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SHORT THOUGHTS

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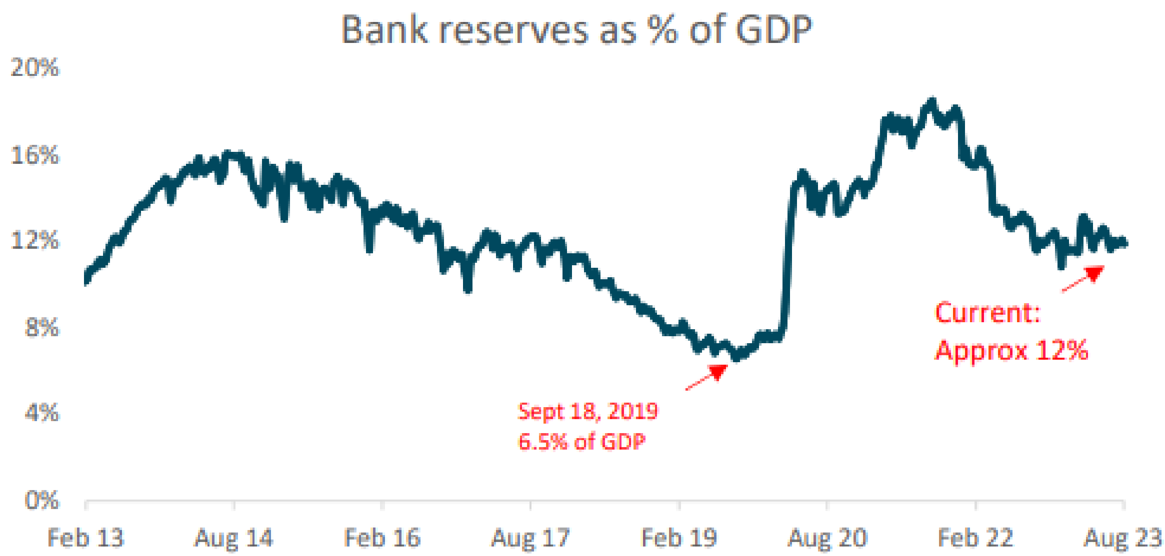
US Bank Reserves Scarcity Revisited

The Federal Reserve Bank of St. Louis last week published an article on reserves scarcity, something wrote about recently. The piece warns that if take-up at the Fed's overnight reverse repo facility increases significantly and sharply, reserve balances will drain. It argues that especially in an era of significantly increased T-bill issuance, RRP balances need to fall to keep reserves from shrinking too far, too fast and creating disfunction in money markets.

Recall September 2019, when reserve balances at the Fed fell to about $1.4trn (or less than 7% of GDP) and money markets seized up. The Fed had to intervene to provide liquidity, essentially reversing quantitative tightening. Indeed, between Sept. 18, 2019 and the onset of the pandemic-era lockdowns, reserves increased by $250bn to $1.65trn. QT had run into the "lowest comfortable level of reserves" (LCLoR) and had to be reversed.

How Far From LCLoR?



Source: BNY Mellon, Bloomberg

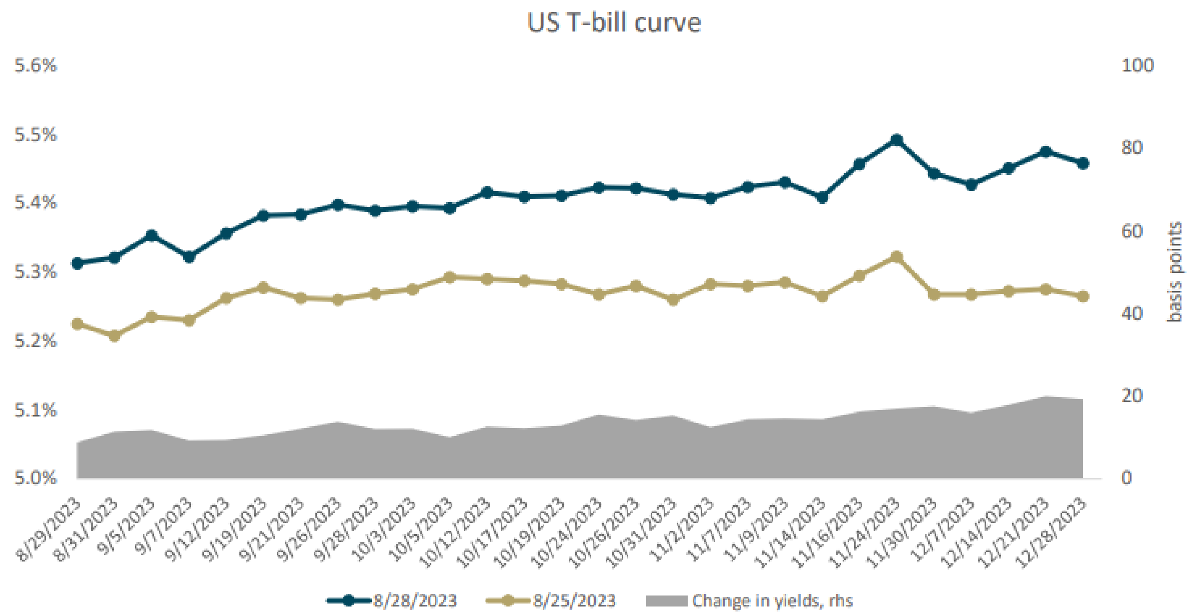
Fast forwarding, in the last three days RRP balances have fallen by $108bn, a significant decline, especially when one considers that take-up had been rising steadily since mid-July. This Monday, a total of $1.71trn was absorbed by the RRP, amongst the lowest take-ups since early April 2022. Cleary, rising bill yields have helped drain front-end cash out of the RRP and into much more attractively priced bills. In just the last four days, T-bill yields have increased by around 10bp at the very front end, and by 20bp for later maturities.

This suggests that RRP usage is highly rate-sensitive. Recall that the RRP facility may be considered a borrower of last resort. When there is a glut of cash at the front end, RRP serves as a 1-day duration asset paying fairly competitive rates, currently 5.3%, 20bp below the upper bound of the federal-funds rate target. Yields on bills at the very front of the curve, as mentioned above, have risen appreciably lately and are currently more attractive than RRP. We have written about this recently - see here.

Rates will have to stay elevated relative to RRP – or indeed, even increase from here – for RRP drainage to continue at the pace of the last few days. Clearly, a post-Jackson Hole consensus that rates will stay higher for longer – and may even rise this autumn if economic conditions warrant – has helped in this regard. The key question is whether this will be sufficient to drain RRP fast enough to offset the reserve shrinkage associated with QT.

The deluge of T-bill issuance from the Treasury has certainly helped cheapen the bills curve. But it may bring potential buyers other than the money market funds (MMFs) that have been active players in recent weeks. Competition between this set of participants and the money funds could keep RRP balances relatively high, and certainly not see these balances fall very quickly, while QT continues to shrink reserves at a steady pace.

Cheaper By The Day

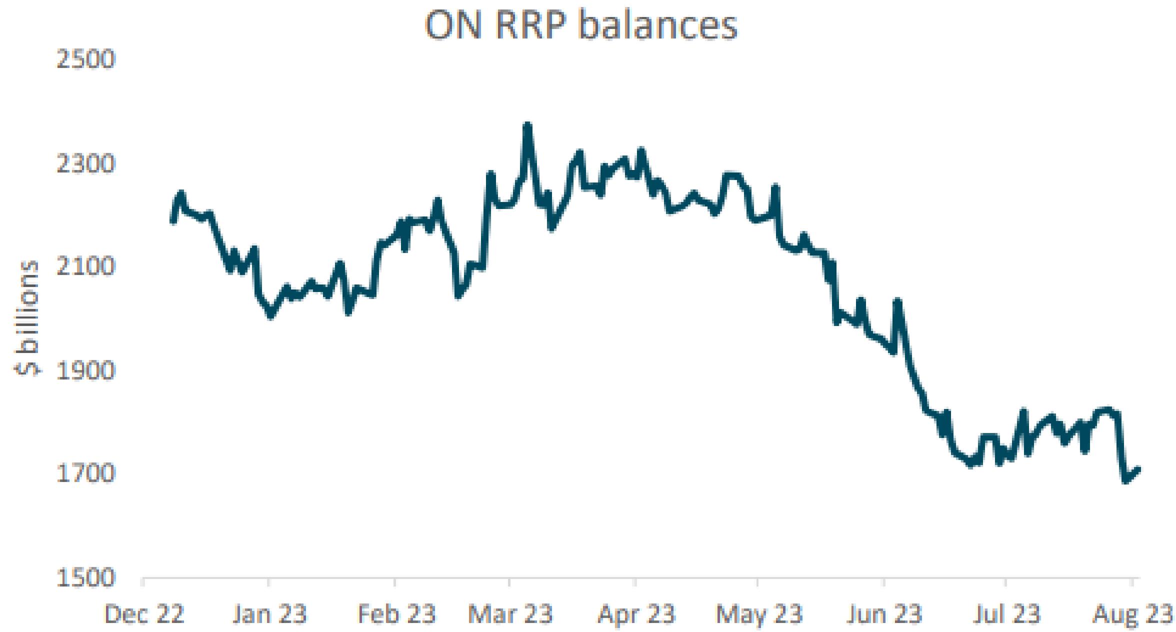


Source: BNY Mellon Markets, Bloomberg

It's tempting to look at the September 2019 episode and conclude that reserves need to stay north of around 7% of GDP to prevent the LCLoR from being realized. Given that this ratio currently stands at around 12%, one might conclude we're a long way away from trouble. That's a very rudimentary analysis, though. It's not clear to what level reserves need to fall to become scarce, and 7% in this era may well below the LCLoR.

So, while QT continues to run "in the background" and with the Fed seemingly comfortable with the current pace of balance sheet runoff, we would need to see RRP balances continue to decline to be comforted that the system is not getting dangerously close slipping below the LCLoR at the aggregate level. Given, as stated above, that RRP balances are rate-sensitive, we might need to see continued upward movement in short-term rates across money market products to prevent LCLoR from being reached. This may not be a problem anytime soon. After all, reserves currently are about 12% of GDP, well above anything we think could threaten LCLoR. However, we would be concerned if RRP drainage plateaus or even slows to a trickle – another potential Q4 risk money markets could be facing.

RRP Needs To Go Lower



Source: BNY Mellon Markets, Bloomberg, Federal Reserve Bank of New York

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

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