Summary of a Recent BPI Symposium on Financial Market Developments

Bill Nelson | March 24, 2021

On Monday, March 22, BPI hosted an informal symposium to discuss financial market developments with market participants, academics and former Fed officials. Half of the discussion was devoted to money market developments, specifically how the money markets were likely to absorb the massive ongoing increase in reserve balances, especially with the temporary exclusions of reserve balances and Treasury securities from the calculation of the supplementary leverage ratio expiring at the end of March. The other half was devoted to a discussion of longer-term interest rates, the outlook for inflation and Fed communications.

MONEY MARKET DEVELOPMENTS

As of March 17, there were $3.9 trillion in reserve balances – a Federal Reserve liability consisting of deposits of banks, U.S. branches and agencies of foreign banks, thrifts and credit unions. That level is $500 billion more than at the end of February and expanding rapidly. The growth reflects both the Fed's ongoing expansion of its balance sheet under its current QE program and, importantly, the reduction in the Treasury's General Account at the Fed, another Fed liability. As the TGA declines from its recent extraordinary high of $1.8 trillion to the Treasury's current target of $500 billion, reserve balances rise, keeping the Fed's balance sheet in balance, with reserve balances on track to reach $5.3 trillion by year end.

Well, not necessarily just reserve balances. Another important Fed liability is its Overnight Reverse Repurchase facility where it accepts overnight investments from money funds, GSEs and FHLBs, as well as other institutions. Overnight RRPs are also likely to grow, dampening somewhat the growth in reserve balances. It is nearly impossible to project growth for reserve balances and RRPs separately at this point. Surprisingly, the even more obscure "other deposits," which consists of the non-interest-earning deposits of GSEs, FHLBs and others has grown $300 billion in the past few weeks, probably because, with interest rates near zero, the institutions have been more content than usual to simply leave the funds at the Fed rather than lend them out.

One way or another, financial institutions have to collectively provide the liabilities necessary to fund the Fed's balance sheet. Collectively, they have no choice, but individually, they do so voluntarily. Interest rates have to adjust to make this miracle happen. Currently, the Federal Reserve is paying 0.1 percent interest on reserve balances (the IORB rate) and 0 percent interest on overnight RRPs (the ON RRP rate). As a general matter, market interest rates have to fall relative to those Fed-established levels so that demand for the Fed liabilities equals their growing supply.

That dynamic was intensified and complicated by the announcement Friday that the Fed would not extend the temporary exclusion of reserve balances and Treasury securities from the denominator of the supplementary leverage ratio. The supplementary leverage ratio is a capital requirement measured essentially as the ratio of equity to assets, where the assets are not weighted for risk. At the bank holding company level, the requirement in the United States is 3 percent for those with total assets above $250 billion and 5 percent for Global Systemically Important Banks. At the bank level, the requirement in the US is 3 percent for the lead insured depository institution of bank holding companies subject to the SLR and 6 percent for the lead IDIs of GSIBs. In April of last year, the Fed announced that, through March 31, it would exclude reserve balances and Treasury securities from the denominator of the SLR for bank holding companies and the banks it supervises. The OCC and FDIC excluded those securities for the commercial bank subsidiaries they supervise, but only if the bank surrendered its independent right to pay a dividend to its parent, an option that only two banks accepted.

There is a lot of uncertainty about how it will all play out. It is unclear, for instance, where all the extra liquidity will go. The U.S. branches of FBOs are the low-cost holders of reserve balances because they do not pay deposit insurance and because their home leverage ratio requirements are lower and only evaluated at quarter-end. These branches have absorbed a large share of the growth in reserve balances over the past year and may have limited capacity to absorb more. The ECB is expected to end its own exclusion of reserve balances from the SLR on June 27, 2021 and European banks have been encouraged to pay greater attention to their daily leverage ratios, although the official metric will still be calculated on quarter end.

With the expiration of the exclusion in the United States, GSIBs must consider the SLR when making decisions about lending, deposit-taking and intermediating in financial markets. While they currently have enough capital to prevent the SLR from binding, the capacity will come under increasing pressure as the year progresses. Moreover, bank capital managers allocate capital across projects based on a consideration of what capital requirements could be binding in the future. Banks allocate capital across different lines of business carefully, and capital is becoming scarcer for low-risk, low-return businesses like Treasury market making and repo lending, a point we return to below. Non-GSIBs may have capacity to absorb more reserve balances than they currently hold.

As GSIBs seek to get smaller, or at least reduce their growth, they will need to shed liabilities as well as assets. In particular, they will seek to reduce deposits, either by charging higher fees or otherwise discouraging customers from leaving deposits at the bank. The banks will be especially eager to reduce the size of nonoperational deposits – which consist of the deposits of their financial sector clients that are not needed for the clients' regular operations – because those deposits are treated as unstable by the Liquidity Coverage Ratio liquidity requirement, forcing banks to hold high-quality (and low-yielding) liquid assets against them. Those deposits may find their way into money funds and those funds, with few attractive investment alternatives, could deposit the cash at the Fed's ON RRP facility. Moreover, supervisors could encourage banks to view all inflows of deposits under the current situation of near-zero interest rates as subject to a rapid reversal.

All of these flows will be driven by changes in market interest rates. With reserve balances both more plentiful and more costly to hold, the federal funds rate, the unsecured interbank lending rate, will fall further below the IORB rate. The fed funds market currently consists of FHLBs lending to branches of FBOs and GSIBs. FHLBs earn zero on their deposits at the Fed and banks earn 10 bp, so the FHLBs and banks essentially split the difference, with the FHLBs currently lending at 7 bp on average (the effective federal funds rate). With that transaction more costly for banks, the fed funds rate seems likely to fall as banks demand a larger slice of the arbitrage profit to participate in the transaction.

The implications for repo rates are less clear. As banks and bank-holding-company-owned broker-dealers determine how to allocate scarce capital, they may intermediate less in repo markets, which will widen the spread between the rate that repo borrowers (for example, hedge funds) will pay and the rate that repo lenders (for example, money market funds) will receive when they lend in the repo market. Wider spreads and less availability of funds in the repo market could adversely affect liquidity in the Treasury markets themselves.

What does seem clear, though, is that it will take time for market interest rates to adjust. Money market lending, as well as deposit taking, tends to be relationship driven. Banks will not drive away deposits lightly or cease providing repo financing for a client abruptly. Over coming weeks, though, capital pressures and profit motives will show through.

If, in the end, the fed funds rate falls too low, the Fed would respond by adjusting the IORB and ON RRP rates. Increasing the ON RRP rate even slightly could have an outsized effect as the rates on many repo transactions are currently negative and a substantial share of the repo market could switch to the Fed.

INFLATION EXPECTATIONS, LONGER TERM RATES AND FED COMMUNICATIONS

Under a standard New Keynesian Phillips curve, inflation depends on inflation expectations; the deviation of employment from its natural rate; and measures of food, energy and foreign exchange effects. If the economy and employment grow steadily, then the Phillips curve indicates inflation would rise moderately as long as all the other factors remain well behaved, and that appears to be the baseline outlook. Nevertheless, several things could go wrong. Rapid growth in the economy or supply shocks could push up inflation and temporary increases could boost inflation expectations leading to a sustained high level of unwanted inflation.

The Federal Reserve may find it difficult to stay ahead of any such increase. Its forward guidance indicates that it will wait for progress on both its maximum employment and inflation mandates before tightening policy, and it has placed a relatively high hurdle on the type of maximum employment it requires. Moreover, if the Fed did find it necessary to tighten policy to reduce inflation by increasing unemployment, the negative political reaction could be extreme. Lastly, the Fed's switch to average inflation targeting and emphasis on realized rather than projected inflation increases the possibility that it could end up behind the curve.

The tension between the FOMC participants' economic forecasts and both the participants' policy forecasts and Chair Powell's rhetoric present the risk of a sharp upward move in interest rates. In the Summary of Economic Projections released following the March FOMC meeting, the FOMC participants marked up their outlook for growth and inflation significantly, but only a few raised their projected path for the fed funds rate and even in those cases only modestly. Moreover, the FOMC statement and Chair Powell in the press conference were fairly constrained in their discussion of growth. If the Fed is following a strategy of downplaying their outlook for growth as well as its effect on the projected path for policy, the Fed's rhetoric and projections will eventually have to catch up. When that happens, interest rates could adjust rapidly upward.

That upward shift could be magnified by the potential poor functioning of Treasury markets. Market conditions have been poor at times during the large increase in rates over the past few weeks and were, of course, terrible in March of last year. Because the full-force SLR will reduce banks' interest in owning Treasuries, lending to others to own Treasuries, or making markets in Treasuries, Treasury market capacity could decline. That reduction combined with sizeable readjustments in the outlook for Fed policy could result in significant financial market volatility.

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