7	2.9	.2	neg.	neg.
Credit union share drafts	<u>2/</u>	.1	.1	neg.	-.1
Money market mutual funds	3.7	3.7	0.0	neg.	neg.
Sub-total	<u>7.8</u>	<u>18.4</u>	<u>10.6</u>	<u>-3.9</u>	<u>-3.2</u>
OTHER FACTORS REDUCING M ₁					
Compensating balances				-1.0	.2
Telephone transfers				-.2	-.3
Preauthorized transfers at banks and S&Ls				-.1	-.2
Other ^{2/}				-.2	-.3
Total				<u>-5.4</u>	<u>-3.8</u>

^{1/} Excludes demand deposit escrow accounts held at MSBs in connection with servicing of mortgages.

^{2/} Includes such items as zero balance accounts and payable through drafts, which enable corporations to maintain low, or no, demand deposits while making current payments. Also includes customer-bank communication terminals in stores that enable individuals to pay for purchases by electronic debiting of interest-bearing accounts.

neg.--negligible.

-6-

as of early January thus yields \$2.5 billion--the figure shown in Table 1. Because the stock adjustment from demand to savings deposits can be expected to diminish in the coming year, the reduction in M_1 growth over this period due to business savings is projected to be a little over \$1 billion, or about half the estimated reduction during the last year.

NOW accounts are estimated to have reduced M_1 growth by \$700 million last year. Such accounts have expanded by about \$900 million since 1975-III and it is thought that about 80 per cent of that growth represented funds diverted from demand deposits. This estimate is based on an analysis of draft activity against NOWs and the distribution of NOW balances between active and inactive accounts.^{5/} In the coming year, balances in NOW accounts are projected to expand by about \$1.5 billion,^{6/} of which \$1.2 billion is expected to be diverted from demand deposits.

Balances in State and local government savings accounts reached \$500 million in the third quarter of 1975--roughly three quarters of a year after banks were first authorized to offer such deposits. However, in the last year State and local government savings balances have expanded by about \$2½ billion, with two-thirds of the expansion

^{5/} For details see John Paulus, "Effects of NOW Accounts on Costs and Earnings of Commercial Banks in 1974-75," Staff Economic Studies, Federal Reserve Board, August, 1976.

^{6/} The NOW "experiment," which began in Massachusetts and New Hampshire in Jan. 1974, was extended to the remaining four New England states--Maine, Vermont, Connecticut, and Rhode Island--in March 1976. Since that date, NOW balances have been growing at a steady rate, averaging about \$125 million per month.

-7-

occurring at nonweekly reporting banks. For many local governmental units, the size of idle balances may not be large enough to make short-term investments profitable. Such balances, which may have been lodged temporarily in demand deposits before late 1974, can now be deposited in a savings account. However, because growth in State and local government savings balances has been highly sensitive to changes in the spread between market interest rates and the ceiling on savings deposits, only a small part of the 1975-III to 1976-III growth--a little less than one-fifth--is estimated to have been diverted from demand deposits. Over the coming year, we expect the diversion of demand balances to State and local government savings accounts to moderate somewhat, and to contribute only marginally to reduced M_1 growth.

Among the remaining commercial bank demand deposit substitutes shown in the top half of Table 1, only demand deposits at mutual savings banks are thought to have depressed M_1 growth by a nonnegligible amount in the last year.^{7/} These deposits--which exclude escrow accounts classified as demand deposits^{8/}--had been expanding by only a few million dollars per month before June 1976. However, in the third quarter of this year, after New York mutual savings banks began offering demand deposits,

^{7/} Mutual savings banks are now allowed, under State laws, to offer demand deposits to consumers in eleven states.

^{8/} Escrow accounts included in demand deposits at mutual savings banks total about \$700 million. These balances are very stable, however, and growth in reported mutual savings bank demand deposits can be traced to an increase in those demand deposits (shown in Table 1) which are not related to escrow accounts.

-8-

demand balances increased by \$125 million.^{9/} We have assumed that MSB demand deposits are very close substitutes for commercial bank demand deposits. Thus, in the last year, all of the \$200 million growth in mutual savings bank demand balances is assumed to have been attracted from commercial bank demand deposits. For the coming year, this constraining effect on M_1 is expected to increase to about \$400 million, mainly reflecting growth in demand deposits at mutual savings banks in New York.

Other substitutes included in the top half of Table 1 are consumer check overdrafts, credit union share drafts, and money market mutual funds, all having a negligible estimated effect on M_1 growth in the last year. Check credit--loans to consumers to cover the overdraft of a checking account--has been stable for the last year, and is not expected to show any appreciable growth in the coming year.^{10/} Credit union share drafts are a relatively new instrument which essentially

^{9/} State chartered New York mutual savings banks were allowed, under State law, to begin offering demand deposits on June 1, 1976. Prior to that date, those institutions had been offering payment order of withdrawal (POW) accounts, which served essentially as demand deposits. On June 1, all balances in POW accounts--some \$60 million--were converted to demand deposits. Demand deposit balances at New York mutual savings banks advanced by \$44, \$45, \$35, and \$13 million in June through September. It might be noted that many New York mutual savings banks are very large and that total time and savings balances at mutual savings banks statewide exceed \$60 billion.

^{10/} A better measure of the effect on M_1 of overdraft privileges might be total lines of credit (used and unused) available to consumers. Such data, unfortunately, are not available. If credit lines have been expanding more rapidly than outstanding check credit, the constraining effect of overdrafts may be nonnegligible, and the estimates shown in Table 1 may be a bit too conservative.

-9-

permit credit union customers to earn interest on balances that can be readily used to make third-party payments.^{11/} These instruments are not yet widely used. However, future use could increase to sizable proportions as credit union balances continue to expand rapidly and as customers become more familiar with share drafts. Money market mutual funds have not grown since mid-1975. While such funds may have attracted several hundred million dollars from demand deposits in 1974, when short-term interest rates peaked, they probably had little effect on M_1 during the last year. Over the next year, the constraining effect of money market mutual funds is likely to be negligible, unless the attractiveness of such funds as a cash management device is increased by sharply rising short-term interest rates.

Other Factors Affecting M_1

Shown in the bottom half of Table 1 are several additional factors which could be reducing the rate of growth of M_1 . The most important over the last year is thought to be changes in compensating balances held against business loans at commercial banks. Assuming a 20 per cent balance requirement, and assuming further that all compensating balances are idle in the sense that they are not used or needed

^{11/} A credit union share draft is a check-like instrument which may be written against a credit union deposit. These drafts are cleared through the credit union's correspondent bank.

-10-

by the business customer for normal transactions purposes,^{12/} the \$5 billion decline in business loans (from \$178 billion to \$173 billion) since 1975-III might account for a \$1 billion reduction in demand deposits in the last year.^{13/}

Moreover, if banks are easing compensating balance requirements (as the quarterly bank lending practices survey and Board contacts indicate) the effect on M_1 of weak business loan demand could be more substantial. For example, suppose average compensating balance requirements have declined from 20 to 15 per cent in the last year. Demand deposits held to satisfy compensating balance requirements would then fall by \$9.6 billion (.20 x \$178 billion minus .15 x \$173 billion). Even a one percentage point reduction in average compensating balance requirements would have a significant effect--nearly \$2 billion--on total demand deposits held to satisfy balance requirements.

^{12/} This latter assumption has been disputed by Richard Davis and Jack Guttentag, "Are Compensating Balance Requirements Irrational?" Journal of Finance 17 (March 1962), pp. 121-126, by Jared Enzler, Lewis Johnson, and John Paulus, "Some Problems of Money Demand," Brookings Papers on Economic Activity, 1:1976, and by Robert Coates, The Demand for Money by Firms, Marcel Dekker, Inc., New York, New York (1976). However, in a recent Board study based on sectoral demand deposit data from the Demand Deposit Ownership Survey, Richard Porter, Helen Farr, and Eleanor Pruitt found that the level of business loans does help to explain variation in demand deposits held by nonfinancial businesses. This suggests that nonfinancial businesses do hold idle demand balances to satisfy compensating balance requirements, and that the size of these idle balances varies positively with the level of outstanding business loans. For details, see Helen Farr, Richard Porter, and Eleanor Pruitt, "The Demand Deposit Ownership Survey," Federal Reserve Board Staff Study prepared for the Advisory Committee on Monetary Statistics.

^{13/} It should also be noted that unused commitments have risen in the last year. Banks sometimes require customers to hold compensating balances--usually thought to be 10 per cent of the line--against these commitments. Thus, an increase in commitments may offset a part of the constraining effect attributed to the decline in outstanding business loans.

-11-

It should be noted, however, that the demand deposit ownership survey indicates that the share of gross IPC demand deposits held by businesses at large banks--where all of the weakness in business loans has been concentrated--has declined only slightly over the last year (see Table 2). Thus, without more evidence we would be reluctant to

Table 2

IPC DEMAND DEPOSIT OWNERSHIP BY SECTOR AT LARGE BANKS
(per cent of total)

Date	Type of Holder		
	Consumer	Nonfinancial Business	Financial Business
1975-September	.25	.56	.12
December	.24	.56	.12
1976-March	.26	.55	.13
June	.25	.55	.13

Source: Demand Deposit Ownership Survey.

attribute more than a billion or so of the weakness in M_1 over the last year to the continuing weak demand for business loans.^{14/}

^{14/} A late 1975 survey at the Reserve banks indicated that bankers did not believe that reduced compensating balances were contributing to the overall weakness in their demand deposit growth. However, an informal survey of six banks in New York City taken last month indicated that some bankers now believe that weak business loan demand has constrained their demand deposit growth.

-12-

Over the next year, demands for business loans are expected to strengthen somewhat. Associated with the expected expansion in business loans will be an increase in compensating balances held against such loans. We estimate that a small part--some \$200 million--might represent balances that customers would not otherwise hold, and would thus add to M_1 growth.

Also shown in Table 1 are telephone and preauthorized transfers between savings and demand deposits at banks and savings and loan associations, which generally facilitate the use of savings deposits for payments purposes. It was found in surveys conducted by the Federal Reserve Board and the Federal Home Loan Bank Board that neither telephone nor preauthorized transfers were widely used by customers. Telephone transfers, however, were widely offered and were often made available to customers on an attractive basis--e.g., interest paid on a day of deposit to day of withdrawal basis and low or zero transfer charges. The constraining effects of telephone and preauthorized transfers are estimated to be modest over the last year, but increasing somewhat next year as customers become more familiar with these services.

Effect of All Factors on M_1 Growth Rates

As shown in the bottom line of Table 1, the total estimated constraining effect on M_1 of all factors is \$5.4 billion from 1975-III to 1976-III. Over the next year it is estimated that these factors

-13-

will reduce M_1 growth by an additional \$3.8 billion.^{15/} It should be emphasized that these are rough estimates, which could miss the mark by several hundred million dollars. Indeed, although \$5½ billion is our best estimate of the total constraining effect of all factors over the last year, the true reduction in M_1 growth could reasonably lie anywhere in the interval from, perhaps, \$4 billion to about \$8 billion. Moreover, there is even more uncertainty associated with the \$4 billion estimated reduction over the next year. This increased uncertainty reflects principally the greater difficulty in forecasting future events which themselves depend on uncertain developments such as changes in interest rates and economic activity.

The estimated reductions in M_1 growth have been translated into comparable effects on the growth rate of the narrowly defined money stock in Table 3. As shown in column 1, the actual growth rate from 1975-III to 1976-III was 4.4 per cent. Adding the estimated \$5.4 billion reduction--1.9 per cent of M_1 in 1975-III--to the actual growth over the last year yields an adjusted growth rate of 6.3 per cent. This essentially represents an estimate of how fast M_1 -type third-party payments balances expanded in the last year.

^{15/} We have ignored the possible effects of automatic overdraft from savings deposits. Final action on this proposal has not yet been taken by the Board. If passed in its current form, which requires that customers forfeit 30 days' interest on savings deposits transferred to a demand account, the proposal might have a relatively modest effect on M_1 growth in the coming year. Nevertheless, such a proposal has a significant potential for reducing M_1 growth if it is widely offered on attractive terms (low transfer charges, etc.).

Table 3

IMPACT ON M_1 GROWTH RATE OF CHANGES IN DEMAND DEPOSIT SUBSTITUTES

	One-Year Periods	
	1975 QIII-1976 QIII	Projected: 1976 QIII-1977 QIII
1. M_1 growth rate	4.4%	5.75% ^{1/}
2. Estimated reduction in M_1 growth rate from all demand deposit substitutes	1.9	1.2
3. Growth in M_1 , adjusted for substitutes ^{2/}	6.3	7.0

^{1/} Assumes no change in M_1 range currently in place.

^{2/} If only substitutes with the more readily quantifiable levels were included, growth in M_1 adjusted for substitutes would be 5.7 and 6.8 per cent in years ending QIII 76 and QIII 77, respectively.

For the next year, if M_1 expands by 5-3/4 per cent--the midpoint of the Committee's current long-run target range--and if substitutes and other factors draw another \$4 billion off demand deposits, adjusted M_1 will expand at an annual rate of about 7 per cent. Thus, if the midpoint of the long-run range for M_1 is achieved, and if M_1 growth is constrained by about \$4 billion as estimated, the 5-3/4 per cent growth in measured M_1 would have essentially the same effect on interest rates and economic activity as a 7 per cent growth rate achieved in the absence of substitutes and other factors constraining M_1 .

-15-

II. SOME IMPLICATIONS FOR M_2 GROWTH

Several of the factors constraining M_1 growth that we have discussed earlier may also raise M_2 growth to the extent that they have encouraged diversions of funds from market instruments and CDs to savings accounts. For example, about \$4 billion of business savings and \$2 billion of State and local government savings are thought to have been attracted from sources other than demand deposits in the last year. If the bulk of these funds were converted from money market assets and CDs, such inflows to business and State and local government savings deposits would have raised the growth rate of M_2 by slightly less than 1 percentage point last year.

Telephone and preauthorized transfers from savings accounts, while depressing M_1 slightly, may also have increased M_2 growth marginally. By increasing the liquidity, and therefore the attractiveness, of savings deposits as a cash management device, such services might have attracted funds from CDs and market instruments as well as from demand deposits

Some shifts of funds may, however, have tended to reduce M_2 growth. Funds diverted from commercial bank demand deposits to NOW accounts at thrift institutions, as well as demand deposits at mutual savings banks would tend to reduce M_2 since thrift deposits are not included in that aggregate. Such transfers, however, are relatively

-16-

small, and total less than \$500 million in the last year.^{16/}

On balance, recent regulatory changes have probably raised the growth rate of M_2 , although only slightly. During the last year, expansion in M_2 may have been about one-half a percentage point faster or a bit more, because of the factors listed in Table 1. In the coming year, these factors--principally business and State and local government savings deposits--should continue to stimulate M_2 growth, but at a somewhat reduced pace. Should interest rates rise well above current levels, causing a runoff of business and State and local government savings deposits to market assets, the stimulative effects of such deposits on M_2 growth could disappear.

III. CONCLUDING REMARKS

Since mid-1974, and especially in the last year, demand deposit balances held by consumers and businesses alike have expanded at a sluggish pace relative to economic activity and interest rates. Coinciding with the beginning of this period of weak growth in M_1 was a peaking of interest rates at record levels in the summer of 1974. Such high levels of interest rates may have increased the sensitivity of money holders to the opportunity cost of holding noninterest bearing deposits. In addition, the several legislative and regulatory changes

^{16/} NOW accounts at thrift institutions grew by \$250 million between July 1975 and July 1976 (the last date for which data are available), while mutual savings bank demand deposits, as shown in Table 1, expanded by about \$200 million.

-17-

that were reviewed earlier facilitated the use of savings deposits for payments purposes during this period.^{17/} These changes provided increased opportunities for reducing demand balances at a time when money holders were probably most receptive to new cash management devices.

As shown in Chart 1, V_1 has risen by about 6 per cent over the last year, a very large increase by historical standards. Our estimates covering this period, although admittedly somewhat imprecise, suggest that the growth rate of M_1 was depressed by about 2 percentage points between 1975-III and 1976-III by the several factors listed in Table 1. This further suggests that M_1 adjusted for substitutes and other factors grew by 6 to 6-1/2 per cent over the last year, or about 50 per cent faster than measured M_1 . Such growth would help to explain why short-term interest rates are now below trough levels and why V_1 has increased so rapidly. If adjusted M_1 were used to calculate V_1 , the increase in velocity over the last year would have been about 4 per cent, and the increase from the trough of the 1974-75 recession would have been 6-1/2 per cent. Such increases in velocity are very close to cyclical increases observed in the last two decades.

In the next year the constraining effect of most factors is expected to continue, although estimated reductions for many factors

^{17/} Perhaps the rising ratio of currency to demand deposits can be explained in part by the fact that most innovations (zero balance accounts, overdrafts, improved computer technology which reduces the cost of efficient management of demand balances) and most legislative and regulatory changes have enabled money holders to economize on demand deposits, while having little effect on the demand for currency.

-18-

are expected to decline. There is considerable uncertainty regarding the effect compensating balances might have on further M_1 growth. On balance, we expect the growth of M_1 to be reduced over the next year, but by perhaps 1 to $1\frac{1}{2}$ percentage points, compared to 2 percentage points in the last year.

The net effect on M_2 of the factors depressing M_1 growth has probably been rather modest. On balance, M_2 growth may have been increased by these factors by $\frac{1}{2}$ to 1 percentage point in the last year. By increasing M_2 growth slightly, while depressing M_1 by a larger amount, the factors thus help to explain the divergent patterns of growth of the two aggregates over that period.

-19-

APPENDIX A

CHRONOLOGY OF
INNOVATIONS AND REGULATORY CHANGES
THAT REDUCED NEED FOR DEMAND DEPOSITS^{1/}
(Items that are thought to have an important constraining effect
on M_1 marked by asterisk)

Sept. 1970 Preauthorized non-negotiable transfers from savings
accounts at S&L's for household related expenditures

Individuals can arrange in advance to permit their S&L to make regular payments out of their savings accounts for household-related expenditures, such as mortgages, to a third party.

June to
Sept. 1972* NOW accounts at state-chartered MSB's in Massachusetts
and New Hampshire

A check can be written by individuals on a savings account to any third party--with the check payable through the MSB's member bank correspondent.

Jan. 1974* NOW accounts at all depository institutions (except
credit unions) in Massachusetts and New Hampshire

Jan. 1974 Installation by S&L in Nebraska of terminal in super-
market that can be used to make withdrawals from
savings account to pay for merchandise

No evidence of significant spread.

Early 1974 Money market mutual funds become important

Several funds permit shareholders to transfer proceeds of their shares (at zero or very low cost) by same day order through wire transfer or check.

Aug. 1974 Federal Credit Unions permitted to issue share drafts

Credit union customer simply writes check to third party and this is cleared through credit union's bank.

^{1/} Source: Steven Roberts, "Developing Money Substitutes: Current Trends and Their Implications for Redefining the Monetary Aggregates," Board Staff paper prepared for the Advisory Committee on Monetary Statistics.

-20-

- Nov. 1974* Commercial banks permitted to offer savings accounts to state and local governments
- April 1975 Member banks authorized to transfer funds from savings to checking account by telephone order
- This is widely offered by banks, but apparently not extensively used in the sense that we have not been able to identify a significant increase in savings account activity that can be attributed to it.
- April 1975 S&L's permitted to make pre-authorized non-negotiable transfers from a depositor's account for any purpose
- Sept. 1975 Commercial banks given the same authority as noted above for S&L's
- This service is apparently not widely offered by commercial banks.
- Nov. 1975* Business savings accounts up to \$150,000 in size permitted at commercial banks
- The great bulk of these are subject to telephone transfer.
- Feb. 1976* NOW accounts permitted at all depository institutions (except credit unions) in all of New England
- May 1976* Consumer demand deposits authorized at state-chartered MSB's and S&L's in New York
- Currently Authorization to permit banks to transfer funds from pending final Board action
savings accounts to cover demand deposit overdraft

-21-

APPENDIX B

OCTOBER SURVEY OF BUSINESS SAVINGS USAGE

During the week of October 6-13, between 10 and 12 banks in each Federal Reserve district were asked the following questions:

- (1) Are business savings accounts relatively active? (relative to individual accounts).
- (2) Do bankers feel that such accounts are being used largely as secondary transaction balances?
- (3) Are business savings deposits being used to satisfy compensating balance requirements?

The responses of 123 member banks--slightly over half of which are weekly reporters--are summarized below.

While about 45 per cent of the respondents indicated that corporate savings accounts were relatively active, only about 30 per cent felt that business customers were using their savings accounts primarily as secondary transactions balances. Customers of small banks appear to be more likely to use savings accounts for payments purposes than those of weekly reporting banks.^{1/} Just under 50 per cent of small banks indicated

^{1/} This appears to differ with the findings of the Board's January 7 survey on business savings. In that survey, banks with deposits less than \$500 million indicated that a little less than 60 per cent of business savings balances represented funds shifted from demand deposits, while banks with greater than \$500 million in deposits felt that nearly 70 per cent of business savings balances represented such funds.

-22-

business savings accounts served as secondary transactions balances, while only about 15 per cent of weekly reporters reported such usage.

The responses to the question whether business savings were being used for transactions purposes were generally quite uniform across districts. Six of the 12 districts reported that 3 of the 10 banks surveyed had answered affirmatively. However, in the San Francisco district, where 30 per cent of total weekly reporting bank business savings balances are held,^{2/} 8 of the 12 banks surveyed, including all six weekly reporting banks, indicated that business savings were being used for transaction purposes. This suggests that on the west coast business savings are being used more extensively for transaction purposes than elsewhere. Because a relatively large proportion of business savings are held in the twelfth district, any crude attempt to "blow up" the 123 bank sample would require that a large weight be given to the San Francisco response.^{3/}

Nine of the 123 banks--about 7-1/2 per cent of respondents--replied that business savings were being used to satisfy compensating

^{2/} Business savings balances at weekly reporting banks in the San Francisco district total \$1.2 billion, or about 30 per cent of the \$3-1/2 billion in such deposits at all weekly reporting banks.

^{3/} Suppose, for example, that a weighted average of responses were calculated with the San Francisco response (2/3 of all banks reporting affirmatively) being given the weight of 1/3 and with all other districts receiving equal weights. The weighted average of affirmative responses to question 2 would be just under 40 per cent (compared to a 30 per cent unweighted response reported earlier). This compares favorably with the ratio of the estimate of business savings diverted from demand deposits (\$2.5 billion) to total outstanding balances in 1975-III (\$6.6 billion), which is also just under 40 per cent.

-23-

balance requirements for some customers.^{4/} A few additional banks indicated that such an arrangement was sometimes made in special cases.

^{4/} Because interest is paid on business savings deposits, this would represent a reduction in effective compensating balance requirements to customers. With business loan demand remaining weak and with banks flush with time and savings deposits, there may be some incentive to attempt to make additional loans by reducing nonprice terms such as compensating balance requirements. This would permit banks to expand their loan portfolios without cutting the prime rate and losing earnings on all loans made at rates tied to the prime.