Daiwa Securities

Daiwa's View

Issues on the liability side due to ongoing reduction in Fed's balance sheet

- Burden on financial system caused by expansionary fiscal policy

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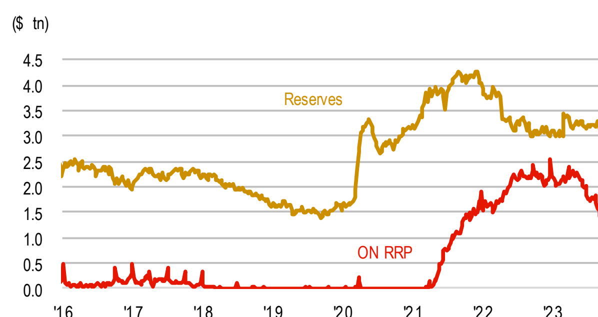
Burden on financial system caused by expansionary fiscal policy

As a response to the debt ceiling problem, the US Treasury Department had constrained the issuance of short-term Treasury bills (TBs) and drawn down the Treasury General Account (TGA) balance to about $22bn. The constrained issuance of TBs and TGA balance reduction had the effect of counteracting the absorption of money from the market. After the resolution of the debt ceiling issue, the TGA balance was restored in line with the issuance of TBs. The balance has now increased to about $680bn. Conversely, the restoration of the TGA balance increases the absorption of money from the market.

The absorption of money from the market due to the Fed's balance sheet reduction decreases either reserves at banks or the overnight reverse repurchase (ON RRP) balance. Since June 2023, a decline has been seen mainly in the ON RRP balance, while reserve balances at banks have largely remained flat. Therefore, we can say that there is currently a major impact on the ON RRP balance (Chart 1). The ON RRP balance had exceeded $2tn during June 2022-June 2023, but it has now decreased to about $1.4tn.

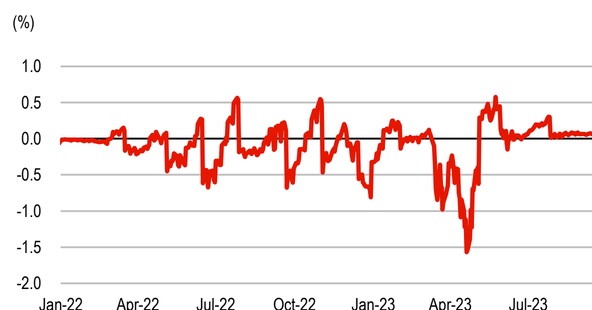
This is probably caused by the transfer of money from the ON RRP facility to TBs by MMFs, which are the biggest investors in TBs. Until the debt ceiling issue was resolved, MMFs refrained from investing in TBs. Since the resolution of the issue, the 1-month TB interest rate has been higher than the ON RRP rate, meaning that TBs remain more attractive in terms of investment return. Therefore, this appears to be leading to aggressive investment in TBs (Chart 2). Furthermore, the average remaining maturity of government MMF assets, which mainly invest in Treasury bonds, was 25 days as of July. As this is shorter than the past average of about 30 days, there is leeway to lengthen the maturity (Chart 3). This is another factor behind aggressive investment in TBs by MMFs.

Chart 1: Reserves, ON RRP



Source: Fed; compiled by Daiwa Securities.

Chart 2: 1-month TB Rate – ON RRP Rate



Source: Bloomberg; compiled by Daiwa Securities.

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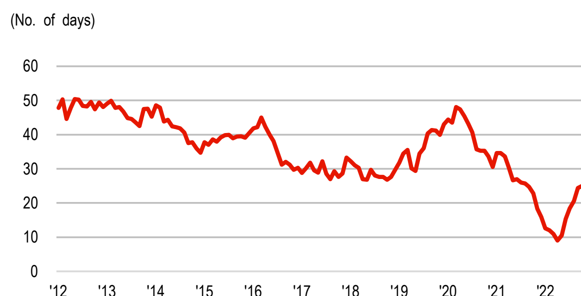
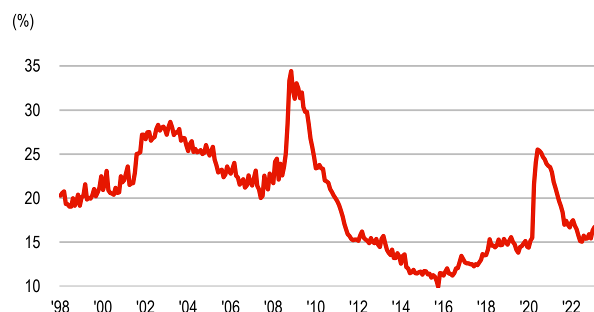
Chart 3: WAM of Government MMFs



Source: SEC; compiled by Daiwa Securities.

Chart 4: Ratio of Outstanding Balance of Short-term Treasury Bills to Total



Source: Treasury Department; compiled by Daiwa Securities.

In light of the MMF's investment capacity, the Treasury Department intends to continue with the large-scale issuance of TBs. According to the quarterly refunding plan shown in August by the Treasury Department, the TGA balance is expected to be increased to $750bn by the end of the year. Although it is recommended to contain the ratio of the outstanding balance of TBs to within about 15-20% of the total, TB issuance is expected to increase and temporarily exceed this range until 1H 2024. As of August 2023, the ratio of the outstanding balance of TBs to the total already reached nearly 20%, the upper limit of the recommended range (Chart 4).

As long as TBs continue to be issued on a large scale in this way, TBs will remain more attractive than ON RRP. Therefore, the ON RRP balance may continue to decline. According to the Survey of Primary Dealers before the July FOMC meeting, dealers expected reserve balances to decline less than the ON RRP balance towards the end of next year (Chart 5).

Chart 5: Estimates of Size of Reserves and Take-up at ON RRP Facility in Survey of Primary Dealers

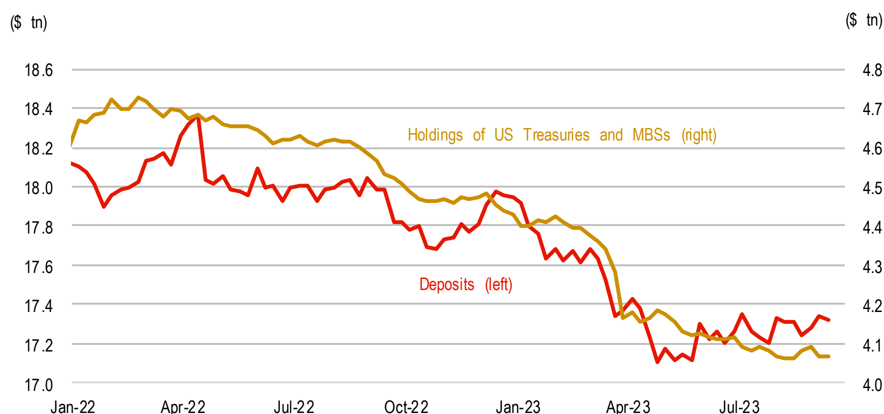
Estimate of the Size of Reserves ($ billions)						
	2023 Q3	2023 Q4	2024 Q1	2024 Q2	2024 Q3	2024 Q4
25th Percentile	2,929	2,779	2,585	2,525	2,423	2,419
Median	3,000	2,864	2,757	2,700	2,642	2,625
75th Percentile	3,100	2,955	2,904	2,992	2,990	3,030
# of Respondents	24	24	24	24	24	24

Estimate of Overnight Reverse Repo Take-up ($ billions)						
	2023 Q3	2023 Q4	2024 Q1	2024 Q2	2024 Q3	2024 Q4
25th Percentile	1,635	1,349	1,102	981	882	761
Median	1,750	1,594	1,350	1,240	1,200	1,100
75th Percentile	1,800	1,616	1,530	1,478	1,430	1,314
# of Respondents	24	24	24	24	24	24

Source: Reprinted from NY Fed materials.

The large-scale issuance of TBs and the subsequent transfer of money are major factors behind the fact that reserve balances have not declined since the beginning of the year amid ongoing balance sheet reduction by the Fed. In addition, bank deposit balances had continued to decline because the extent of the rise in the deposit interest rate has been limited compared to that of market interest rates in line with the Fed's rate hikes since last year. However, bank deposit balances have not declined since April 2023, indicating a pause in deposit outflow from banks. Moreover, banks appear to be reducing their holdings of securities (such as US Treasuries and MBSs), while also reducing the pace at which they are increasing their balance of outstanding loans (Chart 6). These factors appear to be containing the decline in reserve balances.

Chart 6: Deposits, Holdings of US Treasuries and MBSs at US Banks



Source: Fed; compiled by Daiwa Securities.

Currently, the Fed's balance sheet reduction appears to be going well in terms of the absorption of excess money in the market via the decline in the ON RRP balance, rather than reserve balances, without placing a burden on the banking system. However, if the issuance of TBs continues at this pace, and if government MMFs continue to invest, the average remaining maturity of government MMF assets will likely rise to around 30 days at the end of 2023 or beginning of 2024. If so, the investment leeway for government MMFs is likely to decline compared to what it is now.

Furthermore, if Fed rate cuts become imminent, the situation with TB rates exceeding ON RRP rates may change. In order to obtain ON RRP rates, MMFs may maintain the ON RRP balance. In other words, the large-scale issuance of TBs in anticipation of demand for MMFs may cause a decline in reserve balances. According to the minutes of the July FOMC meeting, all participants pointed out that there was no need to end the process of reducing the Fed's balance sheet when rate cuts begin. That said, there is no guarantee that the kind of ideal balance sheet reduction that is occurring now will continue once rate cuts begin.

To begin with, the US is continuing with expansionary fiscal expenditures. According to the outlook by the CBO, the fiscal balance is expected to continue to worsen. Therefore, in the August quarterly refunding plan, an increase in the issuance of coupon bonds was announced, and a further increase in the future was also signaled. As an increase in the issuance of coupon bonds is considered to be a factor in reducing reserve balances, an increase in the issuance in the future in line with fiscal deterioration is likely to accelerate such a reduction. The expansionary fiscal policy seems to be bolstering the economy in an environment with high interest rates. However, caution is needed, as such a policy causes excessive monetary tightening and places a burden on the financial system.

An increase in the issuance of government bonds in line with an expansionary fiscal policy causes (1) deterioration in supply and demand in the bond market and (2) a rise in yields led by term premiums (refer to our 22 August report *Daiwa's View: Higher US Treasury yields led by term-premiums*). Moreover, an increase in the issuance of government bonds when the Fed's balance sheet is shrinking causes banks to constrain investment in US Treasuries and other assets in order to secure cash. This causes a greater deterioration than usual in supply and demand. A rise in yields due to deterioration in supply and demand serves as a factor in increasing government bond interest payments, and causes government bond yields to overshoot the level where they should be from the standpoint of sustainable fiscal finance. In short, the Fed's balance sheet reduction, together with interest rate hikes, serves as a factor in deteriorating fiscal conditions.

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