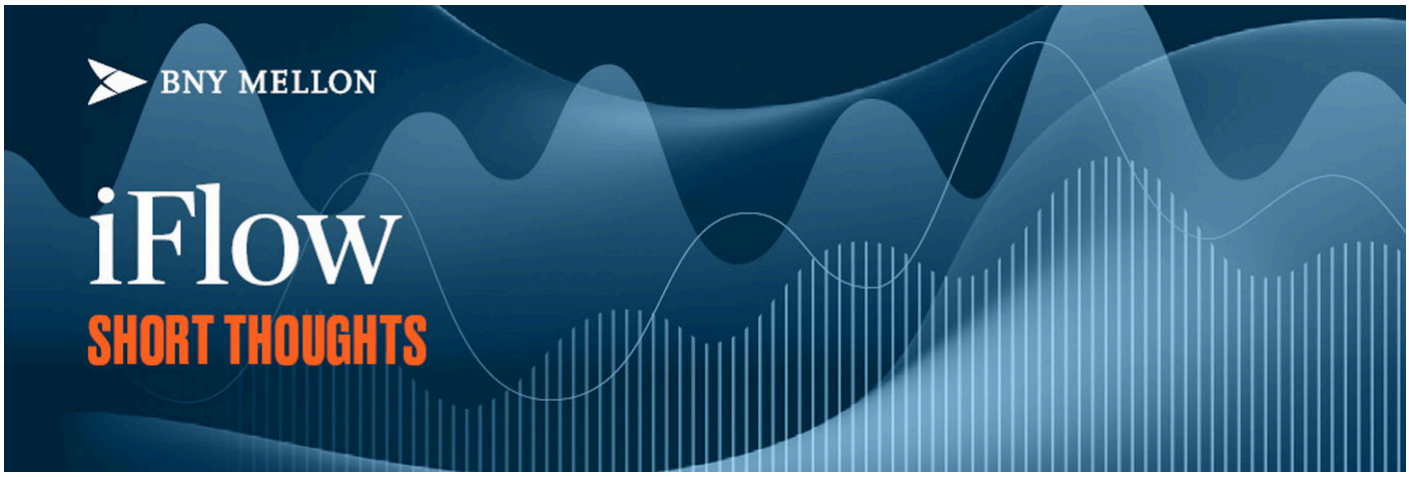


May 14, 2024

US Bank Reserves Riddle: Abundant To Ample

When will we know the line has been crossed?

- Reserves currently abundant; when will they become ample?
- Signals to watch include repo, effective funds rate
- Scant evidence we're at that point

Total systemwide Reserves of Depository Institutions in the US remain comfortably above $3trn, more than ample. Indeed, in Federal Reserve parlance, this is a regime of 'abundant' reserves. This means that demand for reserves by banks is insensitive to changes in supply of reserves. In other words, money market rates – including and especially the federal-funds rate – don’t change, regardless of the supply of reserves; the demand curve is flat.

In an abundant reserves environment, in order to maintain the funds rate within its FOMC-determined target range (currently 5.25-5.50%), instead of changing the supply of reserves at member banks, the Fed has implemented a “floor” system. The floor is the rate of interest paid on reverse repurchase agreements (RRP) between the Fed and participants in money markets. By lending to RRP at the current 5.3% offered, participants (mainly money market funds, or MMFs) are disincentivized to lend to other players at lower rates. This has the effect of keeping the federal-funds rate above RRP, but still within the target band. Currently, the effective funds rate is 5.33%, just above the RRP rate.

As reserves decline as the result of both quantitative tightening and RRP drainage, markets will move from a regime of abundant reserves to one in which reserves are merely 'ample'. In the latter, short-term rates – including fed funds – are more responsive to fluctuations in reserves. At that point we would expect the Fed to cease balance-sheet runoff.

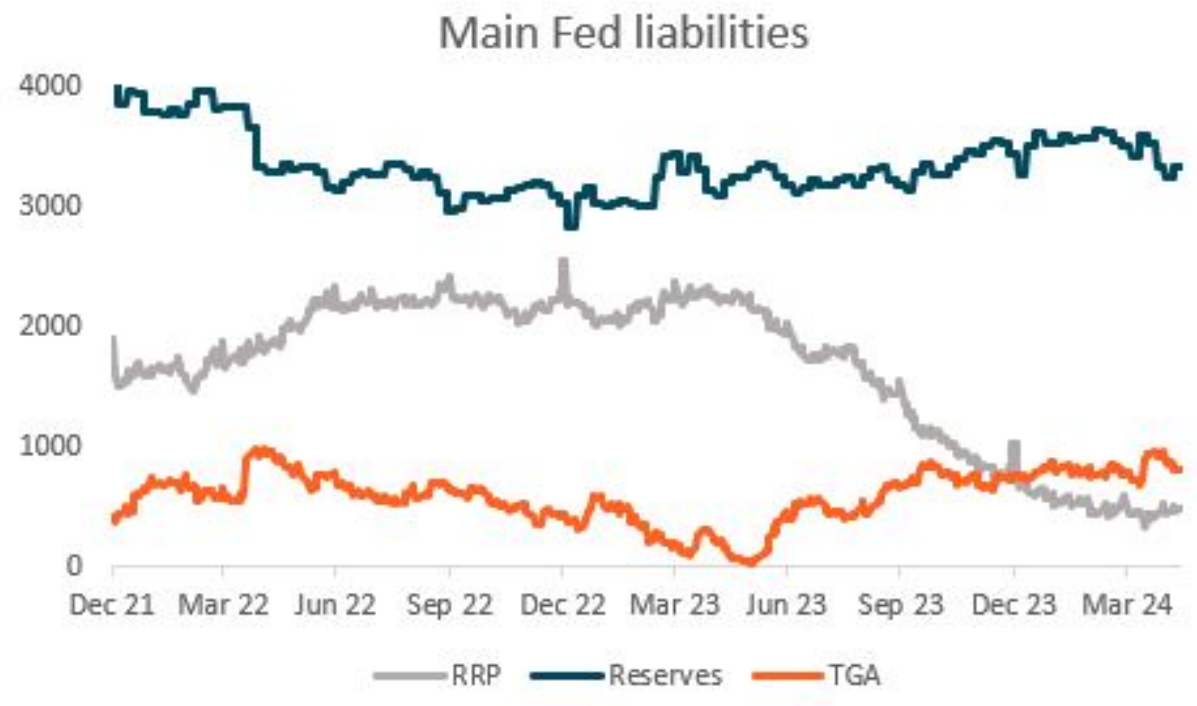
So far, the Fed’s securities holdings in the System Open Market Account (SOMA, through which QT and QE have been conducted) have declined by over $1.6trn since the end of April

2022 as a result of QT. Daily RRP balances have fallen by $1.7trn since late May 2023. So, the entire balance sheet runoff has been roughly matched by a similar drop in RRP usage. In other words, cash on the sidelines which found its way into MMFs and ultimately RRP has offset QT. This has kept reserves relatively steady, as the chart below shows.

Once RRP usage declines to either very low levels or, indeed, zero, we can expect reserves to begin to decline in line with reduced RRP balances, hastening the move from abundant to ample reserves. On May 1, the FOMC – as we expected – announced it was slowing the pace of QT, in part to ensure a smooth glide path to the ample reserves regime. However, we still won't know the exact level to which reserves need to fall to mark the transition to from abundant to ample, thus signaling, as we expect, the need to suspend QT.

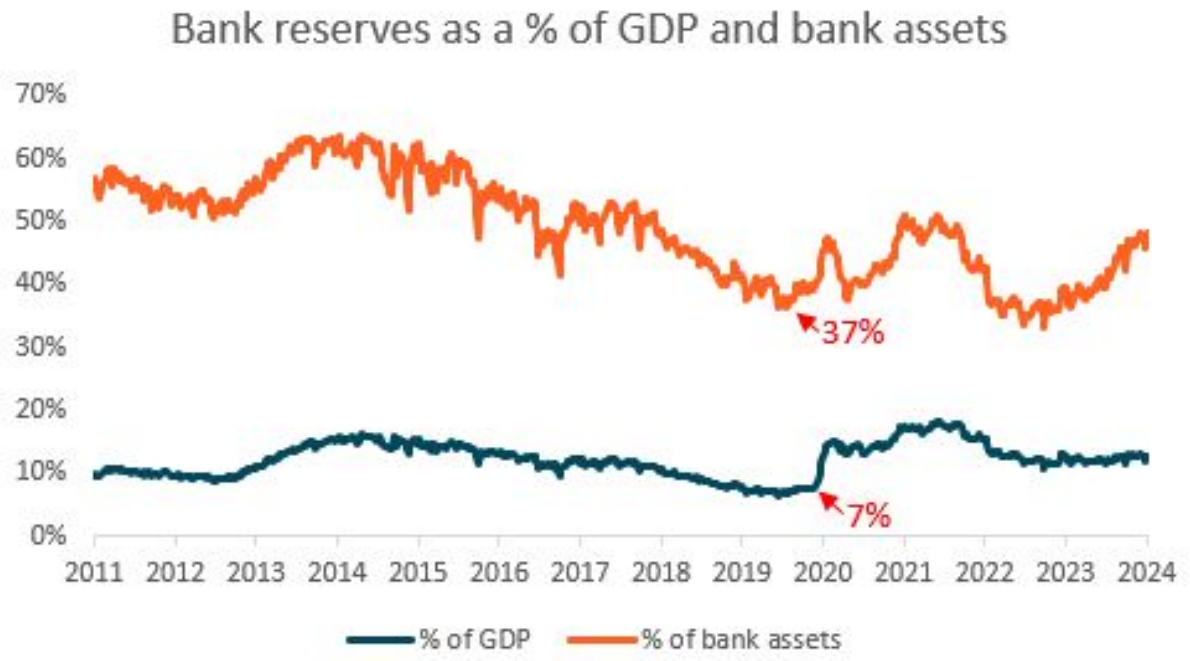
The first chart below shows the three main liabilities of the Fed: reserves, RRP usage, and the Treasury General Account (TGA). Note how reserves remain well above $3trn and RRP drainage has stalled (we discussed this last week). The second chart shows how low reserves became in September 2019, during the Global Financial Crisis-related round of QT in the 2010s. As a percent of nominal GDP (or the size of the economy), reserves then reached a low of around 7%, well below the current 13%. As a percentage of total bank assets, a measure of the overall size of the banking system, they were just 37% when the last bout of repo stress forced the Fed to abruptly end QT. The current level is 48%. We appear to be well short of the reserve scarcity that led to the September 2019 episode.

RRP Stable, Reserves Still High



Source: BNY Mellon Markets, Board of Governors of the Federal Reserve System

Reserves Abundant, High Relative To History



Source: BNY Mellon Markets, Bureau of Economic Analysis, Board of Governors of the Federal Reserve System

In a speech last week, SOMA manager Roberto Perli said as much: “Given that the aggregate level of reserves that is consistent with ample is uncertain, it is sensible to approach that unknown level carefully. Slowing runoff provides more time and opportunity for the FOMC to evaluate changes in market conditions…Continuing runoff at its existing pace might have meant reaching ample reserves sooner, but at the price of a higher risk of rapid changes in market conditions.”

The Fed doesn’t want to arrive at ample reserves abruptly, but gradually instead. How will the Fed – and markets – know when reserves have transitioned from abundant to ample?

Perli, again: “Thus, as runoff continues, it is important to monitor a variety of information sources for any signals of a shift in the balance of supply and demand for reserves.” The market, as it often does, will provide the information sought by key participants.

But what would those conditions be? Perli describes a number of data points to monitor. The most obvious is the behavior of the effective federal funds rate within its target band. Steady at around 5.33% since August 2023, this indicator suggests that we are still at the flat part of the demand curve for reserve balances. However, by the time that the funds rate moves

higher, it could be too late: in that case reserves will no longer be abundant.

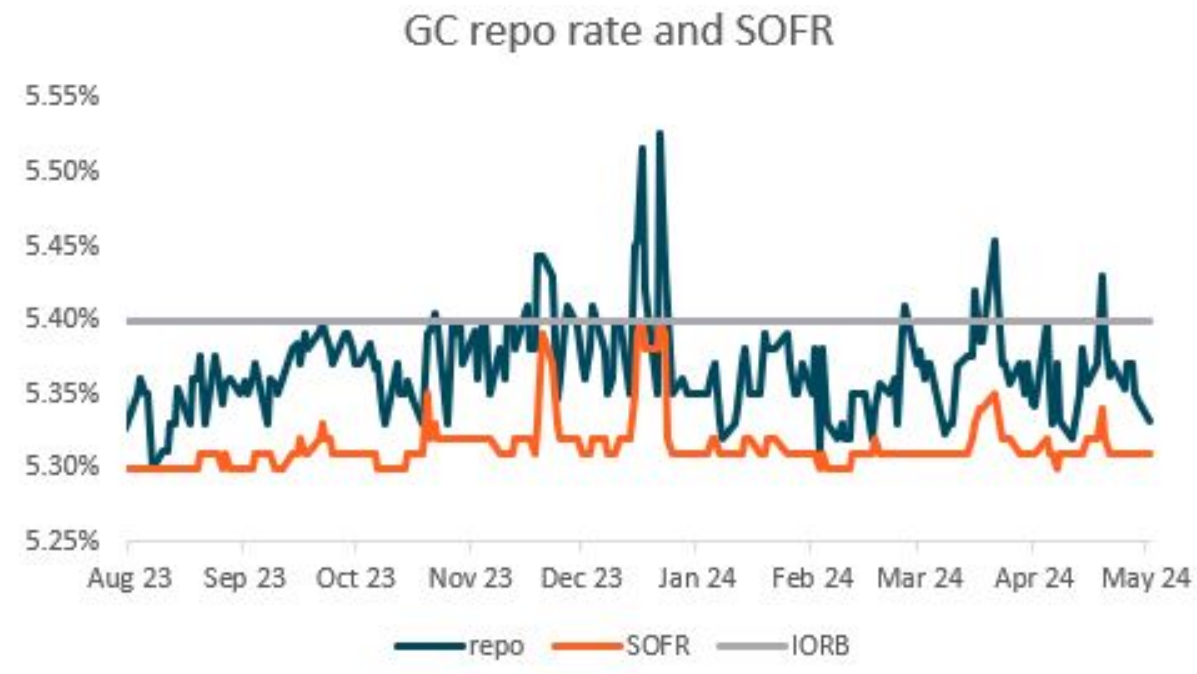
Perli proposes four other potential signals to keep an eye on:

• the total amount of borrowing in the federal funds market by domestic banks. Turning to this funding mechanism instead of more traditional funding methods in the open market would be a warning to markets.
• the share of outgoing interbank payments sent after 5pm. Banks holding onto reserves throughout much of the day until later on in the day, indicating potential bank efforts to avoid reaching lowest comfortable levels of reserves during daytime hours.
• intraday overdrafts by banks, indicating that reserves at the Fed are insufficient for daily transactions.
• the share of Treasury repo trades conducted at or above the IORB rate (the rate paid by the Fed to banks which have excess reserves parked at the Fed). When or if repo rates spike to levels above IORB, it could indicate that banks are having to pay up in excess of normal to borrow in repo markets due to low reserve holdings and would be a strong signal that interbank liquidity is inadequate.

Other than the last sign, market participants have almost no visibility into the other three – these data are lagged and until made public are unobservable to the market. Thus, we turn to repo and SOFR rates to give us something like a real-time indication of tightness in funding markets. The chart below corroborates the inferences we draw from the first two pictures about funding conditions: outside of month-, quarter- and year-end “pops higher”, repo has been well behaved, below IORB for most of the period shown.

Thus, it would appear that reserves are still abundant and we’re far away from any funding strains. This suggests to us that the Fed can continue to reduce its SOMA portfolio without imminent fear of running into a merely ample reserve regime.

Aside From -end Periods, Repo Steadily Under IORB



Source: BNY Mellon Markets, Bloomberg

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