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Yellen Shift on Vast Treasury Cash Pile Poses Problem for Powell

- **Treasury is slashing its bulging bank account at the Fed**
- **Move pushes down money market rates, may make them go negative**

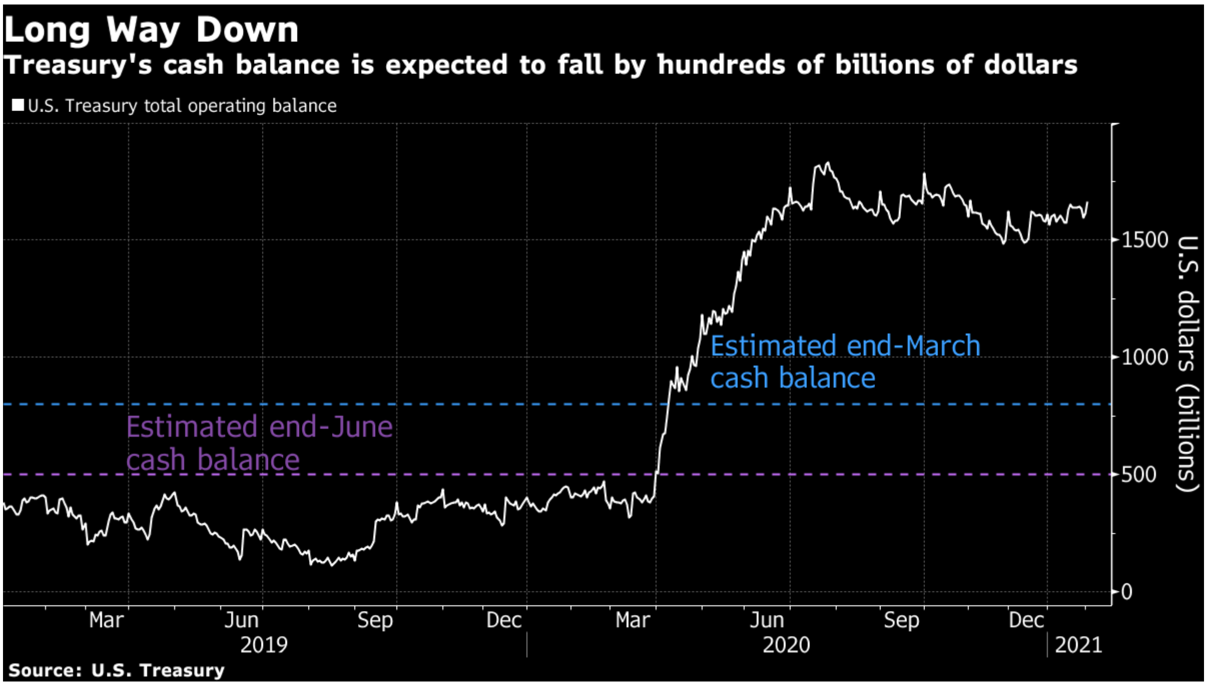
By Rich Miller and Liz Capo McCormick

(Bloomberg) -- Treasury Secretary Janet Yellen is giving Federal Reserve Chairman Jerome Powell a bit of a headache when it comes to managing the money markets.

Already low short-term interest rates are set to sink further, potentially below zero, after the Treasury announced plans earlier this month to reduce the stockpile of cash it amassed at the Fed over the last year to fight the pandemic and the deep recession it caused.

The move, which aims to return its cash position at the central bank to more normal levels, will flood the financial system with liquidity and complicate Powell's effort to keep a tight grip over money market rates.

"All this cash from the Treasury's general account will have to go back from the Fed and into the market," said Manmohan Singh, senior economist at the International Monetary Fund. "It will drive short term rates lower, as far as they can go."



While the Fed has pushed its benchmark overnight policy rate down to nearly zero to aid the pandemic-inflicted economy, a drop in short-term market rates into negative territory could prove disruptive, especially for money market funds that invest in short-dated Treasury securities. Banks may also find themselves hamstrung by effectively being forced to hold large unwanted cash balances at the central bank.

The Treasury's decision -- unveiled at its quarterly refunding announcement -- will help unleash what Credit Suisse Group AG analyst Zoltan Pozsar calls a "tsunami" of reserves into the financial system and on to the Fed's balance sheet. Combined with the Fed's asset purchases, that could swell reserves to about $5 trillion by the end of June, from an already lofty $3.3 trillion now.

Here's how it works: Treasury sends out checks drawn on its general account at the Fed, which operates like the government's checking account. When recipients deposit the funds with their bank, the bank presents the check to the Fed, which debits the Treasury's account and credits the bank's Fed account, otherwise known as their reserve balance.

Dollar Pressure

Market pros are trying to parse out the implications of what could be an unprecedented surge of liquidity. Some forecast downward pressure on the dollar. Others predict buoyant stock and bond prices. Still others see it mostly as a non-event -- except when it comes to the money markets.

When ex Fed chair Yellen was nominated to become Treasury secretary, many analysts saw that as presaging very close knit ties between her department and the central bank. But there are limits on how far that can go, given the institutional imperatives of each organization.

In preparing to lower its cash hoard at the central bank to $500 billion by the end of June from around a gargantuan $1.6 trillion now, Treasury is merely returning to a more normal modus operandi.

"Treasury had just been delaying the day of reckoning for the Fed," said Lou Crandall, chief economist at Wrightson ICAP LLC.

Most Fed officials judge they have the instruments to deal with rising reserves, according to the minutes of their Nov. 4-5 meeting.

But that doesn't mean they won't have to make some difficult decisions about the Fed's interest rate tools, its bank leverage rules and possibly even its asset purchases.

Tweak IOER

In an effort to provide a floor for the money markets, the central bank could lift the rate it pays on excess reserves parked at the Fed by banks and on its reverse repurchase agreements, from 10 basis points and zero, respectively. Tweaking these administered rates is something the Fed has done before.

"If the Fed decides that it wants overnight rates to move away from zero, the most effective approach in my view would be to raise" those two rates together, said former New York Fed official Brian Sack, who is now Director of Global Economics for D. E. Shaw & Co.

But that decision -- which could be made at next month's policy making meeting -- would come as officials try to convince markets that they're not about to reduce support for the economy. While any rate rise would be portrayed as a technical adjustment, there's a risk investors wouldn't see it that way.

"The aesthetics of having to hike these rates, I'm not sure how well the market will digest that," said Tom Porcelli, chief U.S. economist at RBC Capital Markets in New York. "It might be complicated."

What to do about the supplementary leverage ratio the Fed and other regulators impose on banks is also tricky. In order to ease market strains in March, the Fed temporarily exempted banks' holdings of Treasuries and reserves from the ratio's calculation. That exemption expires on March 31, just as banks' cash balances at the central bank will be ramping up.

Fed policy makers say they don't want the exclusion, which has already been in place for about a year, to be permanent. If they do opt to temporarily extend it further, they'll want to get agreement from rule makers appointed by President Joe Biden who may be less inclined to go along.

Leverage Restrictions

If the exemption lapses instead, banks might run the risk of bumping up against the leverage restrictions, especially as they're obliged to hold a greater and greater level of reserves.

Economists are divided over how disruptive that would be.

Jefferies LLC economist Tom Simons said that banks haven't made as much use of the exclusion as expected, so rolling it back shouldn't have a significant impact.

"It's going to be a band aid that needs to be ripped off at some point," he said. "Now is probably a good time to do it."

Others see a potential bond market decline if the rule snaps back as banks sell Treasuries to meet leverage restrictions and make room on their balance sheets for the increasing number of reserves they must hold.

"The concern is that it would further impair banks' willingness to make markets in Treasuries, to hold Treasuries, and to extend repo financing so that others can hold Treasuries," said former Fed official Bill Nelson, now chief economist at the Bank Policy Institute that represents the industry.

At their November meeting, Fed officials discussed another possibility for dealing with the bulge in reserves: adjusting their asset purchase program. But economists see that as a last resort, given how sensitive investors are to any changes on that front.

The coming surge in reserves as the government slashes its cash pile will add to a flood of liquidity already in the system from the Fed's ongoing bond buying.

"This is going to bring to a head the consequences for the money markets of the dramatic increase in the Fed's portfolio," Crandall said.

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