Reserve Requirements Should – and Must – Be Set to Zero

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Section 19 of the Federal Reserve Act authorizes the Federal Reserve Board to establish reserve requirements on depository institutions “...solely for the purpose of implementing monetary policy...” Confirming the implications of that limitation, the Act specifically states that reserves requirements “may be zero.” Consistent with this statutory limitation, the Federal Reserve Board’s Regulation D states that the purpose of reserve requirements is “...facilitating the implementation of monetary policy...”

As of January 2019, the Federal Open Market Committee (FOMC) decided that it would henceforth conduct monetary policy using an “abundant reserve” or “floor” implementation framework. The first Fed staff study considering a floor framework states, “This option would reduce reserve requirements to zero...” This expectation is completely reasonable. Under the Federal Reserve’s earlier approach to monetary policy (a so-called “corridor system”), reserve requirements supported the implementation of monetary policy by helping to create a stable demand for reserves. In the floor framework the Fed has now adopted, the Fed oversupplies reserve balances, driving the federal funds rate down to the “floor” established by the interest rate the Fed pays on reserves; so using reserve requirements to establish a stable demand for reserves is unnecessary. Indeed, the Fed is currently supplying reserves in an amount about ten times the level of required reserves.

Therefore, having apparently and correctly concluded that nonzero reserve requirements serve no monetary policy purpose in the current framework, the Federal Reserve Board should – and legally must — set reserve requirements to zero.

While the legal “must” is clear, there are also good reasons for the “should.” Specifically, doing so will help avoid further turmoil in money markets, reduce the extent that the Fed must blow up its balance sheet, increase the supply of credit to the real economy, and could improve bank liquidity.

Required reserves are excluded by supervisors from the stock of assets judged to be available to meet liquidity requirements (“high-quality liquid assets” or “HQLA”). The theory behind this distinction was that required reserves were not available for a bank to meet a liquidity exigency because they were by definition required. Excess reserves—bank deposits at the Federal Reserve in excess of required reserves—are not only included in HQLA, but they are also considered the safest and most liquid asset a bank can hold. By setting reserve requirements to zero, the Fed will

3. Title 12, Chapter II, Subchapter A, Part 204, §204.1 (b).
4. The conclusion that the only purpose of reserve requirements is to support monetary policy is neither novel nor new. In 1931, the Federal Reserve System Committee on Bank Reserves stated:
   “The committee takes the position that it is no longer the primary function of legal reserve requirements to assure or preserve the liquidity of the individual member bank. The maintenance of liquidity is necessarily the responsibility of bank management and is achieved by the individual bank when an adequate proportion of its portfolio consists of assets that can be readily converted into cash. Since the establishment of the Federal Reserve System, the liquidity of an individual bank is more adequately safeguarded by the presence of the Federal Reserve banks, which were organized for the purpose, among others, of increasing the liquidity of member banks by providing for the rediscount of their eligible paper, than by the possession of legal reserves.”
increase excess reserves, and thus the stock of liquid assets eligible to meet supervisory regulations and expectations, dollar-for-dollar. In fact, when we wrote on September 3 that money market turmoil was imminent because reserves were going to decline sharply in mid-September (see "Impending Money Market Volatility Prompts Warning Light for LCR Tune-up"), our first recommendation for forestalling the turmoil was to change the rules so that banks could use required reserves as a backup source of liquidity, allowing for the inclusion of required reserves in HQLA. The same outcome could be accomplished by setting reserve requirements to zero.

For the same reason, setting reserve requirements to zero would reduce the extent to which the Fed needs to blow up its balance sheet to conduct monetary policy using a floor framework. More than half of the increase in Fed lending to primary dealers in response to the September turmoil would have been avoided if the Fed had set reserve requirements to zero. Moreover, the Fed plans to expand its balance sheet until excess reserves exceed by a fixed buffer the amount banks demand to for liquidity management purposes. That floor amount demanded by banks, and therefore the necessary size of the Fed's balance sheet, will fall dollar-for-dollar with a decline in required reserves.

Eliminating required reserves could also provide a small boost to economic growth. Historically, one of the purposes of reserve requirements was as a tool for influencing the supply of bank credit and, thereby, the economy. When the Fed raised reserve requirements, banks could take in fewer deposits and had to reduce lending. While that money-multiplier mechanism has long-since ceased to function, a more direct link between reserve requirements and credit supply still exists. Required reserves serve no purpose, not even as a source of liquidity. They are a completely sterile asset.

Every dollar a bank keeps on deposit at the Federal Reserve to satisfy reserve requirements is a dollar the bank is not lending out to businesses and households.

Lastly, as we discussed in a recent blog post (available here), because holding additional liquid assets is costly, a few banks have used sweep accounts to shift funds that are in deposit accounts at the end of each day into savings accounts, repo, Eurodollar, or money market funds. By lowering the amount in transaction accounts, sweep programs reduce banks’ required reserves, boosting their excess reserves. Because excess reserve balances do count toward liquidity requirements, the sweep programs save banks money. Ironically, the primary reason the Fed sought the authority to pay interest on reserves, the authority it is now using to conduct policy using a floor system, was to remove the incentive for banks to engage in inefficient behavior such as sweeping deposits (see the testimony of then-Governor Donald Kohn available here). Doubly ironically, to the extent that banks sweep transactions accounts into less stable sources of funding, reserve requirements are reducing, not increasing, bank liquidity.

In sum, by setting reserve requirements to zero, the Fed could come into compliance with two laws, reduce the risk of further money market turmoil, reduce the amount it needs to blow up its balance sheet, increase the supply of credit to Main Street, and eliminate the incentive it is creating for banks to engage in inefficient behavior that edges up liquidity risk. All those benefits are attainable at no cost. With apologies to Milton Friedman, not only do we assert above that the money-multiplier is long dead, we also appear to have identified a gigantic free lunch.

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7 As we explain here, we think the Fed could get smaller, but what matters is what the Fed thinks.
9 As noted, the Fed lacks the required monetary policy purpose to require reserves. In addition, Section 19 of the Federal Reserve Act also provides that any balances maintained to meet required reserves “may be used to satisfy liquidity requirements which may be imposed under other provisions of Federal or State law.” 12 U.S.C. § 461(c)(2). In denying credit for required reserves under the liquidity coverage ratio, the Federal Reserve has rather remarkably interpreted “may” to mean “may not.” (See “Realizing the Liquidity Benefit of Required Deposits at the Fed”).