Structural Disequilibrium and the Banking Act of 1980: Discussion
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decision periods, and that the distribution of asset returns has bounded support. Then, depending upon the parameters of the probability distribution, the rate of return which other intermediaries can earn, and the rate of interest the intermediary promises to pay, he shows that the intermediary will not necessarily choose a portfolio that maximizes expected profits. However, an enlightened insurer could impose a deposit rate ceiling which will insure that the intermediary will hold an efficient portfolio. Bhattacharya proposes to eliminate monopoly rents by auctioning bank charters, but he is more than a bit vague about the number of charters which should be auctioned—especially in light of the extraordinary number of assumptions that have already been made.

I would like to congratulate him on presenting a very stimulating excursion, but urge him in the future to avoid excessive diversification. Most passengers will feel more comfortable traveling in a single bottom, even if the captain has all his eggs in one basket. Each of his vessels could weather quite heavy seas if he would secure his cargo with more formal reasoning and thoroughly work out the details.

DISCUSSION

D. E. LINDSEY*: Paul's paper deals with vital issues of structural disequilibrium in the financial sector and the paper contains many insightful observations. Moreover, I find myself in agreement with his main conclusions that even after the transitional adjustments to the provisions of the Act are complete, remaining structural pressures build into the control system will still reflect a continued disequilibrium state and will induce further structural change. Ironically, however, I cannot agree with the reasons he advances for this conclusion. His summary paragraph contends that the success of the Monetary Control Act "in achieving its objectives is endangered by the inclusion of nonpersonal time deposits in the reserve base control network, by the permission to pay interest on checking accounts, and by the omission of restrictions on checking accounts at institutions not covered by the control provisions of the Act." I would like to consider each of these last three points in turn.

Concerning the inclusion of nonpersonal time deposits among reservable liabilities, I do not see why Paul uses the phrase "built-in self destruct mechanism for the monetary control objectives of the Act." To be sure, control over M1 would be simplified if their required reserve ratio were zero, which the Board has the discretion to do legally. But even with a positive ratio, if reserve requirements on nonpersonal time deposits were accounted for on a lagged basis, as under the Board's current proposal for CRR on transactions accounts only, then required reserves against them would be known with certainty. Reserve targets could thus be adjusted dollar for dollar for movements in required reserves on nonpersonal time to eliminate any effect of changes in these deposits on reserves available to support transactions deposits. In general, I was puzzled by Paul's assumption of fixed total reserves in carrying out his analysis of the impact of various reservable liabilities.

I was also puzzled over why making nonpersonal time deposits reservable made them a better substitute for transaction deposits than nonreservable deposits, like

* Board of Governors, Federal Reserve System.

personal time deposits. It would seem the imposition of the requirement would lower their own rate, reducing the problem.

Regarding the permission for checking accounts to bear interest, Paul is right that the lifting of an even partially effective prohibition on explicit interest (that kept the marginal implicit rate below an equilibrium market own rate) could tend to put upward pressure on short-term market interest rates. To be sure, the payment of a higher marginal own rate after the prohibition were removed would shift the demand function for those transactions deposits outward for a given level of real income, prices and market interest rates. And if the Federal Reserve were targeting a fixed supply, market rates would have to rise to restrain the quantity demanded of narrow money.

However, in principle, the Federal Reserve should adjust their M1 target upward to accommodate the enlarged demand arising from the higher own rate on transactions deposits. This would keep short-term interest rates at their same level as otherwise. Indeed, this was the effect of the Federal Reserve's targeting a 3-½ to 6 percent range for growth of shift-adjusted M1-B in 1981, not observed M1-B, which grew 2-¾ percent faster, owing to nationwide NOWs.

Moreover, I am not sure that continual upward pressures on short-term rates necessarily will accompany the payment of explicit interest on transactions balances, given the Federal Reserve target setting reactions. Admittedly, however, a flexible own rate on transactions balances means that market rates would have to rise more to choke off a higher quantity of money demanded associated with stronger aggregate demand for goods and services than would be the case with a less flexible own rate. But so long as the absence of interest on required reserves prevents the own rate on transactions deposits from rising as rapidly as market rates, these rates will not spiral upward without limit.

I would tend to reverse Paul's argument, and say that it is precisely the artificial impediments to a market-determined own rate on transactions deposits in recent years—and even at present with a 5-¼ percent ceiling on NOW account rates and prohibition of explicit interest on demand deposits—that helped make the opportunity cost of holding transactions deposits so high and encouraged the proliferation of cash management innovations and the development of new transactions-type instruments. This fact, combined with the insufficiently tight control over the trend expansion of narrow money over the last two decades that contributed to inflation and high interest rates, underlies much of the structural disequilibrium that still persists among financial institutions.

Finally, on Paul's point that there is no law prohibiting the development of checkable instruments outside the reserve requirement structure, I agree that a loophole for control over aggregate transactions balances is created. However, I would advocate bringing any such transactions-type instrument under reserve requirements, rather than enforcing by law a monopoly of checkable instruments at depository institutions. I might note, too, that the checkable features of MMMF shares can be exaggerated. There are minimum denominations per check of $500 or more. In fact, average annual turnover of these shares is around 3, compared to 4 for personal savings deposits. Thus, while some substitution of MMMF shares for transactions accounts may have occurred, I would caution against overstressing this impact.