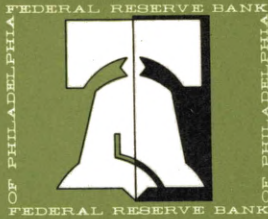


June



In Support of Uniform Reserve Requirements

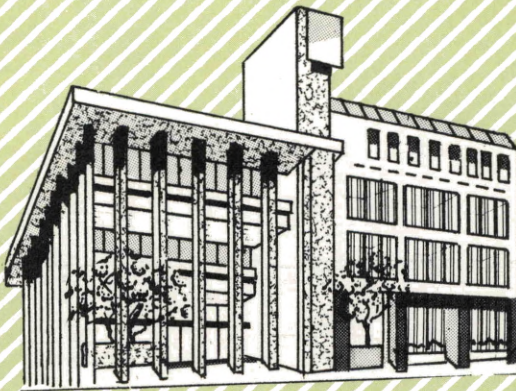
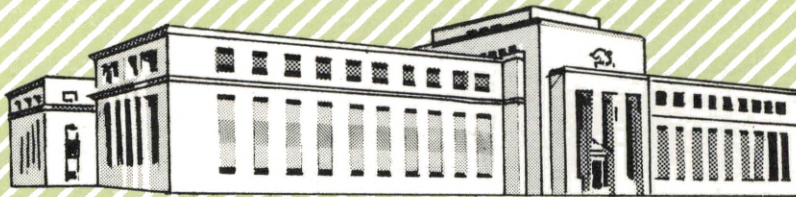
Falling Fed Membership and  
Eroding Monetary Control:  
What Can Be Done?

The Case against Uniform Reserves:  
A Loss of Perspective

The Fed in Print

**FEDERAL RESERVE BANK of PHILADELPHIA**

# business review



## IN SUPPORT OF UNIFORM RESERVE REQUIREMENTS . . .

Uniform reserve requirements can make monetary policy more effective and more equitable. To the extent that a large and growing portion of the nation's checking deposits are held in nonmember banks, which are not presently subject to Federal Reserve requirements, the Federal Reserve System is hampered in discharging its Congressionally mandated responsibility for the conduct of monetary policy.

The two articles presented in this issue examine this problem in detail. The first article, written by Edward G. Boehne, Senior Vice President, analyzes the impact of falling Fed membership on monetary control and suggests two possibilities for stemming the erosion of monetary management in our economy—uniform reserve requirements and payment of interest on reserves. The second article written by Ira P. Kaminow, Economic Adviser, examines the principal arguments of the critics of uniform reserve requirements. To put these arguments in perspective, the article considers the likely impact of uniform reserve requirements on society as a whole as well as on the banking system.

While these articles clearly lay out the problems, achieving workable and equitable solutions poses difficulties in terms of economic and political considerations. Yet it seems to me, the cleanest method of resolving these problems is to pass Federal legislation that would treat equals equally. That is, all institutions which do the same kind of business should have the same privileges and bear the same burdens. This is the approach the Hunt Commission has taken in its recommendations for financial reform. And it is the position the Federal Reserve has taken in its draft legislation on uniform reserve requirements recently submitted to Congress.

The Federal Reserve proposal for uniform reserve requirements offers not only a fair basis for reform, but also a workable one. While a uniform reserve requirement could initially lead to dislocations for some, over the long haul we all stand to gain from an improved ability to manage the national economy.

David P. Eastburn, *President*  
Federal Reserve Bank of Philadelphia

**On our cover:** This month's *Business Review* departs from its regular feature of an historic site, building, or scenic area in the Third District to emphasize the topic of its contents—that is, the issue of uniform reserve requirements. The three illustrations are of the principals involved—the Board of Governors of the Federal Reserve System (Washington, D.C.), the Federal Reserve Bank of Philadelphia, and a bank in the Third District.

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# Falling Fed Membership and Eroding Monetary Control: What Can Be Done?

*By Edward G. Boehne\**

No club likes to lose members, and the Federal Reserve System is no exception. But for the Fed, the drop-out derby is more than a matter of pride; it goes to the heart of central banking—money management and stabilizing the economy. It also poses equity problems for bankers. What can be done is controversial, but there may be hope in uniform reserve requirements or paying interest on reserves.

## **DECLINING MEMBERSHIP IN THE FED**

Membership in the Federal Reserve System is headed downward—either by withdrawal in the

case of state member banks, by charter conversion for national banks, or because member banks merge with nonmember banks. Nationally, a majority—52 percent—of banks belonged to the Fed in 1947; in 1973 only 41 percent are members (see Chart 1). In the Third Federal Reserve District, 67 percent of the banks belong to the Fed compared to 77 percent a quarter century ago. During the same period, the share of total deposits held in member banks has dipped to 78 percent from 86 percent nationally and from 85 percent to 72 percent in the Third District (see Chart 2).

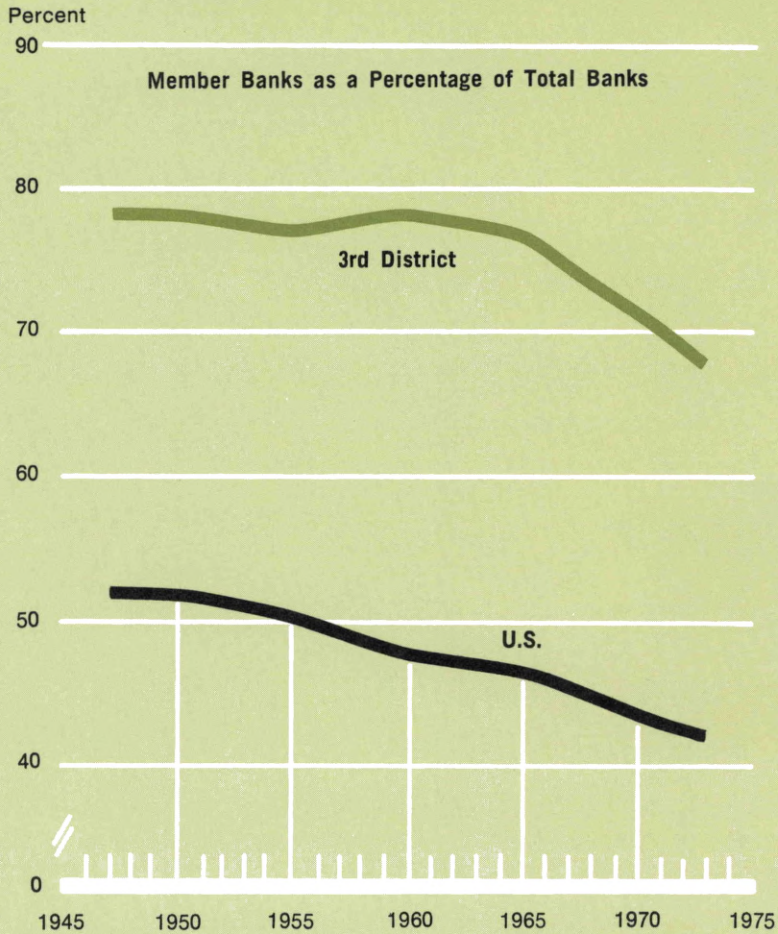
The loss of member banks has not been a slow, steady leakage. In 1947, for example, only seven banks in the entire country left the System, none from the Third District. In 1973, however, 104 banks left the System, 16 from this District. Figures for 1974 will likely show further declines.

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\*Based on remarks delivered at a series of Senior Management Seminars for member bankers throughout the Third District during late 1973 and early 1974. Additional seminars will be held later this year.

CHART 1

DURING THE LAST 25 YEARS, FED MEMBERSHIP BOTH AT THE NATIONAL AND DISTRICT LEVELS HAS TRENDED DOWNWARD . . .



More withdrawals are underway. Compounding the seriousness of recent withdrawals has been the size of banks pulling out. More than twice as many banks with deposits of over \$100 million left the System in 1972-73 than in the previous dozen years combined (see Chart 3).

**WHY BANKS LEAVE THE SYSTEM**

Banks leave the Fed mainly because they get a break on reserve requirements in many states. The break comes not so much from the *level* of reserve requirements as from the *composition* of required reserves permitted by the states (see

CHART 2

AND SO HAVE THE RESPECTIVE SHARES OF TOTAL BANK DEPOSITS HELD IN MEMBER BANKS

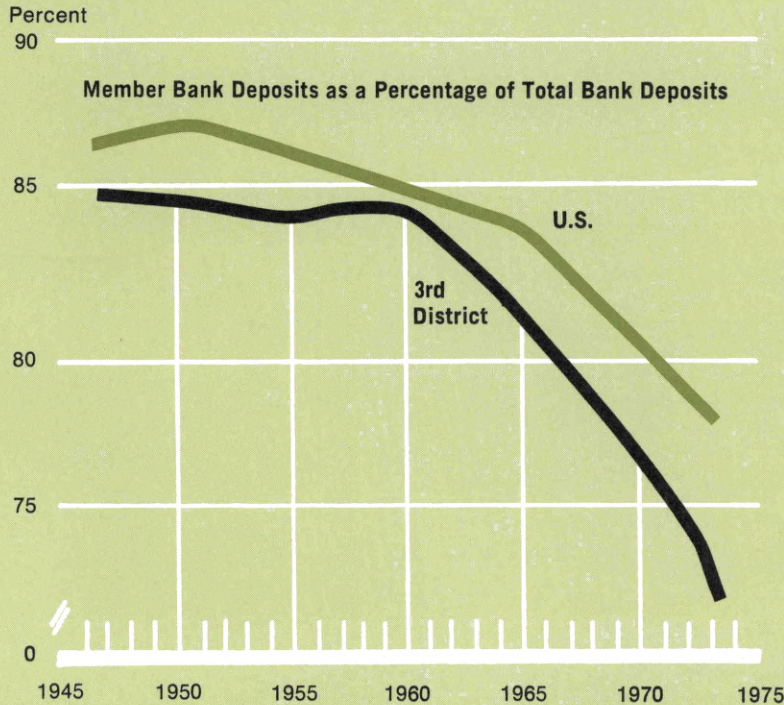


Table). Most states, with notable exceptions like Illinois which has no reserve requirements, have about the same level of reserve requirements as the Fed. The real advantage for nonmembers comes from being allowed to count earning assets (such as U. S. Government bonds) and correspondent balances (including in some cases uncollected items) while Fed members in the main can count only sterile balances on deposit at the Fed as reserves.<sup>1</sup>

Since interest rates generally have risen since

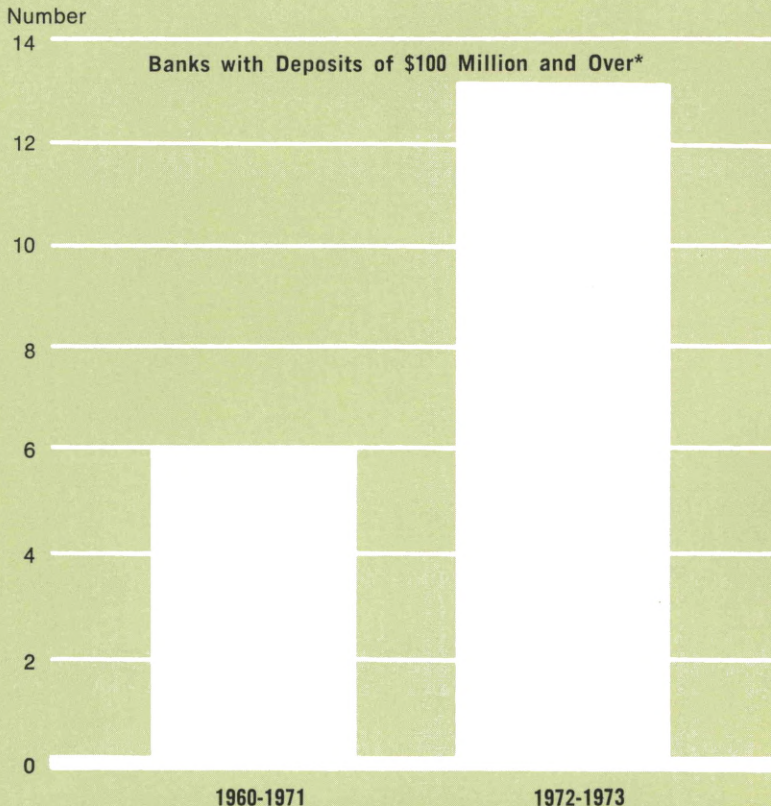
<sup>1</sup>Fed members may also count cash in vaults as part of their required reserves.

World War II, the earnings advantage of non-membership has become more pronounced (see Chart 4). For example, in 1953, nonmember bank reserves invested in three-month Treasury Bills earned an average return of 1.90 percent. In 1963, the average yield was 3.16 percent. During 1973, such reserves yielded a return of 7.03 percent—more than triple the rate of 20 years ago and more than double the rate of 10 years ago.

It is not surprising, therefore, that the exodus of member banks has been accelerating. It is also clear that as long as nonmembers enjoy such a break in reserve requirements that Fed member-

CHART 3

MORE THAN TWICE THE NUMBER OF LARGE BANKS HAVE LEFT THE FED IN THE LAST TWO YEARS THAN IN THE PREVIOUS DOZEN YEARS COMBINED



ship will continue to decline, probably at an even faster rate as withdrawals become more frequent among larger banks.

**WHY BE CONCERNED?**

**Eroding Monetary Control.** Every modern nation needs an effective central bank if it is to

foster an environment consistent with high employment and stable prices. At the heart of monetary policy is the Federal Reserve's ability to control bank reserves. As the share of demand deposits governed by state reserve regulations has increased in recent years, the Fed's ability to control the money stock through bank reserves has been reduced. If more and more demand

TABLE

STATE RESERVE REQUIREMENTS FOR COMMERCIAL BANKS IN EFFECT MARCH 20, 1973

	Reserve requirement shown as percentage		Unless otherwise indicated reserves must be held in vault cash, demand balances in banks (collected and uncollected)*
	Demand	Time	
Alabama	11	3	
Alaska	20	8	
Arizona	10	4	
Arkansas	Same as Federal Reserve	Same as Federal Reserve	
California	do	5	80% T in U.S. securities.
Colorado	15	15	100% in U.S. securities.
Connecticut	12 up to \$5MM	0	Savings
	12½% over \$5MM	5	Other
Delaware	8 up to \$100MM	3	16.7% in U.S. securities.
	10 over \$100MM		
Florida	20	20	100% in U.S. securities.
Georgia	15	5	100% T in U.S. or Georgia securities. 50% D in U.S. securities maturing within 1 year or CDs.
Hawaii	12	5	
Idaho	15	15	33⅓% in U.S. securities.
Illinois	0	0	
Indiana	10	3	
Iowa <sup>1</sup>	7	3	
Kansas	12½ (20 deposits of other banks).	5	
Kentucky <sup>2</sup>	7	3	25% D, 100% T in U.S. or Kentucky securities or CDs.
Louisiana	20	0	
Maine	8 up to \$10MM	3	Savings
	12 over \$10MM		Other: 3 up to \$5MM
			Other: 5 over \$5MM
Maryland	15	3	100% T in U.S. or Maryland securities.
Massachusetts <sup>3</sup>	15	0	80% in U.S. or Massachusetts securities.
Michigan	11	6	90% T in U.S. securities.
Minnesota	12	3	30% in U.S. securities maturing within 1 year.
Mississippi	Same as Federal Reserve	Same as Federal Reserve	30% in U.S. securities (half of the 30% may be in CDs).
Missouri	Same as Federal Reserve	3	
Montana	8 up to \$2MM		
	10 over \$2MM	3	

\*Figures below represent percent of reserve requirement. "D" indicates reserve requirement on demand deposits. "T" indicates reserve requirement on time deposits.

<sup>1</sup>10% of demand deposits of banks located in Reserve city.

<sup>2</sup>10% of demand in Reserve cities.

<sup>3</sup>In Boston: 20% of demand.

<sup>4</sup>In cities of 25,000 or more 30% demand.

**TABLE  
(continued)**

**STATE RESERVE REQUIREMENTS FOR COMMERCIAL BANKS IN EFFECT MARCH 20, 1973**

	Reserve requirement shown as percentage		Unless otherwise indicated reserves must be held in vault cash, demand balances in banks (collected and uncollected)*
	Demand	Time	
Nebraska <sup>4</sup> . . . . .	15	5	50% in U.S. securities.
Nevada . . . . .	Same as Federal Reserve	Same as Federal Reserve	
New Hampshire . . . . .	12	5	40% in U.S. securities maturing within two years.
New Jersey . . . . .	Same as Federal Reserve	Same as Federal Reserve	
New Mexico . . . . .	12	4	50% in U.S. securities maturing within 100 days.
New York . . . . .	1% less than Federal Reserve.	1% less than Federal Reserve.	
North Carolina . . . . .	15	5	
North Dakota . . . . .	8	2	
Ohio . . . . .	7	3	60% T in U.S. securities.
Oklahoma <sup>5</sup> . . . . .	Same as Federal Reserve	Same as Federal Reserve	
Oregon . . . . .	12	4	60% T in U.S. securities maturing within 1 year.
Pennsylvania . . . . .	12	3 up to \$5MM 5 over \$5MM.	50% in U.S., U.S. Agency or Pennsylvania securities.
Rhode Island . . . . .	15	0	60% in U.S. securities maturing within 91 days.
South Carolina . . . . .	7	3	
South Dakota . . . . .	17½	17½	60% in U.S. securities.
Tennessee . . . . .	10	3	
Texas . . . . .	15	5	
Utah . . . . .	Same as Federal Reserve	Same as Federal Reserve	
Vermont . . . . .	27	7	(½ of 60% in Vermont securities.) 60% in U.S. securities maturing in one year.
Virginia . . . . .	10	3	
Washington . . . . .	Same as Federal Reserve	Same as Federal Reserve	
West Virginia . . . . .	7	3	
Wisconsin <sup>6</sup> . . . . .	12	12	33½% D and 58.3% T in U.S. securities maturing in 18 months.
Wyoming . . . . .	20	10	50% in Treasury Bills.

\*Figures below represent percent of reserve requirement. "D" indicates reserve requirement on demand deposits. "T" indicates reserve requirement on time deposits.

<sup>4</sup>Except, 12% on demand over \$10 million.

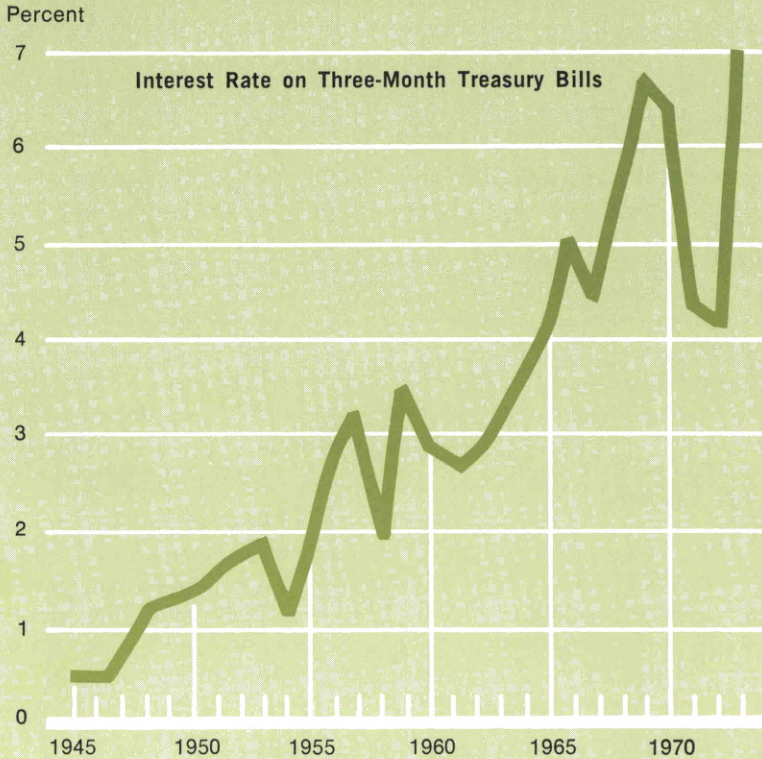
<sup>5</sup>20% for commissioner-approved "Reserve" banks.

Source: "Recommendations for Change in the U.S. Financial System," Department of the Treasury, September 24, 1973.



CHART 4

THE UPSWING IN INTEREST RATES IN RECENT YEARS INCREASES THE EARNINGS ADVANTAGE FOR NONMEMBERSHIP



deposits continue to come under state reserve requirements, the Federal Reserve—the nation’s central bank—will find it more difficult to carry out its main function of effectively managing the nation’s money supply.

State regulation of reserves undermines the Fed’s ability to control the nation’s money supply<sup>2</sup> in two ways. First, some states allow

different types of assets to be counted as reserves. In Pennsylvania, for example, nonmember banks are permitted to keep a large portion of their reserves in correspondent balances and earning assets, such as Government bonds, whereas member banks must hold their reserves in non-interest-bearing deposits with the Fed or in cash. Counting correspondent balances as reserves results in a pyramiding of reserves which loosens the link between reserves and deposits. (Incidentally, one of the reasons Congress established the Federal Re-

<sup>2</sup>More precise, demand deposits and cash held by the public, sometimes referred to as M<sub>1</sub> or the narrow money supply.

serve System in 1913 was to avoid the frequent monetary panics of the late 1800s and early 1900s which were intensified by the pyramiding of bank reserves.)

Take a simple example in which both the Fed and the states require a 10 percent reserve against demand deposits. Member banks must keep their reserves on deposit at the Fed and nonmember banks may count correspondent balances as reserve requirements. Now suppose the Fed injects an additional \$100 of new reserves into the banking system. If only member banks are involved, the \$100 in new reserves can ultimately support an increase in deposits and the money supply of \$1,000 (see Chart 5, upper panel). If nonmembers are involved and they count as reserves correspondent balances at member banks, the same \$100 increase in reserves will support as much as \$10,000 in new deposits (see Chart 5, middle panel). If nonmembers count as reserves correspondent balances in nonmember banks which then deposited reserves in member banks (for example, Nonmember A holds reserves in Nonmember B and Nonmember B holds reserves in Member C), then a \$100,000 increase in deposits can be supported by \$100 in added reserves (see Chart 5, lower panel). Going to the extreme, if there were no member banks and correspondent balances could serve as reserves, then \$100 in new reserves would theoretically support an unending increase in the money supply as pyramiding could continue without interruption.<sup>3</sup>

Pyramiding of reserves can make the Fed's job more difficult because of the uncertainties it creates. The Fed has no way of forecasting perfectly the extent of pyramiding that will take place. At any point in time, the amount of pyramiding will depend on the demands of correspondent and respondent banks. Therefore, to the extent that the Fed cannot predict or offset this pyramiding, its control of money through reserves is diluted.

<sup>3</sup>In practice, the expansion would not be unlimited because even nonmember banks would need working balances. But these working balances likely would be less than required reserves and less predictable.

Counting Government bonds as reserves can also complicate the conduct of monetary policy because the Fed does not control the availability of these bonds. If individual banks can add to the economy's reserve base simply by purchasing Government bonds, then the Fed no longer controls the availability of reserves which act as the foundation for the money supply.

For example, if the Fed wants to reduce reserves, it sells Government securities. If a member bank buys the securities, its reserve deposits at the Fed are reduced and the money supply will ultimately be reduced because of the smaller reserve base (see Box 1). (Again, this example is oversimplified for illustrative purposes.) Suppose, however, that a nonmember bank buys the bonds and under state regulations it can count the bonds as reserves. In effect, open-market operations have been nullified because the total amount of reserves in the economy remains the same. What has happened is that reserves on deposit have been traded for reserves held in the form of Government bonds. No change will result in the money supply.

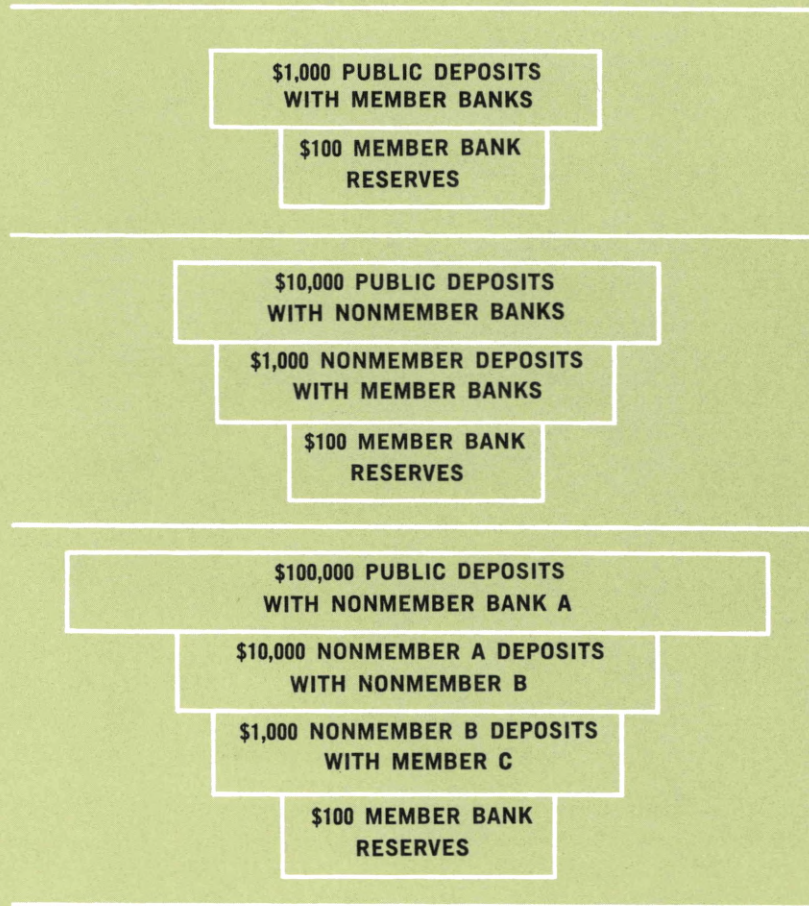
This, of course, is an extreme example. Shifting of assets between members and nonmembers will in general only partially offset the impact of open-market operations. The difficulty is, however, that there is no easy way for the Fed to anticipate the exact amount of these asset shifts, so it doesn't know how much to adjust for them and, to that extent, monetary control can be impaired.

**Equity.** A second reason for concern is that the present arrangement is simply unfair. Demand deposits in all banks are part of the money supply and reserve requirements—both the level and the composition—play a pivotal role in the conduct of monetary policy. Yet, member banks carry a heavier burden in most states than nonmembers because members can't hold even part of their reserves in earning assets.

Sometimes they carry an additional burden in terms of level as well. During the high inflation period of 1973, for example, the Fed raised reserve requirements twice on certificates of deposit to inhibit the expansion of bank credit.

**CHART 5**

**BECAUSE OF ITS UNPREDICTABILITY, PYRAMIDING OF RESERVES  
CAN MAKE THE FED'S JOB OF CONTROLLING THE MONEY STOCK  
MORE DIFFICULT**



## BOX 1

## HOW THE FED CONTROLS THE MONEY SUPPLY

In the United States, the Federal Government and the commercial banks are the issuers of money (currency plus demand and, possibly, time deposits at commercial banks\*). However, the Federal Reserve System, an agency of the Federal Government, has the responsibility for controlling the money supply. The Fed exercises control through its own liabilities—currency and reserves of member banks (so-called high-powered money). It is through injecting or withdrawing high-powered money into or from the economy that the money supply is changed.

**Changing High-Powered Money.** There are two methods the Fed uses to alter the amount of high-powered money in the economy. By far the most important of these is the use of "open-market operations." Using this method the Fed buys or sells (U. S. Government) securities in the financial marketplace. When securities are bought, the sellers (individuals, corporations, and security dealers) receive payment in dollars which they either hold as currency or deposits in the bank. When securities are sold, the buyer usually pays by check and the Fed debits the reserve account of the bank on which the check was drawn. A second significant but far less important method is directly making loans to banks. Again, however, the Fed has the ultimate power to limit how much it will lend.

**Changes in High-Powered Money Change the Money Supply.** Adding high-powered money to individuals' currency holdings directly adds to the money supply. However, since individuals and businesses keep only a small part of their total money holdings in currency form (about a fourth), most of the high-powered money goes into reserves in the commercial banks. With an increase in reserves, a bank is able to increase its checking (or savings) account liabilities—in part by crediting the account of the depositor of high-powered money and in part by making more loans and, hence, crediting the borrower's account by the amount of the loan. Thus, by changing banks' reserves, the money supply is also changed. In fact, since banks keep less than a dollar in reserves for every dollar of deposits issues, a change in bank reserves of a dollar results in a change in deposits and, hence the money supply, of more than one dollar.

The Fed's control over the money supply is by no means absolute, especially within the space of a month or even one to two quarters. For example, the Fed cannot be sure exactly how much the money supply will change every time it puts in or takes out a given amount of high-powered money. Nonetheless, as long as the Fed controls the reserve base, the relationship is fairly predictable over several quarters and over the space of, say, one year, Fed actions become the major determinant of changes in the money supply.

\*The criterion for including time deposits in the money supply is whether individuals regard this asset as a close substitute for assets accepted as a means of payment—that is, for currency or demand deposits. For policy matters, current practice is often to consider both the narrower and more inclusive definition. Because movements in the money supply according to one definition tend to parallel movements according to the other definition, the use of either definition usually leads to similar policy implications or conclusions.

Only member banks were obliged to adhere to these higher reserve requirements. Nonmember banks were not obligated to participate in this national program of monetary restraint and many did not. Equity demands that equals be treated equally. Yet, banks across the street from each other, competing in the same markets, with roughly the same resources are treated most unequally. Bankers are put in the awkward position

of choosing between what is good for an effective monetary policy and what is most profitable for their shareholders.

### WHAT CAN BE DONE?

There are two often-heard approaches to eliminating (or at least substantially reducing) the inequities between members and nonmem-

bers and mitigating the further erosion of the Fed's ability to control the money stock. The first approach is to equalize the burden of reserve requirements for all banks of the same size. The other approach is to pay member banks something for keeping reserves on deposit at the Fed.

**Uniform Reserve Requirements.** A fundamental approach for insuring equity and preventing the further dilution of monetary control is for all banks to have uniform reserve requirements. With this in mind, the Federal Reserve has submitted to Congress proposed legislation<sup>4</sup> that would make all but the smallest nonmember banks subject to its reserve requirements. The specifics of the draft legislation are as follows:

1. Demand deposits would be subject to a reserve requirement, set by the Fed, ranging from 5 percent to 22 percent. The present range is from 7 percent to 22 percent—from 10 percent to 22 percent at reserve city banks and from 7 percent to 14 percent at other banks. Under the proposal, no distinction would be made between reserve city and other banks.
2. Interest-bearing deposits from which withdrawals may be made by negotiable instruments (such as NOWs) would be subject to a reserve requirement ranging from 3 percent to 20 percent. NOW accounts at member banks in Massachusetts and New Hampshire—the only states where such accounts are permissible—are at present subject to the reserve requirement that applies to time and savings deposits, which may range from 3 percent to 10 percent.
3. There would be no required reserves against the first \$2 million of net demand deposits and NOWs at nonmember institutions. About 3,000 small nonmember banks, therefore, would continue to be exempt from Federal reserve requirements. Even with this exemption, however, the

portion of the nation's demand deposits subject to Federal control would jump from 78 percent at present to 97 percent when the legislation becomes effective.

4. Time and savings deposits of member banks would be subject to a reserve requirement ranging from 1 percent to 10 percent (instead of 3 percent to 10 percent at present). Time and savings deposits of nonmember institutions would not be subject to reserve requirements.
5. Every institution that receives demand deposits or offers NOW accounts would be required to report its deposit liabilities and required reserves, if any, as the Fed may request. (See Box 2.)
6. Nonmember institutions subject to reserve requirements would have access to the discount window, subject to regulations issued by the Fed.
7. A transition period of four years would apply to the total amount of demand deposits held by nonmember institutions at the time of enactment of the new law. During the first calendar year following the date of enactment, an institution would be required to carry 20 percent of the required reserves on base period demand deposits, 40 percent during the second year, 60 percent during the third year, 80 percent during the fourth year and 100 percent after that. Additions to demand deposits beyond the base period amount would be subject to the full reserve requirements when the new bill becomes effective.
8. The new law would become effective at the beginning of the first calendar year following its enactment.

It is important to note that the proposal for uniform reserve requirements does *NOT* require mandatory membership in the Federal Reserve System. Membership in the Fed is not critical to an effective monetary policy if banks are required to maintain uniform reserves at the Fed. Control of the reserve base is what matters.

Uniform reserve requirements, therefore, are not a threat to the dual banking system. Banks

<sup>4</sup>U. S. Congress, Senate, Committee on Banking, Housing and Urban Affairs, *S. 2898: A Bill to Modify Reserve Requirements of Member Banks of the Federal Reserve System*. . . , 93rd Cong., 2d sess., 28 January 1974.

## BOX 2

## THE DATA GAP: MEASURING MONEY WITH NONMEMBERS

The Fed's main job is to manage the nation's money supply. To do so effectively, it must have accurate information about present and past levels of the money supply. As obvious as this may seem, the Fed now gets poor data for the part of the money supply on deposit at nonmember banks.

Under present arrangements, member banks report their deposits on a daily basis. (In some cases, member banks send their reports to the Fed daily; in other cases, daily figures are sent weekly). In contrast, levels of nonmember bank deposits are reported only infrequently. The Federal Deposit Insurance Corporation requires that FDIC-insured nonmember banks file statements of financial condition only on four call dates each year.

Several problems arise from this reporting arrangement for nonmembers. First, the money supply displays substantial day-to-day fluctuation. Thus, the data for call dates may not be representative of data for adjacent days and weeks. Second, the call report data from nonmembers are worked into a money supply estimate only with a three- or four-month lag. This means that by the time the Fed finds out that the actual money supply level differed from the level desired, the impact of that error may be starting to affect the economy. Third, between call dates the Federal Reserve must guess at the level of nonmember deposits, and therefore at the level of the money supply itself. Although some time and effort go into making the best guesses possible, the errors can be large. As a result, monetary policy, in fact, may be tighter or easier than the best estimates would indicate.

Recent revisions provide an example of how inaccurate money supply figures can be because of data problems stemming from nonmember banks. The Fed estimated that the money supply ( $M_1$ ) had grown at 8.3 percent in 1972 and 5 percent in 1973. When nonmember data became available, these estimates were revised to 8.7 percent in 1972 and 5.7 percent in 1973. For half-year periods the differences are even larger. The growth rate for the second half of 1972 was raised from 8.5 percent to 9.4 percent; and for the first half of 1973, from 6 percent to 7.7 percent. At a time when the economy was rapidly nearing its capacity to produce, monetary policy was significantly more expansive than had been thought to be the case when policy was being made.

The need for better nonmember bank data is, therefore, quite clear. As the fraction of deposits held by nonmember banks continues to rise, even larger revisions may occur in the future. If Congress is willing, this problem can be solved easily by allowing the Fed to put nonmember banks on the same daily reporting basis as member banks.

would still be free to choose between national and state charters, and if state-chartered, between membership and nonmembership in the Fed. Uniform reserve requirements would not change the separate regulatory rules governing member and state nonmember banks. Healthy competition between chartering authorities could still foster regulatory innovations.

Dual banking has been with us for over a century. It has survived and prospered with the National Banking Act of 1863, the establishment of the Federal Reserve System in 1913, and the creation of the FDIC in 1935, despite warnings to the contrary. Dual banking would also prosper

under uniform reserve requirements. In fact, without some remedy the dual banking system will be strangled in states like Pennsylvania where reserve requirements so unfairly favor state nonmember banks.

**Paying Interest on Reserves.** Another approach to protect the effectiveness of monetary policy and redress the current inequities is for the Federal Reserve to pay interest on reserve deposits of member banks. From a monetary policy standpoint, even though required reserves would be drawing interest, the Fed could still control the amount of reserves.


Paying interest on required reserves has the appeal of giving something to member banks rather than taking something away from non-member banks as would be the case with uniform reserve requirements. Equity would be achieved by giving members a similar break to what nonmembers in many states already enjoy rather than taking an existing break away from nonmembers. However, paying interest on reserves would cut into Fed earnings and result in smaller payments to the Treasury. Many see this as a drawback of the plan. Last year, for example, the Fed returned \$4.3 billion to the Treasury from surplus earnings. Had the Fed paid, say, 5 percent on required reserves, payments to the Treasury would have been reduced by \$1.8 billion. Member bankers may claim this has been their money all along because they are forced to keep sterile balances at the Fed, but others may see paying interest on reserves as a raid on the Treasury. Nonetheless, paying interest on reserves deserves serious consideration.

## CONCLUSION

Monetary policy is clearly a national responsibility; it cannot be sliced 50 ways and still be effective. Monetary policy is the Federal Reserve's job, and to carry out its monetary policy responsibility the Fed must maintain control

over reserves—the foundation of the nation's money supply.

With declining membership in the Federal Reserve likely to continue, some way needs to be found to assure that the Fed has sufficient control over the money stock to do its job. A fundamental approach is uniform reserve requirements for all banks—whether member or nonmember. Another approach is to compensate member banks for the costs of membership by paying them interest on required reserves.

These are basic approaches. Variations of each approach or combinations of approaches are, of course, possible. For example, under the Fed's proposed bill, uniform reserve requirements would be phased in over four years and the level of reserve requirements could be reduced from existing levels. In addition, about 3,000 small nonmember banks would be exempt from uniform reserve requirements. Although not a part of the proposed bill, some payment of interest on reserves is worth considering. But whatever the details of reform, fundamental reform is essential. Bankers should not have to choose between what's good for their stockholders and what's good for an effective monetary policy. The benefits of a healthy economy are shared by all bankers and the burdens of an effective monetary policy should be shared by all bankers as well. 

## NOW AVAILABLE: INDEX TO FEDERAL RESERVE BANK REVIEWS

Articles which have appeared in the reviews of the 12 Federal Reserve Banks have been indexed by subject by Doris F. Zimmermann, Librarian of the Federal Reserve Bank of Philadelphia. The index covers the years 1950 through 1972 and is available upon request from the Department of Public Services, Federal Reserve Bank of Philadelphia, Philadelphia, Pennsylvania 19101.

# The Case against Uniform Reserves: A Loss of Perspective

*By Ira Kaminow*

Thoughtful discussion is a prerequisite of wise policy. Fortunately, financial policies have always been subject to vigorous and constructive debate from all sides, and proposals for uniform reserve requirements are no exception. While many see the proposal<sup>1</sup> as beneficial, others view it with skepticism or outright disapproval. Proponents of the plan argue that it will improve the Fed's ability to control the money stock, an important instrument of monetary policy. In addition, they claim that uniformity is fairer because it subjects all issuers of demand-type deposits to the same reserve requirements re-

gardless of membership status. Among those favoring uniform reserve requirements are: The Federal Reserve System, the Commission on Money and Credit, the President's Committee on Financial Institutions (1962), and the President's Commission on Financial Structure and Regulation (1971). Despite this rather broad support, however, the plan is not without critics.

Opponents have three reservations: The proposal will have only negligible impact on monetary control; it will severely weaken the dual banking system; and it will severely weaken correspondent bank relationships. Anyone interested in the issue will have to decide for himself how valid and important these objections are. But in evaluating them, it is important to keep each in its proper perspective so that a fair decision can be made.

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<sup>1</sup>The proposal, if adopted would subject banks that are not members of the Federal Reserve to the same reserve requirements as members. For details, see the article by Edward G. Boehne in this issue.



## UNIFORM RESERVE REQUIREMENTS AND MONEY STOCK CONTROL

Few if any analysts deny that uniform reserve requirements will improve the Fed's ability to control the money stock. However, some observers believe the degree of improvement will be negligible, especially in comparison with the myriad other problems facing the Monetary Authority both in controlling the money stock and in figuring out what to do with it once it's under control.

There's truth in this point of view. At this moment, inadequate control of the money supply is not the most serious problem of monetary policy. Indeed, the greatest gains to effective monetary policy will probably come more from learning how to use better the tools now available than from forging better tools. In addition, it must be granted that uniformity of reserve requirements is only one of many steps that could be taken to improve control of the money stock.

But, true as these propositions are, they cloud the basic issue. It makes no sense to reject improvements simply because they are small or incomplete. The real issue is whether the potential benefits of adoption—however large or small—outweigh the likely costs. To gain insights into this key issue, we must have some idea of the potential benefits of uniform reserve requirements. How much will the plan actually improve control of the money stock?

Unfortunately, answering this question is not as easy as some believe. It depends on how people behave, how well the Fed can predict behavior and how the Fed goes about monetary control. To make matters worse, the answer will be different in today's world in which three-fourths of the nation's demand deposits are at member banks and tomorrow's in which this fraction may be smaller. But, these difficulties aside we can at least discuss what's at issue.

Over the years, the Fed has been able to count on a fairly stable relationship between the money stock (currency plus demand deposits) and member bank reserves. If historical experience is a guide, every dollar increase in member

bank reserves will eventually lead to growth in money of about \$7.80. Money and reserves are chained together by several links (see Chart 1).

Link 1: Member banks generally issue about \$4.50 in demand deposits for each dollar of reserves.

Link 2. Total deposits are usually one-third higher than member deposits, so for each \$4.50 in member deposits, we can expect about \$6.00 in total demand deposits.

Link 3: The public mixes money about 1 part demand deposits to .3 part currency. This last link tells us that \$6.00 of demand deposits means about \$7.80 worth of money.<sup>2</sup>

If all the links held tight, the Fed could simply inject one dollar in reserves for every \$7.80 in money it desired. Unfortunately, the links hold together only loosely, especially in the short run. Instead of \$4.50 in member demand deposits per dollar of reserves, we might get only \$4.40 in member demand deposits in a particular month. If all other links held, this would mean only \$5.87 in total demand deposits and \$7.63 (instead of \$7.80) in money.<sup>3</sup> Similarly, the public might choose to hold a little more than .25 of total demand deposits at nonmember banks. If the fraction were .26, one dollar in member reserve would parlay into \$7.90 in money. So, because of shifts in bank and public behavior the 7.80:1 ratio jumps around, especially in the short run. And this jumping around can be a prime cause of short-run changes in the money stock. The Fed must therefore try to anticipate and offset shifts in public behavior by injecting more or less reserves or accept undesired short-run fluctuations in the money supply. Whatever policy it chooses, however, it would be better if shifts in bank and public behavior had a smaller impact on the money stock. A well-designed reserve requirement structure can accomplish this.

A good illustration is uniform reserve requirements. If all banks were subject to the same reserve requirements, fluctuations in the deposit

<sup>2</sup>\$4.50 × 1⅓ = \$6.00; \$6.00 × 1.3 = \$7.80.

<sup>3</sup>\$4.40 × 1⅓ = \$5.87; \$5.87 × 1.3 = \$7.63.

CHART 1

TODAY'S RESERVE-MONEY CHAIN HOLDS TOGETHER LOOSELY IN THE SHORT RUN . . .

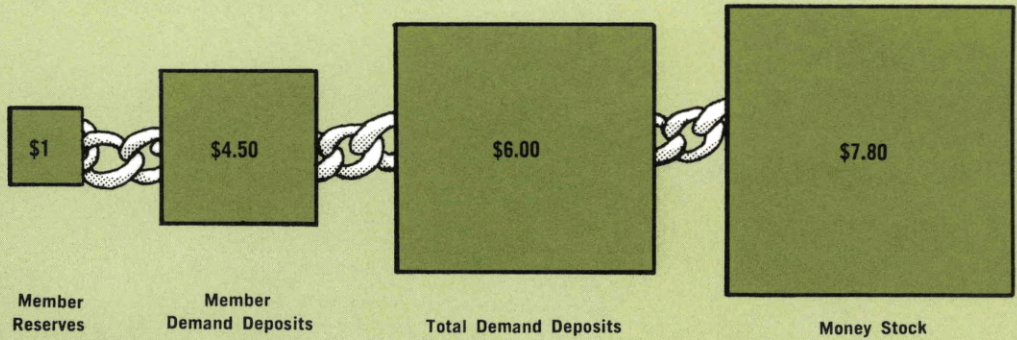
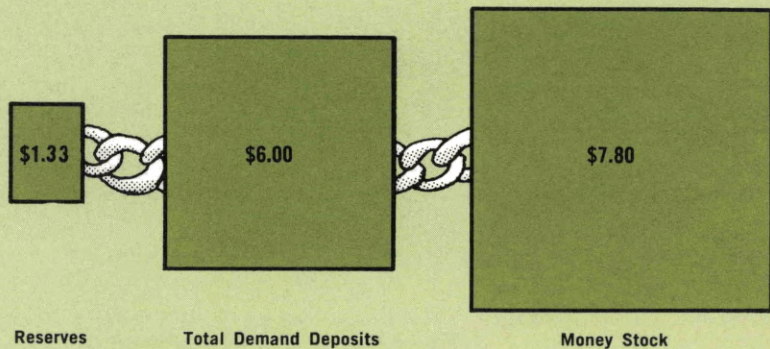


CHART 2

BUT WITH UNIFORM RESERVE REQUIREMENTS, ELIMINATION OF THE SECOND LINK COULD REDUCE FLUCTUATIONS IN THE MONEY STOCK



mix between member and nonmember banks would not have an impact on the money stock. One of the uncertain links would be eliminated. (see Chart 2).

Unfortunately, there is no way to determine the importance of eliminating this uncertainty. Because nonmember banks report their deposits only four days a year <sup>4</sup> (instead of every day in the case of members), there is no way to determine what fluctuations in the deposit mix have been or are likely to be. Nevertheless if improved control from uniform reserves could be put to use, it might well help us in achieving our national inflation and unemployment goals. In relative terms it may or may not make a big difference, but given the enormity of our economy, even tiny improvements in policy can translate into many millions of dollars.

## UNIFORM RESERVE REQUIREMENTS AND DUAL BANKING

Dual banking means, quite simply, that a bank may choose to obtain its charter either from its state or the Federal Government. The choice has a number of technical, though sometimes important, implications for bank operations and profitability. Among the most important of these implications is that only national banks are required to become members of the Federal Reserve System. Hence, under present law, state banks can avoid Fed reserve requirements by declining to join the system. Of course, state banks must meet state requirements but many perceive these requirements to be less costly than those of the Fed.<sup>5</sup>

Opponents of the uniform reserve plan see it as a threat to the advantages of dual banking. While not everyone agrees that dual banking works to society's benefit, those who favor the system do so for two related reasons. First, under dual banking, banks are free to choose the set of

regulations and regulators they find more compatible. Second, because banks can switch, there are checks and balances that discourage one or the other government from treating banks unkindly. As Ross Robertson, an advocate of charter choice, put it:<sup>6</sup> "The 'dual' banking system . . . persists largely because state legislators are more readily persuaded than Congress to pass laws favorable to small banks."

Whatever your views on the merit of dual banking, however, it is important to remember that uniform reserve requirements will leave dual banking essentially intact. Banks will continue to have freedom to choose their chartering and regulatory authorities. Of course, some may switch to national charters if they were no longer able to escape Fed reserve requirements through state chartering. However, many banks would continue with their states. Even today, many members are state banks.

The question, therefore, is not whether uniform reserve requirements are consistent with a viable dual banking system—they are. The question is whether the nation will be better off under the present system of nonuniform reserves which seems to favor growth in state chartering or under uniform reserves which may favor growth in national chartering.

No one really has the answer to this question. There is no magic formula for the correct mix of state and national banks. Certainly, there's no reason to believe that the current mix is the best possible. The mix we have today is simply a consequence of the particular set of advantages and disadvantages built into each kind of charter. The relative advantages have developed largely through more or less random historical and political forces and subject to no grand or well-thought-out design. No one can say that a shift in the direction of national chartering will be good or bad from society's point of view. Since, however, it is apparently the option to choose and not the choice itself

<sup>4</sup>In addition to uniform reserves the proposed legislation would require nonmembers to report deposits daily.

<sup>5</sup>See the article by Edward G. Boehne in this issue for a discussion of this point.

<sup>6</sup>Ross M. Robertson, assisted by Abby L. Gilbert, *The Comptroller and Bank Supervision* (Washington: Office of the Comptroller of the Currency, 1968), p. 8.

that is the key to dual banking, a mere shift in the balance would probably not be very significant for better or worse.

### UNIFORM RESERVES AND CORRESPONDENT BANKING

Despite a certain mysticism surrounding banking, it is a business much like any other. And, as with other industries, banking has a complex service network involving wholesale and retail aspects. In general, small banks cannot produce a wide variety of banking services entirely on their premises so they frequently buy at "wholesale" from larger banks with whom they have correspondent relationships. For example, many large banks acting as correspondents maintain inventories of currency which they supply to smaller "respondent" banks as the demand arises. Similarly, correspondent banks help respondents by providing check-clearing services, financial advice, lending opportunities, accounting services, and so on. While respondents sometimes pay for these services directly, they frequently pay by maintaining interest-free balances with correspondents. The correspondents can then lend the funds made available at market interest rates. Paying this way is especially attractive to nonmember respondents because in most states each dollar of these correspondent balances can also be used by the respondents to meet state reserve requirements.

For some services, the ultimate correspondents are the Federal Reserve Banks. The Fed provides the whole banking system—either directly or indirectly through correspondents—with currency and national check-clearing services. In addition, the Fed, like private correspondents, makes loans to its members through the discount "window" and performs a variety of miscellaneous services such as safe-keeping of valuable documents. It also clears checks regionally. Because the Fed serves large and small banks, there are those who see it not only as the correspondents' correspondent but also as the correspondents' competitor.

Some believe that uniform reserve require-

ments will improve the Fed's competitive position and hence weaken private correspondent banking. Since under uniform reserves all banks will be required to meet Fed reserve requirements, many nonmembers may decide to "join-up" and get free services from the Fed. The problem this presents, say opponents of uniform reserves, is that many correspondents will lose profitable business. In addition, more of the "production" of correspondent services will be handled by the Fed. Because the Fed is already the largest single "correspondent," it is feared that this will significantly reduce competitive forces. The danger is considered especially great since the Fed is a quasi-Government agency.

There is undoubtedly some truth in both these points but we should be careful not to overstate their importance. Opponents sometimes note that even if all nonmembers joined the Federal Reserve, correspondent balances might fall by as much as 20 or 25 percent. Proper analysis requires that we look at this figure a little more carefully. From the point of view of the whole banking system, this projected decline represents only about 1 percent of total deposits. For banks that do a lot of correspondent business that figure will be higher—perhaps 3 or 4 percent—and for them this may result in some loss of profits. But even this 3 or 4 percent may overstate the actual loss. Remember that one reason respondents hold correspondent balances is to meet state reserve requirements. It makes sense that if a bank no longer needs to meet these requirements it will pay for more services directly. So a bank that joins the Fed may cut back balances with correspondents more than it cuts back on demand for correspondent services.

In any event, we must evaluate uniform reserves from the point of view of the whole society, not just correspondent banks. In this broader perspective, a small loss in profits by some banks must certainly be considered but it is of much less consequence. In addition, from society's point of view, some services that respondents drop when they become members may not be worth their costs. To the extent that nonmembers hold correspondent balances to meet state reserve requirements, the services they get are

“free” because they would hold the balances anyway. Nonmember respondents will therefore demand some services they would not otherwise be willing to pay for. It is largely those services that respondents will drop when they are no longer required to hold correspondent balances to meet reserve requirements.

If declining correspondent balances are not all that important for society, what about concentration of correspondent business in the hands of the Fed? Unnecessary concentration of productive capacity should clearly be avoided. It is true that the Fed may wind up producing more services if membership grows. But probably not as much as many believe. The overwhelming share of bank services offered by the Fed is devoted to services already enjoyed by nonmembers, or available to them on the same terms as members. The principal Fed services offered to the banking community are interregional and regional check clearing, provision of currency and coin, and making loans available to members. Nearly all of the country’s interregional check clearing is already performed by the Fed. And, to a large extent, the Fed makes its regional check-clearing operations available to nonmembers on the same terms as members. Similarly, currency and coin is made available to members and nonmembers alike, although nonmembers unlike members must pay for the delivery of currency. Among all the Fed’s major services, only access to the discount “window” is available exclusively to members.


Looking at it from the banks’ side, private correspondents perform many services that are unavailable from the Fed. Assistance with records management, portfolio advice, and loan participations are a few.

In short, the overlap between Fed and correspondent services may not be as great as many believe. So there may not be very much of a switch to Fed-produced services as a result of uniform reserves.

## CONCLUSION

Perspective is the key to evaluating uniform reserve requirements. As we examine their likely contribution to economic stabilization, we should keep in mind that uniform reserves may be only a small step on the road to an ideal monetary policy. But, in a positive way we should also recognize that their contribution to money stock control could be more than negligible, especially when we realize that even small gains when added over all Americans could amount to many millions of dollars.

And when looking at other consequences of uniform reserves, we must acknowledge that there *will* be dislocations, as there are with any change in the financial structure. We should not, however, overstate the importance of these dislocations. It is not likely that uniform reserves will threaten the existence of “the most equitable of all possible institutional arrangements”<sup>7</sup> (that is, dual banking). Nor should we overstate the amount of correspondent concentration that would result from uniform reserves. If adopted, the proposal would hardly give the Fed “monopoly power”<sup>8</sup> in correspondent banking.

Perspective is important in another sense. When we evaluate uniform reserves, or any proposed change in policy, it is important that we do it from the perspective of the whole country. To be sure, gains and losses from uniform reserves will not be equally distributed among all sectors of the economy. When the final judgment on the proposal is made we should be sure to take into account the interests of all Americans. 

<sup>7</sup>Koss M. Robertson and Almarin Phillips, *Optional Affiliation with the Federal Reserve System Is Consistent with Effective Monetary Policies* (Conference of State Bank Supervisors, Washington, 1974), p. 25.

<sup>8</sup>Lawrence Kreider, “The Changing Structure of Banking” a speech delivered to the Maryland and Massachusetts Banking Associations, Bermuda, May 29–30, 1973, p. 6, mimeo text.

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