

Research Department
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Managing the Public's Cash

Financial analysts are well aware of the many innovations made by corporations and individuals in cash-management techniques in recent years, but few have noted the equally impressive strides made by state and local governments in managing their \$250 billion in annual revenues. Yet given the magnitudes involved, government treasurers can add considerably to public revenues by wisely investing the cash balances that they have available in excess of operating needs. Moreover, their actions can have a far-reaching impact, influencing both the level of commercial-bank liabilities and the behavior of the monetary aggregates.

In this new environment, the pooled investment of excess public funds has become one of the favored techniques of government treasurers—a prime example being the State of California's Pooled Money Investment Account. That sophisticated operation has expanded rapidly over time, and this year began handling local as well as state government funds. An examination of the California Account should throw some light on the future trend of public cash management and its potential effect on banks and the public.

Operating a pooled fund

When established in 1956, the California Pooled Money Investment Account was limited to investing monies received by the State Treasurer in demand accounts at banks

that serve as state depositories. In 1967, its investment facilities were extended to special state funds, and in January of this year, local jurisdictions also were allowed to place their excess funds with the Account. Over the years, the scope of the Account also was broadened to include investment in a broad range of eligible securities.

Today, counties and other governmental units can receive a return on their otherwise idle funds which is computed on the average yield of the entire Account, and as an added attraction, can withdraw their funds on one day's notice. The Account also offers local treasurers a much wider investment range than they could obtain for themselves—similar to the range of options available to a major bank's money desk. The Account can purchase U.S. Treasury and Agency securities, negotiable CD's, collateralized time deposits, commercial paper, and bankers' acceptances—and can also make repurchase agreements on any eligible security. Reflecting these advantages, 260 local jurisdictions utilized the Account in the first six months of the new program, contributing \$1.2 billion to the Account's total resources of \$6.5 billion as of June 30, 1977.

Impact on deposits

California's pooled investment program has significantly affected the amount and volatility of deposits at commercial banks within the state.

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Over the last decade (fiscal 1966-76), State revenues increased from \$3.6 billion to \$10.2 billion, and available funds in the California Account jumped from \$729 million to \$3.6 billion—but the funds held in bank demand deposits by the Account were no higher (\$47 million) at the end than at the beginning of the period. Over the decade, then, the demand-deposit share of the Account's total available funds dropped from 6.5 percent to 1.3 percent. Further economizing of demand balances is now being achieved with the recent extension of pooled-investment facilities to local-government units.

These and other factors have also affected the amount and volatility of funds held in bank time deposits. Over the last decade, the share held in that form has dropped from 27 percent to 17 percent of the total, reflecting the broader variety of investment vehicles available to the Account's managers. Indeed, the trend may accelerate in the future, because under recent authorization, the Account is now beginning to place funds in time deposits of savings-and-loan associations, and also in negotiable CD's issued by banks outside California.

Cyclical interest-rate factors also affect the flow of funds in and out of bank time deposits, although not to the extent that might be expected, because the Account normally invests in large-denomination time certificates (\$100,000 and over), which are not subject to Regulation Q rate ceilings and are thus competitive with money-market instru-

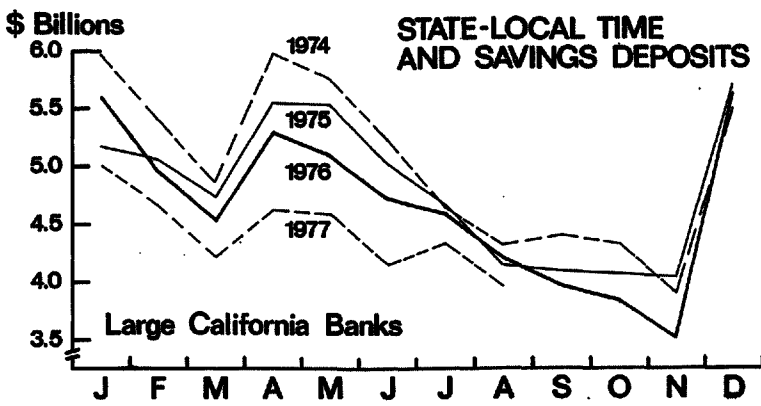
ments. Still, an increased volatility in time deposits has become evident over time with the increase in the number of alternative investment vehicles, reflecting shifts in the rate differential between time deposits and other instruments.

The normal seasonal pattern of time-deposit flows has continued this year, although at a lower level following the incorporation of local-government funds in the California Account. Typically, public time deposits run off in the first three months of the year, and then rise in April following the semi-annual property-tax date. That pattern was again evident in 1977, although the seasonal run-off was steeper, and the spring rise substantially smaller, than in other recent years.

Impact on bank policy

The California experience suggests that pooled investment programs can have a major impact on bank policies—especially the aggressive utilization of funds known as liability management. An efficiently operated investment fund minimizes resources allocated to non-earning demand balances. As a result, state-local demand balances may show little or no growth over time—no matter how substantial the increases in total public revenues or in the volume of money handled by pooled funds.

Pooled investment programs, with their increasingly wide array of investment alternatives, also imply greater volatility in public time deposits held at banks. The volatility is most evident when government



funds are held in time-deposit forms subject to Regulation Q ceilings, because those funds are likely to be withdrawn whenever rates on money-market instruments rise above the deposit rates banks can pay. Deposit flows of course would reverse whenever rates moved in the opposite direction, but at such times banks might find themselves incurring extra costs because of the relatively high above-market rates paid on deposits. Again, in view of the growing tendency for governments to put their funds in large negotiable CD's (not subject to Reg Q ceilings), banks may find themselves incurring heavy interest costs in order to compete for such funds.

Pooled investment does not represent a problem today, when banks have adequate sources of funds available in relation to loan demand. However, the increasing volatility of such funds could make it difficult for banks to carry out liability-management strategy in a period of strong loan demand. Banks can no longer be certain of offsetting private deposit outflows with inflows of public deposits during periods when income-tax and property-tax payments normally flow into government coffers.

Shifts among aggregates

More efficient cash management—whether by state and local governments or by corporations and individuals—leads to economy in demand balances and to other shifts of funds which affect the major monetary aggregates. Investment decisions by managers of pooled-investment funds thus influence trends in M₁ (currency plus

demand deposits), M₂ (M₁ plus bank time deposits except large CD's), and M₃ (M₂ plus thrift-institution deposits).

If fund managers shift demand-deposit balances into bank time and savings deposits, they reduce M₁ but leave M₂ unchanged. If they shift time-deposit funds out of banks into savings-and-loan associations, they reduce M₂ but leave M₃ unchanged. If they then shift those funds out of deposit institutions into money-market instruments, they reduce M₃, and so on. In the past few years, improvements in public (as well as private) cash management have in fact contributed to the faster growth of M₃ relative to M₂, as well as the faster growth of M₂ relative to M₁.

Increasingly efficient cash management is evident in the record of the California Pooled Money Investment Account. Interest income earned by the account climbed from \$30 million in fiscal 1966 to \$204 million in fiscal 1976, when interest-bearing investments made up all but one percent of the Account's total resources. In the next few years, as more local governments utilize the pooled-investment fund, the Account's earnings should rise significantly. Indeed, the public should benefit from this improved cash management by state and local governments. With the maximization of resources allocated to interest-bearing investments, tax rates needed to meet any given level of expenditure will be reduced.

Ruth Wilson

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 10/5/77	Change from 9/28/77	Change from year ago	
			Dollar	Percent
Loans (gross, adjusted) and investments*	101,397	+ 534	+ 8,045	+ 8.62
Loans (gross, adjusted)—total	79,003	+ 705	+ 7,254	+ 10.11
Security loans	2,433	+ 763	- 2,133	- 46.71
Commercial and industrial	23,960	- 102	+ 1,476	+ 6.56
Real estate	25,824	- 95	+ 5,039	+ 24.24
Consumer instalment	13,669	+ 86	+ 1,891	+ 16.06
U.S. Treasury securities	8,126	- 170	- 732	- 8.26
Other securities	14,268	- 1	+ 1,523	+ 11.95
Deposits (less cash items)—total*	100,265	+ 851	+ 9,028	+ 9.90
Demand deposits (adjusted)	28,939	+ 1,213	+ 2,665	+ 10.14
U.S. Government deposits	455	- 504	- 14	- 2.99
Time deposits—total*	68,773	- 373	+ 6,288	+ 10.06
States and political subdivisions	5,278	- 2	+ 97	+ 1.87
Savings deposits	31,914	+ 29	+ 3,995	+ 14.31
Other time deposits‡	29,231	- 367	+ 2,245	+ 8.32
Large negotiable CD's	11,576	- 354	+ 468	+ 4.21
Weekly Averages of Daily Figures	Week ended 10/5/77	Week ended 9/28/77	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves (+)/Deficiency (-)	+ 97	+ 49	+ 65	
Borrowings	38	28	0	
Net free(+)/Net borrowed (-)	+ 59	+ 21	+ 65	
Federal Funds—Seven Large Banks				
Interbank Federal fund transactions				
Net purchases (+)/Net sales (-)	- 590	- 883	- 290	
Transactions with U.S. security dealers				
Net loans (+)/Net borrowings (-)	+ 171	+ 274	+ 752	

*Includes items not shown separately. †Individuals, partnerships and corporations.

Editorial comments may be addressed to the editor (William Burke) or to the author. . . .
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