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Food For Thought

What does the steep rise in reverse repurchase agreements imply?

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The Story…

There have recently been some interesting developments in the Federal Reserve Bank's (FRB) balance sheet that are worth mentioning. These developments do not necessarily reflect any change in the FRB's monetary policy, though a few variables mirror the trends witnessed during the worst phase of the Great Recession in 2008-09 and could be a cause for concern if they continue. We will be keeping a close watch on these variables and their trends in order to keep our readers informed as and when required.

Reverse repurchase agreements (RRAs) climb to a new high…

What is most noteworthy is the steep rise in reverse repurchase agreements (RRAs), also known as reverse repo. When a party, FRB in this case, buys securities with a promise to sell them back on a specified date in the future at a fixed higher price, such a transaction is known as RRA. Chart 1 given below shows the outstanding amount of RRAs with foreign officials and international accounts (FOIA).

Chart 1: RRAs with foreign officials & international accounts, USD mn, weekly

Source: Federal Reserve Bank (FRB)

** Shaded region implies the 2008-09 recession as per National Bureau of economic Research (NBER) from December 2007 to June 2009*

For the week ending August 17, 2011, the FRB conducted reverse repo worth $25.4 bn, marking the highest weekly transaction at least since 2003. Although the weekly transactions have reduced since then, the outstanding amount of RRAs with the FOIA was $95.3 bn as per the recent data for the week ending September 21, 2011 (down from its peak of $103.4 bn in the first week of September), much higher than $65.4 bn at the end of July 2011. While the amount appears insignificant in this world of multi-trillion dollars debts and deficit, it is important to note that there are no offsetting repo transactions (wherein the FRB buys securities, thereby injecting liquidity, with a promise of selling them back) since February 2009.

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Are rising RRAs normal or a cause for concern?

There are two implications of the rising trend in reverse repo transactions. Firstly, it implies that the Fed is sucking money from the system at historically high levels with a promise to inject it back in less than 15 days (the maturity of the reverse repo transactions). In other words, this is a form of reverse QE. But why would the Fed do that when it has been assuring the markets that it will take whatever measures that may be required to support the markets? If the amount of reverse repo falls at a similar pace in the weeks to come, or repo transactions take place, then the cash flow will be balanced.

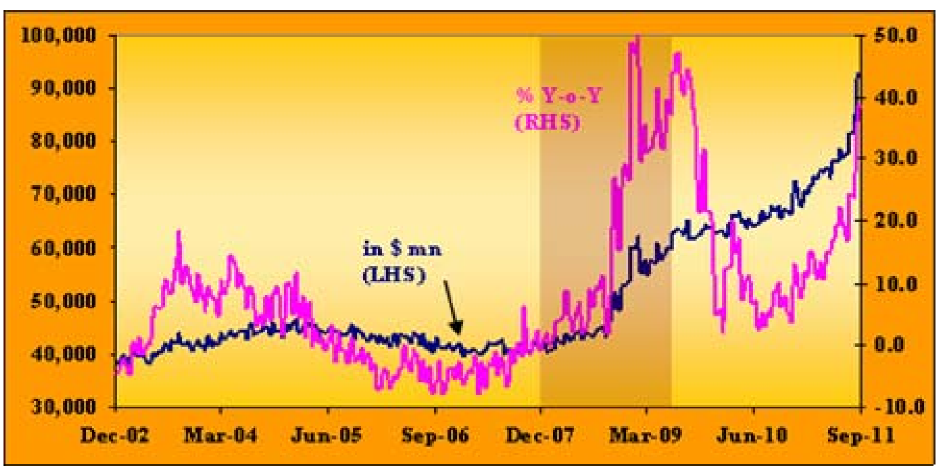
The rising reverse repo could also be attributed to foreign officials withdrawing their deposits from European banks and depositing the same with the FRB via reverse repo transactions. There are a number of anecdotal evidences available that support this argument and is hardly surprising, considering the turmoil in the Euro Zone.

However, one could also view the rising reverse repo as normal shuffling of deposits undertaken between central banks in order to reduce volatility in local currencies.

Required reserve ratio increases to decade-high level in August 2011…

A look at Chart 2 given below provides a clearer picture and shows the amount of required reserves (RR) that commercial banks are required to maintain with the FRB. The amount of RR increased from $78 bn at the end of July 2011 to $93 bn, as per the data available for the recent week. In terms of Y-o-Y growth, the amount of RR has been growing at a faster pace (up 38.7% Y-o-Y in the recent week), as shown in Chart 2 given below, which is comparable to the Y-o-Y growth recorded in late 2008 and early 2009.

Chart 2: Required reserves with the FRB



Source: Federal Reserve Bank (FRB)

In other words, the ratio of required reserves to total deposits at commercials banks has increased from 0.60% at the time of the collapse of Lehman Brothers, which was the lowest level since at least 1975, to 1.11% in September 2011, marking the highest level in a decade. This shows that the FRB wants commercial banks to maintain a higher portion of their deposits as reserves. This has two obvious implications: 1.) The total amount left with commercial banks, which has already been significantly impacted by huge excess reserves, is lower than the earlier levels, thereby negatively affecting their ability to lend to the retail markets; 2.) Consistently rising required reserves ratio indicates that the FRB does not believe in a sustained recovery and hence, wants commercial banks to be in a better position in comparison to the 2008-09 period.

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A look at Chart 1 and Chart 2 shows that the increasing trend in reverse repo agreements is a cause for concern instead of being a normal trend.

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