Economic SYNOPSES
short essays and reports on the economic issues of the day
2008 ■ Number 15

Monetary Policy's *Third* Interest Rate

Richard G. Anderson

The federal funds rate and the discount rate are familiar monetary policy terms. Textbooks typically describe Federal Reserve monetary policy in terms of setting a policy target for the federal funds rate, often guided by a Taylor rule–style equation. Texts also discuss the discount rate, the rate of interest charged to banks and other depository institutions on loans they receive at the Fed's discount window. Today, the Fed offers three discount programs: primary credit, secondary credit, and seasonal credit, each with its own interest, or discount, rate.

The implementation of monetary policy in developed economies, in addition to a policy target rate and one or more discount rates, features a third, less-discussed interest rate—the "remuneration rate," which is the rate of interest the central bank pays on the deposits that banks hold at the central bank.[1] This interest rate, through its interaction with the policy target rate and the primary credit, or discount, rate charged on borrowings from the central bank, is important in the implementation of monetary policy. The interaction among the three interest rates results from an unusual aspect of central banking: Central banks can simultaneously affect (and sometimes closely control) the supply of and demand for deposits at the central bank. The monetary role of deposits held at the central bank is to settle interbank claims arising from the exchange of goods, services, and real and financial assets. The overnight interest rate on such deposits is an important element of monetary policy.

In the past, central banks imposed statutory reserve requirements to increase the stability and predictability of demand for deposits at the central bank. Today, many central banks do not impose such requirements; when they are imposed, the rates are modest. The European Central Bank, for example, imposes a 2 percent requirement. The Federal Reserve imposes a graduated set of requirements, depending on a bank's deposits. In the United States, however, retail deposit sweep programs have allowed many banks to reorganize their balance sheet so they are unaffected by statutory requirements.[2] The demise of statutory reserve requirements was brought about largely by two factors. First, statutory requirements place affected banks at a competitive disadvantage. This was a minor issue when regulation limited the scope of competition among financial institutions, as the requirements' cost tended to be offset by the economic rent created by regulation. Second, statutory reserve requirement systems tend to be expensive to administer; they require collection of large amounts of data and careful monitoring of the eligible assets that banks hold.

The remuneration rate provides an alternative tool for a central bank to manage the demand for deposits held by banks at the central bank. The experience of non-U.S. central banks suggests two things: (i) a relatively high elasticity of demand for such deposits with respect to the gap between the remuneration rate and the target policy rate; and (ii) the potential for a small (or zero) gap to increase the smooth operation of a nation's payment system. Deposits doubled at the Reserve Bank of New Zealand when it reduced the gap to near zero. As a benefit, its payment system operated more smoothly: The larger quantities of deposits at the Reserve Bank eased timing mismatches of payments among banks. In addition, day-to-day variation in overnight interest rates decreased. For many central banks, minimizing daily variation in overnight rates increases the predictability of the cost of payment-settlement funds and is an important ingredient in a smoothly functioning payment system.

The Federal Reserve currently is prohibited by law from paying explicit interest on deposits held at the Federal Reserve, a prohibition that will end in 2011. The *Wall Street Journal* reported on May 7, 2008, that the Board of Governors recently initiated discussions with Congress to end the prohibition sooner, perhaps by year-end. Today, approximately 60 percent of these deposits are not remunerated, and 40 percent are remunerated at a rate somewhat less than the federal funds rate. These latter deposits are ones that banks have voluntarily agreed to maintain at the Federal Reserve, in excess of any necessary to meet statutory reserve requirements, to facilitate payments. Remuneration is paid in "earnings credits," which may be used to defray the cost of financial services purchased from the Federal Reserve. These credits expire one year after issue and may not be converted into cash. A more flexible remuneration environment likely would provide the Federal Reserve a new, more flexible policy-implementation tool similar to those of many other central banks. ■

[1] Two excellent papers surveying these aspects of monetary policy are by Claudio Borio: "A Hundred Ways to Skin a Cat: Comparing Monetary Policy Operating Procedures in the United States, Japan and the euro area," BIS Papers 9, December 2001; and "The Implementation of Monetary Policy in Industrial Countries: A Survey," BIS Economic Papers No. 47, August 1997.

[2] Richard. G. Anderson and Robert. H. Rasche, "Retail Sweep Programs and Bank Reserves, 1994-1999," Federal Reserve Bank of St Louis *Review*, January/February 2001, *83*(1), pp. 51-72.