

DISCUSSION QUESTION

Name:

Instructor:

Course:

What is a money leakage? Discuss banks holding excess reserves and cash holdings by individuals and businesses.

PEER GROUP PROBLEM SOLVING

Name:

Instructor:

Course:

What is meant by “fractional reserve banking”? What is meant by “required reserves”? If the required reserve ratio is 18%, what is the required reserve amount from a deposit of \$24,000? How much is available for use by the bank?

IN-CLASS EXPERIMENT / ACTIVE EXERCISE

What is the money multiplier and how is it calculated? Calculate the money multiplier if the required reserve ratio is 18%. Would a higher reserve requirement or a lower reserve requirement result in lower multiplier effects?

SOLUTIONS AND INSTRUCTOR NOTES

Discussion Question

What is a money leakage? Discuss banks holding excess reserves and cash holdings by individuals and businesses.

Money leakage is a reduction in the amount of money used for lending that reduces the money multiplier.

Banks holding excess reserves: If banks hold excess reserves, or reserves above the legally required amount, the amount of money in circulation, the money supply, is reduced. Banks would hold excess reserves if they were concerned about economic conditions and the ability of borrowers to repay loans.

Cash holdings by individuals and businesses: When interest rates are low, there is less incentive for individuals and businesses to keep money in an account in the bank. In addition, when there is a general fear about the financial system, people may believe their money is not safe and thus may choose to hold more cash. In doing so, there is less money in the banking system and thus less money available to be loaned to someone else and the money multiplier is reduced.

Peer Group Problem Solving

What is meant by “fractional reserve banking”? What is meant by “required reserves”? If the required reserve ratio is 18%, what is the required reserve amount from a deposit of \$24,000? How much is available for use by the bank?

Fractional reserve banking system: A banking system in which a portion of bank deposits are held as vault cash or in an account with the regional Federal Reserve Bank.

Required Reserves: The amount of funds legally required to be held in reserves.

Required Reserves from a deposit of \$24,000 with a reserve ratio of 18%: \$4,320 must be held and \$19,680 is available for lending by the bank.

In-Class Experiment / Active Exercise

What is the money multiplier and how is it calculated? Calculate the money multiplier if the required reserve ratio is 18%. Would a higher reserve requirement or a lower reserve requirement result in lower multiplier effects?

Money Multiplier: Measures the potential or maximum amount the money supply can increase/decrease when a dollar of new deposits enters/exits the system.

Money Multiplier Calculation: 1 divided by the reserve requirement

Money Multiplier with RRR of 18%: 5.55



Multiplier effects: With a higher reserve requirement the multiplier effect is lower for every dollar deposited. This means less money is being created. With a lower reserve requirement, the multiplier effect is higher meaning more money is being created.

For more in-class experiment and active learning ideas, visit www.econedactive.com