

FED WATCHING

Fed to Pay Interest on Reserves; Boost TAF Auctions

Amidst signs that the credit crisis is expanding its global reach, the Fed announced three additional steps this morning to provide liquidity to the U.S. financial system. First, the TARP legislation permitted the Fed to pay interest on bank reserves—this is important because it enables the Fed to expand its balance sheet while maintaining a fed funds rate somewhere “close” to the target rate. Second, the Fed is upping the size of the TAF program to \$600 billion (TAF is essentially auctioned discount window loans to banks) from \$300 billion and announced the size of the forward TAF auctions for yearend will be \$300 billion. Third, the Fed allowed one bank to use discount window loans to buy assets from an affiliated money market fund (suspending the so-called 23A restriction) and invited other requests from banks to do the same.

The Fed will pay interest on the reserves at two rates. For required reserves, which averaged \$41.4 billion over the last 52 weeks, the Fed will pay the average fed funds target rate over the two-week maintenance period less ten basis points (currently 1.9%). However, since vault cash, which is used to meet reserve requirements, averaged \$34.4 billion over the last year, the required reserve balances that the Fed will pay interest on averaged only \$7.0 billion over the last year. Paying interest on required reserves effectively reduces a tax on the banks (assuming the same level of required reserves over the next year puts that tax relief at around \$133 million). For excess reserves, which typically average around \$1½ billion, but have mushroomed to \$68.8 billion at the end of September (and will likely surge further when the early October data are released on Thursday), the Fed will pay the lowest target rate in the two-week maintenance period less 75 basis points (currently 1.25%). This is now the effective floor on the fed funds rate and, given the increase in liquidity facilities announced today and the already high levels of excess reserves, we would expect the fed funds rate to trade at this floor rate (this is very important for the fed funds contract, which is based on an average of the effective rate in a given month, not the target rate). The Fed said that this 75-basis-point discount from the fed funds rate target for the rate paid on excess reserves “may be adjusted subsequently in light of experience and evolving market conditions.”

Since the day that TARP was announced (September 18th) to the present, the effective fed funds rate has averaged 1.28%. This is roughly the area we would expect the fed funds rate to trade in as long as (i) the fed funds target rate remains at 2%; (ii) the Fed maintains the 75-basis-point discount on the rate paid on excess reserves; and (iii) the Fed’s balance sheet continues to expand to provide liquidity to all quarters of the market. *Thus the fed funds contract will for a while be a very poor indicator of the market’s expectation of the fed funds target rate.* If the Fed cuts the funds rate target by 50 basis points on October 29th, to 1½%, the rate paid on excess reserves (or the floor for the funds rate) would fall to 0.75%.

BOTTOM LINE: There is now a corridor in which the fed funds rate should trade. The floor is set by the interest rate paid on excess reserves (75 basis points below the target rate) and the ceiling set by the ‘discount’ rate (25 basis points above the target rate). However, the fed funds rate has little relevance in current circumstances to market rates given the upward pressure on LIBOR. Since September 18th, three-month LIBOR has risen from 3.20% to 4.29% this morning. It makes no sense at present to think of LIBOR as a spread to the fed funds rate. LIBOR is simply a statement of the lack of confidence by financial institutions in other financial institutions. Liquidity is being hoarded, as evidenced by the explosion in excess reserves, and the Fed has become the lender of last resort to everyone (banks, primary dealers, AIG, money market funds, and foreign central banks). What is needed (yes at the expense of future moral hazard issues) is for the Fed and other central banks to guarantee transactions between regulated banks for a period of at least one year. We have a confidence shortage, not a liquidity shortage, and knowing that central banks would be the ultimate counterparty would go a long way to restoring confidence. As for the wider firebreak, it appears alas that TARP is now no longer enough.

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