

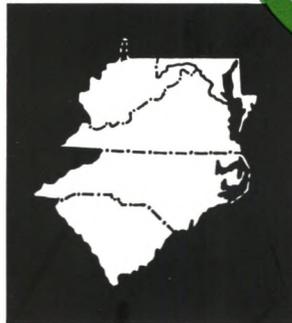
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FEDERAL RESERVE BANK OF RICHMOND

MONTHLY REVIEW

*Regulation Q:
An Instrument of Monetary
Policy*

The Public Information Function



JULY 1970

REGULATION Q:

an instrument of monetary policy*

In recent months Regulation Q, the regulation which specifies maximum interest rates banks are permitted to pay on time and savings deposits, has become increasingly the subject of controversy. Debate has centered around two major questions: (1) Is Regulation Q effective as an instrument of general monetary control? (2) Are the selective impacts of Regulation Q desirable or undesirable? This article will describe experience with Regulation Q through the years and then catalog the major points in the current debate about whether Regulation Q is an effective policy tool.

EXPERIENCE WITH REGULATION Q

Regulation Q was not initially intended as an instrument of credit policy. The Banking Act of 1933 amended the Federal Reserve Act to permit the Federal Reserve Board to regulate the rate of interest which member banks pay on time deposits and to prescribe different rates on deposits having different maturities, different conditions of withdrawal or repayment, or different locations. The rationale for the legislation and subsequent regulation grew out of the widespread bank failures of the 1920's and 1930's. It was believed that interest rate competition encouraged banks to move into high-risk assets in order to be able to cover ever-rising deposit costs and therefore weakened the internal soundness of the banking system. Thus, the amendment granting authority to regulate interest rates on deposits was just

one of many pieces of legislation passed during the 1930's to protect the banking system by limiting competition and maintaining the solvency of individual institutions.

Banks were flooded with reserves in the late 1930's as a result of huge inflows of gold and, in the 1940's, as a result of the Federal Reserve's policy of pegging the prices of U. S. Government bonds. During this period market interest rates remained substantially below the established Regulation Q ceilings, and for all practical purposes the ceilings were inoperative, either as a regulatory device or as an instrument of monetary policy.

Period of Accommodation The situation changed in the mid-1950's. As Chart I shows, the ceilings, which had remained unchanged for almost 20 years, finally became binding in late 1955. The combination of strong loan demand and restrictive monetary policy drove market rates of interest up to and then beyond the Q ceilings. The growth of time and savings deposits at commercial banks promptly slowed. Depository institutions which were not subject to Regulation Q continued to experience rapid inflows of savings. In order "to permit individual member banks greater flexibility to encourage the accumulation of savings" and to compete "actively for time and savings balances by offering rates more nearly in line with other market rates," the Board of Governors raised the Regulation Q ceilings effective January 1, 1957. Table I shows the Regulation Q ceilings since the inception of the regulation.

With this change, a period began which might be

* This article is adapted from remarks made by the author at a seminar on monetary policy held at the Federal Reserve Bank of Richmond on February 23, 1970.

described as one of accommodation of Q ceilings to market interest rates. During the period from 1957 to 1966, the Board generally raised the maximum permissible rate when rising market rates of interest made time and savings deposits unattractive. The only notable exception was the period of high interest rates in 1959 and early 1960. From mid-1960 to mid-1966, the Board tended to keep the Q ceilings comfortably above market rates. The volume of time deposits grew at the rapid rate of about 14 per cent per year.

The underlying rationale of the rate increases in this period was to permit banks to compete for time and savings deposits as yields on closely substitutable investments were irregularly rising. The ability to compete was viewed as having various desirable consequences. The early 1960's was a period of dual concern—about sluggish economic expansion on the one hand and about the balance of payments deficit on the other. In explaining all of the increases in the early 1960's, the Board cited the higher permissible rates as a marginal factor which would benefit the external accounts as banks were allowed to compete more vigorously for foreign deposits. The higher ceilings were also regarded as desirable "to provide an added incentive for accumulation of the savings necessary to finance . . . future economic growth. . . ."¹

¹ Annual Report of the Board of Governors of the Federal Reserve System, 1961, p. 103.

Regulation Q took on new significance when negotiable certificates of deposit came into widespread use in 1961. At that time the large commercial banks in New York began to offer large-denomination certificates of deposit in order to retain the deposits of large corporate customers who were making strenuous efforts to economize on demand balances. A secondary market for CD's developed, and as the practice of issuing negotiable CD's spread throughout the country, the volume outstanding grew rapidly. The sensitivity of CD customers to interest rate differentials enhanced the potential of Regulation Q as a policy instrument.

So far as commercial banks were concerned the growing popularity of the CD and other time deposit instruments prompted the emergence of a new concept of liquidity. Banks began to rely to a greater degree on their ability to attract money market funds. This led to liquidity management from the liability rather than the asset side of the balance sheet.

Active Use of Q as a Policy Instrument The policy of accommodation to market changes ended in 1966. In December 1965, the Q ceilings on time and savings deposits were raised substantially to a uniform 5½ per cent on all maturities. The aim of this larger-than-usual increase was to make the Q ceilings inoperative by raising them to a level well above market rates. But the new ceilings quickly became binding. Interest rates rose sharply as Gov-

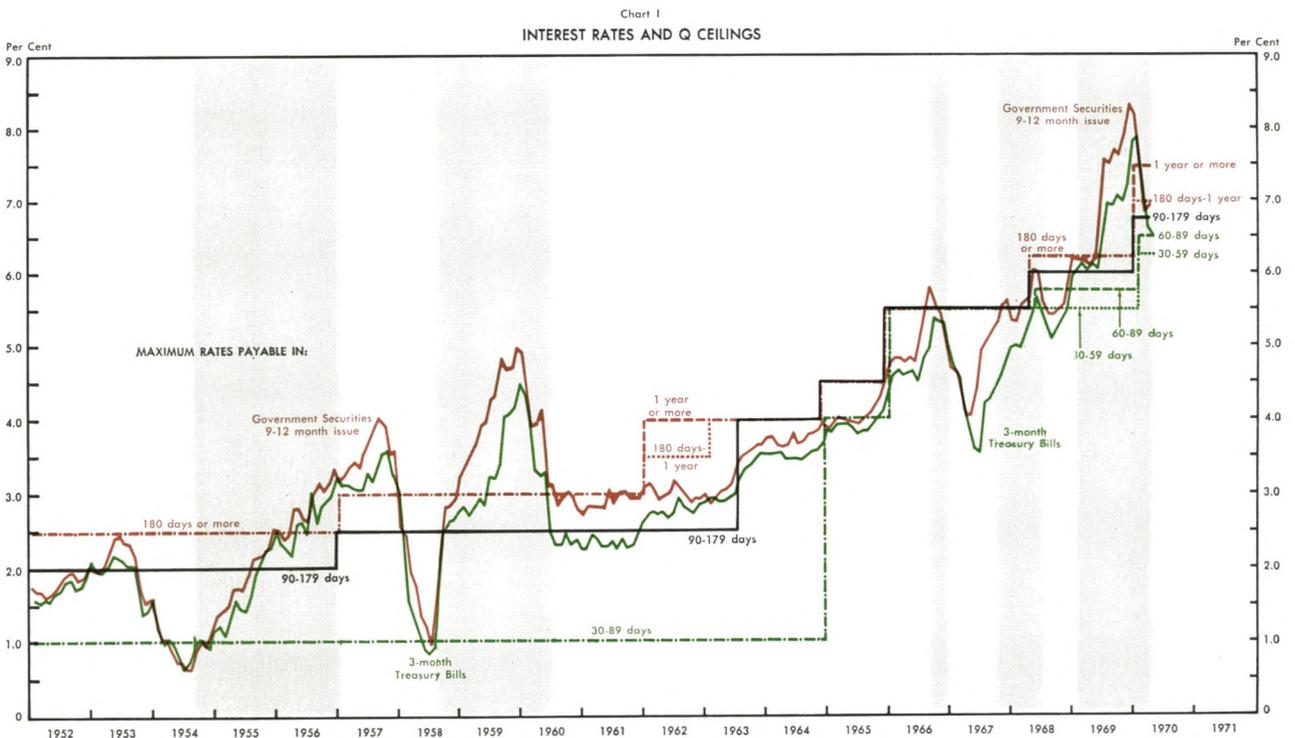


Table I
MAXIMUM INTEREST RATES PAYABLE ON TIME AND SAVINGS DEPOSITS
 (Per cent per annum)

Type of Deposit	Rates January 1, 1963—July 19, 1966					
	Effective Date					
	1/1/36	1/1/57	1/1/62	7/17/63	11/24/64	12/6/65
Savings Deposits held for:						
30 days to 1 year	2½	3	3½	3½	4	4
1 year or more	2½	3	4	4	4	4
Other Time Deposits:						
30-89 days	1	1	1	1	4	5½
90-179 days	2	2½	2½	4	4½	5½
180 days-1 year	2½	3	3½	4	4½	5½
1 year or more	2½	3	4	4	4½	5½
	Rates Beginning July 20, 1966					
Type of Deposit	Effective Date					
	7/20/66	9/26/66	4/19/68	1/24/70		
Savings Deposits	4	4	4	4½		
Other Time Deposits:						
Multiple maturity:						
30-89 days	4	4	4	4½		
90 days or more	5	5	5	5		
Single maturity:						
Less than \$100,000:						
30 days-1 year	5½	5	5	5		
1 year	5½	5	5	5½		
2 years	5½	5	5	5¾		
\$100,000 or more:						
30-59 days	5½	5½	5½	6¼		
60-89 days	5½	5½	5¾	6½		
90-179 days	5½	5½	6	6¾		
180 days-1 year	5½	5½	6¼	7		
1 year or more	5½	5½	6¼	7½		

ernment and agency borrowings became very heavy and as the economy expanded rapidly, leading to a substantial increase in borrowing of the private sector. This time, the Board of Governors did not raise the Q ceilings when they became restrictive. Banks generally had heavy loan commitments outstanding, and keeping the ceilings unchanged caused a severe squeeze, especially at those banks which had made commitments in anticipation of being able to acquire funds by issuing CD's at attractive rates.

In failing to raise the rates, the Board aimed at two objectives. First, it hoped that a runoff of CD's would result in a slowdown in the rate of growth of bank credit and in particular that it would force banks to cut back their lending to business borrowers, thereby removing some of the financing that was spurring the investment boom. Second, it hoped to reduce bank competition with the financial intermediaries which specialized in mortgage lending. Savings and loan associations and mutual savings banks found themselves experiencing the severest

liquidity squeeze of the postwar period and the housing market was severely depressed.

The Board of Governors was very concerned about the mortgage market. It wanted to lower maximum rates payable on those classes of commercial bank time and savings deposits which competed most vigorously with the liabilities emitted by the other thrift institutions. But it had only limited authority to set differential rates on different classes of time and savings deposits. Using the authority it had, the Board, on July 20, 1966, scaled bank rates on multiple maturity time deposits—all the way to 4 per cent in the case of those deposits having a maturity of less than 90 days. On September 21, the President signed into law a bill which gave the Board wide latitude to set differential rates according to numerous criteria, including size of deposit. Five days later the Board scaled back the maximum rate payable on single maturity time deposits of less than \$100,000 to 5 per cent. These small rollbacks in the ceilings probably had only a marginal impact

on the thrift institutions and the housing market, but they served to demonstrate the Board's concern that the incidence of monetary restraint was falling disproportionately onto the housing industry.

Banks confronted with heavy CD attrition, particularly the large money market banks, attempted to meet firm loan commitments and gain time in which to make orderly asset adjustments by tapping nondeposit sources of funds. U. S. banks borrowed large amounts in the Eurodollar market and sold increasing amounts of short-term notes. For the banking system as a whole, this amounted to a conversion of deposit liabilities into nondeposit liabilities having no reserve requirements. Thus, the Eurodollar market and the market for short-term notes provided not only a safety valve for individual banks, but also a means whereby banks collectively could reduce average required reserves at their own initiative. This only partly compensated, however, for the extraordinarily high rates which banks had to pay in the Eurodollar market. Thus, they had strong incentive to ration credit aggressively, and the Board added to this incentive by plugging the loophole of short-term promissory notes effective September 1, 1966. These were defined as deposits subject to Regulations D and Q. The purpose was "to prevent the future use of those instruments as a means of circumventing the regulations governing reserve requirements and payments of interest on deposits."²

The charts show that since 1965, time deposit growth has fluctuated widely as interest rates have fluctuated above and below the Q ceilings. The sharp decline in time deposits in late 1966 was followed by an even sharper rise in the first three quarters of 1967 as market rates fell well below the ceiling rates. Growth moderated in late 1967 and early 1968 as rising market rates reduced the relative attractiveness of CD's. Growth spurted following the increase in the Q ceilings in April 1968 and remained rapid through the rest of the year. The spurt was not intended. The Board raised maximum permissible rates only on large-denomination CD's having maturities of 60 days or more. The intent of the new graduated scale of ceiling rates was to set them at levels which would "enable banks to resist further large reductions in such deposits, but not so high as to permit significant expansion in the outstanding

volume of CD's and thus in bank credit."³ Early in 1969 rising market rates made CD's unattractive, the Board did not raise the Q ceilings, and CD attrition became massive. Outstandings declined about \$13 billion, or 44 per cent during the course of the year.

As in 1966, banks sought to compensate for the CD losses by turning in large volume to nondeposit sources of funds—Eurodollars, sale of assets under repurchase agreement, and sale of commercial paper by bank holding companies and affiliates. The Board looked upon this development with disfavor for several reasons. First, the regulatory power of the Board was being eroded as the liability structure of the banking system shifted from deposits subject to regulation to nondeposit liabilities not subject to regulation. Second, equity considerations were involved. While some banks, mainly by virtue of size and structure, had ready access to nondeposit sources of funds, other banks had little access to such sources. Third, monetary restriction was being eroded as average reserve requirements were in effect being reduced by the shift of liabilities from deposit to nondeposit status. Of course, this evasion of monetary restraint could have been offset, or more than offset, by further tightening through open market operations, but the Board chose instead to reclassify all these nondeposit sources of funds as deposits subject to reserve requirements, or Q ceilings, or both.⁴

In January 1970, despite concern that raising the Q ceilings might be interpreted as a relaxation of monetary policy, the Board of Governors raised the Q ceilings on most classes of time and savings deposits. It held the increases to "moderate size so as not to foster sudden and large movements of funds into the banking system that could . . . lead to an upsurge in bank lending." Sharp declines in market rates of interest in February made longer-term time deposits competitive with market instruments. The volume of time and savings deposits outstanding has increased at about 15 per cent annual rate since early February.

Effects of Regulation Q on Bank Credit What have been the effects of Regulation Q and the ebb and flow of time deposits on the growth and com-

² Annual Report of the Board of Governors of the Federal Reserve System, 1966, p. 91. Some types of promissory notes were specifically excluded from the expanded deposit definition. These included Federal funds, interbank borrowings, transfer of assets under repurchase agreement, and bank notes issued for capital purposes with a maturity of more than two years and subordinated to claims of depositors.

³ Annual Report of the Board of Governors of the Federal Reserve System, 1968, p. 81.

⁴ Liabilities resulting from repurchase agreements entered into on or after July 25, 1969, became subject to Regulations D and Q beginning August 28. On October 16, Eurodollars acquired by member banks from foreign banks became subject to a 10 per cent marginal reserve requirement on amounts in excess of daily average outstandings during the four-week period ended May 28. On October 28, the Board proposed making commercial paper sold by a bank affiliate to raise funds for a bank to use in its banking business subject both to Regulation D and Regulation Q. The effective date of this change was postponed a number of times, and at the time of this writing commercial paper is not subject to either regulation.

position of bank credit? This is a difficult question to answer because so many other variables are involved, such as the strength and composition of private loan demand, Treasury financing needs, the effects of other policy instruments, etc. But in general, periods of rapid growth in time deposits have been associated with rapid growth of bank credit, and vice versa. Moreover, Regulation Q has affected the composition of bank credit as well as the total. As a rule, banks have tended to invest the proceeds of time deposits in high yield assets, particularly tax-exempt securities. As may be seen from Chart II, the relationship between the rate of change of time deposits and the rate of change of other securities (mainly tax-exempts) has been very close. During periods of rapid time deposit growth banks have been the mainstay of the tax-exempt market, buying at such times as much as three-fourths or more of all new issues. On the other hand, during periods of declining time deposits, banks have sometimes become net sellers. This shifting pattern of bank behavior has resulted in very large swings in interest rates on tax-exempt securities. To the extent that state and local expenditures are affected by the shifting fortunes of the tax-exempt market, Regulation Q can be said to have had a selective economic impact.

Summary of Experience This historical review reveals that, rightly or wrongly, Regulation Q has become an instrument of policy. Obviously, the use of Q has had two dimensions. It has been both a general control and a selective control. As a general control, the Board has looked upon Q as a means of influencing the total quantity of bank credit. For example, restraint has been attempted by encouraging or allowing market rates to rise above the Q ceilings. The resulting conversion of time to demand deposits has been tantamount to an increase in average reserve requirements. Moreover, Q has perhaps been regarded as a means of speeding the effect of restraint by quickly exerting pressure on the reserve positions of those big banks which rely heavily on CD's. Raising Q ceilings when they are restrictive has been thought of as a move toward less restraint. This argument was frequently cited as a reason for not raising Q ceilings in 1969.

The year 1966 serves as the best example of using Q as a selective control. Failure to raise rates on large-denomination CD's was looked upon as a way of forcing quick rationing of credit to business customers. Reducing rates payable on consumer-type deposits was viewed as a means of reducing the impact of tight money on savings and loan associations, the mortgage market, and housing. In short, Regula-

tion Q was used in such a way as to try to shift the composition of total credit flows. Regulation Q was used in essentially the same way in 1969. Ceilings on savings deposits and consumer-type time deposits were kept at the 1966 levels, and while ceilings on large-denomination CD's were higher, they became binding as market rates rose to new highs. The debate about the efficacy and the desirability of using Regulation Q as a policy instrument has become more vigorous in recent months. Space is not available for a detailed examination of all the arguments pro and con. What follows is a mere listing and a brief discussion of the major arguments.

ARGUMENTS SUPPORTING REGULATION Q

Regulation Q Is a Good Tool of General Monetary Control The basic argument for Q as a general control probably rests on the degree to which Q influences the extent of financial intermediation in the economy. Other things equal, it is generally assumed that increased intermediation is stimulative and vice versa. Since banks are the largest intermediaries, any policy instrument which affects the extent of their intermediation has considerable leverage. Keeping ceiling rates high relative to market rates encourages the channeling of funds from savers to ultimate investors through an efficient intermediary with the result that funds are more readily available and at lower cost than would otherwise be the case. Conversely, relatively low ceilings tend to force funds to flow from savers to ultimate investors via various routes which are less efficient and more costly.

Given that banks want to compete for time and savings deposits, it is probably true that Regulation Q can be used both to stimulate and to restrain the economy. Whether it is the best available instrument is, of course, another matter. To answer this question one must compare Regulation Q with other instruments, including in the analysis the possible selective impacts of the various alternatives. The incidence effects cannot be ignored.

Regulation Q Produces Desirable Allocative Effects While Regulation Q may be useful as a general control, most arguments in favor of Regulation Q seem ultimately to boil down to the idea that Q produces desirable allocative effects, especially during periods of tight money when Q ceilings may reduce the pressure which would otherwise be exerted on the mortgage market and the housing industry. The linkages in this case are seen as both direct and indirect. The straightforward argument is simply that during inflationary periods Q ceilings

reduce bank competition with those intermediaries which specialize in mortgage lending. The indirect argument is that use of Regulation Q results in a smaller run-up of interest rates and therefore a lesser effect on the mortgage market than would be the case if the same degree of restraint were achieved by use of other tools. This argument is implicit in Duesenberry's article, "Policy Effects on Thrift Institutions," which appeared in the 1969 *Conference on Savings and Residential Financing*.

ARGUMENTS AGAINST REGULATION Q

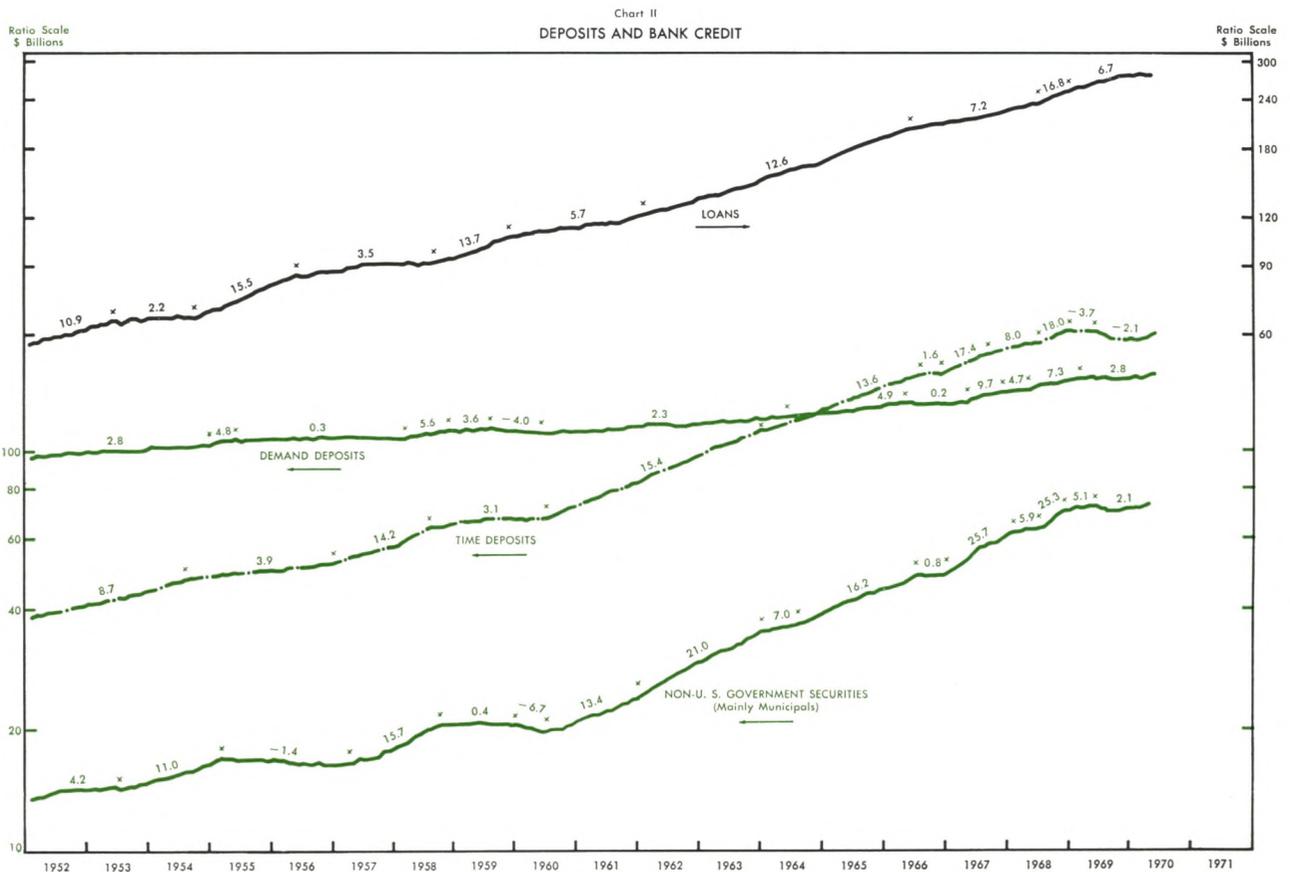
The arguments against Regulation Q have multiplied in recent months. In general they fall into two categories: (1) The effects of Regulation Q are either perverse or neutral. (2) The effects are discriminatory and produce distortions in credit flows. Each category will be considered in turn.

Regulation Q Produces Perverse or Neutral Effects Different people arrive by different routes at the conclusion that the effects of Q may be the opposite of those intended. The conclusion is easily reached by those who attach preminent importance to the narrowly defined money supply as an indicator of the ease or tightness of policy. If the Federal Reserve injects reserves at a given rate and if holders

of time deposits choose to switch into some other asset (Treasury bills or whatever), demand deposits and the money supply will grow at a faster pace. The monetarist who excludes time deposits from his definition of money would conclude that monetary policy has eased, not tightened. This view, of course, regards as unimportant the behavior of total deposits and bank credit which would grow at a slower rate.

But some who focus on total credit (bank plus nonbank) also say that the effect of a CD runoff is at best neutral and perhaps expansionary. Their argument is two-pronged. First, they say that bank lending power is not greatly reduced because of banker ingenuity in designing and issuing liabilities not subject to regulation. Second, such reduction of bank lending power as occurs does not curb spending because the financing of economic activity is merely diverted from the banks to the nonbank public. The August 1969 issue of the Morgan-Guaranty Survey puts the matter as follows:

... Business borrowers ... obviously can be accommodated by lenders other than banks, and there is ample reason to think that many of the funds disgorged from bank certificate-of-deposit accounts flowed directly into the commercial paper market and thus were put at the disposal of exactly those people whose credit usage the authorities were seeking to curb.



These and similar arguments have been put forward recently as a possible explanation for the failure of the economy to slow down as quickly in 1969 as was generally expected.

Regulation Q Is Discriminatory and Leads to Distortion of Credit Flows Perhaps most of the criticism of Regulation Q has centered on its being discriminatory and leading to distortions of credit flows. The idea is that rates payable on time and savings deposits are prices which should be allowed to fluctuate in accordance with changes in supply and demand conditions in the market. When the Federal Reserve sets a ceiling which becomes binding, it departs to some appreciable extent from its normal practice of using "general controls" which create a climate within which the interaction of private decisions produces particular prices with their implications for reserve allocation. Presumably, this allocation achieved by the free market is in accordance with the tastes and preferences of the public and therefore superior to the allocation achieved when particular prices are set outside the market.

Numerous alleged distortions resulting from Q have been reported in the financial press. It is frequently heard, for example, that Regulation Q discriminates against those large banks which rely heavily on CD's as a source of funds. This discrimination presumably forces credit to flow through other, less-well-developed channels, with loss of economic efficiency. Of course, these large banks are the first to turn to nondeposit sources of funds, but as these sources are made subject to regulation, the argument comes to the fore again. In any case, opponents of Regulation Q argue that it is time consuming, costly, and therefore inefficient for banks to be forced to invent new access routes to the money market. Banker ingenuity in turn forces the monetary authorities to invest scarce legal and regulatory talent plugging loopholes. The end result is the use of scarce resources in unproductive lines of activity.

Second, the rechanneling of credit flows is said to work hardships on particular sectors. For example, as has already been explained, the tax-exempt market

has been a frequent casualty in recent years. Also, the effects of Q have spread beyond our own shores. In terms of volume, Eurodollars have been the largest nondeposit source of funds. Heavy bidding by the few U. S. banks with access to the Eurodollar market helped push Eurodollar rates to unusually high levels. These high rates led to reserve losses by several countries which requested changes in our regulations to limit the access of U. S. banks to the Eurodollar market. This sentiment was certainly one factor in the imposition of the marginal reserve requirement against Eurodollar borrowings.

These are just a few of many examples of altered credit flows brought about by Regulation Q. Of course, one cannot object to altered credit flows per se. It is in the very nature of monetary policy, however conducted, to lead to alterations in credit flows, specifically, to dry up or expand that portion flowing through the commercial banking system. One objection to Q is that it tends arbitrarily to redirect flows without sufficient regard for private preferences.

CONCLUSION

This article has reviewed the experience with Regulation Q and has simply cataloged some of the arguments which have swirled around it recently. No analysis has been attempted here.

At the present time there appears to be a growing dissatisfaction within the Federal Reserve System with the use of Q for purposes of general monetary control. In a recent speech, Chairman Burns expressed the following sentiments:

... I regard interest rate ceilings on deposits as one device that is overdue for serious re-examination. As a matter of personal economic philosophy, I would like to see an evolution away from reliance upon interest rate ceilings as an ancillary device of monetary policy, at least as far as instruments of the money-market type are concerned. When and as circumstances permit, I believe an element of greater economic rationality would be introduced into the financial system if interest rates on such instruments were permitted to find their own level as a result of market forces.⁵

Jimmie R. Monhollon

⁵ Arthur F. Burns, Chairman, Board of Governors of the Federal Reserve System, "The Federal Reserve and the Banking System," Speech before the 59th Annual Meeting of the Association of Reserve City Bankers, Boca Raton, Florida, April 6, 1970, p. 10-11.

EDITOR'S NOTE: *After this article went to press, the Board of Governors announced the suspension, effective June 24, of ceilings on interest rates payable by member banks on certificates of deposit and other single-maturity time deposits in denominations of \$100,000 or more with maturities of 30 through 89 days.*