

## POLICY UPDATE

# Fed to Begin Paying Interest on Reserves

BY JOHN WALTER AND PATRICIA WESCOTT

On Oct. 13, 2006, legislation was enacted granting the Federal Reserve System a new power: to pay interest on balances held by depository institutions at Federal Reserve banks, even balances in excess of reserve requirements. Holding reserves at the Fed is mandatory for insured U.S. depository institutions, which include banks, credit unions, and savings institutions. The amount that institutions must set aside (either as balances at the Fed or as vault cash) varies but in most cases is about 10 percent of total deposits.

Reserve requirements can help foster the implementation of monetary policy because they create a predictable demand for reserves. Paying interest on reserves is not a new idea. In fact, the Federal Reserve has long promoted it, and the Nobel Prize-winning economist Milton Friedman advocated the idea more than 40 years ago. The provisions will take effect on Oct. 1, 2011.

Proponents argue that the legislation could lead to a number of improvements. First, depository institutions today expend considerable resources to minimize their required and excess reserve balances. They do so because the Fed does not pay interest on such balances. Thus, every dollar held on deposit at the Fed as reserves is one less dollar that can be employed elsewhere to earn interest. There will be fiscal costs to paying interests on reserves. However, since the Fed will earn interest on any new, excess reserves, it can at least partially offset these costs.

Depository institutions spend significant time and money to shift funds away from liabilities on which the Fed imposes reserve requirements and into liabilities on which it does not. Sophisticated, and costly to establish, bank sweep programs move customer funds from deposits that are subject to reserve requirements.

In addition, banks incur personnel and software costs to closely monitor reserve holdings, trying to ensure that *only* the required minimum is held. Such monitoring is complicated and costly because reserve balances serve a dual role: 1) meeting reserve requirements and 2) providing the channel for interbank payments. Banks want to hold no more than necessary to satisfy these two needs because they earn no interest on reserves.

Once the Fed pays interest on reserves, depository institutions will have less need to expend resources minimizing their balances. The upshot may be that a more efficient economy is produced. Depository institutions can spend fewer resources to keep tabs on reserve requirements

and redirect their efforts to more useful projects.

When the Fed begins paying interest on required reserves, and especially if it decides to pay interest on excess reserves, the payoff from investments in personnel to monitor reserve balances will diminish. Currently, with no interest payments on required and excess reserves, the payoff is equal to the difference between market interest rates and zero, so the payoff is the market rate. Once the Fed pays interest, the payoff will be the difference between the market rate and the rate the Fed pays, which is likely to be fairly small, on a risk-adjusted basis. With a smaller payoff, depository institutions will decrease their spending on monitoring their excess reserves.

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Payments system risk could be moderated by the payment of interest on reserves, especially if interest is paid on excess reserves and such reserves increase. The Federal Reserve and depository institutions face the risk that a depository will have insufficient funds on hand to make a required

payment. In such a case the defaulting institution's troubles could lead to financial difficulties for other institutions. With little or no excess reserves, institutions at times rely on expected funds from other institutions in order to complete their own payments; so the default of one institution can create problems for others. Paying interest on excess reserves would encourage depository institutions to hold excess reserves. Any additional reserves reduce the chance of defaults since depositories will have a larger buffer against payments demands.

The Fed's job of implementing monetary policy could be eased somewhat by paying interest on reserves. The Fed conducts monetary policy through its ability to influence short-term interest rates. More specifically, it attempts to maintain the federal funds rate — the interest rate depository institutions charge when lending reserves to one another — at a varying target rate that is determined by the Federal Reserve to keep inflation in check while allowing for sustainable economic growth. Observers argue that the fed funds rate is likely to be less volatile if the Fed pays interest on reserves. As a result, the Federal Reserve will have an easier time hitting its target. Of course, as with any new policy, the magnitude of these anticipated benefits is uncertain.

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