The public option works

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Competition in banking deposit markets is weak but can be strengthened. Because of the weak competition in deposit markets, the Federal Reserve, surprisingly, began competing against banks for the funds of the large money market investors in 2014; it offered those investors a "public option." Select large investors could invest on a risk-free basis, for up to $30 billion each, on terms that were favorable relative to investing in bank deposits. At its height, this public option attracted more than $400 billion. Banks hiked their rates as a result. Presumably because the option is open only to the largest money market investors, it seems to have had little effect on retail deposit rates. This experiment in the government entering a market to compete directly with the private sector suggests that such competition is effective. Ironically, the Federal Reserve is preventing the private sector from offering services that compete with its successful public option.

That deposit markets suffer a lack of competition is not in dispute and has been studied extensively by economists. It became clear after the Federal Reserve Banks began paying interest on reserves in 2008, and even more acutely obvious after the Fed began raising the rate of interest paid to banks in December 2015. As Jeb Hensarling, the then Chairman of the House Financial Services Committee put it to Fed Chairman Powell during his February 2018 monetary policy testimony, "But you're paying 150 basis points, our constituents are getting 10 basis points." Chairman Hensarling was exaggerating how much banks were paying depositors. At that time, according to the FDIC, the average deposit rate on jumbo checking accounts at banks across the U.S., where a jumbo account is one that is excess of $100,000, was 4 basis points; it has increased to 6 basis points as of January 7, 2019. In the same time period, the rate of interest the Fed pays to banks on their reserves increased from 150 basis points to 240 basis points.

In the lead up to the Federal Reserve deciding to lift interest rates off their effective lower bound at 0 – 25 basis points, it was concerned that relying solely on the payment of interest on reserves to banks might prove insufficient in raising market interest rates, given the weak competition in banking deposit markets. The Federal Reserve decided on a bold solution: create an overnight investment facility in which large money market mutual funds, Federal Home Loan Banks, and some others could invest directly at the Fed for a fixed and certain interest rate, near to the rate paid by the Fed to banks.

The new public option was called the "ON RRP." As Simon Potter, the Federal Reserve's System Open Market Account Manager put it in an April 5, 2017 speech "…when we were at the zero lower bound, we weren't able to rule out the possibility that initial increases in the policy target might not translate one-for-one into increases in money market rates…ON RRP, which is offered to a broad selection of counterparties that includes money market funds, is intended to intensify competition in money markets…"

Intensify competition it did! The Fed has repeatedly pointed out that the federal funds rate, which is essentially a deposit rate offered by banks to large money market investors, like the Federal Home Loan Banks, has been consistently above the rate offered in its public option, the ON RRP. Prior to the introduction of public sector competition, in the period between 2009 and 2013, for example, the spread between the rate paid to banks by the Fed and the federal funds rate was large and variable. The federal funds rate was as much as 17 basis points below the rate paid to banks on their reserves for an extended period. In contrast, since the introduction of the public option facility, the federal funds rate has generally been much closer to the rate the Fed pays to banks and much more stable. For example, in 2016, the rate was consistently around 10 basis points below the rate of interest paid on reserves, indicating banks had to raise their bids to attract money market investors' funds.

The good news is that competition from the public sector is a powerful way to cause price responses from private firms. The Fed's public option successfully led banks to raise interest rates for large deposits. The bad news is that only relatively few of the largest money market investors have privileged access to this government's public option, limiting its salutary competitive effects to the market for large deposits.

More ominously, when the State of Connecticut chartered a private sector narrow bank, designed to offer institutional money market investors high deposit rates safely--by investing all the proceed of deposits in reserves--the Federal Reserve denied the bank its account services. My co-founders and I started that bank, TNB USA Inc., to compete with the ON RRP, and to bring safe deposits and high interest rates to other institutional investors, most of whom haven't been extended the privilege of investing in the public option. The Federal Reserve's actions to restrict entry into this safe overnight investment market serve to deny many American investors the benefits that a relative few enjoy today, reducing competition for deposits and preserving a subsidy in its payment of interest to banks. Today, the Fed's prevention of entry into this market by innovative private sector firms makes its public option the only option, available exclusively to a few.

The Fed should change course and consider expanding access to its public facility and to provide services to TNB USA Inc., for the good reasons that it would improve competition and depositors' well-being, and because it has a clear statutory mandate to provide services to a chartered depository institution.