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Daiwa's View

Issues surrounding Fed's balance sheet after resolution of US debt ceiling problem ~ Liabilities

➢ Can see who was swimming naked once the tide goes out

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Can see who was swimming naked once the tide goes out

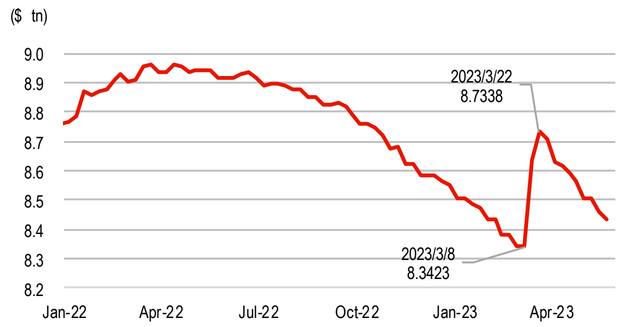
◆ Fed officials' intent on affirming balance sheet policy status quo

Since the May FOMC meeting, the market has been both pleased and disappointed by statements from Fed officials regarding further additional rate hikes. Although not noticeable in these statements, Fed officials recently have been commenting more on their own about balance sheets.

In particular, unlike statements regarding interest rate hikes, hawks and doves are both intent on affirming the perception of maintaining the status quo for the Fed's balance sheet policy. For example, Federal Reserve Bank of Atlanta President Raphael Bostic, who is viewed as a dove, said on 16 May that the shrinking of the Fed's balance sheet has not caused any turmoil. Also, Federal Reserve Bank of Chicago President Austan Goolsbee, who is seen as a prominent dove, said that changing the Fed's balance sheet reduction plan would require a high hurdle.

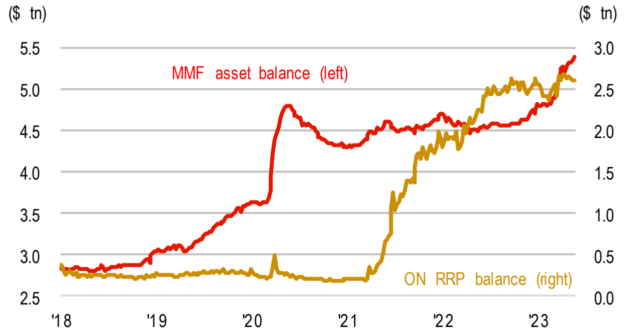
Fed officials are all stressing that the current situation is appropriate in this manner due to the growing awareness (concern, criticism) among outside experts and others of the problems with the Fed's balance sheet policy. Specifically, after the March Silicon Valley Bank shock, brought about by sharp policy rates hikes, the Fed shouldered the burden of the private-sector credit crunch by expanding its balance sheet through the Bank Term Funding Program (BTFP) and other emergency measures (Chart 1). As a result, this has left the "buds" for more and more inflation. If further interest rate hikes are used to nip these "buds," a negative cycle would likely emerge.

Chart 1: Asset Balance at Fed



Source: Fed; compiled by Daiwa Securities.

Chart 2: MMF Asset Balance, ON RRP Asset Balance



Source: Fed, ICI; compiled by Daiwa Securities.

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Following the sudden collapse of Silicon Valley Bank, First Republic Bank, and other lenders, bank depositors began to have more doubts about the safety of their deposits. However, to begin with, interest rates paid by banks to depositors are much lower and more entrenched than money market fund yields. Therefore, the normal process is that more bank deposits are withdrawn each time the Fed raises interest rates. The New York Fed's overnight reverse repurchase (ON RRP) system has served as a receptacle for surplus funds such as MMFs (Chart 2).

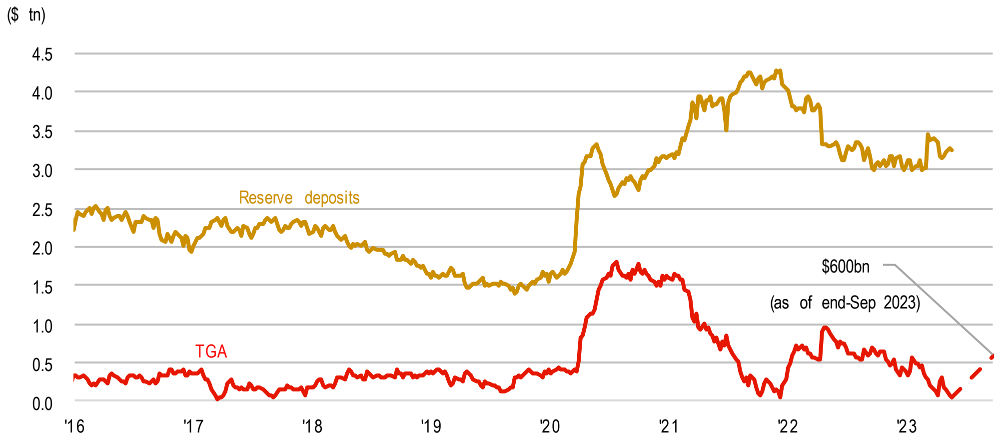
Of course, the ON RRP system itself does more than just assist in the management of the effective FF rate, while providing a strong lower bound for short-term money market rates. It also supports monetary policy execution through its financial and economic stabilization functions. Federal Reserve Bank of San Francisco President Mary Daly stressed during a 22 May symposium that the Fed's repo facility is working as intended. However, under the current situation, the very existence of the huge facility could clearly increase concerns about the banking system. Meanwhile, the remaining excess liquidity is disrupting the Fed's efforts to control inflation.

Minutes of FOMC on 2-3 May (24 May 2023)
The ON RRP facility continued to support effective policy implementation and control over the federal funds rate, providing a strong floor for money market rates. Balances at the ON RRP facility remained within their recent range, indicating that use of the facility was not an important factor driving outflows of deposits from the banking system. Use of the ON RRP facility declined at times over the intermeeting period in response to increases in rates on overnight secured money market instruments and on short-term Federal Home Loan Bank debt.

◆ Fed's balance sheet (debt side) after resolution of debt ceiling problem

Certainly, in recent months the debt ceiling problem has made the reality of the Fed's balance sheet reduction policy more difficult to see. To date, the Treasury Department has been making do by drawing down Treasury General Account (TGA) balances as a response to the debt ceiling problem (Chart 3). These TGA balance reductions had the effect of counteracting the absorption of money from the market (reserve deposits, ON RRP) by the Fed's $95 billion monthly pace of balance sheet reduction (refer to our 29 May 2023 report *What will come following debt ceiling deal)*. Normally, funds would be absorbed from the market through the issuance of short-term Treasury bills (TBs), but this is because TB issuance has been restrained by the TGA withdraws. For that reason, tightening via the Fed's quantitative tightening (QT) was apparently offset.

Chart 3: Reserve Deposits, TGA



Source: US Treasury Department; compiled by Daiwa Securities.
Note: End-Sep 2023 forecasts are as of the release of the regular May quarterly tender.

However, if the debt ceiling problem is successfully resolved before the so-called "X-date" (time at which US government can no longer pay its bills), the Treasury will begin restoring TGA balances. The TGA balance declined to $37.4 billion as of 30 May. However, the regular quarterly tender in May indicated that the TGA balance at the end of September is expected to be around $600 billion and the balance will be restored at a rate of more than $100 billion each month. While the large issuance of TBs to restore this balance is expected to be carried out cautiously so as to avoid negatively impacting the market as much as possible, unlike the approaches used in the past, there will be significant tightening through the absorption of money via QT.

Reserve balances have been declining since the Fed began shrinking its balance sheet last year. On the other hand, ON RRP balances have remained high, exceeding $2.0 trillion. Which balance is more likely to decrease after the debt ceiling problem is resolved? Over the near term (immediately after resolving the debt ceiling problem), there will no longer be any concerns about defaults for short-term US Treasury yield payments. If seen as attractive relative to the rate earned from the ON RRP, MMFs would likely decrease their ON RRP balances and increase their TB purchases. This would result in a larger decrease in the ON RRP balance than in the reserve balance. However, this would mean that the rates offered by MMFs would rise further, widening the gap with bank deposit rates. As a result, banks would face further competition from MMFs to secure deposits.

Furthermore, if the short-term interest rate level, which had been rising on default concerns, were to sufficiently pull back, the investment appeal of TBs for MMFs would diminish and the pace of decline for the ON RRP balance would slow. This would eventually lead to a decline in reserve balances. In any event, the environment in which reserve balances are likely to decline should remain intact. Actually, according to the Survey of Primary Dealers before the May FOMC meeting, the already-large ON RRP balance and the reserve balance are both expected to decline at the same time (Chart 4). If the reserve balances decrease in this manner, banks will further tighten their lending standards, which would lead to increased tightness for the real economy.

Chart 4: Estimates of Size of Reserves and Take-up at ORR Facility in Survey of Primary Dealers

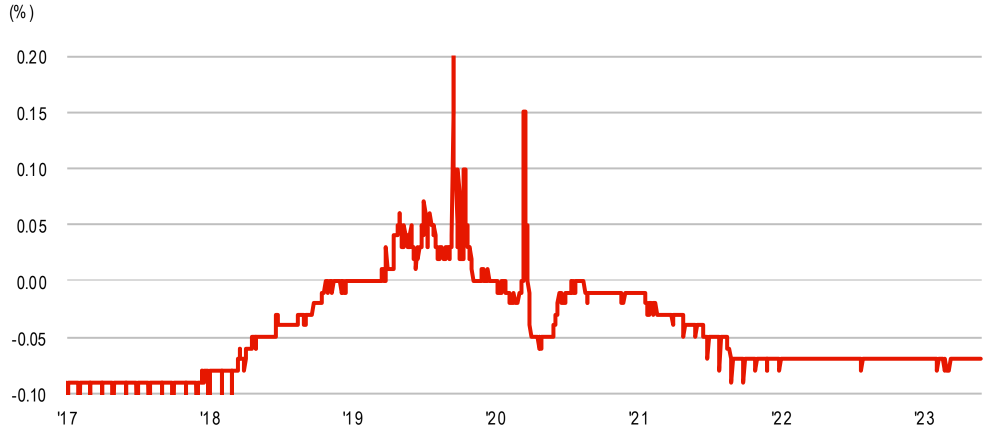
Estimates of the Size of Reserves ($ billions)							
	2023 Q2	2023 Q3	2023 Q4	2024 Q1	2024 Q2	2024 Q3	2024 Q4
25th Percentile	2,931	2,738	2,638	2,500	2,475	2,375	2,295
Median	3,006	2,861	2,758	2,713	2,708	2,738	2,700
75th Percentile	3,196	3,063	2,925	2,908	3,017	3,091	3,077
# of Respondents	24	24	24	24	24	24	24

Estimates of Take-up at the Overnight Reverse Repurchase Facility ($ billions)							
	2023 Q2	2023 Q3	2023 Q4	2024 Q1	2024 Q2	2024 Q3	2024 Q4
25th Percentile	2,082	1,788	1,463	1,168	983	873	722
Median	2,200	1,965	1,700	1,500	1,264	1,200	1,049
75th Percentile	2,300	2,169	1,912	1,634	1,509	1,413	1,274
# of Respondents	24	24	24	24	24	24	24

Source: Reprinted from NY Fed materials.

However, the effective FF rate has remained stable at a level lower than the interest rate on reserve balances (IORB) (Chart 5). This suggests that there is still plenty of money in the banking system overall. This interest rate differential is a good measure of the tightness of money in the market, as the repo market disruption occurred in October 2019, following a lag after the effective FF rate exceeded the IORB. Once again, this was in the midst of a contraction in the US bank reserve deposit balances due to the Fed's balance sheet contraction that began in October 2017. Eventually, the repo rate spike led the Fed to halt QT and again expand its balance sheet.

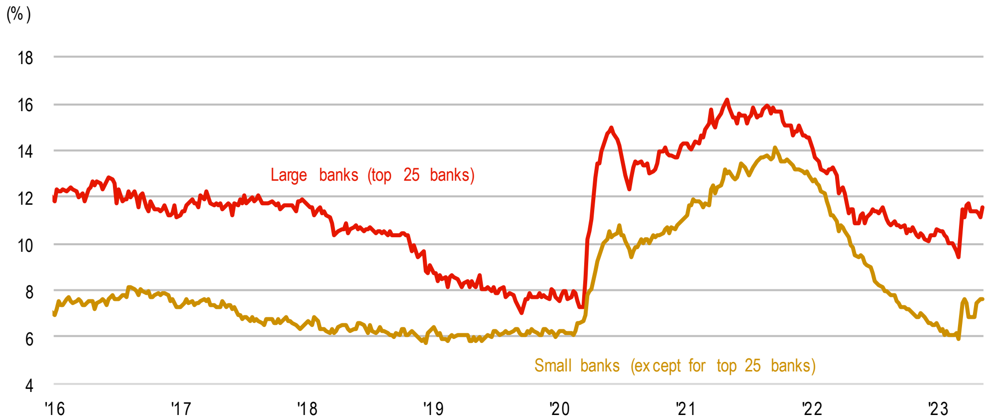
Chart 5: Effective FF Rate – IORB



Source: Bloomberg; compiled by Daiwa Securities.

As such, the short-term money market trends indicate that there is still plenty of available money overall. Since the Fed is likely to continue shrinking its balance sheet due to the above-mentioned problem awareness (regarding its balance sheet policy), reserve balances are likely to decrease faster than ON RRP balances for some time to come. That said, reserve balances have declined more markedly at smaller banks than at larger banks and money is not uniformly tight (Chart 6). The Fed's continued quantitative tightening could have a more significant negative impact on the fragile sections of the financial system.

Chart 6: Percentage of Cash Assets at US Banks



Source: Fed; compiled by Daiwa Securities.

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