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Statement by

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I appreciate the opportunity to appear before you to give the Federal Reserve Board's views concerning the role of money market funds in our nation's financial structure and the question of what, if any, additional regulatory action is called for. Money market mutual funds have increased by over $100 billion since the end of 1978, obviously becoming a significant competitive force and institutional presence in financial markets. Their rapid growth over this period reflects a particular constellation of market forces -- especially the high level of short-term interest rates, relative both to past experience and longer-term interest rates, and the regulatory framework applicable to established depository institutions. Whether money market mutual funds would remain so strong a competitive force in a different market environment is not clear, but as matters now stand it is evident that the rapid growth of these funds is having strong implications for the competitive positions of financial institutions, the cost and availability of credit to certain borrowers, and the implementation of monetary policy.

As important as they have become, the expansion of money market funds can be seen as part of broader developments in U.S. financial markets in recent years. Against the background of inflation and interest rate pressures and uncertainties, there has been a progressive shortening in the effective maturity of financial assets, in part through much greater use of floating interest rate arrangements, and greater sensitivity to interest rate differentials in the shifting of investor funds among various savings outlets. Given the regulatory and economic constraints on long-established savings and payments instruments, the search for yield and liquidity has increasingly led to the issue of close substitutes for traditional deposit instruments. The resultant blurring of the distinctions between what has traditionally been considered money and these close substitutes could result in potentially serious complications for the conduct of monetary policy -- particularly for a policy approach focusing on the monetary aggregates. Considerations of equity and fair treatment among institutions offering comparable services arise as well. In a broader sense, I am also concerned about the structural implications for the financial system of more and more short-term liabilities subject to rapid shifting among institutions.

Clearly, there has been erosion of the distinctions between services offered by depository and other financial institutions. This erosion undoubtedly reduces the impact, from the standpoint of the economy as a whole, of many bank and thrift institutions regulations, and raises questions concerning their continued rationale. Among the regulations in question are those governing the geographical expansion of banks and thrifts, the range of services they can offer, and restrictions on their assets and liabilities. Alternatively, to the extent such regulations clearly remain important in the public interest, we are forced to consider whether their application needs to be extended to newer institutions.

I will be touching upon a number of these issues this morning in the course of suggesting a logical framework for the regulatory treatment of money market funds, but you will recognize that many of the issues extend well beyond the scope of my testimony today. Even so, actions taken to affect money market funds must be formulated with this broader background in mind.

Background

The growth of money market funds and other newer short-term financial assets has been fostered by the economic, interest rate, and regulatory environment of the late 1970s and early 1980s. Our economy has suffered from rising inflation over a period of many years; as borrowers and lenders have adapted to the more rapid pace of price increases, interest rates have risen. The higher rates of inflation and interest have increased the penalty for holding demand deposits or other assets whose yields are constrained, whether directly by regulation, by other regulatory burdens, or by the inability of some institutions to pay higher rates because they are locked into older lower-yielding assets. The increase in rates has been more pronounced for shorter-term assets than for longer-term ones, leaving short-term yields above those that can be earned on longer-term assets -- the opposite of the relationship usually prevailing since the 1930s -- so that new institutions dealing in short-dated instruments on both sides of the balance sheet have had an advantage. The public's desire to hold highly liquid short-term assets also appears to have been boosted by a heightened sense of uncertainty about the future course of the economy and financial markets. This uncertainty is fundamentally related to the strength and persistence of inflation and its consequences for economic and financial activity. High and volatile interest rates have been one reflection of these uncertainties. With less confidence among borrowers, lenders and intermediaries about their ability to predict the future level of interest rates, there is a tendency to minimize individual risks by avoiding long-term credit agreements, or by utilizing floating rate arrangements. However, it is an open question, to say the least, whether the individual "self-protective" tendencies, which only serve to re-distribute risks, contribute to the broader stability and solidity of the financial and economic system as a whole.

Due to regulatory and economic constraints, traditional deposit instruments have not satisfied the public's demand for high-yielding liquid assets. From a regulatory perspective, the institutions have been limited by interest rate ceilings on deposits and, to a lesser extent, by the requirement to hold nonearning reserves at the Federal Reserve, and other rules. Many institutions are also limited in their capability to pay market interest rates on all their deposits because they hold longer-term fixed-rate assets acquired earlier when inflation and interest rates were lower.

Money market funds are not responsible for the inability of many depository institutions to meet the current preferences of investors, but they have benefitted from this condition. Money market funds offer a high yielding asset that also is highly liquid, in that it can be redeemed quickly by a variety of methods without the penalties associated with early withdrawal of time deposits and with only a small risk of declines in the market value of the investment.

The funds have attracted a diverse group of shareholders. For many institutional investors -- such as bank trust departments -- the appeal of money market funds derives from the asset diversification and professional management the funds offer at low cost. For these investors, the funds primarily provide an alternative to direct purchases of money market instruments. For households and small businesses, on the other hand, the low minimum purchase requirements of the funds allow access to money market yields by investors who otherwise would find their short-term options quite circumscribed. A significant portion of the flows into money market funds from these sectors has been diverted from depository institutions.

Funds moving into money market funds are simply recycled into purchases of money market assets, both domestically and internationally. Since most of these assets are issued by banks or their large business customers, the growth of the funds does not appear to have added to liquidity pressures on depositories as a whole. But money market funds do tend to concentrate their investments with the larger banks and corporations. To the extent that money market funds are diverting deposits from smaller banks and thrift institutions, the effect is in the first instance to channel funds away from the borrowers and geographic areas more dependent on these institutions. While market incentives will tend to redistribute the funds to the point of demand, at least for a time the distribution of credit is affected.

The tendency for money funds to divert resources from smaller banks and thrifts remains of concern to the Federal Reserve. The Board appreciates the industry efforts that have been made to broaden the number of banking and thrift institutions from which the money funds will purchase negotiable CD's. We also understand that those efforts have been impeded by a variety of problems involved with soliciting, packaging and placing CD issues from a large number of relatively small institutions that have not ordinarily raised funds in money markets. Private initiatives to overcome these problems should be encouraged.

Thus far, the evidence suggests that a greater proportion of money market fund shares, taken as a whole, seem to substitute for time or savings deposits -- as well as purchases of short-term securities -- than for transaction balances. Despite their easy redeemability, available aggregate data indicate that money fund shares on the average turn over only about three times each year -- roughly comparable to savings accounts -- and that only a few checks are drawn on the "average" account each year. However, these averages undoubtedly mask a significant amount of transaction activity. Moreover, there are indications that such activity may become more important. For one, several brokerage houses apparently are contemplating offering combined margin and money market fund accounts with checking account capabilities. If they are similar to accounts of this type currently available, they will have no minimum denomination for checks and will be accessible by a credit card, greatly increasing the opportunity for them to be used extensively for transactions purposes. The use of money fund balances for transactions would be further encouraged if the discussions now underway to link credit cards and money market funds outside the context of margin accounts come to fruition. Moreover, even the relatively infrequent use of large checks against a money market fund can enable a customer to reduce his balance in a traditional checking account by bunching his "small" checks on that account after a transfer from a money market fund.

Competitive Considerations

Because they have been able to restructure their assets, many traditional intermediaries are prepared to compete for savers' dollars, but are prevented from doing so by regulations, such as interest rate ceilings and reserve requirements, that directly affect rates of return they can pay the public. Some aspects of the operations of money market funds are closely regulated by the Securities and Exchange Commission, but the impact of these rules on the yields that the funds can offer to shareholders is small compared to those limiting banks and thrifts. The resulting disparity raises serious questions about the ability of the deposit-taking institutions to compete on an equal footing with intermediaries offering newer instruments.

I don't think we can take lightly the erosion of the competitive position of our banks and thrifts or of regulatory coverage. These institutions have long been at the core of our financial system and have many customers,especially for the particular types of credit they extend, for whom there are no easy alternatives. Moreover, the regulations circumscribing their actions were not conceived arbitrarily. Reserve requirements, for instance, are a key part of the apparatus for the conduct of monetary policy, and presumably will be maintained permanently. Other regulations, particularly those governing interest rates, may now be seen to be no longer necessary, desirable, or effective over time; many of these are in the process of being phased out. We are in the midst of a difficult transition period in that respect, but we should not lose sight of the desirability of equalizing competitive conditions by removing regulatory burdens in instances when that corresponds with sound long-range policy.

Monetary Policy Considerations

In recent years there has been a deepening recognition of the importance of controlling monetary growth. This widely accepted approach toward monetary policy depends, of course, both on our ability to define and measure the growth of "money" and on our ability to effectively control that growth over reasonable periods of time. The difficulties of defining and controlling money are greater to the extent institutional change is rapid and new forms of "money" become larger relative to the traditionally defined monetary aggregates. It is for those reasons that the rapid growth of the money market funds, or similar developments that blur distinctions between transaction and nontransaction accounts, become potentially significant for monetary policy.

These considerations are not new; concerns of this kind lay behind the enactment of the Monetary Control Act last year, when reserve requirements were extended to transactions balances of all depository institutions and the definition of transactions balances was to some extent clarified. At that time, the decision was made to stop short of money market funds in the coverage of reserve requirements. Such funds have doubled since that time, growing from $60 billion to $120 billion.

I would not suggest that the effectiveness of monetary control has been crucially affected so far. We have, however, had to make increasingly difficult judgments about the implications of this growth for the defined monetary aggregates. The prospect for continued rapid growth of money market fund shares, particularly should their significance as transaction balances rise, as seems likely, makes the issue much more pointed. There is a clear logical case for closing a gap in a monetary control system built on the premise that reserves should be assessed against transaction balances wherever they might be held. Given recent and prospective developments, the point has strong practical, as well as logical, significance. If we are unwilling to cope with the problems raised by the growth of these instruments, we have to recognize and be prepared to live with the consequences for the meaning and control of particular monetary aggregates.

Competitive and equity considerations point in the same direction. We should not be surprised that money market fund assets rise relatively rapidly when those funds do not bear regulatory costs associated with similar instruments in depository institutions.

Possible Responses

Faced with these concerns, lawmakers and regulators have a number of possible responses open to them. One conceivable course is to do nothing at all -- to let the market take its course within the current structure of regulation and control -- recognizing that some important regulations, those affecting interest rates on consumer deposits, are in any event being phased out. Indeed, it can be pointed out that the competitive pressures of money market funds and other innovations help assure rapid phaseout of interest rate ceilings, which would offer the consumer maximum advantage.

But there are also compelling disabilities to that approach. Reserve requirements, which from the viewpoint of a depository institution are analogous to a tax on transaction account business, are a permanent part of the regulatory apparatus. In that sense, money market mutual funds have an artificial and continuing competitive advantage, so long as interest is not paid on reserve balances. Other things equal, money funds would continue to expand more rapidly and their greater use as transaction accounts would be induced. Traditional intermediaries would continue at a "permanent" disadvantage in attracting some types of deposits, and small businesses and other borrowers dependent on thrifts and non-money center banks for credit extensions might find funds more expensive, or less available, than otherwise. The increasing use of money market funds for transaction purposes would make interpretation of incoming monetary data even more difficult, and the Federal Reserve's control over a true transactions aggregate would erode.

At another extreme would be the imposition of stringent controls and regulations on the newer instruments -- placing the same regulatory constraints on them as now prevent banks and thrifts from responding fully to investors' desires. For money market funds, this might entail subjecting them to interest rate ceilings, putting all their shares under reserve requirements, or restricting their investments. Implementing this approach could make the money funds so unattractive that shareholders would abandon them in favor of a return to direct investment in money market instruments and deposits at banks and thrifts. The resources available to depository institutions would be greater, although their profitability might not be benefitted significantly since much of the additional growth in deposits undoubtedly would be concentrated in those tied to market rates. Any such inflow would be circumscribed by the strong continuing incentive to find other methods to avoid the effects of regulations. Considering the ingenuity of markets, we can be quite confident that it would not be too long before this Subcommittee would once again be holding hearings to discuss extending regulations to new intermediaries or instruments. Moreover, this approach would significantly penalize some savers -- reducing the returns available to them and the variety of instruments they can invest in -- at a time when concern is widespread about the inadequacy of savings flows in the economy. The effect of these actions on the aggregate level of savings would not likely be large, but the direction would be clear, and could be interpreted as signalling a lack of concern about factors tending to discourage savings.

A third possible approach might be to provide for a greater degree of competitive equity among institutions by reducing regulation of banks and thrifts. With respect to interest rate ceilings on time and savings deposits, such a course already has been legislated to occur over the next few years. Removal of these ceilings will greatly enhance the ability of depository institutions to compete with money market funds and other innovative savings instruments. The speed with which the deregulation can be accomplished has been constrained by the earnings positions of many institutions -- that is, their holdings of low-yielding, longer-term assets will preclude their soon being able to pay current market rates for a much larger share of their liabilities. That constraint will become less binding over time as existing assets mature, and the DIDC has some leeway for permitting more competitive instruments. The Committee has before it several suggestions regarding the overall strategy of deregulation at its meeting this afternoon. The reality is that the condition of the thrift industry limits the possible rapidity of prudent change, but great progress can be made in this direction over time.

We also must recognize that, even after interest rate ceilings are liberalized, banks and thrifts still will be subject to important regulations that put them at a competitive disadvantage relative to money market funds. Two of the most significant of these are the prohibition of interest payments on demand deposits, which will still affect business customers, and the holding of noninterest earning reserves against transaction and nonpersonal time deposits. If full competitive equity is to be sought by removing restraints from banks and thrifts, Congress would have to allow market forces to determine returns on demand as well as time and savings deposits. Reserve requirements, on the other hand, must be left in place to facilitate Federal Reserve control of the money stock. The constraint of holding sterile reserves on the ability of banks and thrifts to compete for funds would have to be eliminated by Congressional sanction for the Federal Reserve to pay market rates of interest on required reserves.

If all these actions were taken, banks and thrift institutions would be in a far better situation to meet competition. Newer instruments, such as money market funds, would not lose their appeal entirely, but the potential for massive shifts into these funds, causing their explosive growth and attendant difficulties in defining and controlling the money supply would be greatly reduced. However, I must doubt that such changes are practically feasible over a relevant time period. Moreover, we would still face a transition period of some years.

Recommended Approach

The approach I am proposing is designed to provide a framework for fair competition between money market funds and established depository institutions over time, to protect against erosion in our ability to measure and control the money stock, and to maintain attractive incentives for savings. The proposal does not undermine the legitimate competitive role of money market funds, nor should it be viewed as "the answer" to the immediate pressures on thrift institutions.

Specifically, the logic of the situation points to legislation authorizing the Federal Reserve to impose reserve requirements on those money market fund shares that in fact serve as the functional equivalent of transaction balances, and to enforce a cleaner distinction between transaction balances and other liquid savings. In other words, we are requesting that the basic premise of the Monetary Control Act be kept intact by extending its reserve requirement provisions to encompass those money market mutual fund shares that provide the function of transaction balances.

In our implementation of the Monetary Control Act we have designated a transaction account as 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 is inevitably difficult 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 transactions capability that are likely to be developed. For example, this might include plans that involve an integral coupling of a credit card and a money market fund or other account, even if the money fund is accessed only once each month to pay accumulated charges.

Our expectation would be that money market funds would react to the imposition of such reserve requirements on shares that can be used for transaction purposes by segregating such accounts, subject to reserves, from accounts without "checking" privileges. 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 last year 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.

Regulatory incentives to separate accounts with transaction capabilities from those providing a convenient and relatively liquid outlet for savings would have several beneficial consequences. It would provide more positive identification of the transaction component of money market fund shares for statistical and analytical purposes. Specifically, the "M_1" definition of money would be cleaner. Monetary control would not be complicated by movements among different types of transaction accounts. As a matter of equity, one important artificial incentive favoring the use of money market funds over traditional depository institutions would be removed. These objectives are all fully consistent with the philosophic framework of the Monetary Control Act.

The approach proposed would in no way impair the returns available to individuals looking to money market mutual funds as an attractive savings vehicle; such "non-transaction" accounts would not be subject to reserve requirements. The fact is, even for those for whom the transaction characteristics are important, yields on transaction-oriented money market funds in current circumstances would still exceed those available at such accounts at other institutions. There is no reason to believe that an approach along the lines of our proposal would lead to substantial shifts in the current distribution of funds among depository institutions and money market funds, although one perverse regulatory incentive to the use of these funds as transaction balances would be removed. In time, as interest rate ceilings are phased out, and as the constellation of interest rates change, the relative advantages and disadvantages of money market funds vis-a-vis depository institutions would reflect market competition. Meanwhile, individuals and businesses would be left with a full range of choices.

The implementation of our proposal -- straightforward and simple in concept -- would require the resolution of some difficult definitional and other issues. Transaction accounts, as applied to money funds, would need to be precisely defined. More broadly, given the rapid pace of innovation in our financial system and the blurring distinctions between institutions, we should recognize other types of institutions may also come to issue transaction-type accounts, particularly if the traditional institutions remain shackeled by regulatory restraints and no interest is paid on reserve balances. Our proposal is confined to money market funds, where growth and competitive disparities are so evident at present. We recognize that other new developments would eventually raise sensitive questions of monetary control and competitive equity. That possibility will be reduced to the extent unnecessary constraints are removed from existing institutions, but we will, in any event, need to keep these developments under review.

Similar treatment of money market fund shares and deposits for reserve requirement purposes may raise the question of whether money market funds might have access to Federal Reserve services and to Federal insurance on share accounts. We do not believe that is either necessary or desirable. Reserve requirements are a part of the apparatus of monetary control and, in one significant respect, would "level the playing field" in competition for transactions business. However, those reserve requirements would not otherwise impinge upon the characteristics of the funds or upon their investment portfolios. Banks and thrifts will be facing regulatory ceilings on time and savings deposit rates for some time, and on demand deposit rates for the foreseeable future. Their asset acquisitions and other operations must conform to a host of other regulations, including, for instance, the Community Reinvestment Act. In other words, in important respects depository institutions and money funds are, and will remain, very different institutions; comparable treatment with respect to reserve requirements does not, in our judgment, require the same treatment in all respects; indeed, extending Federal Reserve services and Federal insurance privileges to the funds would seem to imply that we also take the further step of invoking the whole panoply of banking-type controls, a step that would seem clearly unnecessary and undesirable.

Although our proposal speaks to some of the concerns generated by the growth of money market mutual funds, we recognize that it does not come fully to grips with a number of the issues raised by the broader trends I discussed earlier in my testimony. For example, it does not address the questions of limits on bank services and geographical location. In addition, it does nothing to stem the movement toward shorter-term assets and liabilities and deals only partially with the resulting problem of differentiating transaction and nontransaction balances. Although it would treat those balances directly accessible by transaction instruments as transaction balances, it does little to distinguish such balances from very liquid short-term assets that are nearly equivalent to transactions balances because they can be converted almost instantly with little or no capital risk. Examples of such balances might include overnight repurchase agreements, savings accounts, and any varieties of money market fund shares that might arise without transactions privileges but were nonetheless immediately redeemable.

The growth of these close substitutes for transactions balances has implications for the conduct of monetary policy since shifts between actual transaction balances and these near-transaction balances can change the relationship between the monetary target and spending patterns. At the same time, excessive reliance on what are in effect demand obligations by financial institutions may be an element of weakness in the financial structure.

One approach to creating a more definitive line between transaction and nontransaction accounts would be to encourage a practice that intermediary claims not subject to transaction reserve requirements, significant price risk, or early-withdrawal penalties have either a fixed or minimum maturity or a notice requirement -- that is, some minimum mandatory waiting period between a request for redemption and the receipt of funds, perhaps of a few days. Such a requirement would force savers to decide which funds they might want to have immediately available to make purchases, and which they were putting away for longer periods. That approach -- with the exception of savings deposits, where payment on demand has long been the custom -- has traditionally been embedded in banking practice and regulation. Market and competitive pressures, however, seem to be working in the other direction. In my judgment, sound legislative and regulatory practice would encourage either notice or maturity requirements on non-transaction accounts, including any new short-term accounts authorized for established institutions, and a similar approach would be relevant for money market fund shares.

Concluding Comments

I am struck, and in many respects encouraged, by the ability of our economic system to generate new ideas and products to meet emerging needs. "New" is not, however, always synonomous with constructive. When the motive of change is simply to escape from outmoded and unnecessary regulation, the regulation should be changed; when the regulatory principle is sound, evasion should be prevented.

Recent changes have in major part been stimulated by the strong incentives growing out of high and variable interest rates. Those incentives should recede, as we are successful in coping with inflation, but it may take some time for rates to decline and a more stable economic environment to emerge. Moreover, advances in technology, greater freedom for international flows of funds, and the new packages of financial services facilitated by combinations of firms in different sectors of the financial markets are likely to give rise to further rapid developments in instruments and techniques whatever the course of inflation, the economy, and interest rates. That they will do so is testimony to the vitality of our free market system, and to the wisdom of allowing wide latitude for this system to operate.

As lawmakers and regulators, it is our responsibility to see to it that this process of innovation does not impair the requirements of monetary policy formulation and implementation, or the necessity to protect the safety and soundness of the financial system and the public's confidence in it. The proposals I have reviewed today should be viewed in that light -- not as a futile effort to turn back the clock, to discourage change, or to stifle a new institution, but rather to provide a framework within which change can be consistent with the continuing needs of public policy.

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