Bankers on Pricing Consumer Deposits

As part of a study of the evolving market for consumer deposits in a deregulated environment, the Federal Reserve Bank of New York undertook a series of interviews with senior commercial and savings bankers on pricing these deposits. The interviews took place between November 1986 and January 1987. The bankers were asked to discuss their views of pricing practices in the market generally as well as their own approach to pricing the interest rate and non-rate dimensions of these deposit products. In no sense should these interviews be regarded as a "scientific" sample of nationwide banking practices. The interviews were relatively few in number, were confined to New York State institutions, and were mainly with larger banks. From the general consistency of the responses, however, it seems reasonable to believe that these responses were at least representative of the views at larger institutions in the New York market

Our primary interest in these interviews was to gain better insight into the ways in which pricing practices for the various types of consumer deposits might be influencing the way deposit rates respond to changes in market rates. These deposit-rate responses, in turn, clearly influence the volume of funds moving into and out of the various types of deposits. Thus they influence the behavior of the monetary measures targeted by the Federal Reserve.

The statistical record of the past two and one-half years, in which market interest rates have fallen some 500 basis points, suggests some interesting differences in the response of interest rates on the various kinds of accounts, and thus of deposit flows, to changes in money market rates.[1] Rates on consumer CDs have tended to respond relatively rapidly and relatively completely to movements in market rates. Rates on MMDAs have responded somewhat less rapidly and less completely, while the response of Super NOW rates has been even slower and less complete than the MMDA response Savings deposit rates, subject to a $5^1/_2$ percent ceiling until April of last year, remained generally at that ceiling until recently when there have been declines in some markets.

The overall result of this divergent response to the decline in market rates has been a substantial compression of yields on the various kinds of accounts. As the rate advantage of consumer CDs relative to the other kinds of deposits has contracted, these CDs have gone from rapid growth to outright declines. Similarly, the narrowing rate advantage of MMDAs relative to NOWs and savings deposits seems to have slowed their growth too, though less dramatically. In the meanwhile, inflows to relatively sticky-rate accounts, the savings and NOW accounts, have accelerated as the rate advantage of other kinds of instruments has narrowed. Indeed the sharply declining opportunity cost of holding NOW accounts (included in M1) appears to be a major factor in the recently very rapid growth in that monetary aggregate.

Our interviews suggest that the falling opportunity costs of holding NOWs, in turn, reflect the significant differences in the market's approach to pricing the various deposit products, differences that seem to stem

[1]See John Wenninger, "Responsiveness of Interest Rate Spreads and Deposit Flows to Changes in Market Rates," this *Quarterly Review* (Autumn 1986), pages 1-10

rather naturally from the differences in the nature of the products themselves. The interviews also touched on the question of how the various deposit rates might evolve if market rates were to continue at current levels or decline, as well as on how deposit rates might respond if market rates were once again to move substantially higher. Before reviewing the considerations that enter into the pricing of the various individual deposit products, we turn first to the major components of the general pricing decision.

Major Components of the Pricing Decision

With some variations in emphasis and in ways of collecting the relevant data, the institutions we talked to tend to focus on similar factors in setting interest rates on consumer deposit products. Rate decisions are apparently reviewed frequently—several mentioned weekly reviews—though of course actual rate changes may be less frequent.

Most banks indicated that their rate decisions begin with estimates of the relevant wholesale cost of funds as a measure of the alternative cost of money. Rates on large CDs were mentioned by several bankers as the measure of wholesale funding costs. These wholesale rates have to be measured in terms of the relevant term to maturity. This is a relatively straightforward matter in the case of consumer time deposits, but is much less clear-cut in the case of MMDAs, NOWs, and savings deposits since they are cashable on demand and therefore have no definite "maturity." In comparing wholesale and retail costs of funds, adjustments also have to be made for any differences in the relevant reserve requirements and for the higher costs of servicing retail accounts

Some institutions begin the pricing decision with a desired spread under the wholesale cost of money they would like to achieve in setting rates on consumer accounts. However, all institutions mentioned a number of factors that would influence the spread they would actually set, and one or two said explicitly that they often failed to meet their objective because of competitive conditions or other factors.

All institutions indicated that they had to take explicit account of what their competitors were doing in the various markets. With varying degrees of explicitness, they also try to take into account the interest rate elasticity (responsiveness) of their customers' demand for the various kinds of instruments they offer—though this is obviously hard to estimate in quantitative terms. Most bankers also mentioned as decision inputs their own deposit flow data for the various kinds of consumer accounts (sometimes differentiated by maturity category for consumer CDs) and the schedule of maturing deposits they faced over the coming period. Some banks indicated that the rates they offered at different branches or regions might differ depending upon local competitive conditions. With one partial exception, the banks indicated that they did *not* take variations in the bank's short-term funding needs into account in setting consumer deposit rates, preferring to make such adjustments in the wholesale market.

Most of the institutions we talked to obviously go to considerable lengths to collect and organize the relevant input data—the cost of money, deposit flows, rates offered by competitors, etc.—needed to make rate decisions But this input seems much more directly relevant in pricing some kinds of products, notably consumer CDs, than it does for others such as savings and NOW accounts where additional considerations, discussed further below, are also very important Most bankers emphasized, moreover, that no matter how sophisticated the mechanism for collecting and organizing information may be, actual rate decisions cannot be reduced to formula. Instead they must rely heavily on experience and judgment.

Setting Rates on Consumer CDs

As noted earlier, the national data indicate that consumer CD rates have responded most consistently and fully to changes in money market rates. Several comments by the bankers we interviewed suggested reasons why this should be so. One banker argued that the quick adjustment of CD rates to market rates, relative to the slower adjustment of other consumer deposit products, reflected differences in interest rate elasticity, with CD demand highly responsive to rates and other products less so This seems highly plausible since rates would seem to be by far the most important determinant of consumer CD demand in contrast to other deposit products where non-rate considerations may also be important. And if customers are in fact highly rate-sensitive with respect to CDs, banks would stand to lose (or gain) market share relatively rapidly if the rates they offer fail to adjust quickly to changing market conditions.

Some bankers confirmed that they did try to respond relatively quickly to changes in the wholesale cost of money in pricing consumer CDs. One banker argued that wholesale banks, especially, tend to price these CDs in relation to wholesale funding costs. He also argued, however, that thrifts and regional banks tend to price more in relation to relatively slower changing asset yields and therefore tend to adjust their CD rates more slowly.

The savings bankers we talked to did say that the CD offering rates of thrifts tend to be somewhat higher than those of their commercial bank competitors.[2] While no

[2]The available data supports this contention See "Responses to Deregulation Retail Deposit Pricing from 1983 Through 1985,"

full explanation was given for this phenomenon, one savings banker commented that the thrifts "may be a little paranoid" about the risks of losing deposits. One commercial banker, also noting a tendency for thrift CD rates to exceed rates paid by commercial banks, said he thought this spread had remained about constant as the overall level of rates has come down, but that the spread has become more important to consumers at the lower absolute level of rates. Another commercial banker argued that some thrifts were "pricing well above the market and can't sustain this over time."

Money Market Deposit Accounts

Bankers offered a number of explanations for the fact that MMDA rates have tended to respond somewhat more slowly and less fully than CD rates to changes in money market interest rates. Several bankers suggested that MMDA demand was less interest-sensitive than CD demand, arguing that MMDA accounts were often used simply as "parking lots" for excess funds awaiting decisions to reinvest the funds in other instruments. The fact that spreads of money market rates over MMDA rates were larger than the spreads of money rates over consumer CD rates was also cited as a reason for feeling "less urgency" to move MMDA rates when market rates changed. One banker noted that when a bank changes its offering rates on CDs, only new money and rollovers are affected in the short run. When a change in MMDA rates is made, however, it affects the entire outstanding volume of deposits at once, making banks more cautious about changing MMDA rates.

These various considerations would clearly help explain why bankers might be relatively slow in adjusting MMDA rates upward in response to rises in market rates. However they are less clearly relevant in explaining why MMDA rates might be slower than CD rates to decline in the face of reductions in money market rates. One banker offered the explanation that as market rates have declined, banks have been reluctant to breach successive single digit "floors" (such as an even 6.00 percent) and have been particularly slow to cut MMDA rates below the old ceiling rate on regular savings deposits even though such cuts might be justified on cost of money grounds. Such a line of argument would suggest that the bankers believe that at least at some critical points, the rate elasticity of demand for MMDAs may be fairly high, so that they fear losing market share by cutting rates at such points. In any event, at the time of these interviews, MMDA rates at the banks we talked to—mostly at 5 percent or somewhat higher—were at or below statement savings account rates at the same institutions.

MMDAs were originally conceived largely as a response to the rapid growth of the money market mutual funds. Through late 1982, when the new MMDAs first became available, these money market funds had grown to some $185 billion. Certainly a significant part of this money had come out of consumer deposits at banks—though much of it may have been ultimately recycled in the form of purchases by the money funds of wholesale CDs and bank-related commercial paper. In any case, only two bankers in our recent interview program mentioned competition from the money funds in connection with MMDA rate decisions. One banker acknowledged that rates offered by the money funds were initially "very important" in pricing, but he argued that they were much less important currently. Another banker said that the MMDA could not compete fully with money fund accounts, especially "central asset accounts," because of the limitation imposed on the number of third-party checks that can be written on MMDAs. But he went on to say that for most smaller savers, the presence of FDIC insurance on MMDAs made it possible to market them competitively at 50 basis points below rates being offered by the money funds.

Savings Deposits

Savings deposits come in two forms, the traditional passbook account and the statement account. At the time of the interviews, most banks we talked to offered both kinds of accounts, but a minority no longer offered passbook accounts. Moreover, one banker expressed a desire ultimately to eliminate his bank's passbook account, which, he said, entailed significantly higher maintenance costs than do statement accounts. Most of the banks we talked to were continuing to offer statement savings accounts at the old ceiling rate of 5½ percent (deregulated at the end of March 1986) while a minority offered somewhat lower rates. Of those banks we talked to that continued to offer both kinds of savings accounts, a majority were offering passbook rates below the rate offered on the statement savings account.

In one way or another, all the bankers we talked to expressed the view that the time had come to cut savings account rates because of declines in the cost of money. Nevertheless, they all expressed great caution about taking such a step. Most noted that depositors had continued to hold funds in these accounts during periods when other rates were far above the old 5½ percent ceiling. In various ways, the bankers conveyed the feeling that this had imposed on them an implicit obligation not to cut the savings rate when market rates had fallen. Bankers used terms like "moral commitment" and "implicit contract" to express their reluctance to cut

Footnote 2 continued
Patrick I Mahoney, Alice P White, Paul F O'Brien, and Mary M McLaughlin, Board of Governors of The Federal Reserve System, Staff Study Number 151, January 1987

rates on depositors who had held savings accounts in earlier years when other rates were far above the $5^1/_2$ percent ceiling. Thus some bankers expressed the fear that these account holders would feel "cheated" if the rate were cut now. Moreover, they were reluctant to "sensitize" such account holders to rate considerations since these depositors might then very well expect savings deposit rates to move up if market rates were to climb once again. In effect, the bankers seemed to prefer the rate-sensitive savings customers to stay in the MMDA accounts rather than in savings accounts—although with MMDA rates below regular savings rates at a majority of the institutions we talked to, some thought there was evidence that the rate-sensitive money was in fact moving into savings accounts from the MMDAs

Some of the bankers we talked to referred to savings accounts as being, along with NOW accounts, "core" accounts—that is, accounts that tend to tie the holder's overall banking business with the bank at which the core account is maintained. This consideration would mean that the customer's entire banking business, and not just his savings account business, might be at stake if the savings account rate were to be cut.

Despite all these considerations, many bankers argued, as noted, that the savings deposit rates prevailing at the time of the interviews were "too high" given the current money market rates, even while expressing considerable reluctance to be the first to move to a lower rate themselves. Some bankers mentioned that they had recently sent written notice to their savings account customers that in the future they might need to adjust their savings account rate if market conditions warranted. However, they had not actually lowered the rate as of the time of the interviews. Moreover, several bankers suggested that any future changes in savings accounts rates would be made only infrequently and only in response to significant and sustained changes in interest rates generally.

NOW Accounts

Until January 1986, Federal regulation distinguished between two types of NOW accounts, "regular" NOWs subject to no balance requirements but subject to a maximum interest rate of $5^1/_4$ percent, and "Super NOWs," subject to a minimum balance requirement but with no interest rate limitation. Currently, depository institutions may offer interest rates without restriction on any NOW account, regardless of balance. Even after the rate restriction on "regular" NOWs was removed, many banks continued to offer two types of accounts, one paying a rate fixed at or close to the old $5^1/_4$ percent ceiling and another paying a higher rate adjusted from time to time in light of changing market conditions. By the time we conducted our interviews, however, the decline in market rates had compressed NOW rates so that most of the banks we talked to either no longer offered a "Super NOW" product or offered one with a rate equal to or only slightly above the old regular NOW ceiling rate of $5^1/_4$ percent. As one banker put it to us, the Super NOW had become "a product without much meaning" in current market conditions. Thus in his view, the pricing of Super NOWs as such had become a "non-issue" in the market.

Nevertheless, it was clear from our conversations that the pricing of NOW accounts, however distinguished, presented some difficult issues. There are clearly problems in measuring both the costs and the net revenues arising from such accounts, making rational pricing a complex problem. Some bankers, for example, mentioned the difficulty of estimating accurately the costs of account maintenance, both the "brick and mortar" fixed costs and the variable costs. Some also cited the difficulty of getting a realistic handle on the appropriate opportunity cost of funds for deposits that have no fixed maturity. As one banker put it, it is very hard to know what "notional" term to maturity to put on these funds in measuring opportunity costs, "not the Federal funds rate, but not 10-year money either." Another intangible cited by one banker was the relative stability of NOW account deposits, a feature that is attractive to banks but for which it is hard to establish a precise numerical value.

For all these reasons, it appears to be difficult for the banks to measure the profitability of NOW accounts, even on a "stand-alone" basis. Most who discussed the subject did believe that at interest rates above 5 percent, NOW accounts were not in fact currently profitable on such a basis But the most important complication in pricing these accounts arises from the fact that most bankers do *not* look at them on a stand-alone basis. Instead, they view them as a "core" product, the centerpiece of a complete banking relationship where the value of the NOW account as such cannot be meaningfully separated from the total value of the customer's dealings with the bank.

Several of the institutions we talked to seek to reinforce the "relationship" aspect of NOW accounts by permitting balances in other accounts to be used to satisfy the minimum balances in NOW accounts required to avoid fees and/or by offering reduced loan rates to NOW account customers. One banker noted with some irony that at the very time that the corporate banking business is moving toward unbundled pricing, consumer banking seems to be moving in the opposite direction. As some bankers pointed out, the "relationship" aspect of NOW accounts makes it doubly difficult to assess their profitability. It is difficult not only because their current profitability has to take into account the collateral banking business they are currently attracting, but also because accepting current losses on NOW accounts may retain a customer whose total business *over the long run* may make the account profitable when viewed over that longer time horizon. Given all these problems, one banker said quite frankly that you could make such accounts look profitable or unprofitable depending upon just what alternative plausible cost and revenue assumptions were used in the calculation.

In expressing reluctance to lower NOW account rates even at a time when they seemed "too high" in terms of current money costs, some bankers voiced the same kinds of reservations they had mentioned in connection with possible cuts in savings deposit rates. Thus they noted that regular NOW customers had maintained balances at times when market rates were far above the old 5¼ percent ceiling Moreover, they feared that "sensitizing" such account holders to interest rate movements could lead to significant reductions in NOW balances in response to any subsequent increases in other rates. One banker argued that customers' decisions in choosing NOW accounts were determined more by convenience and service considerations and thus were in fact rather *in*sensitive to small or moderate interest rate differences. But, he added, if the NOW rate were to become so far off the market that the customer were induced to move his account to another institution, the original bank would lose not only the deposit, but all the customer's other banking business as well.

The savings bankers we talked to suggested that NOW accounts play a somewhat different, and lesser role for thrifts than they do for commercial banks. One savings banker said that NOW accounts at thrifts are often secondary checking accounts and are viewed like savings accounts by their holders Another savings banker noted that NOW accounts constitute only a small fraction of his institution's total deposits so that the concept of "relationship pricing" of such accounts as a means of attracting other business is of little or no consequence to them.

The Non-Rate Dimensions of Pricing

In addition to setting interest rates, banks must set terms on a wide array of non-rate dimensions of the total deposit package These include minimum balances to earn interest and/or avoid monthly fees, fee schedules covering per-account fees, per-check fees and other types of fees, as well as methods of computing balances and of computing and crediting interest and other matters. In the following article, we report the results of a survey of commercial bank practices as of late 1985 regarding these non-rate dimensions of consumer deposit pricing.[3] Our conversations with bankers yielded a few additional insights on the issue of setting non-rate terms on such deposit products.

Several bankers said that the balances in most of their NOW accounts were above the minimum levels needed to avoid monthly account fees. For this reason, one banker said that these minimum balance levels were "a small issue" for him. He noted, however, as did others, that they serve the purpose of making below-minimum-balance accounts at least cover account maintenance costs through the fees charged. One banker made the point that while fees enable low balance accounts to pay their way, and while high balance accounts are also profitable even without such fees, accounts with balances only a little above the minimum needed to avoid fees may *not* be profitable. However, he said that the alternative pricing approach of charging fees on *all* accounts regardless of balance to ensure that all accounts at least cover cost would "irritate" the higher balance customers, the value of whose deposits are alone sufficient to cover costs

Another banker said that establishing different minimum balance levels to avoid fees was a way of establishing "product distinction," with the different accounts also differentiated with respect to fees, interest rates paid, and collateral benefits offered One banker suggested that crediting balances in all the customer's accounts toward the minimum balance requirement for his transactions account did cost the bank some fee income But he thought the approach was nevertheless worthwhile as a means of building a total banking "relationship" with the customer In general, decisions about the non-rate terms offered on accounts appear to be made relatively infrequently—several banks mentioned once a year—in contrast to rate decisions, which, as noted earlier, appear to be reviewed at least weekly at most institutions.

Future Prospects in Pricing Consumer Deposits

We asked the bankers whether they thought the price-setting process in the industry had had time to settle down following the completion of the deregulation process or whether some further evolution was likely The answers we got varied considerably, in part because the various bankers tended to focus on different aspects of the problem.

There seemed to be general agreement that the market had not yet reached an "equilibrium" with respect to the relatively fixed rate accounts, the NOWs and savings

[3]See "The Pricing of Consumer Deposit Products—The Non-rate Dimensions," this *Quarterly Review*, pages 14-18

accounts. As noted earlier, most felt that these rates were too high relative to money rates and would be under downward pressure. Indeed, there were some rate reductions on these products in the New York City market after our round of interviews was completed. But with all the potential, hard-to-quantify risks of cutting rates on these accounts, few bankers were prepared to suggest where the market would ultimately settle, even in the absence of significant further changes in interest rates generally. One banker, saying that the whole area of consumer deposit pricing is "still evolving," emphasized that banks were still trying to get a good feel for the fixed and variable costs of the various kinds of accounts—implying that absent such a feel, they would remain uncertain as to just what an appropriate "equilibrium" price might be at any particular level of money rates.

Apart from the obvious continuing uncertainties surrounding NOW and savings deposit rates, there was a fairly general feeling that pricing practices *had* settled down, at least to some extent. One banker noted, for example, that the rates set by his competitors seemed to be responding to changes in money market rates "in a pretty predictable way," suggesting to him that their decision-making processes, at least on consumer CD and MMDA rates, had stabilized. At the same time, some bankers suggested that there would always be a tendency for "rate wars" to break out from time to time as some banks sought to increase their market share at the expense of competitors.

There was some disagreement as to whether deposit rates would respond more slowly to a sustained rise in money market rates than they had to the declines of the past two and one-half years. One banker thought that deposit rates *would* respond relatively more slowly to the rise in market rates, with thrifts moving up even more slowly than the commercial banks. Several bankers, however, suggested that while banks might try to lag more on the upside, competitive forces would undermine any such effort. Thus if banks did lag, some institution would see an opportunity to gain market share by raising deposit rates and the others would then be forced to follow.

A few bankers noted that the *relative* speed of response of the various kinds of accounts on the upside would be similar to the pattern observed when rates had fallen. Thus consumer CD rates could be expected to move relatively rapidly, with little or no increase in the gap between money market rates and CD rates. On the other hand, rates on the relatively fixed rate types of accounts, NOWs and savings deposits, would respond only slowly. Hence the rate gap on these accounts relative to market rates would widen once again as market rates rose, much as this gap had narrowed when market rates were falling.

Some Tentative Conclusions and Unresolved Questions

Obviously no firm inferences can be drawn from a small-scale survey of bankers in a geographically limited portion of the consumer deposit market. But some tentative conclusions about this market are at least suggested by the survey results.

For one thing, the evidence suggests that consumer CD rates are likely to continue to respond reasonably promptly and fully to changes in money market interest rates. To banks, consumer CDs are an alternative to funding through wholesale deposits. And since consumers' demand for these CDs appears to be quite rate-sensitive, the volume of funds a bank can raise from this source will be responsive to changes in offering rates. Thus whenever wholesale funding costs rise above currently prevailing consumer CD rates (allowing for differences in reserve requirements and other costs), banks will have a strong motive to push up offering rates to increase their takings from this source. Conversely, should wholesale rates decline, banks have a strong motive to bring consumer CD rates down into line with the wholesale rates. It was not completely clear whether this adjustment process would move as rapidly when market rates are rising as it does when they are falling—our interviewees differed on this point. In any case, the actual speed of adjustment in any given local market will depend on the extent of competition in that market.

With respect to money market deposit accounts, their nature makes it likely that they will continue to respond less rapidly than CD rates to changes in market rates. On the downside, there is the apparent reluctance of bankers to break visible psychological barriers posed by even-numbered interest rate levels and by rates offered on slow-adjusting accounts such as savings and NOW accounts. On the upside, the likelihood that MMDA money is less rate-sensitive than CD money, coupled with the fact that a change in the MMDA rate applies immediately to the entire outstanding stock of MMDA deposits, suggests that bankers will tend to delay in raising MMDA rates at least until they feel reasonably sure the rise in market rates is likely to stick.

Given the variations that have occurred in the spread between MMDA rates and money market rates generally (including money fund rates), the question arises as to what the long-run "equilibrium" rate on MMDAs for given levels of market rates may be. Econometric work suggests that over periods of up to three months, the MMDA rate makes only a partial adjustment (about 60 percent) to movements in money market rates.[4] But over a somewhat longer period, the response of MMDA rates

[4]See Wenninger, *op. cit.*, page 7

to market rates may well be fairly complete, and indeed that is what one banker we talked to asserted. Moreover, since money fund rates, by their very nature, must also respond fully to changes in market rates over a period long enough for their portfolios to turn over, it seems likely that over time MMDA rates and money fund rates should tend to move more or less in tandem even though bankers may not regard them as closely competitive in the short run.

The savings deposit product is clearly designed to be marketed to relatively rate-insensitive customers. The banks' approach to pricing this product suggests that they seek to preserve this role for the savings deposit account by responding only slowly and reluctantly to the recent sharp declines in money market rates in setting rates on saving deposits. As a result, the profitability of these deposits to the banks has been much reduced in the recent period. To the extent that the savings account can be preserved as a repository for rate-insensitive funds, however, it could once again become quite valuable to the banks should market rates rise.

From the point of view of monetary policy, perhaps the most interesting—and most perplexing—question raised by our interviews is the likely course of NOW account rates over time. Alone among the types of interest-bearing accounts discussed in this article, NOWs represent a component, and an important component, of M1. This narrow money measure was, for a period, the monetary aggregate most closely watched by the markets and the policymakers. More recently, its importance has been substantially downgraded because of its highly aberrant behavior relative to earlier experience—a change in behavior that is clearly related in part to the pricing approach banks have adopted to consumer deposits.

When it first became apparent that deregulation would make possible a transactions deposit whose rate could fluctuate in line with market rates, many analysts suggested that the responsiveness of M1 to market rates would decline sharply. Their reasoning was that the opportunity cost of holding these deposits need no longer be affected by changes in market rates. Experience suggests, however, that deregulation has had just the opposite effect on the responsiveness of M1 to changes in market interest rates. On the one hand, the creation of market-rate-sensitive alternatives to M1 accounts has made it much easier for the average depositor to adjust his transactions balance levels in line with changes in the opportunity costs of holding them. All he needs to do is to shift money between different deposit accounts—accounts that are more often than not held in the same institution.

At the same time, it has turned out in practice that the rates paid on NOW accounts respond only slowly and incompletely (except perhaps in the very long run) to changes in market rates. So the ability of depositors to respond to changing rate spreads has increased. And because NOW rates adjust slowly, these spreads have continued to fluctuate substantially with fluctuations in the general level of interest rates. Moreover, everything we have learned in the course of our talks with bankers suggests that the sluggish response of NOW rates is likely to be a persisting feature of these accounts. So on balance, it appears that even though these transactions deposit rates are now theoretically free to move in line with market rates, the overall interest-rate sensitivity of NOW accounts, and hence of M1, has probably been significantly increased as a result of deregulation.

One perplexing and potentially important question is where the long-run "equilibrium" spread between money market rates and NOW rates may turn out to settle. In the last half of 1983 and most of 1984, when market rates were much higher than they are now, market rates (as measured by the six-month bill rate, for example) tended to run from 2 to 3 percentage points above the then-prevailing rates on Super NOWs. In recent months, this spread has been much smaller, ranging between roughly zero and one-half percent.

Clearly the bankers we talked to do not think the current level of NOW rates represents a long-run "equilibrium." They obviously think there is downward pressure on the NOW rate at current levels of money market rates. But how far below current levels would NOW rates have to fall to reach such an equilibrium? If the 1983-84 range of spreads in fact did represent an equilibrium position, NOW rates would ultimately have to fall to within a 2.5 to 3.5 percent range, far below their current levels. On the other hand, the high spreads prevailing in the 1983-84 period may also have been abnormal—abnormally high. Thus they may *not* be a reliable guide to where market rate/NOW rate spreads may ultimately settle given today's lower level of market rates.

Most likely, the "true" long-run equilibrium spread between money rates and NOW rates lies somewhere between the very high 1983-84 levels and the very low to negligible levels prevailing recently. But just exactly where it may lie within this range is far from clear—especially in view of all the uncertainties, even for the bankers themselves, about both the costs and the revenues associated with NOW accounts.

In any case, if there is currently pressure for the NOW account rate to fall, even absent further declines in money market rates, this pressure poses a new problem for the use of M1 as an indicator of monetary stimulus. By itself, a downward drift in the NOW rate would clearly reduce the demand for NOWs and thus for total M1. If M1 growth were left unchanged under such circumstances, the downward drift in money demand would tend to put downward pressure on market rates and would thus provide additional stimulus to the economy. If the additional stimulus were undesired from a policy perspective, it would be necessary to reduce the target rate of M1 growth by a sufficient amount to offset the impact on market rates of the reduction in the demand for M1.[5] The problem is that it is very hard to say how rapidly any downward movement in NOW rates might occur, if it happens at all, and how far it might go.

[5]To the extent that the slower growth of NOW accounts reflects a shift of funds from NOW accounts into consumer CDs, M2's growth would not be affected since NOW accounts and consumer CDs are both M2 components

Consequently, the needed allowance for this factor in setting monetary targets is equally hard to determine. Consideration of such questions makes it clear that the behavior of the narrow money supply has become much harder to analyze under deregulation than it was in the old days when it consisted only of non-interest-bearing demand deposits and currency.

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