Statement by

Lyle E. Gramley

Member
Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy
of the
Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

March 3, 1982
I appreciate the opportunity to present to this Committee my views regarding the effects of financial innovations on the conduct of monetary policy.

Innovation in U.S. financial markets and practices has been proceeding at a phenomenal pace in the last decade. The innovational process is by no means completed. It is therefore appropriate and timely to examine the implications of this development for monetary policy. Let me begin, if I may, with a review of the principal forces responsible for the drastic changes we have seen in financial markets.

Our economy has suffered from a rising trend of inflation since the mid 1960's. As borrowers and lenders came to expect inflation to continue, or even accelerate, market interest rates moved progressively upward.

Higher market rates of interest increased the penalty for holding deposits whose yields were constrained by law or regulation. The yields that depository institutions could pay were limited by prohibitions or ceilings on the payment of explicit interest, and also by reserve requirements that reduced the rate of return on the investment of deposit proceeds. Moreover, the thrift institutions have
been, and still are, severely limited in their capacity to pay market interest rates on deposits because they hold a substantial volume of longer-term assets acquired earlier when inflation and interest rates were lower.

As the public has become increasingly sensitive to the earnings lost by holding noninterest-bearing or low-yielding deposits, they have become more adept at economizing on cash balances and more receptive to new kinds of financial investments. The increased financial sophistication of households and businesses, moreover, has been coupled with technological advances in the computer and telecommunications industries that have reduced the transactions costs of transferring funds.

New institutions and instruments have emerged to satisfy the public's demand for high-yielding liquid assets. The most widely publicized of these are the money market mutual funds, which have grown explosively during the past several years. These investment companies offer small savers the opportunity to invest indirectly in diversified pools of very short-term, large denomination, money-market instruments such as commercial paper and negotiable certificates of deposit. While money market funds are a
repository for savings, they also can serve as transactions balances, or as a very close substitute for them. Most money market funds allow the immediate withdrawal of balances by check or other convenient means.

More recently, other interest-bearing assets have attracted considerable public interest as substitutes for money. A number of brokerage firms now offer cash management accounts which combine the features of money market funds and margin accounts. Most of these allow for withdrawal of funds by check in any denomination, and by debit card. The money market fund component of the Merrill Lynch Cash Management Account has already grown to more than $13 billion. Very recently, new types of "sweep" arrangements have emerged, some designed primarily for smaller businesses and others for households. "Sweep" arrangements permit funds to move automatically into or out of conventional transactions balances to investment accounts paying market-related yields.

The financial innovations of recent years have affected principally the asset portfolios and the cash management practices of individuals and other small investors. They parallel developments that began many years earlier in the management of cash by nonfinancial corporations and other
large investors. The problems for monetary policy posed by these innovations have thus been around for awhile.

Financial innovation has, however, raised more questions in recent years about the appropriate definition of money, about the precision of the Federal Reserve's control over the money stock, and about the meaning of changes in money balances. I will touch on each of these issues in turn.

Definitions of Money

The difficulties associated with defining money are not new; the existence of money substitutes and "near monies" has always made it hard to decide which assets should be included in a particular measure of money. Traditionally, the issue has boiled down to drawing the line somewhere along a spectrum of assets ranked according to degrees of "moneyness," starting with balances serving as a generally accepted means of payment --having few investment characteristics--and moving successively to less liquid assets offering higher returns. The difficulties of defining money have increased as new instruments have come into use that possess overlapping
transactions and investment characteristics. The conventional measure of transactions balances, M1, now includes interest-bearing checkable deposits that have a significant savings component. At the same time, money market funds and cash management accounts—which are not included in M1—are also used in part for transactions purposes.

Periodic redefinitions of money are needed when financial innovation proceeds rapidly. The 1980 redefinition of the monetary aggregates was designed to bring all transactions accounts into M1. Available evidence at that time suggested that money market mutual funds were not extensively used for transactions purposes, and so they were included in M2. Last month, M2 was revised to exclude shares in money market mutual funds held by institutional investors; retail RP's, which are close substitutions for small denomination time deposits, were brought into the definition of M2.
Further revisions in definitions of the monetary aggregates may be necessary in the near future. The Federal Reserve Board staff, with the help of the Investment Company Institute, is undertaking a survey to determine the extent to which money market mutual funds are used for transactions purposes. The staff will also be gathering data this year on IRA and KEOGH accounts. These latter data may provide the basis for removing these accounts—which are of a long-term nature—from the definition of M2, or for a better understanding of changes in M2.

**Controlling the Monetary Aggregates**

Turning next to the issue of controlling the monetary aggregates, my judgment is that financial innovations have not, as yet, created a serious problem. The Monetary Control Act of 1980 extended reserve requirements to all depository institutions, a step that helped to strengthen the link between reserves and narrow money balances. The extent to which balances used for transactions purposes escape reserve requirements because they are held outside depository institutions is not known with precision, but it appears to be small at present. For example, the average turnover rate
of money market mutual fund shares is about 2 to 3 times per year, slightly lower than that for passbook savings deposits at banks and thrifts. However, the prospect of rapid growth of transactions balances not covered by reserves poses a potentially serious problem for monetary control in the future. I will return to that subject shortly.

**Stability of Money Demand**

In recent years, the principal monetary policy problem stemming from financial innovations has been their effect on the relationship among the money stock, nominal GNP and interest rates. Relative stability in this relationship is an important ingredient in a central bank's use of monetary aggregates as intermediate targets or indicators of policy. Prior to 1974, it was possible to predict reasonably well the amount of M1 that the public would want to hold given the size of the economy and the level of interest rates. Since then, however, growth of M1 has been considerably slower, relative to the rise of nominal GNP, than indicated by historical relationships. More importantly, the period since 1974 has been characterized by a greater degree of short-run instability in money demand.
Estimates of the amount of shortfall in money growth, relative to expectations based on historical experience, differ from one money demand equation to another. But a large number of studies of the public's demand for transactions balances point to a similar conclusion: for reasons that we understand only imperfectly, money demand has grown more slowly than expected over the past seven or eight years, and it has also been rather unstable in the short run.

The relationship between the broader monetary aggregates and GNP has also changed in recent years because of financial innovations and regulatory changes. In past periods of rising market interest rates, M2 growth tended to slow abruptly because the flow of funds was diverted from depository institutions to market securities. But the composition of M2 has changed materially since 1978; now, over 60 percent of its nontransaction component consists of assets bearing market-related yields. This helps to insulate the growth of M2 and its relationship to GNP from the effects of changing market interest rates. Consequently, even in the face of substantial interest rate variations, the velocity of M2 has changed relatively little over each of the last three years, in contrast to the swings that used to occur.
I do not by any means conclude that the recent instability of money demand requires a basic change in our procedures for implementing monetary policy. On the contrary, setting targets in advance for growth of money provides an important safeguard against the pitfalls that would be encountered in a policy focussed largely on interest rates. As history prior to October 6, 1979 amply demonstrates, focussing too much attention on interest rates in the conduct of monetary policy is apt to lead to a rate of monetary expansion that produces inflation. We have made substantial progress since the fourth quarter of 1979 in reducing the expansion of money and credit, and also in reducing the rate of inflation. The methods of monetary control employed since then have contributed to those developments.

There are, however, several implications for monetary targeting that can be drawn from the experience of recent years. First, short-run movements of the money stock have even less meaning than they once did as indicators of monetary policy. It is what happens to money growth over longer periods that counts. Second, monetary targets should be expressed in rather wide ranges; the present ranges of three percentage points are certainly not too wide. Third,
we need to continue to use multiple targets, rather than to focus on any single measure of money. Indeed, somewhat greater weight may need to be given to the broader monetary aggregates in the future as a consequence of the relative instability of the demand for M1. Finally, we need to stand ready to accept growth of money outside of our target ranges--or even to modify the ranges--if changes in the public's asset preferences warrant it.

What we cannot do, and what the Federal Reserve will not do, is to abandon its basic objective of gradually slowing the growth of money and credit in the interests of reducing inflation.

It is sometimes argued that our present monetary targets should be replaced by the monetary base. I do not believe that such a step would improve monetary policy. The base is a rather arbitrary combination of the various components of the monetary aggregates. Its largest component is currency whose magnitude has always been--and, I believe, always should be--determined by the public's demands for currency. The remaining portion of the base, reserves, is basically a weighted sum of the reservable deposit components of the monetary aggregates, with the
weights determined by their respective reserve ratios. When the significance of movements in the aggregates is uncertain, so also is the significance of changes in the monetary base. Furthermore, there is little reason to think that stability in the growth of the base will produce economic stability. Annual growth in the base actually was very stable over the 1970s, with yearly growth rates never deviating more than 1-1/4 percentage points from their decade average. Nevertheless, the 1970s was a period of considerable economic instability.

Finally, targeting on a broad credit aggregate—another suggestion sometimes offered—has some intellectual appeal for me. Unfortunately, the suggestion seems impractical. The data on credit flows become available with very substantial lags and are subject to large revisions.

Legislative Remedies

Let me turn now to legislative actions that would enhance the effectiveness of monetary policy. The greatest concern at this moment is the possibility that an increasing proportion of the financial assets used for transactions
purposes will, over time, be held in forms other than deposits, thus escaping Federal Reserve reserve requirements. Such a development, besides its implications for monetary control, would mean that a growing fraction of the nation's money stock would lack the protection of deposit insurance and be held at institutions beyond the scope of supervision and regulation of the traditional Federal financial regulatory authorities. If such shifts in asset preferences occurred suddenly, and on a wide scale, they might be accompanied by rather marked reductions in the supply of credit to borrowers heavily dependent on depository institutions as a source of funds--borrowers such as farmers, other small businesses, consumers, and home buyers.

I would therefore recommend that the Congress authorize the Federal Reserve to impose reserve requirements on money market fund shares and all other instruments to the extent that they serve as the functional equivalent of transaction balances, regardless of the issuer. Such legislation would keep intact the basic philosophy of the Monetary Control Act, which extended reserve requirements to transaction balances of all depository institutions. It would also provide a framework for fairer competition among financial intermediaries.
In implementing the Monetary Control Act, the Federal Reserve designated as a transaction account one that is accessible by check or debit card, or one that can be used with some frequency for third party transfers by other means, such as by telephone. The distinction between a transaction account and other accounts payable on demand inevitably is vague at the margin, and I believe the Federal Reserve should retain sufficiently flexible authority to put forward definitions to include the many new types of plans with transaction capabilities that are likely to be developed.

My expectation would be that money market funds would react to the imposition of such reserve requirements by segregating shares that can be used for transaction purposes from other accounts. Their customers would be offered a choice among types of funds, with the "transaction balance" account offering a somewhat lower yield. During the short period in 1980 when marginal reserve requirements were imposed on money market funds, fund managements amply demonstrated the feasibility and relative ease of "cloning" their funds to accommodate changes in the regulatory environment. Such an approach would not affect the returns available to individuals holding money market fund shares purely as a savings vehicle.
This step alone would not address fully the existing disparities of regulatory treatment among financial intermediaries. Given the prohibition of explicit interest payments on demand deposits, and the ceiling rates on time and savings deposits, deposit-taking institutions are unable to compete on an equal footing with intermediaries offering newer instruments. The depository institutions have long been the core of our financial system and many of their customers have no ready alternatives for the particular types of credit they extend. I do not think we can take lightly the erosion of their competitive position.

Ceilings on rates paid on time and savings deposits will be phased out under existing legislation over the next four years. I wish the process could take place faster, and that we could also remove the prohibition of interest on demand deposits. Great caution must be exercised, however, to ensure that the process of deregulation does not add unnecessarily to the burdens of thrift institutions, whose earnings are already under severe strain.
Financial innovation will no doubt continue at a rapid pace in the foreseeable future. We as regulators and legislators must ensure that the process of innovation is consistent with an effective monetary policy and equitable treatment of financial institutions.