

## Guided Reading Questions for *Notes from the Vault's* "Interest on Reserves" (Answer Key)

This month, *Extra Credit* offers a set of guided reading questions for your students to use as they read *Notes from the Vault's* "Interest on Reserves" [article](#) about the monetary policy tool. The post is by Larry Wall, executive director of the Atlanta Fed's Center for Financial Innovation and Stability.

1. What two announcements recently put the spotlight on the interest on reserves tool of monetary policy? *At its meeting in December 2016, the Federal Open Market Committee decided to increase its target for the federal funds rate and rate paid on bank reserves. In January 2017, the Fed announced its remittances to the U.S. Treasury. Critics estimated that the increase in the interest rate for paying interest on reserves could have decreased the remittance to the Treasury by \$12 billion.*
2. How did Federal Reserve member banks with reserves held at the Fed respond to rising interest rates in the 1970s? What did the Federal Reserve propose to counteract the response, and what action did Congress actually take? *National and state banks with membership in the Federal Reserve did not receive interest on the reserves they were required to hold with the Fed. The rising interest rates available at other depository institutions made the cost of membership with the Fed higher and banks started to withdraw from membership. To stem their departure, the Fed proposed paying interest, but Congress instead decided to require all banks to hold reserve requirements.*
3. Prior to the financial crisis, what complaint did banks have about keeping reserves with the Fed? *Since banks were required to hold a percentage of demand deposits as reserves without earning interest on those reserves, banks viewed that as a tax. This created incentives for banks to find ways of moving funds from accounts requiring reserves to accounts without reserve requirements.*
4. When Congress enacted the Financial Services Regulatory Relief Act of 2006, why did it postpone the Fed's ability to pay interest on reserves until 2011? *Congress knew this would result in lower remittances to the U.S. Treasury from the Federal Reserve. By postponing implementation, there would be time to minimize the impact of the reduced remittances on the Treasury's budget.*
5. Why did it become difficult for the Fed to conduct monetary policy by targeting the federal funds rate during the financial crisis? *Beginning in 2007 and continuing through early 2009, the Federal Reserve provided a large number of loans to financial institutions through its discount window. The increased liquidity expanded bank reserves and caused the federal funds rate to fall to near zero. With the target rate near zero and more liquidity needed, targeting the federal funds rate was not an effective way to stabilize the economy.*

6. What act of Congress advanced the date on which the Fed could begin paying interest on reserves and when did the Fed implement this authority? *Congress included section 128 in the Emergency Stabilization Act of 2008, authorizing the Fed to begin paying interest on reserves in October 2008.*
7. How does the author explain the possible effects of the Fed's interest on reserves on the Fed's remittances to the Treasury? *The author suggests two effects. By paying interest on reserves to banks, all else remaining constant, the Fed lowered its earnings and thus would have a reduced remittance to the Treasury. However, if the interest earned on the large-scale asset purchases by the Fed increased earnings, then the change in remittances to the Treasury may be ambiguous.*
8. According to the author, what are some possible consequences of eliminating the policy of interest on reserves? *Eliminating interest on reserves would reinstitute the implicit tax on banks for holding reserves and banks would look for cost-reducing alternatives. Elimination would cause an immediate change in monetary policy and the author believes it would be much more accommodative than current conditions require. Experts suggest expansionary effects could be countered by a sale of assets from the Fed's balance sheet. The danger here is that the Fed has little experience selling securities during times of growth and may have difficulty determining the appropriate quantity and price of asset sales.*