The determination of commercial bank reserve requirements

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Abstract

Excess reserve ratios have been studied extensively and are believed to be endogenously determined. In contrast, required reserve ratios are conventionally treated as exogenous. However, there are public policy reasons for a positive response of reserve requirements to interest rates. These are opposed by private incentives to secure lower requirements when their cost rises with interest rates. Several kinds of evidence support the hypothesis that reserve requirements are inverse functions of interest rates, sometimes with long lags that reflect the political process. The results also suggest that banks are not passive creatures of regulation but mold their environment.

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1. Introduction

Reserve requirements are effectively taxes paid by holding non-interest-bearing government cash in bank vaults or on deposit with the Federal Reserve.1 They would not be held by

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1 See Feinman (1993) for a history of reserve requirements and estimates of their burden. The current 2-week averaging system is described in the study of Wood and Wood (1985).

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banks without legal compulsion because they are dominated by other assets: legal “excess” reserves (excess only in the sense of exceeding legal requirements) are superior because the reserve use of required cash is restricted, and cash does not reduce risk or improve solvency relative to Treasury bills.

Commercial bank lobbying for cuts in reserve requirements has been stronger in some periods than others. A main hypothesis of our study is that the resources devoted to this activity have responded to their expected benefits. Since the burden of the tax is directly related to the profitability of bank investments, if these efforts are in some degree successful, we should expect reserve ratios to vary inversely with interest rates. A negative relationship between the aggregate bank reserve ratio and the prime commercial paper rate is indicated in Fig. 1. Inverse movements were especially pronounced during the 1930s and from the 1950s to the 1980s. These movements have attracted considerable attention, but there has been no previous attempt to identify a relationship between bank reserve ratios and their costs for the entire period of the national banking system.

Although textbooks present required reserve ratios as instruments of monetary control, their use for this purpose was sparing even when it was feasible, that is, from the time the Federal Reserve was given discretion over requirements in the Banking Act of 1935 to the withdrawal of that discretion except in emergencies in the Monetary Control Act of 1980. The Fed had lobbied for control of requirements (Federal Reserve Board, 1916, p. 28), but after the attempt to “mop up” excess reserves by doubling requirements in 1936–1937,

![Fig. 1. Average bank reserve ratio (Res/D) and commercial paper rate (R).](image-url)
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