

October 22, 2024

Tolerating Repo Volatility

New Indicator from the Fed, But Not a Lot of Concern

- Reserve Demand Elasticity is close to zero, suggesting reserves are still abundant, despite repo strain
- RDE successfully identified the September 2019 stresses
- Repo strains will have to be “tolerated” due to frictions within funding markets, not reserve scarcity

The abundance of bank reserves has been a hot topic recently, particularly after the repo market volatility witnessed at the end of September and beginning of October raised concerns about system-wide liquidity. Recent communications from Fed officials, including the public introduction of a new measure of reserve abundance, suggest that policymakers are relatively sanguine on the matter.

System Open Market Account (SOMA) manager, Roberto Perli of the New York Fed has periodically commented on the reserve regime, most recently a few weeks ago (see [here](#)). By his reckoning, and with the assistance of some quantitative tools, reserves are still abundant.

An abundant reserve regime is defined as one in which the effective federal funds rate (EFFR) is unresponsive to changes in system-wide reserve balances. In formal terms, this means that the demand curve for reserves is flat (or inelastic). There are so many reserves in the system, in other words, that small and gradual changes in reserve levels lead to no movement of the EFFR.

The New York Fed has produced and now makes available on its website (see [here](#)) a close-

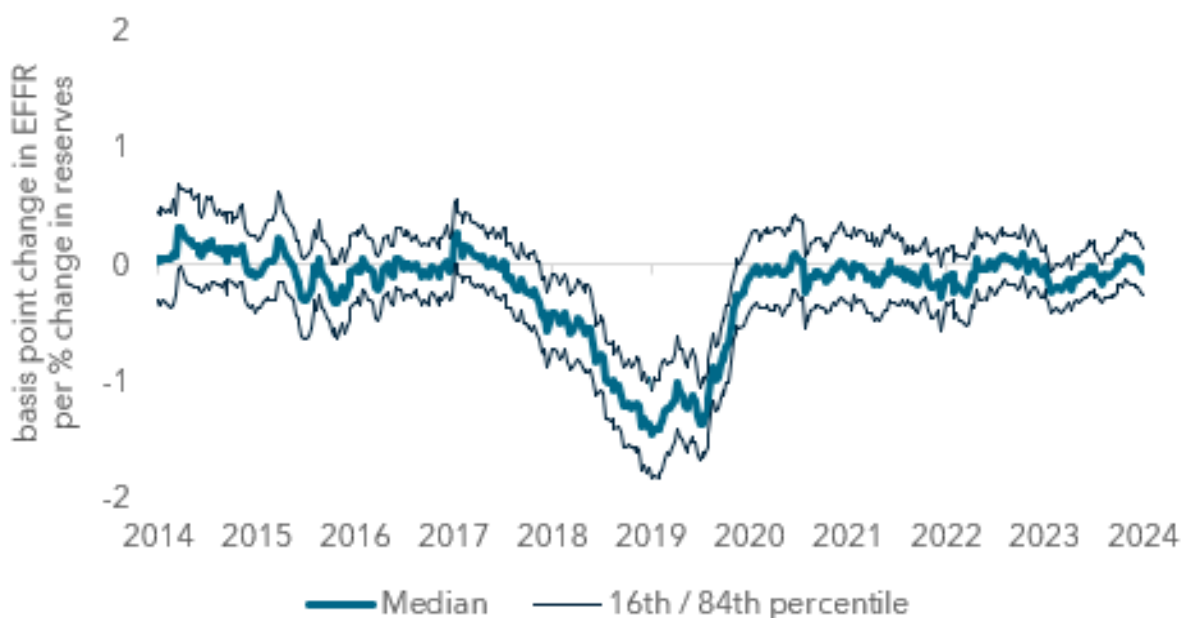
to-real-time estimate of this elasticity, christened Reserve Demand Elasticity (RDE) by its developers. Based on [previous academic work](#) from the Fed, RDE is derived by regressing daily changes in the effective federal funds rate on changes in reserves. If the coefficient of this regression is statistically indistinguishable from zero, then the elasticity of the demand for reserves to changes in reserve levels is also zero; the demand curve for reserves is flat, in other words.

This new measure of RDE [debuted](#) on the NY Fed's website last week and will be updated and released every Thursday at 10 a.m. Current estimates indeed show zero reserve demand elasticity. Exhibit #1 below plots the weekly estimate of the slope coefficient, obtained from the New York Fed's calculations.

Note that since 2021 RDE has been flat at zero – indicating reserves have been (not surprisingly) abundant since the Fed embarked on quantitative easing in 2020. More interestingly, note that in 2019, RDE fell significantly below zero. Of course, in September 2021 markets experienced an infamous episode of repo and funding market stress that required the Fed to suspend its post-GFC policy of QT and provide liquidity to the markets via special operation. The behavior of RDE in this period was consistent with merely ample reserves. The slope of the demand curve for reserves was calculated to be negative, meaning that small decreases in reserves led to a higher EFFR. Indeed, on September 17, 2019, the effective federal funds rate rose from around 2.13% to 2.30%, well above the top of the fed funds target range (which was 2.25%).

Exhibit #1: Zero Elasticity

NY Fed - Reserve Demand Elasticity (RDE)



Source: BNY Markets, Federal Reserve Bank of New York ([link to data](#))

What then of the repo strains earlier this month? It has been broached by Fed officials – including current SOMA manager Perli and former manager and current Dallas Fed President Logan – that elevated and volatile repo rates have been less a signal of reserves moving from abundant to merely ample and more a reflection of “frictions” in money markets. For example, counterparty limits on money market funds (MMFs) have prevented them from expanding their repo lending and is inducing them instead to keep cash in the Fed’s reverse repurchase program (RRP). Furthermore, balance sheet constraints at dealers make it more difficult for them to intermediate between segments of the market.

In a recent [speech](#), Logan argued that “...we are likely to continue to see occasional, modest rate pressures as our balance sheet shrinks... from a policy perspective, I think it’s important to tolerate normal, modest, temporary pressures of this type so we can get to an efficient balance sheet size.” In other words, as the balance sheet shrinks, under the current market structure, we will likely continue to see repo stresses from time to time, and these stresses – according to the Fed – would be normal and must be tolerated.

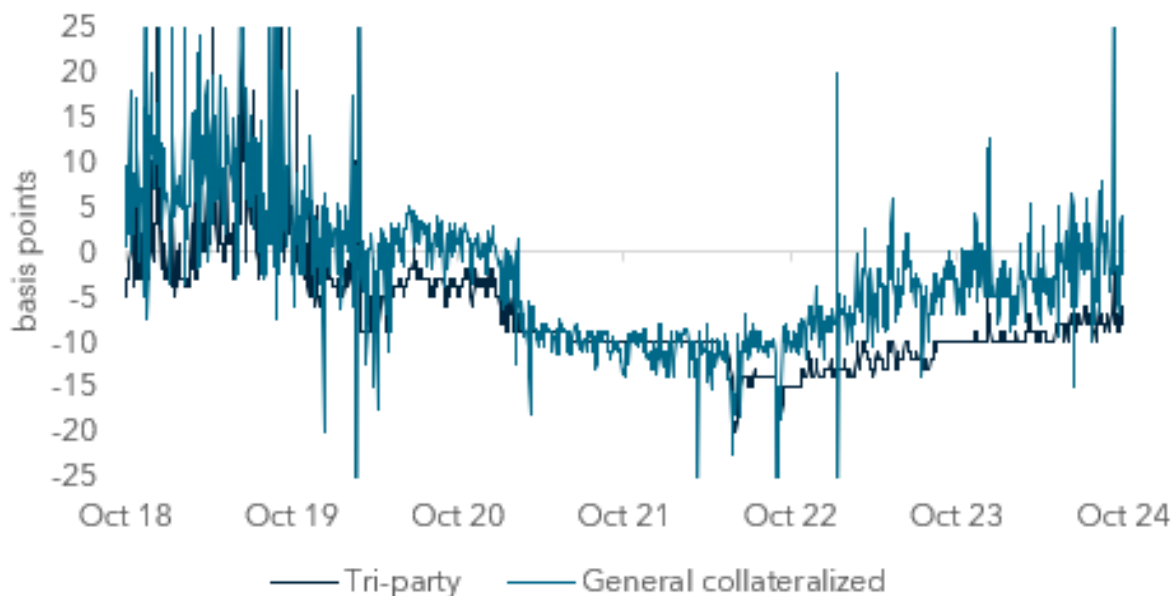
We do hasten to add to Logan’s (and Perli’s before her) point on funding rate volatility going forward that the current situation in repo markets is not unprecedented. Exhibit #2 shows that funding rates before the pandemic exhibited similar – if not even greater – volatility and have been periodically quite elevated since before the pandemic.

We think that the market structure “frictions” explanation for market volatility has some merit to it. We also can’t argue with the empirical inferences that come from the Fed’s RDE calculation. Our concern is twofold, however. First, whatever the sources of repo stresses – even if they aren’t related to the quantity of reserves, they are still stresses. We could find they emerge again, and indeed reveal themselves to be more disruptive. The Fed’s standing repurchase facility (SRF), put in place to backstop firms that encounter difficulty in securing funding, was tapped for \$2.6bn back in early October – the first meaningful use of the facility since its inception in 2021. We could see rising SRF use in circumstances when funding is expensive and hard to secure in the future. How much SRF use becomes a signal of something deeper afoot?

Second, with the weekly publication of RDE now, market participants could overlook other signals of repo stress. The New York Fed has described nearly a half dozen indicators that it will monitor for signs of reserves scarcity, but most of them – and their underlying data – are not available to the public without long lags. RDE is the only one we can see in real time. It seems to us that the market – per Logan’s admonishment – will experience elevated and volatile funding rates from time to time in the near future. While market participants can indeed tolerate them when they occur, it will be important – but we fear difficult – to identify the sources of strain and verify that liquidity itself is not transitioning from abundant to ample.

Exhibit #2: Is This Normal for Repo Rates?

Funding rates vs IORB



Please direct questions or comments to: iFlow@BNY.com



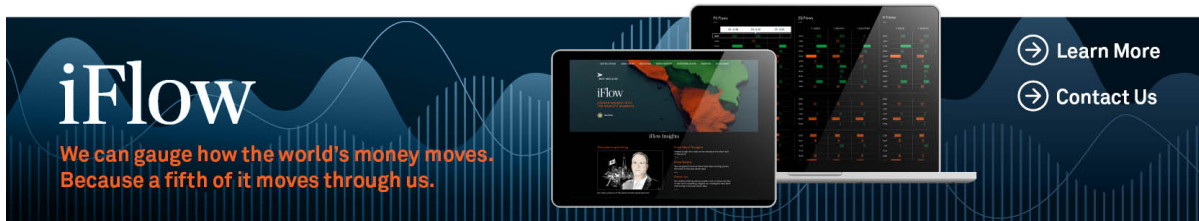
John Velis

AMERICAS MACRO STRATEGIST

CONTACT JOHN



Can't see the email? [View online](#)



We take our data protection and privacy responsibilities seriously and our privacy notice explains how we collect, use, and share personal information in the course of our business activities. It can be accessed [here](#).

This email was sent to james.cohen@bnymellon.com, and was sent by The Bank of New York Mellon 240 Greenwich Street, New York NY 10286.

Your privacy is important to us. You can opt out from receiving future Newsletters by unsubscribing via [this link](#) at any time. You can also select the topics that you want to receive by [managing your preferences](#).

This message was sent from an unmonitored email box. Please do not reply to this message.

[Contact Us](#) | iflow@bny.com

© 2023 The Bank of New York Mellon Corporation. All rights reserved.

This message was sent from an unmonitored email box. Please do not reply to this message.