

Research Department
Federal Reserve
Bank of
San Francisco

June 30, 1978

Liquidating California's Surplus

Howard Jarvis, the major architect of the initiative which won a 2-1 majority in California's June election, visited Washington last week to spread the tax-reduction gospel through the halls of Congress. Meanwhile, back in Sacramento, the California legislature rapidly developed a plan to allocate \$5 billion — most of the state's surplus — to compensate local governments for much of the \$7 billion they will lose in property taxes because of the initiative. Public officials understandably have been intensely interested in the criteria to be used in distributing the surplus funds. For economists, however, the more interesting question concerns the impact on financial markets as the surplus monies shift out of investment funds and into county and city expenditure streams.

Banks, thrift institutions, and money markets generally will be affected as the state's \$5 billion surplus is liquidated. But fortunately, because of the manner in which the state's surplus funds are invested, there should be no *abrupt* loss of time deposits at banks and thrift institutions. In the money market, short-term upward pressures on interest rates might develop as the state reduces its invested savings. While some of these effects may be offset through higher private-sector savings, in the form either of time deposits or money-market instruments, this may not be a "wash." The reason is that the public and private sectors differ regarding their rate of savings, composition of savings, and timing of savings decisions.

Where is the surplus?

California's surplus funds — whether from the state's general-revenues or from Federal revenue-sharing funds — are invested through the state's Pooled Money Investment Account. This Account includes temporarily idle funds from the state, state agencies, counties, and other local government units that elect to use this investment facility. Each entity shares in the interest earnings of the entire Pooled Account, based on the ratio of its dollar contribution to the Account's total dollar investments.

In early June the Pooled Investment Money Account held about \$8.7 billion in invested funds. About \$1.1 billion — 13 percent — was in time deposits at commercial banks and savings-and-loan associations. The remainder was invested in a variety of short-term money-market instruments — including U.S. Treasury and Agency obligations, bankers acceptances, commercial paper, repurchase agreements and (uncollateralized) large negotiable CDs.

The state of course will not turn over \$5 billion at the beginning of the fiscal year to various local units. Probably only the surplus funds *loaned* to local governments — perhaps \$900 million — would be made immediately available to carry local-government units over their seasonal "low" point in revenue receipts. Normally, these units would rely on short-term borrowing through warrants and tax-anticipation notes, but this year that avenue will be restricted because of

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their reduced property-tax revenues. Presumably, the remainder of the state's surplus could be liquidated in an orderly manner over the fiscal year to meet on-going needs of counties, cities and other units.

Impact on banks and S&L's

Any abrupt withdrawal of state deposits from banks and S&L's could severely affect the state's economy. The resources of these depository institutions are currently strained by heavy mortgage demand and diminished savings inflows, and a further reduction in funds available for mortgage lending would tend to reduce new-home construction. The adverse effect would be greatest on S&L's, which currently hold about 75 percent of the Account's total time deposits. The S&L share was less than 10 percent a year-ago, but it then rose sharply after the Account received permission to use mortgages as collateral for state deposits.

Fortunately for these depository institutions, the Account recently received authority to invest in longer-term deposit maturities, and thus has significantly lengthened the average maturity of its time deposits to about 20 months. Since Federal regulations impose substantial interest-rate penalties for time-deposit withdrawals prior to maturity, the Account probably will hold most of its deposits to maturity.

However, S&L's and banks will not be able to count on a roll-over of the Account's maturing certificates. (This

could create problems for individual institutions if large amounts of deposits mature at a given point in time.) In addition, these institutions cannot look forward to new deposits from continued state surpluses. They also face a reduced volume of time deposits of local government units, as reduced property revenues limit the amount of temporarily idle funds which would customarily have been invested in time deposits. These local units may place some of the funds received from the state in time deposits, but because of their tight financial situation, probably not to the same extent as before.

Filling the gap

To fill the gap left by reduced state and local deposits, banks and S&L's will have to seek alternative sources of funds. Corporations may invest some of their net savings from the lower property-tax payments in bank time CD's, but some of these savings may go into other money-market instruments or be used for increased inventory or capital-goods spending.

Similarly, individuals could become a source of increased savings funds for banks and S&L's. In the short run, however, consumer savings behavior is not always predictable — especially so in this case, because households will face higher income-tax payments and fees of various types before reductions show up in their December 1978 and April 1979 property-tax bills. Again, they may elect to spend their net savings rather than increase their savings

accounts, or to invest in other instruments. In the near term, those state-local employees who become unemployed because of budget cut-backs will begin withdrawing rather than adding to savings. But property owners generally will show a rise in income because of lower property taxes, and presumably over time will boost their savings as a result.

The savings rate of the public sector (state and local governments) differs from that of the private sector (corporations and individuals), and the two sectors differ in the composition of savings investment and in the timing of savings decisions. In the short term, depository institutions may find alternative sources of funds more costly and difficult to obtain, bringing upward pressure on loan rates. If, over the long-term, the sharp tax reduction stimulates a rise in economic activity, this should generate a higher volume of private-sector savings available for investment in deposits. Over time, state and local governments also should make the necessary adjustments between their expenditures and revenues, and be able to reestablish a more traditional cash-management position.

Impact on the markets

The maturities of securities held in the Pooled Money Investment Account range from one day to one year, but generally are below six months. Therefore, the Account probably will run-off its very short-term repurchase agreements (RP's) and other money-

market instruments to meet the immediate demand for \$900 million in loans to local-government units. Since the Account normally would reinvest a substantial proportion of maturing funds, this massive transfer of funds could cause temporary rate pressures on some of these money-market instruments.

Over the fiscal year, the Account's investment activities will decline as it channels state surplus funds to local governments. This disinvestment may be large enough to affect some money-market instruments, such as bankers acceptances, that the Account customarily holds in its investment portfolio. The Account also may enter fewer repurchase agreements with banks and selected dealers. This could affect banks' own liability-management practices, since they use RP's with the Account to help smooth the effect of seasonal deposit shifts between the private and public sector. But again, over the long run, any reduction in the public sector's money-market holdings should be offset by increased private-sector savings.

In the past, depository institutions and financial markets have displayed remarkable resiliency in adjusting to shifts in financial flows of funds. Similar adjustments can be expected over time to the changes dictated by Jarvis-Gann. And with the nationwide spread of the crusade for tax reductions, the California experience will have national financial implications as well.

Ruth Wilson

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities	Amount Outstanding 6/14/78	Change from 6/7/78	Change from year ago	
			Dollars	Percent
Large Commercial Banks				
Loans (gross, adjusted) and investments*	113,726	+ 462	+ 14,915	+ 15.09
Loans (gross, adjusted)—total	91,434	+ 656	+ 16,189	+ 21.52
Security loans	3,110	+ 296	+ 863	+ 38.41
Commercial and industrial	27,608	+ 118	+ 3,985	+ 16.87
Real estate	30,336	+ 199	+ 6,370	+ 26.58
Consumer instalment	16,036	+ 90	+ 3,289	+ 25.80
U.S. Treasury securities	8,179	- 54	- 1,864	- 18.56
Other securities	14,113	- 140	+ 590	+ 4.36
Deposits (less cash items)—total*	111,094	+ 363	+ 13,470	+ 13.80
Demand deposits (adjusted)	30,540	+ 0	+ 2,420	+ 8.61
U.S. Government deposits	412	+ 144	- 574	- 58.21
Time deposits—total*	78,163	+ 92	+ 11,165	+ 16.66
States and political subdivisions	6,723	- 239	+ 1,126	+ 20.12
Savings deposits	31,483	- 134	- 151	- 0.48
Other time deposits‡	36,753	+ 364	+ 9,137	+ 33.09
Large negotiable CD's	18,323	+ 229	+ 7,452	+ 68.55
Weekly Averages of Daily Figures	Week ended 6/14/78	Week ended 6/7/78	Comparable year-ago period.	
Member Bank Reserve Position				
Excess Reserves(+)/Deficiency (-)	- 20	+ 19	- 29	
Borrowings	30	37	32	
Net free(+)/Net borrowed (-)	- 50	- 18	- 61	
Federal Funds—Seven Large Banks				
Interbank Federal fund transactions				
Net purchases (+)/Net sales(-)	+ 159	+ 678	+ 733	
Transactions with U.S. security dealers				
Net loans (+)/Net borrowings (-)	+ 226	+ 565	+ 689	

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

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