Testimony of Robert D. Auerbach Before the Subcommittee on Financial Institutions and Consumer Credit, The House of Representatives Committee on Financial Services Hearings on H.R. 758, the Business Checking Freedom Act, and H.R. 859, the Business Checking Freedom Act, March 5, 2003 [1]

Mr Chairman and members of the Subcommittee on Financial Institutions and Consumer Credit, I am very honored to present my views on H.R. 758, the Business Checking Freedom Act, and H.R. 859, the Business Checking Freedom Act.

I support the removal of the prohibition against paying interest on demand deposits as authorized in H.R. 859. That needed improvement was attempted in 1980 when I assisted House Banking Chairman Henry Reuss in developing the Monetary Control Act (MCA) of 1980. It failed to gain the necessary support.

I oppose the provisions in H.R. 758 on the payment of interest on required reserves held at the Federal Reserve. When reserve requirements were 16 ½ percent on checking deposits at large Fed member banks in 1980 one solution to end this heavy tax was to pay interest on reserves. That solution to stop the rush of banks threatening to leave their Fed membership failed to gain support. The MCA did give the Fed authorization to raise "supplemental" reserve requirements and pay interest on those reserves if it declared that an emergency situation existed.. I will respectfully suggest that the payment of interest on required reserves held at the Fed has become largely irrelevant and that the legislation being considered would not be in the public interest.

There had never been mandatory Federal reserve requirements until passage of the MCA in 1980.It reduced the reserve requirements on checking accounts of larger banks from 16½ percent to an initial 12 percent.[2] The problems of trying to build a wall around several types of deposits that have reserve requirements was discussed with the Fed which rejected a remedy.

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[2]The 16 ½ percent reserve requirement applied to demand deposits in excess of $400 million. The Monetary Control Act of 1980 gave the Fed the authority to set reserve requirements in a range of 8 to 14 percent. The reserve requirements were fully phased in for all banks except those in Hawaii by October 24, 1985 and in Hawaii by 1993.The 1980 MCA reduced the reserve requirement to 3 percent on amount on checkable deports below a cutoff that was adjured to $41.3 million in 2002. The 1982 Garn-St Germain excluded from reserve requirements those banks with the 3 percent required reserve requirements to a cutoff adjusted to $5.7 million in 2002.

Under MCA the Fed produced its periodic sky will fall defense (actually a warning to preserve the power of its government bureaucracy): *we will lose control of the money supply without more required reserves*. As expected from monetary theory and from the record of banks that operated with no reserve requirements, that loss of control did not happen. Despite their own warning the Fed subsequently lowered the reserve requirements further to 10 percent.

To assure that the Fed would not lose control of the money supply Fed Chairman Paul Volcker negotiated for inclusion in MCA supplemental reserve requirements of up to 4 percent. The Fed can implement them if it deems there to be a national emergency and it is authorized to pay interest on these supplemental reserves. Unlike the proposed legislation you are considering that does not specify any particular short-term interest rate, the MCA specifies a limit to the interest rate the Fed can use as explained in a footnote.[3]

The supplemental reserve requirements were never used. Instead, the required reserves held at the Fed fell from as high as $35 billion in the early 1990's to less than $10 billion, as shown in the chart submitted with testimony. Total required reserves did not appreciably change as the money supply increased. There are two general causes:

[3]The interest rate will be no higher than the average interest rate on the Federal Reserve's own portfolio of financial assets.

- ATM's loaded with cash satisfy part of the reserve requirement.[4]

  - Large banks found increasing ways to reduce their required reserves:. Sweep accounts, overnight repurchase agreements as well as placing deposits, with the depositors agreement, in an accounting record labeled as an overseas account. The weekend dollar game described in a footnote was called to the attention of the Fed by the Banking Committee chairman in the 1980's. They replied that since there were other way to bypass reserve requirements it would be desirable to fix this one problem.[5]

The contention that the money supply or the Federal funds rate have become more difficult to control because of these changes would need much more evidence. One new policy significantly increased the control of the Federal funds as indicated in the Fed's own research. This was the result of the 1992-1993 struggle for maintaining secrecy by the Greenspan Fed with members of Congress including Henry B. Gonzalez. The Fed began the immediate announcement of changes in its target Federal funds rate in February 1994. The variability of the Federal funds rate.

Another recent potential improvement in money supply control has been the long overdue recently implemented "penalty" rate on bank borrowing from the Fed.

Given this background consider the effects of the proposed payment of interest on reserves. The Fed held $9.3 billion of the private banks' required reserves on February 5, 2003.[6] I assume that the Fed will use the Federal funds rate or something close to it for these interest payments. A graph of the Federal funds rate is included in this testimony for the period up to March 2000, eliminating the present atypical period of a prolonged depressed economy with a reduced demand for loanable funds. The average Federal funds rate in the 30 years from 1970 to 2000 was 7.7 percent. To avoid the complaint that those thirty years were somehow an anomaly

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[4]Cash held at banks for daily operations and in ATM's is deductible from required reserves needed to be passed though to the Fed the reserve requirement.

[5] The weekend dollar game is enabled by the Fed's improper counting Friday as three days in computing average reservable deposits. Switching accounts on Friday to London produces "due froms" that reduce average deposits subject to reserve requirements. The deposits are returned to a domestic account on Monday.

[6]This estimate is not adjusted for reserve requirements or seasonals.

and the current period of low interest rates will be the norm I settle for a long term average Federal funds rate of 5 percent.

That rate for a guaranteed perpetual government subsidy will certainly increase the size of reserves at the Fed. The reserves at the Fed could rise to their level in 1990 of over $35 billion. I use $20 billion as a conservative estimate of the required reserves parked at the Fed. At a 5 percent they would yield $1 billion a year. Assuming a 6 percent rate of discount for this guaranteed government income stream would have a value of $16.7 billion.

Past contributions to the Fed's surplus account have no real budgetary effects. Changing the money recorded in one government account to another has no economic content. This bookkeeping change has been used before to avoid limits imposed by the appropriations process. The interest payments will not bestow more income on the banks at zero cost. The full cost will be borne primarily by the public.

Small banks that do not have any or few required reserves will be less able to benefit from this government transfer. Depending on interest rates (and the slope of the yield curve) banks will have an incentive to reduce cash intensive services such as ATM's and place more of their reserves at the Fed. Benefits will accrue to large financial holding companies that can move funds in and out of their domestic checking accounts from all corners of their operations.[7]

The government annuity will have a built-in benefit from higher interest rates for banks which elect 2/3 of the boards of directors at the twelve Federal Reserve Banks who in turn elect the people who vote on the nation's money supply. Inflation which raises market interest rates will have benefits for this Fed constituency.

The $16.7 billion asset given by the government to the banks can have positive welfare effects if its income stream is transferred to depositors as interest on their deposits, as some economists have theorized assuming the banking industry is a competitive industry. This is the wrong model. I would be happy to explain this point using the example of parallel pricing the industry uses for its advertised prime rate. The primary recipients of the $16.7 billion government guaranteed perpetual annuity will be the stockholders of large banks. They will receive very respectable capital gains.

[7]Once the government patches one distortion of the price system with another economists will have a field day trying to determine who wins and who loses.

Federal Funds Rate 1965 - 2000
Peak to trough of recessions in this period are shaded.