



Recent developments in the US repo market: a cause for concern?

By Andy Hill



On 17 September 2019, US repo rates unexpectedly spiked 750 basis points, printing at a high of 10%.

Volatility in repo rates is not in itself a reason for alarm. Repo rates, like any asset price, are a function of demand and supply, and are generally not static in healthy, functioning markets. Rather it was the size of the move that drew attention.

US money market rates had begun to edge higher on 16 September, largely as a result of increased demand in anticipation of corporate tax payments (with around \$100 billion being drained from the banking system). Further pressure on reserves appears to have come from \$54 billion of new Treasury issuance also settling on 16 September. It is estimated that at the same time money funds saw outflows of around \$30-35 billion (due to corporate drawdowns to meet tax liabilities). All of this seems to have culminated to catch the market, and the Federal Reserve, off guard.

In general, central banks do a pretty good job of anticipating large drains on the banking system and manage reserves (usually through the repo market) to counter potential funding market dislocations caused by demand-supply imbalances. What has complicated this, however, is the unwind of quantitative easing and with this the Fed's ability to estimate the "comfortable" level of banks' excess reserves. Excess reserves have been declining in line with the post-QE contraction of the Fed's balance sheet. However, at \$1.4 trillion going into the week of 16 September (see chart), the expectation may have been that banks were still holding a healthy buffer of cash that could easily absorb the outflows from the system. Based on survey data, it would seem that the estimated tipping point at which reserves become "sticky" (known as the "steep part of the curve") was around \$1.2 trillion, comfortably below the current levels. But what is more difficult to estimate is the capacity for banks to recycle reserves through the repo market due to regulatory constraints (such as leverage ratio and G-SIB buffers). Separating out these two considerations is fiendishly tricky.

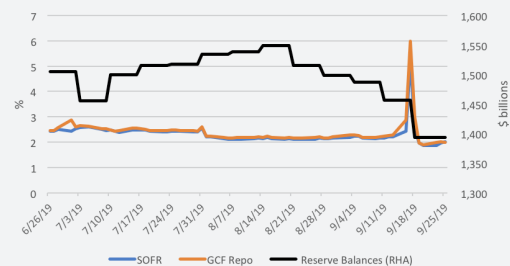
The Fed did respond to the sharp spike in rates on 17 September by offering \$75 billion in overnight repos to primary dealers (known as "open market operations", or OMOs). However, this operation was not conducted until almost 10 am: the vast bulk of repo trading activity has taken place by the time most of us have had our first coffee of the day, and so the OMO was

undersubscribed. The Fed has continued to inject temporary funds into the system on subsequent days (see chart), as well as introducing term (two-week) repos to help dampen potential further volatility over quarter-end. At the time of publication, it was not clear whether the Fed might consider implementing a more permanent solution to counter further declines in reserves (such as resuming outright asset purchases).

While perhaps the press has made too much of the episode, it nonetheless highlights two serious concerns for central bankers, both in the US and elsewhere. First, while executing QE has its challenges, unwinding QE is a far more difficult balancing act. Second, estimating the impact of regulation on banks' capacity to intermediate in the repo market is a guessing game. We should expect a lot more repo market volatility ahead.

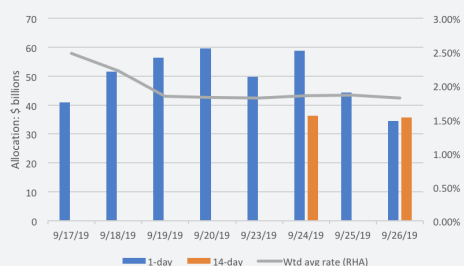
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Repo Rates & Reserves



Source: ICMA analysis using Bloomberg data

Fed OMOs



Source: ICMA analysis using Federal Reserve Bank of New York data