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Fed's push into funding markets stirs fears of widening role

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The Federal Reserve's latest effort to calm the financial system — pumping $100 billion a day into trillion-dollar funding markets — is intended to be a temporary role, born of necessity. But it may turn out to be a significant expansion of the Fed's footprint.

It has happened before. The Fed's role in private markets has ballooned over the past decade, stemming from its actions to safeguard the financial system during and after the 2008 crisis, when it bought trillions of dollars in assets and took on a much more aggressive role in supervising the biggest banks.

As with its previous moves, the Fed's massive intervention in the so-called repo market — a central piece of the financial system where banks and other firms get short-term funding — has begun to stoke criticism even as it succeeded in stopping a dramatic spike in interest rates.

"The biggest danger of the Fed staying in the repo market is that it cements the expectation that the U.S. central bank will protect not just banks in a liquidity squeeze but volatile markets that are inconvenient to monetary policy," said Karen Petrou, managing partner at Federal Financial Analytics, which advises financial institutions. "That's moral hazard."

The market for repurchase agreements — the temporary exchange of cash for, say, a Treasury security — is also a crucial source of overnight funding for brokerage firms, hedge funds and other financial institutions. And it is often an early stop for newly issued government debt as it's absorbed into the economy.

That means the repo market helps influence the amount of interest paid by taxpayers to fund the federal government and the rates paid by consumers on mortgages and other loans. And the Fed has taken new responsibility for influencing rates in that market, at least for the time being.

It's doing so to keep the rate it directly targets — the federal funds rate — where it wants. But "you definitely get the sense that the Fed now sees itself as responsible for the level of repo rates," said Bill Nelson, chief economist at the Bank Policy Institute and a former Fed staffer.

The Fed used to participate in repo markets regularly, back when it actively managed the cash supply because reserves were scarcer. But those operations were limited and intended to manage small day-to-day variations in how many reserves were needed in the financial system. It didn't attempt to actively corral those rates.

The dynamics of funding markets have shifted considerably since the financial crisis, when the Fed pumped tons of reserves into the economy, making the cash supply abundant. That meant the central bank didn't have to regularly manage the supply of reserves, something the Fed saw and still sees as a preferable situation.

The central bank also moved to require large lenders to keep a certain amount of that cash on hand, in case of a downturn.

After the Fed spent nearly two years pulling close to half of those reserves out of the financial system, a confluence of factors led to a surge in interest rates in the repo market. That mid-September rise led to a brief time when the central bank's target rate went above the Fed's set range.

To prevent such episodes in the future, the Fed for now has aggressively stepped in to offer overnight cash loans to select banks that hold Treasuries or mortgage-backed securities.

It has also begun permanent purchases of short-term Treasury securities to once again boost the reserve supply to at least the size it was before the mid-September volatility, the idea being: with more cash available, banks should be more willing to temporarily part with some of their already-ample supply for a profit.

Until they get there, "they're … pretty much compressing all overnight rates to a very narrow range," said Lou Crandall, chief economist at Wrightson ICAP.

Unfortunately for the Fed, it can't know with any certainty how big the supply needs to be to get to that point.

"Banks' demand for reserves is not static," said Lorie Logan, acting markets head at the New York Fed, in a speech last week. "It shifts in response to changing financial conditions and will evolve through time as banks adjust their business models and respond to changes in the economic and regulatory environment."

Indeed, demand for reserves could grow along with the supply. Multiple experts pointed to the example of Norway's central bank, which found that the more reserves it provided, the more reserves banks wanted.

"The Fed is in danger of becoming the whole U.S. money market," said George Selgin, an economist at the libertarian Cato Institute who believes the central bank should return to its pre-crisis framework. "It's very difficult to tease out all the implications of that."

"The Fed doesn't want to be the repo market," he added. "It doesn't want to do all these things, and yet it seems to be going down the road toward doing these things."

Others were more confident that the Fed would be able to step back and play a supporting role. "But they still have a reasonably good chance of intermittent spikes, so I think they're going to have to always be standing by at the first sign of tension," said Seth Carpenter, chief U.S. economist at Swiss bank UBS.

When reserves do reach a point where the Fed feels comfortable pulling back, there are a few approaches it's likely to consider to phase itself out of repo markets. It could limit the scope of cash it is lending out or increase the price, so that private sector lenders like money market funds can once again take more of a frontline role.

"Assume that things in general work on most days and on the weird days where they don't, the Fed takes care of the problem," Carpenter said. "That's where I think they end up."

The Fed could also permanently offer funding, at a rate slightly above the interest it pays to banks for their deposits, to act as a standing backstop for the market. That could allow the Fed to keep its balance sheet smaller than it would otherwise need to be.

Still, banks have argued that it's not just the amount of cash available that's causing friction but also regulations that require them to hold on to some of it, as well as capital requirements that make holding lots of Treasuries more costly.

"[The Fed] can get around the problems for a while, … but in the end I think they have to address the structural problems," BPI's Nelson said.

For his part, Fed Chair Jerome Powell has said that the solution is not to weaken post-crisis regulations but to increase the reserve supply. He has also suggested the Fed might give banks more flexibility to temporarily overdraw their accounts at the central bank during the day, something that used to be common.

The Fed has pledged to continue injecting cash into repo markets at least through January, an attempt to get the markets through the end of the year, when megabanks are expected to deflate their asset holdings to reduce the calculation of their capital surcharge.

Once they're in the new year, Fed officials will have to determine how much more they need to continue building the reserve supply before they can begin to withdraw from funding markets.

"They'll be looking for an exit strategy from this," said Crandall. "The way they are operating in [funding markets] right now … is not a healthy long-run solution."