

Reserve Requirements
Chapter 14

Legal Reserve Requirements

- The focal point of the Federal Reserve's control of our money supply is *legal reserve requirements*
 - Every financial institution in the country is legally required to hold a certain percentage of its deposits on reserve, either in the form of deposits at its Federal Reserve District Bank or in its own vaults

Copyright ©2002 by The McGraw-Hill Companies, Inc. All rights reserved. 14-9

Legal Reserve Requirements

- **Technical Term Meanings**
 - *Required Reserves (RR)* is the minimum amount of vault cash and deposits (RD) at the Federal Reserve District Bank that must be held (kept on the books) by the financial institution
 - *Actual Reserves (RD)* is what the bank is holding (on the books)
 - *Excess Reserves = Actual Reserves - Required Reserves*
 - $ER = RD - RR$

Copyright ©2002 by The McGraw-Hill Companies, Inc. All rights reserved. 14-10

Legal Reserve Requirements [March 1997]

Checking Accounts	
\$0 - 42.8 million	3%
Over 42.8 million	10%
Time Deposits	0%

Copyright ©2002 by The McGraw-Hill Companies, Inc. All rights reserved.

14-11

Legal Reserve Requirements [March 1997]

Checking Accounts	
\$0 - 42.8 million	3%
Over 42.8 million	10%
Time Deposits	0%

If a bank had \$100 million in checking deposits (DD), how much reserves would it be required to hold?

Copyright ©2002 by The McGraw-Hill Companies, Inc. All rights reserved.

14-12

Legal Reserve Requirements [March 1997]

Checking Accounts	
\$0 - 42.8 million	3%
Over 42.8 million	10%
Time Deposits	0%

If a bank had \$100 million in checking deposits (DD), how much reserves would it be required to hold?

The model below excludes vault cash

Copyright ©2002 by The McGraw-Hill Companies, Inc. All rights reserved.

14-13

Legal Reserve Requirements [March 1997]

Checking Accounts

\$0 - 42.8 million 3%

Over 42.8 million 10%

Time Deposits 0%

If a bank had \$100 million in checking deposits (DD), how much reserves would it be required to hold?

The model below excludes vault cash

Bank		Fed
RD 100.000	DD 100.000	RD 100.000
	.03 X 42.8 = 1.284	100.000
	.10 X 57.2 = 5.720	- 42.800
		<u>57.200</u>

Copyright ©2002 by The McGraw-Hill Companies, Inc. All rights reserved.

14-14

Legal Reserve Requirements [March 1997]

Checking Accounts

\$0 - 42.8 million 3%

Over 42.8 million 10%

Time Deposits 0%

If a bank had \$100 million in checking deposits (DD), how much reserves would it be required to hold?

The model below excludes vault cash

Bank		Fed
RD 100.000	DD 100.000	RD 100.000
RR 7.004		
	.03 X 42.8 = 1.284	
	.10 X 57.2 = 5.720	
	RR = 7.004	

Copyright ©2002 by The McGraw-Hill Companies, Inc. All rights reserved.

14-15

Legal Reserve Requirements [March 1997]

Checking Accounts

\$0 - 42.8 million 3%

Over 42.8 million 10%

Time Deposits 0%

If a bank had \$100 million in checking deposits (DD), how much reserves would it be required to hold?

The model below excludes vault cash

Bank		Fed
RD 100.000	DD 100.000	RD 100.000
- RR 7.004		
ER 92.996		
	.03 X 42.8 = 1.284	
	.10 X 57.2 = 5.720	
	RR = 7.004	

Copyright ©2002 by The McGraw-Hill Companies, Inc. All rights reserved.

14-16

Primary and Secondary Reserves

- Every bank holds secondary reserves, mainly in the form of very short-term U.S. government securities
 - Treasury bills, notes, certificates, and bonds (that will mature in less than a year) are generally considered a bank's secondary reserves
 - These can be quickly converted to cash without loss if a bank suddenly needs money

Copyright ©2002 by The McGraw-Hill Companies, Inc. All rights reserved.

14-20
