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SHORT THOUGHTS

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Fed QT & RRP, And The TGA

When Will We Hit An Ample Reserves Regime?

- Recent discussions from Fed's Waller and Logan frame eventual slowing of QT
- The transition from "abundant" to "ample" reserves is not identifiable in advance; money markets will tell us when
- The April tax date is a potential shock that could result in funding stresses

Waller And Logan Weigh In

Last Friday, both Federal Reserve Governor Waller and Dallas Fed President Logan served as discussants for an academic paper on quantitative tightening. Their remarks gave us some interesting insight into these FOMC members' view on what to expect going forward.

Two common threads were the role of the reverse repo facility (RRP) in warehousing liquidity, and that the fuzzy line between abundant bank reserves (now) and merely ample reserves is impossible to know in advance; it must be arrived at more or less by inference.

Both expressed the view that with RRP balances still around $500bn, there is abundant liquidity above and beyond the $3.5+ trillion in system-wide reserves. Once RRP usage approaches a low level it will be appropriate to slow the pace of QT. Logan mused that the appropriate level of RRP balances should ultimately be zero. To quote, "After the ON RRP is drained, asset runoff will reduce reserves 1-for-1, all else equal. In this environment, moving more slowly can reduce the risk of an accident that would require us to stop too soon."

More specifically, the transition from abundant to ample reserves is likely to be felt in funding markets if and when reserves – at least for a subset of institutions – decline sufficiently. The risk here is that some banks will see reserves decline below their lowest comfortable levels before others. Another risk is that reserves fall too much too quickly in aggregate, leading to

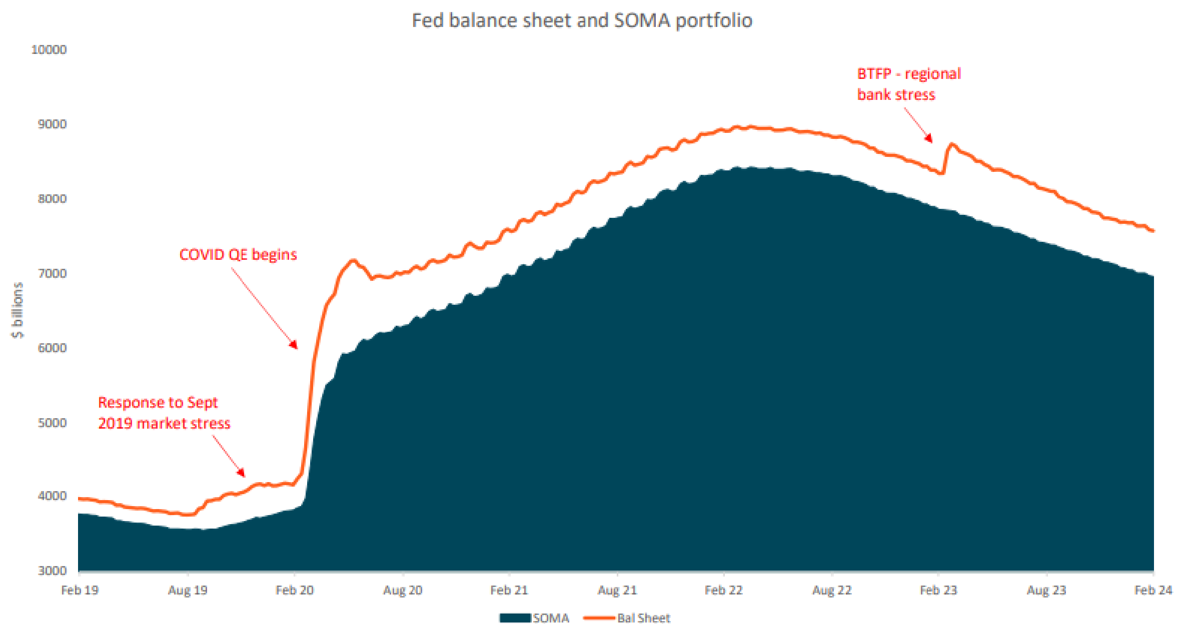
funding stresses across the money markets. Again, from Logan: “There’s more upside rate risk from reserves falling too low than downside rate risk from reserves rising too high.”

The chart below shows the evolution of the Fed’s System Open Market Account (where it holds assets purchased on the open market and from it runs off expiring securities) from the beginning of 2019 through the latest data. The Fed first initiated QT in the beginning of 2018, reducing its balance sheet after successive rounds of post-GFC QE. In all, between early 2018 and September 2019 the SOMA portfolio declined by some 15%, or by over $600bn.

Note the turnaround in both the SOMA portfolio and the overall Fed balance sheet from September 2019. Significant funding market stresses emerged then, and in response the Fed initiated a large-scale liquidity operation to calm these markets and effectively ended post-GFC-related QT. The balance sheet actually started to expand again in late 2019 as a result. Soon thereafter, of course, pandemic-related stresses emerged, and the Fed embarked on another round of QE, eventually resulting in an increase in the SOMA portfolio from $3.7trn to $8.4trn by the beginning of 2022. The portfolio has declined by nearly $1.5trn since QE ended and QT began in March 2022.

We infer from the Logan and Waller comments that the Fed wishes to continue runoff but will eventually become wary of – especially after RRP usage falls close to zero – too few reserves and too quick of a transition from an abundant to an ample regime. To keep QT running for longer, we contend – and infer from the two speeches referenced here – that it will eventually need to go slower. The Fed, in the January FOMC meeting minutes, indicated that the March meeting will feature an in-depth discussion of the impacts and policy choices facing reducing the speed of QT. We have been on record and remain of the opinion that a slowing of QT will be announced at the May meeting and initiated in June.

A Potted History Of QE & QT, 2018-present (click to enlarge)



Source: BNY Mellon Markets, Federal Reserve Board of Governors

When Times Get Taxing

Two of the widely cited culprits of the September 2019 episode were quarterly corporate tax payments, which required cash to be removed from the system by corporates in order to remit funds to Treasury; and a large tranche ($54bn) of long-dated Treasury debt which settled on Sept. 16, the same day corporate tax payments were due. These settlements increased primary dealers' Treasury holdings and drained cash from the system, as well.

Such events suggest that that at lower levels of reserves, shocks like those described above can quickly drain liquidity from daily funding markets. By September 2019, reserves were just around 6.5% of GDP, compared to 12% currently. So there appears to be sufficient liquidity to ride out any similar events. There are, however, events on the horizon that could prove to be nontrivial shocks to the funding markets. One of the most easily identifiable potential hurdles is the looming personal income tax filing date on April 15.

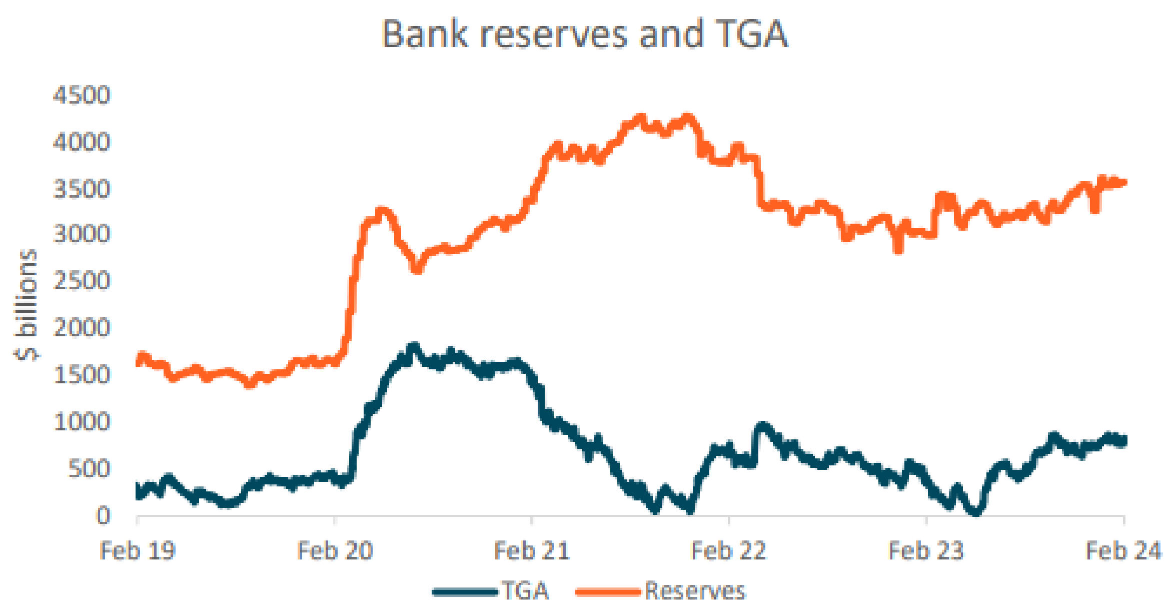
If we subtract the March daily average level of the Treasury General Account from the same for April going back to 2016, we observe that the mean increase between the two months is just under $50bn, mainly due to the US tax filing season. We exclude 2020 and 2021 due to COVID-related distortions. At the same time, reserves tend to fall between March and April, essentially the opposite side of the coin from the TGA increases over the period. Essentially, via the Internal Revenue Service, increases in the TGA come out of reserves.

While we’re not in the business of forecasting daily changes in the TGA – let alone tax revenues – we do expect April to feature higher tax revenues and a larger TGA increase than last year, when capital gains were replaced with capital losses and California residents got a

reprieve from filing income tax in April due to natural disasters. This time around, capital gains seem sure to be positive, personal incomes are up nearly 5% between December 2022 and December 2023, and no block of filers is expected to be missing this year. The upshot: there is likely to be a fall in reserves in response to the TGA increasing with tax revenues hitting in April. Note also that the TGA is currently quite large, at $837bn, well above the $750bn that Treasury has been targeting over the last few quarters.

With RRP balances expected to be much lower in mid-April than they are today, there is a good chance that the increase in the TGA will come at the expense of reserves. Whether or not this shock would be big enough to spur a reprise of the September 2019 experience is a key unknown, but something to monitor. Unlike in 2019, the Fed has set up a Standing Repo Facility, where cash-strapped institutions could turn to for funding in the event of a squeeze. Furthermore, the Fed has also been encouraging the use of the discount window as a source of funds. Stigma from using either of these facilities exists, so if institutions eventually turn to these facilities, it's likely because they have no alternatives to raise cash, and that the era of abundant reserves has given way to the arrival of a regime of ample reserves.

Reserves vs TGA: Will Taxes Lead To A Drain In Reserves?



Source: BNY Mellon Markets, Federal Reserve Board of Governors

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