

Experimenting with Exit Instruments

The Federal Reserve Bank of New York has been experimenting with new instruments to assess its ability to raise the fed funds effective rate closer to the rate being paid on bank reserves. The NY Fed began to raise the rate it offers on 7 day time deposits on November 13, 2014 (see table below). On December 1, the NY Fed auctioned \$402 billion of 7 day term deposits at 30 bps in an operation settled on December 4 and maturing on Thursday December 11.

Term Deposit Auctions

(in USD billions)

Settlement date	Maturity Date	Amount	Rate	Participants
13-Nov-14	20-Nov-14	307.8	27	80
20-Nov-14	26-Nov-14	316.0	28	85
26-Nov-14	4-Dec-14	334.7	29	90
4-Dec-14	11-Dec-14	402.1	30	97

Source for all tables: Federal Reserve Bank of New York website

The NY Fed also increased the rate it offers on overnight reverse repos, from 7 to 10 bps on December 1, while on Monday December 8 it began to offer term reverse repos with a maximum offer rate of 10 bps. The auction on Monday established a rate of 8 bps at the 28 day maturity.

Overnight Reverse Repo Auctions

in USD billions

Settlement dates	Max Amount	Rate	Amount
30-Oct-14	300	5	142—186
3-Nov-14	300	3	99—125
17-Nov-14	300	7	116—174
1-Dec-14	300	10	102—166
December 15 and after	300	5	

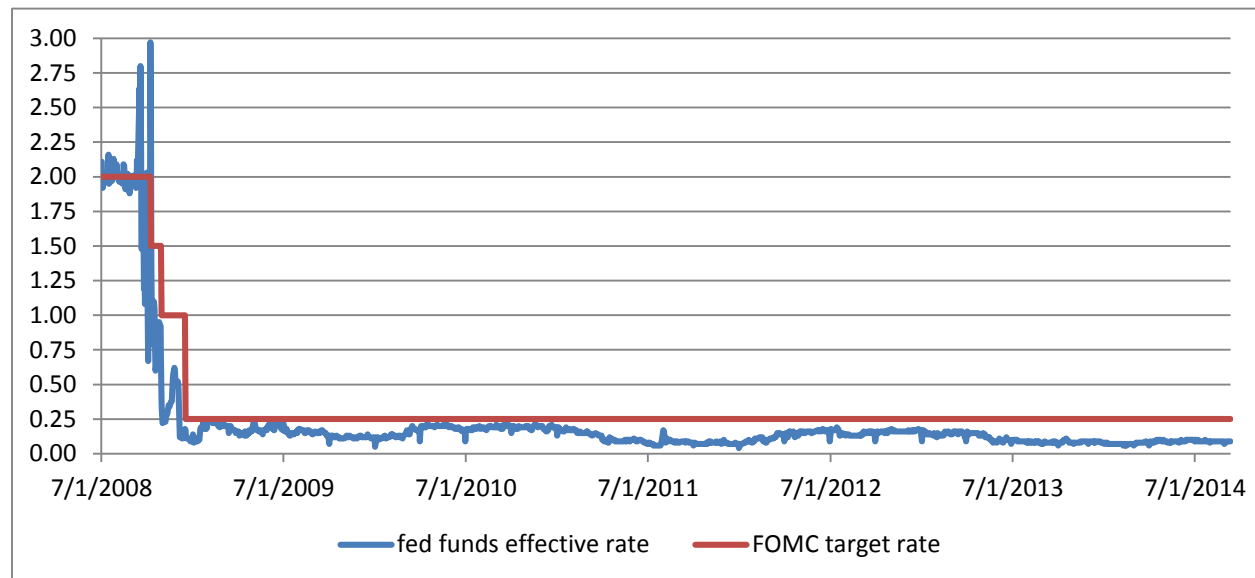
Term Reverse Repo Auctions

in USD billions

Settlement date	Maturity Date	Offer Amount	Rate	Duration
8-Dec-14	5-Jan-15	50 (102 bid)	8	4 weeks
15-Dec-14	5-Jan-15	50	(max) 10	3 weeks
22-Dec-14	5-Jan-15	100	(max) 10	2 weeks
29-Dec-14	5-Jan-15	100	(max) 10	1 week

The Fed is experimenting with its new tools to test its ability to control the fed funds rate in advance of an eventual decision by the Federal Open Market Committee to raise the fed funds target range from its current level—0 to 25 bps. Although it might be thought the interest on reserve rate—currently set at 25 bps would set an effective floor on the fed funds rate, in fact, the fed funds rate has traded below the “floor” every single trading day for more than six years—well in excess of 1,000 trading days. The reason

for this apparent anomaly is that certain significant suppliers of fed funds—Fannie Mae, Freddie Mac, and Ginnie Mae, among others, do not receive interest on their balances at the Federal Reserve. Consequently, they are willing to lend to banks—who *do* receive interest on reserves—at less than the rate paid by the Fed on reserves. See the trend rate of fed funds trading compared with the FOMC target (until December 2008) and the 25 bp interest on reserve rate (since December 2008) below.



As may be evident in the diagram, the Fed is rightfully concerned that merely raising the interest on reserve (IOR) rate may not be sufficient to move the fed funds rate or at least that its control over the level of the fed funds rate will be much less powerful than it had been before the crisis. Consequently the Fed has been positioning its tools to accomplish two related objectives. The reverse repo rate—available to nonbanks such as Freddie, Fannie and Ginnie—would establish a floor for the fed funds rate. Freddie would not lend to a bank at a rate lower than it could obtain from the Fed (provided it could obtain a full allotment at the auction). The term deposit rate, on the other hand, would drain overnight deposits at the Fed into term deposits thus reducing the current supply imbalance in bank reserves. Eventually, as the supply of overnight funds would be reduced significantly, both by increasing amounts of reverse repo operations (which also drain overnight deposits out of the fed funds market) and through increased term deposits, the fed funds rate should rise toward the IOR rate¹.

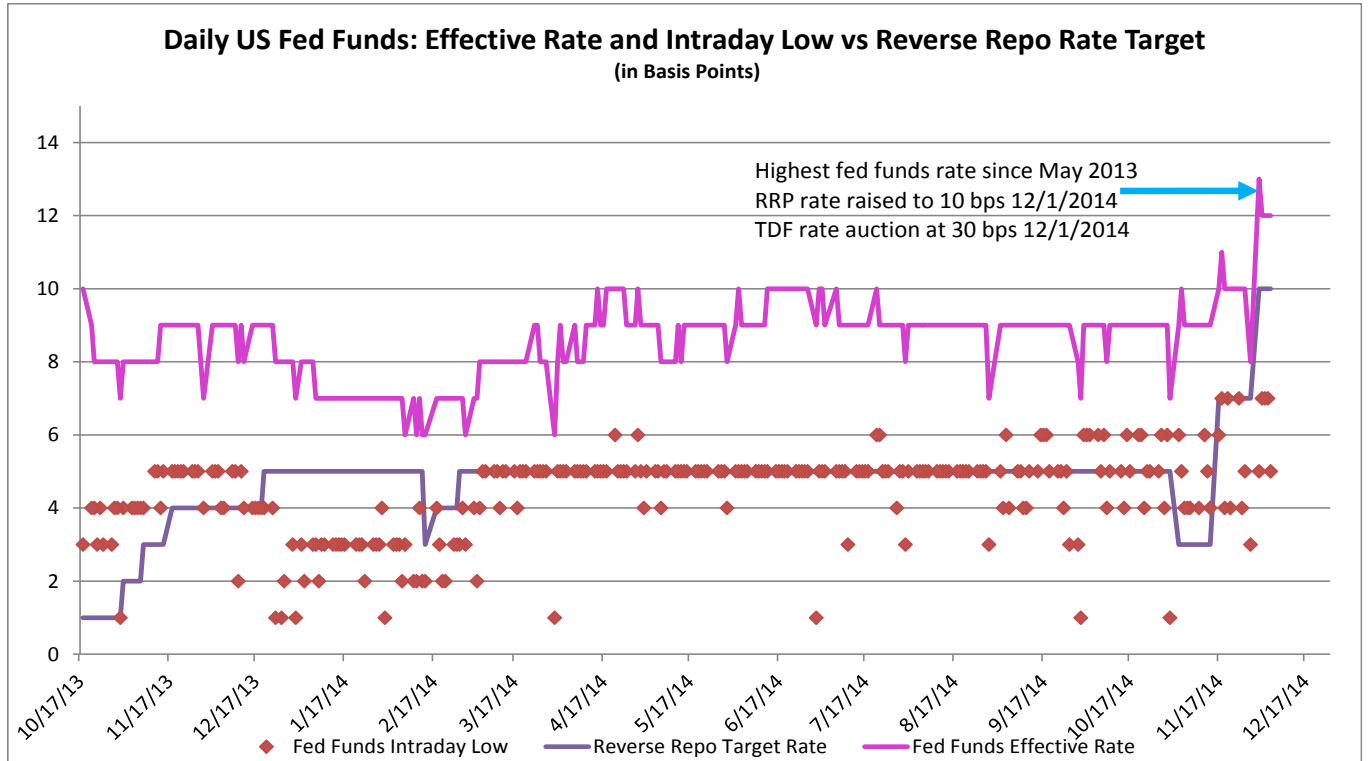
A coordinated rise of the three key rates set by the Fed—the IOR rate (the primary “attracting magnet”)², the term deposit rate (a secondary “attracting magnet”) and the rate on reverse repos (the “repulsing magnet”)—would raise the fed funds rate in a “maglev” operating system.

¹ The employment of these instruments presupposes the Fed will not shrink its monetary liabilities through outright asset sales.

² See the magnet analogy in *Interest Rate Control during Normalization* Simon Potter (October 7, 2014).

As can be seen in the following chart, the coordinated use of two of the three new instruments—an increase in the term deposit rate and in the reverse repo rate—has led to a small increase in the fed funds rate, to the highest level it has attained since May 2013.

Expect to see more such experimentation in the run up to the decision to raise the target band.



Peter Stella

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