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Reverse Repo Program Not Reversing Yet

The Fed needs to carefully mop up excess liquidity to avoid funding stress.

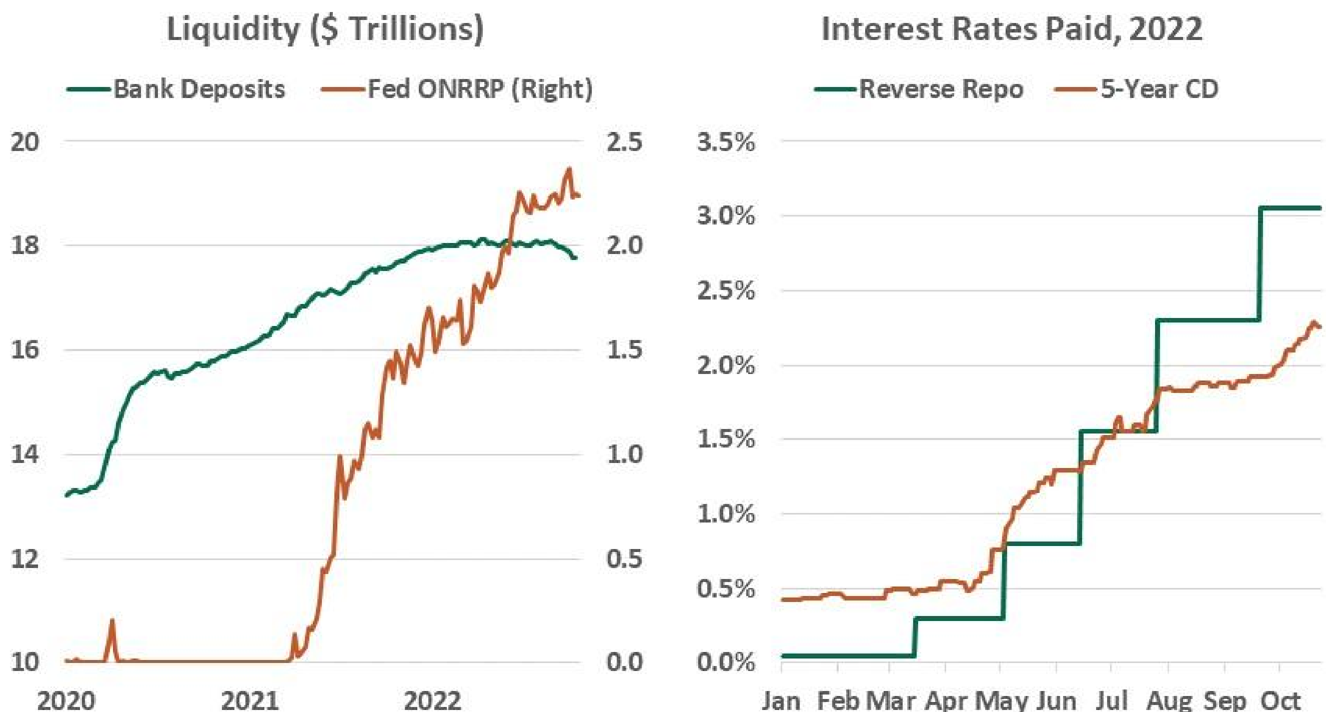
By Ryan James Boyle

Images of floods can be quite striking on newsreels, but high water alone does not capture the full experience of surviving a flood. First, there is a long wait for waters to recede; and then, the messy business of cleaning up begins.

The flood of liquidity in the COVID stimulus cycle has passed its high water mark, but levels in the financial system are still well above their old norms. High use of the Federal Reserve's

overnight reverse repurchase (ONRRP) facility bears this out.
First, a quick refresher: repurchase (or repo) transactions are a form of short-term, secured borrowing. A dealer sells an asset to an investor, with a pledge to buy it back at a higher price. For example, banks routinely trade their reserve assets like government bonds for cash to meet nightly liquidity requirements. ONRRP works in the opposite way: The Fed takes in excess cash overnight from investors, pledging its Treasury securities as collateral.
Use of the Fed's ONRRP grew through the pandemic recovery, from nearly zero at the start of 2021 to over $2 trillion every night since June. Nearly all of this utilization has come from money market funds, which are awash in inflows.

Excess cash will flow where it can earn the best returns.



Sources: Federal Reserve, WSJ, Haver Analytics

Rising interest rates were the primary driver of growth in money funds. Holders of cash are shifting to products that earn better returns than bank deposits. Money market fund managers are funneling this liquidity into the ONRRP. The facility currently offers risk-free returns of over 3%.
Banks may need to raise rates to retain their deposits and lower the risk of breaching their liquidity guidelines. The Fed's balance sheet runoff is reducing market liquidity, just at a time that liquid assets are in high demand; **market funding stress** could derail the Fed's planned balance sheet paydown. The funding pressure could ease if the Fed reinstates its COVID-era **exemption** of Treasuries from banks' leverage ratio calculations.
The liquidity flood helped to prevent COVID-19 from causing a financial crisis. The cleanup will need to be carefully managed to avoid any further stress.

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