Research Department
Federal Reserve
Bank of
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Towards Uniformity

Equivalent reserve requirements should apply to all deposits that effectively serve as a part of the public's money balances. That is the principle underlying the Federal Reserve proposal for the extension of the present system of reserve requirements to nonmember institutions, to the extent that such institutions issue deposits that perform any type of checking-account function.

Under the proposed legislation, the reserve-requirement range would be between 5 and 22 percent for demand deposits, with the specific figure determined, just as now, by the Federal Reserve Board of Governors. The range would be between 3 and 20 percent for NOW accounts, that is, interest-bearing deposits for which the depositor can make withdrawals by negotiable or transferable instrument. (Other time and savings deposits of nonmember institutions would not be covered.) The proposal would apply not only to banks, but also to savings and other depository institutions, along with foreign-owned banking institutions that provide demand (or checking account) deposits. The reserves would be held in the form of vault cash or non-interest-earning deposits at the Fed.

Easing the transition

Uniform requirements could impose some burden on nonmember institutions, because even more of their assets than now could be required to be in non-interest-bearing form, thereby cutting into earnings. To offset this problem, the legislation includes a provision which effectively exempts the first $2 million of net demand deposits and NOW accounts from reserve requirements. In view of this provision, about 62 percent of present nonmember banks would be exempt from any reserve requirements that exceed their present vault-cash holdings. This apparent exception to the basic principle of equivalent reserve requirements can be safely ignored, because the dollar amounts involved are relatively small and thus do not represent a problem for Federal Reserve control of the monetary aggregates.

To ease the transition, required reserves would be phased in gradually over a four-year period, on those deposits (over $2 million) held at the time the law goes into effect. However, deposit increases above those existing at time of enactment would be immediately subject to the full reserve requirement. The legislation also would permit Federal Reserve credit to be made available to any institutions that maintain deposits with Reserve Banks, thus easing the rigid restrictions that now make nonmember borrowing difficult. This increased access to the Fed's discount window would provide a useful resource at times of strong pressures on institutions' liquidity positions.

Liquidity—and policy

Bankers have always recognized the need to hold some funds in liquid

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form to honor deposit withdrawals promptly. Such reserves were usually held in the form of vault cash, deposits with central banks or other commercial banks, or short-term government securities. To ensure maintenance of adequate liquidity, many nations have enacted banking legislation specifying minimum reserves to be held against deposits. In this country, prior to the founding of the Federal Reserve System, reserve requirements were imposed by national and state legislation as a means of protecting bank liquidity.

The basic function of minimum reserve requirements, however, is not to ensure bank liquidity, but rather to permit the Federal Reserve to control the supply of money and credit in the pursuit of its important monetary-policy objectives. Reserve requirements can influence the growth of bank loans, investments and deposits, and thus are an important element in the monetary-control mechanism. The Federal Reserve controls the total amount of assets eligible to be used as legal reserves (through open-market operations) as well as the percentage of deposits that must be held as reserves, and thus can influence the key monetary aggregates in accord with its basic policy goals.

To permit proper central-bank management of the supply of money and credit, banking institutions should meet their reserve requirements by holding assets in a form which is under the most direct control of the Federal Reserve. These assets could be either vault cash (Federal Reserve notes) or deposits at the Reserve Banks.

This test cannot be met by present state legislation. Under such legislation, nonmember banks are not required to hold reserves in the form of deposits at Federal Reserve Banks, but may rather hold their reserves as correspondent balances with other commercial banks. When such reserves are held at a member bank, that bank naturally must support these balances with its own reserves consisting either of vault cash or cash at the Federal Reserve, but the size of its cash reserves will be only a fraction of the initial deposit at the nonmember bank.

With present differential reserve requirements, therefore, shifts of deposits between member and nonmember banks alter the quantity of deposits at all commercial banks that can be supported by a given volume of bank reserves. This factor tends to loosen the links between bank reserves and the money supply, and weaken the Fed's control over the monetary aggregates.

Combatting erosion

The problem has been magnified by the substantial variability in the relative growth rates of member and nonmember banks. Over the past decade, nonmember banks have accounted for about 40 percent of the total increase in the volume of checking deposits, but the proportions have varied widely from year

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to year. This variability has made it difficult to measure the impact of Federal Reserve actions on the monetary aggregates—and therefore on final policy objectives related to income, employment and prices. This may not have been a problem in 1945, when nonmember banks accounted for only 14 percent of all commercial-bank deposits, but it is a decided problem today, when the nonmember-bank share is 22 percent and rising.

The growing importance of nonmember banks mainly reflects the competitive disadvantage imposed on member banks by requiring them to hold reserves in the form of vault cash or as deposits at the Federal Reserve. Nonmember banks, in contrast, can utilize required reserves as earning assets even when they are held as demand balances with other commercial banks, since these balances also serve as a form of payment for services rendered by city correspondents. As a consequence, banks generally have an incentive to avoid membership in the Federal Reserve System. Since 1960, about 750 banks have left the System through withdrawal or mergers, and nearly 1,700 newly chartered state banks have remained outside, compared with just over 140 that elected System membership.

The erosion of membership in the System not only reduces the precision of monetary control, but it also reduces the potential for using changes in reserve requirements as an effective instrument of policy. In effect, the System must use this monetary weapon quite sparingly, since an increase in required reserves would worsen the competitive disadvantage of member banks and thereby threaten a further erosion of membership. Admittedly, reserve requirements were increased during the 1973 boom, but their utilization as a major anti-inflationary weapon may have been inhibited on other occasions by the considerations noted here.

Confronting NOW

Finally, the concept of equivalent reserve requirements gains new urgency because of the recent efforts of nonbank deposit institutions to evolve new modes of money transfer. Mutual savings banks in Massachusetts and New Hampshire have begun to offer depositors a NOW account that closely resembles an interest-bearing checking account. In California, savings-and-loan associations have sought direct access to an electronic money-transfer system operated by California banks, so that they could charge and credit the savings accounts of their customers in much the same way that checking accounts are handled at commercial banks.

These initiatives offer obvious marketing advantages. However, they could affect monetary control adversely unless reserve requirements established by the Federal Reserve were applied to all deposit accounts involving money-transfer services.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/9/74	Change from 1/2/74	Change from year ago Dollar	Change from year ago Percent
Loans adjusted and investments*	79,461	− 770	+ 9,996	+ 14.39
Loans adjusted—total*	60,615	− 716	+10,022	+ 19.81
Securities loans	1,475	+ 35	+ 156	+ 11.83
Commercial and industrial	20,951	− 168	+ 3,116	+ 17.47
Real estate	18,310	+ 10	+ 3,134	+ 20.65
Consumer instalment	9,146	+ 7	+ 1,265	+ 16.05
U.S. Treasury securities	6,039	− 98	− 1,398	− 18.80
Other securities	12,807	+ 44	+ 1,372	+ 12.00
Deposits (less cash items)—total*	75,077	−1,063	+ 6,938	+ 10.18
Demand deposits adjusted	22,831	− 158	+ 1,103	+ 5.08
U.S. Government deposits	735	− 564	+ 12	+ 1.66
Time deposits—total*	50,330	+ 222	+ 5,807	+ 13.04
Savings	17,737	− 22	− 660	− 3.59
Other time I.P.C.	22,733	+ 298	+ 5,511	+ 32.00
State and political subdivisions	7,261	+ 68	+ 598	+ 8.97
(Large negotiable CD's)	10,619	+ 94	+ 3,846	+ 58.36

Weekly Averages of Daily Figures	Week ended 1/9/74	Week ended 1/2/74	Comparable year-ago period
Member Bank Reserve Position			
Excess reserves	30	32	8
Borrowings	79	217	68
Net free (+) / Net borrowed (—)	− 49	− 185	− 60
Federal Funds—Seven Large Banks			
Interbank Federal funds transactions Net purchases (+) / Net sales (—)	+1,755	+1,852	+420
Transactions: U.S. securities dealers Net loans (+) / Net borrowings (—)	+ 264	+ 348	+364

*Includes items not shown separately.

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