

a bank's balance sheet

Let's say that we have a small town that is completely isolated from everywhere else. There is \$1,000 in currency in this town, no banks, and no money enters or leaves this town. Then one day, someone sets up a bank, and everyone deposits their money.

(1)

Because most of the money is just sitting there, the bank decides to start making loans. It also decides to always keep **reserves** equal to 10 percent of **deposits**.

So, the bank has imposed on itself a _____.

Now,

(1b)

assets	liabilities
reserves	deposits
loans	

What happens to the \$900 in loans? _____

Now,

(2)

assets	liabilities
reserves	deposits
loans	
total	total

Given its reserve requirement, how much does the bank now have to keep in reserve (i.e., in its vaults)? _____

How much can it loan? _____ It lends that amount, and now:

(2b)

assets	liabilities
reserves	deposits
loans	
total	total

These loans are then deposited into the bank. Now,

(3)	assets	liabilities
	reserves	deposits
	loans	
	total	total

Given its reserve requirement, how much does the bank now have to keep in reserve (i.e., in its vaults)? _____

How much can it loan? _____ It lends that amount, and now:

(3b)	assets	liabilities
	reserves	deposits
	loans	
	total	total

These loans are then deposited into the bank.

(4)	assets	liabilities
	reserves	deposits
	loans	
	total	total

How much currency exists in this town? _____

How much money, right now, exists in this town? _____

(1) The reserve requirement is the **percentage of deposits** that has to be **kept in reserves**.

(2) The rest of the reserves (which is the available currency) can be used for loans.

(3) When (and if) the loan is deposited, it will count as a deposit and, until new loans are made, it will be in the reserves.

(4) The purpose of the balance sheet is to verify that assets equal liabilities.

(5)

Let's say that this bank gives Jeff a \$500 loan. He spends the entire \$500 on burritos from Pete's Famous Burritos. Pete deposits the \$500 in the bank. Jeff, however, can't pay back the loan. What happens??