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FED SHADOW

A Run on the Fed?

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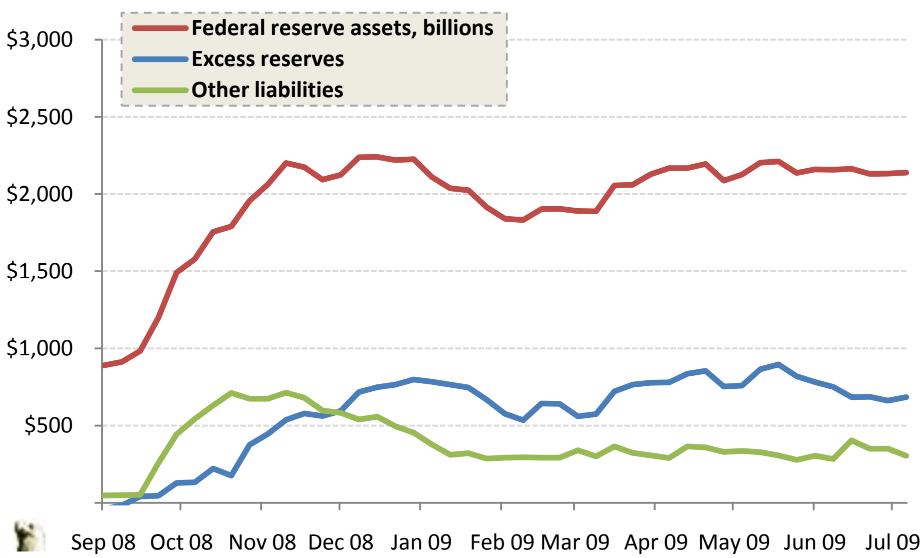
The Fed is losing the short-term financing for its long-term liabilities.

Update to strategic view
US MACRO, FED FUNDS: Excess reserves funding the Fed's assets are running off, leaving the Fed with a dilemma -- curtail its stimulative asset acquisition program, or finance itself by inflationary liquidity creation. Falsely comforted by their output gap model of inflation, we forecast they will choose the latter.
[see Investment Strategy Dashboard]

Amid the bounteous expansion of the assets on the Fed's balance sheet since last fall, one significant offsetting factor has been the banking system's buildup of its excess reserve holdings at the Fed. In essence, the excess reserves could be seen as a funding source for the acquisition of assets on the balance sheet. The extent to which the assets are funded reduces the need for the Fed to engage in inflationary liquidity creation to acquire them. As of mid-May, $895 billion of the Fed's $1.2 trillion in asset growth since last September was financed by growth of excess reserves. Even including other smaller funding sources such as the Treasury's Special Financing Program, the Fed's assets have now grown since last September by $313 billion more than the liabilities that finance them.

That's a tremendous amount of new liquidity, but at least the accumulation of excess reserves has served as the largest factor offering some buffer against runaway liquidity growth. But now it appears that buffer may be dissipating. Since peaking in May, excess reserves have fallen about $212 billion. The asset side of the balance sheet has contracted less over the same period, by only about $74 billion, as various emergency liquidity facilities and central bank liquidity swaps put in place during



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the credit market crisis last fall have been running off, as credit conditions improve. Considering all sources of financing, not just excess reserves, the Fed's "net assets" -- that is, the value of its assets not financed by its liabilities -- now stand at an all-time high of $1.15 trillion. And the Fed's commitment to acquire $1.75 trillion in Treasuries, mortgage-backed and agency securities remains very much in play. To date, those asset purchases (or unsettled net commitments to acquire assets) have totaled about $902 billion, and the Fed has not ruled out an expansion of those acquisitions. In addition, the extent to which the Fed's Term Asset-Backed Securities Loan Facility (TALF) will fund purchases of legacy assets under the Treasury's Public-Private Partnership Investment Program (PPIP) is an open question (see "A Deflationary Correction" July 9, 2009). That could mean as much as another almost $1 trillion in asset purchases, beyond the approximately $25 billion already lent by TALF.

To a large extent, the drawdown of excess reserves is a sign of healing in the banking system. Until the Fed began paying interest on excess reserves last fall, these holdings were frictional, totaling less than $2 billion. But in the extraordinary uncertainty and chaos of the near-meltdown of the banking system, the safe harbor of even a 25 bp return was enough of a lure. With the crisis atmosphere fading and the Fed showing no inclination to raise the funds rate from its rock-bottom levels, banks can essentially capture an arbitrage without venturing too far out on the risk curve.

To this point, the drawdown of excess reserves hasn't shown up in new lending. It's something of a mystery just where they *are* going. Wherever, it is a sign that banks are willing to take at least a little more risk -- and that at least points to a near future in which lending will likely come as the economy continues to stabilize and it becomes clear that the recession is over. As banks see better uses for the funds, the excess reserve drawdown will likely accelerate. If the Fed were a normal bank, this would be a serious problem -- the same kind of "run" on short-term financing of long-term assets that brought down Bear Stearns and Lehman Brothers. But the Fed is no ordinary bank. It can fund its assets by creating liquidity *ex nihilo*, which is to say, by printing money -- but this puts the Fed's liquidity posture increasingly in a surplus position. Indeed, while we have lingering concerns that the short-run deflationary threat has not yet been entirely extinguished (again, see "A Deflationary Correction") the Fed is setting the stage for a repeat of the kind of bubbles experienced coming out of the last cycle of hyper-accommodative policy earlier this decade. The drawdown of the excess reserve backstop will only exacerbate the problem.

As the economy comes out of recession and risk abhorrence fades, demand for money should normalize. With monetary velocity bouncing back from the depressed levels occasioned by the credit market calamity, it will then become incumbent upon the Fed to normalize its posture and begin to unwind its great liquidity bulge. As yet, there appears to be very little serious cognizance of this reality among policymakers. The consensus is that even with the economy showing signs that the recession is bottoming, resource utilization will remain "slack" (see "Steady -- And Easy -- As She Goes" June 25, 2009). In the output gap model which is the secular religion of our central bankers, the existence of such slack ensures against the risk of higher inflation. But this model has repeatedly proven to offer highly flawed policy guidance (see "Fed Says, Give Us Some Slack" May 6, 2009). Prior to the exogenous deflationary shock which hit the economy last fall, for example, CPI inflation had ramped up to nearly double digit rates, while the Fed had for months been offering assurances that it expected inflation to "moderate." But much like it did in late 2003, the Fed now confidently asserts that "economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended time." It's probably a safe bet that it sees continued expansion of the asset side of its balance sheet in the same light.

BOTTOM LINE: Excess reserves funding the Fed's assets are running off, leaving the Fed with a dilemma -- curtail its stimulative asset acquisition program, or finance itself by inflationary liquidity creation. Falsely comforted by their output gap model of inflation, we forecast they will choose the latter.