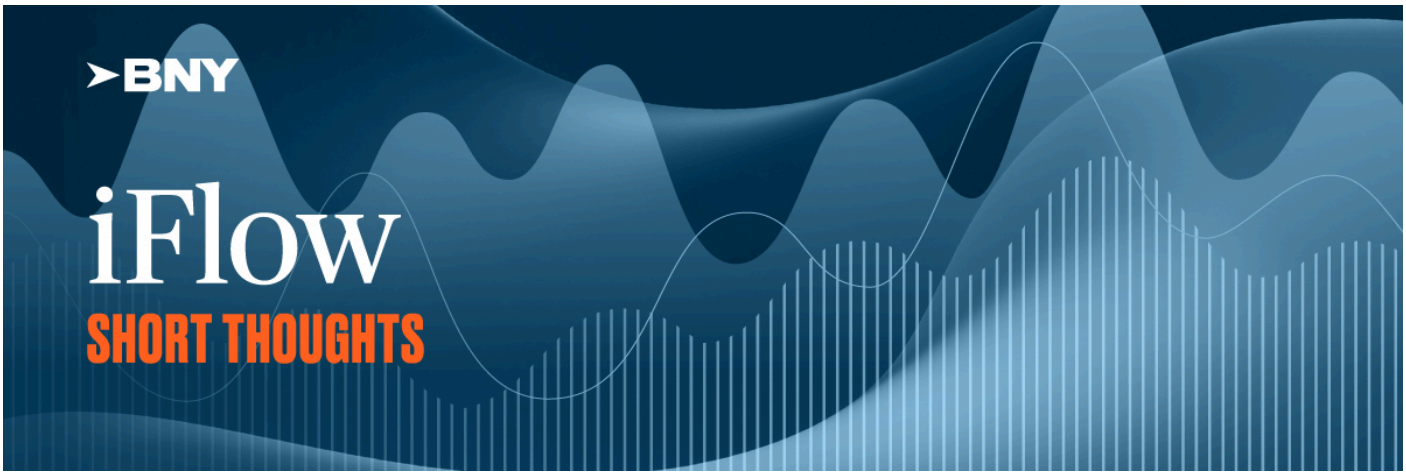


August 20, 2024

Jackson Hole Preview – Expect Few Details

- We expect a dovish tone from Powell at the end of the week
- But maybe not dovish enough, as we don't expect key questions on rates policy to be answered
- New modeling suggests that bank reserves are still abundant
- The sensitivity of the policy rate to reserves is close to zero

Powell Can't Tell Us What He Doesn't Know

On Friday this week, Fed Chair Powell will deliver remarks at the Jackson Hole Economic Symposium, the annual late-summer confab of central bankers and academics organized by the Federal Reserve Bank of Kansas City. We anticipate a generally dovish speech, with the Chair teeing up a rate cut at the next FOMC meeting on September 18. However, we don't expect the speech to be heavy on specifics and it's unlikely that key questions about the size of the first rate cut, or the frequency or length of the cutting cycle will be answered.

As we try to anticipate what Powell will – and won't – say, we think of ourselves in his position on Friday. What could we say with any great certainty about the rate path into the end of the year, with three more meetings on tap in 2024? All we could really do is say what we know, point out what we don't know and highlight the need for further information as the economy and inflation outlooks evolve.

First, we feel a great deal of certainty that cuts will begin in September and Powell will admit at least to that much. The market is more than fully priced for a cut. The inflation data are generating greater confidence that it's on its way towards the 2% Fed target, and the economy is slowing. Indeed, we feel the labor market is in balance, if not even a little softer

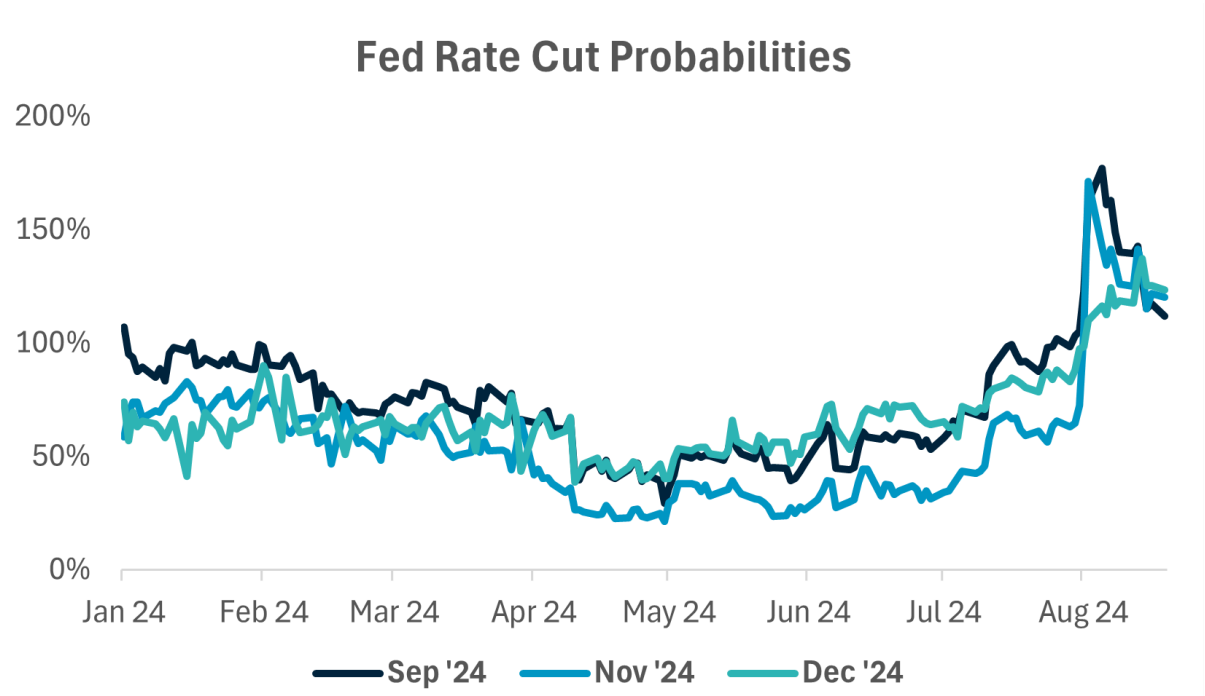
than that. Powell and other Fedspeakers have recently – and frequently of late – pointed out that the risks to the outlook are on both sides of the dual mandate (labor and prices), and policy needs to entertain a softening jobs market.

Second, while at the moment, we still see only a 25bp cut in the federal funds rate on September 18, we acknowledge risks toward 50bp, with the incoming data – particularly the August jobs data, released on September 6 – to guide the decision. We don't think Powell will hint at, or even bring up, the size of the September cut; instead, he will likely continue to preach a "meeting by meeting" approach, and the need for more data. After last month's soft labor market report, the August data will be determinative.

Third, as for the speed and frequency of the cuts to come, we expect little guidance at all, even between the lines. If the choice between 25 and 50bp comes down to the September 6 data release, the November and December meetings (both of which are fully priced to feature cuts) will be similarly data dependent. Powell would never pre-commit to – or even wink and nod toward – a specific policy path, especially when the economy is showing lagging macro momentum. In addition, the September FOMC will feature the 3Q Summary of Economic Projections (otherwise known as "the dots"), and the Committee's collective wisdom on the evolution of the main macro variables and the policy rate.

The risk for Friday, then, is that Powell doesn't say "enough" to satisfy a dovish setup in the markets. We don't think he'll be deliberately vague, but reasonably circumspect, sticking to what he knows – the time has come to lower rates, but eschewing what he doesn't know and what he doesn't have enough information for to be precise.

Exhibit #1 Three Cuts Fully Priced for This Year



Source: BNY Markets, Bloomberg

Estimating the Transition from Abundant to Ample Reserves

Last week in a series of posts on its Liberty Street Economics blog, the New York Fed discussed ways to determine when reserves drop from abundant to merely ample, a subtle but important distinction for monetary policy and the Fed's balance sheet management policy. We have written about this topic in the past (for example, here), and we endeavor to stay on top of this emerging debate.

It is presumed that once reserves decline (primarily thanks to quantitative tightening) from "abundant" to "ample," the federal funds rate (as well as other important interbank funding rates) will display more sensitivity to changes in the level of reserves. In an abundant reserves regime, the policy rate is inelastic to the quantity of reserves. In other words, reserves are so abundant, the price to access them (the policy rate) is low and stable. When reserves become less-than-abundant, and only ample, there should be some relationship between changes in the supply of reserves and the policy rate.

The Liberty Street Economics blog argues that the elasticity of rates to reserves could offer clues about when a transition from abundant to ample takes place. If over time, this elasticity goes from zero (which would correspond to an abundant reserves regime) to a statistically negative value, reserves have transitioned to an ample regime. In other words, in an ample reserves environment, meaningful declines in reserve levels should exert an upward

movement in the policy rate. If this elasticity were indeed to become negative, it would indicate that reserves are now becoming expensive (higher rates) and liquidity becoming more sensitive and challenged.

How does one determine this elasticity? In principle, a comparison of changes in reserves to changes in the effective federal funds rate, should reveal this elasticity. In the article, the authors present work from a longer and much more technical paper, derived from complicated regressions modeling this relationship, and conclude the slope of the demand curve for reserves is close to zero, signifying still abundant reserves.

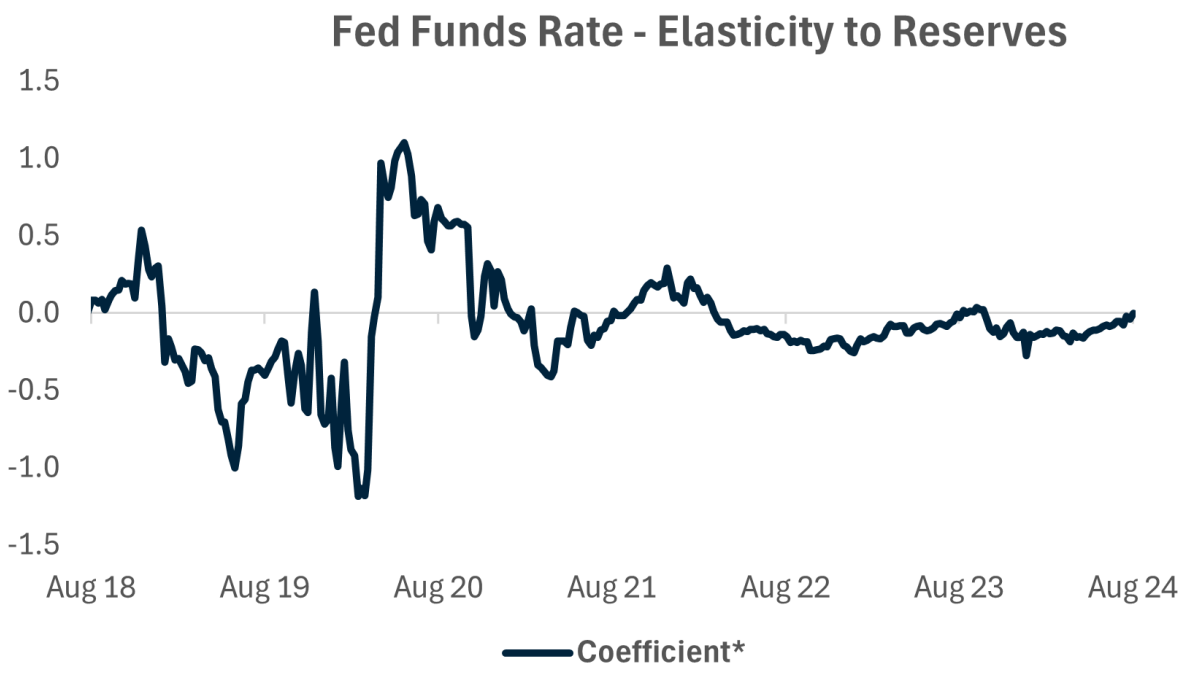
We are somewhat more constrained in data availability than the NY Fed's study, so we perform a simpler form of this estimation. We start with weekly reserve levels (as a percent of total bank assets), and the 75th percentile effective federal funds rate (versus the upper range of the target rate). Every week, we run a rolling 30-week regression of the latter against changes in the former, the coefficient being a measure of rate sensitivity to changes in reserves. We present the results below.

Note a few things. On this naïve calculation, it appears that the elasticity became quite negative in early 2019, presaging the repo market turmoil of September 2019. By the end of 2019, the coefficient returned to near zero, the result of significant increases in reserves via special programs set up by the Fed in a response designed to replenish system-wide liquidity.

During the initial phase of the COVID lockdowns, liquidity again became scarce and the relationship of reserves to the policy rate became negative again, until the Fed embarked upon extraordinary measures to unlock liquidity in response to the crisis.

In recent years, this coefficient has hovered just under zero, but statistically indistinguishable from zero. Reserves on this measure are still abundant. Any steady and significant decline in this measure of elasticity could indicate the transition is upon us. However, we haven't seen signs yet of a structural break in the abundant reserves regime at present.

Exhibit #2: Our Estimate Suggests That Reserves Are Still Abundant



Source: BNY Markets, Federal Reserve Board of Governors, Bloomberg

*NOTE: Coefficient is derived from a rolling 30-week regression of the 75th percentile federal funds rate on weekly changes in reserves (as a percent of total bank assets).

Please direct questions or comments to: iFlow@BNY.com

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