Fed Faces a Tricky Early Exit From Quantitative Tightening
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By Tracy Alloway
(Bloomberg) -- The Federal Reserve started winding down its massive balance sheet in June in a process known as quantitative tightening.
But just three months and $809 billion later, analysts are already talking about the potential for an early end from QT — and how the central bank might orchestrate its exit.
At issue is the possibility of the financial system falling below a desired level of liquidity, as measured by the amount of reserves sloshing around the banking sector, at a time when the Fed expects to be raising rates to combat the highest level of US inflation in four decades.
While the Fed wants to drain liquidity, it doesn't want to take out too much too soon. And the prospect of a faster-than-expected balance sheet runoff raises bad memories of September 2019, when a sharp drop in bank reserves sparked chaos in the repo market that has often been called the 'plumbing' of the financial system.
"While QT only commenced in June, reserves have been declining at a rapid clip this year, falling $809 billion year-to-date," wrote JPMorgan Chase & Co. analysts led by Alex Roever. "We currently stand only around $1 trillion away from the $2-2.5 trillion threshold the New York Fed estimates to be an ample reserve regime. In light of these developments combined with recent comments from Chair [Jerome] Powell who argued against any future scarce reserve framework, there is increasing concern over a potential early exit out of QT."
JPMorgan isn't alone in thinking about the potential for an early end to balance sheet runoff. While the central bank itself still expects the process of unwinding its $8 trillion balance sheet at least another couple of years, analysts at Deutsche Bank AG and UBS Securities have also voiced worries about the possibility of an earlier exit.
Concerns are picking up after quantitative tightening kicked into high gear this month. The Fed doubled caps for balance sheet runoff from up to $30 billion in US Treasuries and up to $17.5 billion in agency mortgage-backed securities, to up to $60 billion and $35 billion, respectively. That means the central bank could in theory be reducing its balance sheet by as much as $95 billion per month from now on.

But there are a number of factors complicating the exit — including the fact that inflation-protected Treasuries have been soaring in value.

"In recent months, increases in the Consumer Price Index have resulted in an adjustment higher in the inflation compensation associated with SOMA TIPS holdings, offsetting some of the reduction in the par value of Treasury securities holdings associated with runoff," the New York Fed wrote earlier this month.

And even Patricia Zobel, currently manager "pro tem" of the Fed's System Open Market Account, said last week that the unwind could prove more complicated because the composition of the Fed's liabilities is different now than the unwind in the 2017-2019 period.

Meanwhile, exiting QT early could also prove problematic as the Fed struggles to calibrate liquidity across the financial system. Balances at the Fed's reverse repurchase agreement facility (RRP) where big investors can effectively park their securities in return for interest, for instance, have soared to more than $2 trillion, and the popularity of the facility means it could be difficult to shift investors out of it and back into the banking system.

"We think the hurdle for the Fed to abandon QT early because of reserve scarcity is high, but it's not without its challenges," the JPMorgan analysts said. "Current market conditions and market structure make this exercise of draining RRP harder in practice."

Moving investors out of the RRP could prove difficult at a time when issuance of new bonds and securities is constrained and the RRP is offering rates above the level of interest paid on bank reserves (IORB).

"Given this backdrop, Fed intervention is most likely necessary to encourage liquidity rotation," JPMorgan said. "While technical adjustments aimed at widening the RRP/IORB spread should encourage more money to flow into money markets, any tampering could jeopardize the Fed's SOFR/IORB spread."

Instead, the strategists "believe that a reduction in RRP counterparty caps could possibly be the most efficient method to encourage cash movement. All in all, going forward we could very well see an environment of both elevated RRP balances and reserve scarcity next year."

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