The case for abundant reserves

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Excess reserves: scarcity vs. abundance

• Debate is sometimes framed as a corridor vs. a floor

• In my experience this terminology has confused general listeners
  – Old system wasn’t a corridor, nor is the new system a floor
Going from abundance to scarcity

- Is it feasible? That is, would it work as smoothly as it did prior to 2007?
- Is it optimal? If we can get scarcity to work smoothly, would that be the best system?
Preview of conclusions

• Returning to scarcity would be feasible, but would require coordination with other official bodies

• Harder to argue scarcity is optimal
  – Historical precedent seems less compelling, as historically the Fed didn’t have an IOR facility
  – Abundance protects the Fed balance sheet, improves payment system functioning, and may have other benefits as well
Feasibility: what is different from 2006?

- Payment volumes haven’t increased much
- Autonomous factor volatility has increased, particularly Treasury’s general account

Factors Absorbing Reserve funds: Treasury deposits with F.R. Banks
weekly change, million USD (eop)

Source: Federal Reserve Board, J.P. Morgan
Feasibility: what is different from 2006?

• Regulatory regime shift
  – LCR: replacing reserves with other (mostly) HQLA
  – CLAR: Comprehensive Liquidity Assessment and Review
    • Public documents indicate tests of liquidity stress scenarios
    • Not all HQLA created equally. Reserves have settlement immediacy that even Treasuries lack
  – Banks internal liquidity standards may have changed, particularly with respect to intraday liquidity
Optimality: if we can go back, should we?

- Arguments for abundant reserves:
  - Operational simplicity
  - Reduced credit risk to the Fed
  - Reduced settlement risk in the banking system
  - Less inter-day interest rate volatility
  - Public provision of safe, short-term assets
Reducing Fed credit risk: with abundancy, reserves are bought, not borrowed
Improved payments liquidity (borrowing from Bech, Martin, and McAndrews)
Lower inter-day interest rate volatility

Federal funds rate

daily change, % per annum

Source: Federal Reserve Board, J.P. Morgan
Conclusions

• Staying with the current system would be operationally simpler, particularly in the transition period
• Abundant reserve balances minimize the Fed’s credit risk
• They would also support better functioning of the payments system, with associated benefits
• Interest rate volatility can be expected to be lower with abundant reserves
• Public provision of safe, short-term assets: this may get too close to mission creep