



REALTIME ECONOMIC ISSUES WATCH

Recent Market Turmoil Shows that the Fed Needs a More Resilient Monetary Policy Framework

Joseph E. Gagnon (PIIE) and Brian Sack (D. E. Shaw Group)
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US markets for short-term credit experienced several days of tumult in mid-September 2019, as interest rates in the Treasury market for repurchase agreements, or repos, soared and market participants fretted over a possible reduction in funding availability for their investment activities. All eyes turned to the Federal Reserve Bank of New York to restore order to the market, and it used its considerable operational firepower to do just that. Nevertheless, this episode indicates that the operational framework established by the Federal Reserve is not as resilient as it could be. In our view, the Fed should make several changes to help create a more resilient and effective operating system.

The Treasury repo market, where banks and other financial institutions get short-term funding in exchange for Treasury collateral, may not be well understood by many people, but it is critically important to the US financial system and the economy. More than \$1 trillion in funds flow through it every day.

Volatility in this market threatens the functioning of markets more broadly and could ultimately hurt the economy. Even though the Open Market Trading Desk at the New York Fed (the Desk) was able to quell that volatility over a few days, relying on discretionary operational responses by the Desk allows market strains and uncertainty to persist to a degree that is unnecessary. A better approach is needed.

To be clear, the issue is not that the Fed chose the wrong type of operating regime. The so-called floor system, which leaves abundant liquidity in the financial system and relies on the Fed's ability to pay interest on those balances, has the capacity to provide highly effective control of overnight interest rates. Instead, the issue rests with specific choices about how the floor system has been implemented. We suggest several changes.

First, the Fed should implement a standing fixed-rate repo facility from which a set of counterparties (including banks) can borrow at a rate modestly above the rate of interest the Fed pays on excess reserves (IOER). The most important lesson from the recent episode is that, even in a regime with ample reserves, unexpected developments can occur that put upward pressure on money market rates. A standing repo

facility, first proposed in our [2014 PIIE Policy Brief](#), would provide a guardrail against those unexpected developments. Recent events leave little doubt that a guardrail is needed. By relying on a standing facility, the Fed would make the operational response transparent, predictable, and forceful, which would in turn stabilize the behavior of market participants.

Second, the Fed should aim for a higher level of reserves in general. We are not making a simple inference from recent developments that aggregate reserves are too low; that conclusion would be premature until those developments are better understood. Instead, we want to push back on the general notion that the Fed should identify some minimum level of reserves for the financial system and seek to get close to that level. The minimum level of reserves is conceptually murky, impossible to estimate, and likely to vary over time. The best approach is to steer well clear of it, especially since maintaining a higher level of reserves as a buffer has no meaningful cost. To that end, a case can be made for the Fed to increase the general level of reserves by \$250 billion over the next two quarters through outright purchases of Treasury securities. Thereafter, the Fed should continue to grow its balance sheet as needed to expand reserves in line with nominal GDP.

Third, the Fed should be explicit about its desire to control the repo rate. Right now, the directive that the Federal Open Market Committee (FOMC) gives to the Desk is specified in terms of the federal funds rate, with instructions to conduct operations only as needed to keep this rate within its target range. But the federal funds market is much smaller and less important than the repo market, so this directive is dangerously inadequate. For example, the FOMC directive would suggest that last week's money market conditions were largely acceptable (the Desk missed the target range on only one day and by only a small amount), which would be an absurd perspective. It is important for the Fed to control the repo rate, and the FOMC directive should explicitly state that. In fact, the Fed should consider even going as far as adopting the repo rate, as measured by the secured overnight financing rate (SOFR), as the targeted policy instrument.

Fourth, the Fed should ensure that the bottom end of the interest rate target range is strong. Even though this aspect of the framework is not a pressing issue today, the Fed should be prepared for when market conditions change. The recent decision to bring the reverse repo (RRP) facility rate—the rate that provides the strongest floor on market rates—below the bottom end of the target range was puzzling, and it could become problematic for the Fed when market rates soften. The strongest and most equitable policy approach would be to set both the RRP rate and the IOER at the bottom of the target range.

The lesson from this episode is that unexpected circumstances can arise abruptly at any moment. It is, therefore, crucial to design a monetary policy system that stands up to the unexpected. The four changes suggested here would create a more resilient and effective operating system for the Fed.

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