Subject: Reserve Requirements of Depository Institutions

Date: Nov 13, 2008

Proposal: Regulation D - Reserve Requirements of Depository Institutions
Document ID: R-1334
Document Version: 1
Release Date: 10/06/2008
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Interest on Reserves On October 6, 2008 the Federal Reserve announced that it would begin to pay interest starting on October 9, 2008 on required and excess reserves that individual banks maintain at the Fed. The stated rationale for the policy is to encourage banks to hold larger reserves. “[P]aying interest on required reserve balances will eliminate much of the reserve tax and lessen the incentive for depository institutions to engage in reserve avoidance behavior, which absorbs real resources and diminishes the efficiency of the banking system.” This is exactly the wrong policy objective in an environment where banks are reluctant to lend to businesses and others. Banks faced with a choice between lending to risky business ventures and putting the money into excess reserves where interest (albeit short term) is guaranteed, they will choose the less risky. This tendency is especially strong now that the financial community has undergone a substantial shock where financial institutions were caught holding toxic loans which endangered their very existence. The current environment is also one where the velocity of money is dangerously low. This is reflected in a substantial increase in the value of the dollar. This, in turn, puts downward pressure on exports. It might be argued that paying interest on excess reserves is a small influence on bank behavior. However, such an assertion ignores the lesson of the 1937-38 depression. The recovery from the Great Depression was well on the way in the middle 1930s when the Federal Reserve observed that banks were holding more than twice the level of reserves that was required by Fed. Given the authority under the Banking Act of 1935, the Board of Governors of the Federal Reserve System doubled the reserve requirement of member banks between August 15, 1936 and May 1, 1937. The feeling was that the doubling the reserve requirement would generate an increase in public confidence and would not change the behavior of the banks. However, the banks responded to the Fed’s signal by sharply increasing their already sufficient reserves. The result was the “over-deflation by the mid summer of 1937” and the subsequent sharpest downturn in U.S. economic activity in history. [Theories of the 1937-38 Crisis and Depression, Melvin D. Brockie, The Economic Journal, Vol. 60, No. 238 (Jun., 1950), pp. 292-310] Paying interest on excess reserves poses a substantial threat to the recovery. The policy should be immediately reversed. If it is not reversed the Federal Reserve risks causing the current downturn to be even sharper than the depression of 1937-38. Remember, it took World War II to correct that mistake. James L Johnston Economic Advisor and Director The Heartland Institute 19 South LaSalle Street Suite 903 Chicago, Illinois 60603 JJohnston@Heartland.org November 13, 2008