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More is sometimes enough

America's banks have too much cash

Abundant liquidity is meant to help markets. It might soon cause trouble

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WHEN BOND markets seized up in the spring of 2020 the problem was a shortage of cash. A global dash for dollars caused bond yields, which move inversely to prices, to spike. It sent the greenback soaring in currency markets. And inversely to prices, to spike. It sent the greenback soaring in currency markets. And it caused trading in Treasuries, usually the world's most liquid market, almost to dry up. Today the opposite problem looms: a surfeit of money. It stems from the Federal Reserve's response to last year's crisis. The central bank calmed markets by buying vast quantities of bonds with newly created cash, and has continued its purchases, at a current pace of at least $120bn a month. The abundance of dollars is causing headaches for banks and investors.

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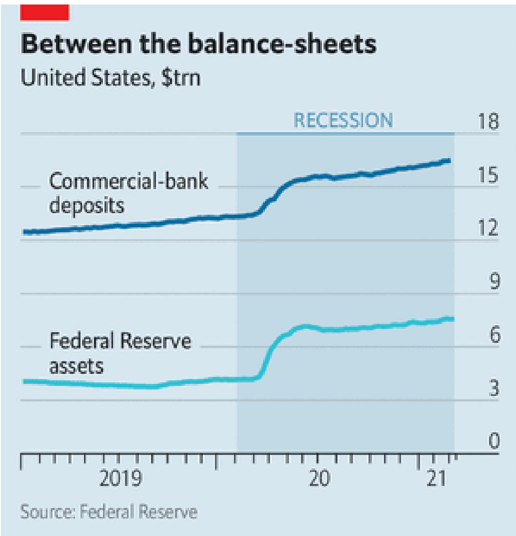
A central bank buying a bond for cash sounds like a simple swap of asset for asset. In fact it often swells the banking system. When the Fed buys assets in the secondary market, say from a pension fund, it cannot pay the fund with the electronic money it creates, because only banks can hold these so-called "reserves". Instead, the fund gets a newly created deposit at its bank, and the bank gets the newly created reserve at the Fed. The bank ends up bigger, with a new liability and a new asset. The same thing also happens when a bank buys freshly issued debt at a Treasury auction, then sells it to the Fed. When the government spends the funds it has raised, such as by sending cheques to households or paying its staff, the banking system grows.

With both mechanisms at work in the pandemic, the Fed's assets and deposits at banks have shot up in tandem (see chart). The balance-sheet of JPMorgan Chase, America's biggest bank, grew from $2.7trn to $3.4trn in 2020 as deposits rose by 35%.



The Economist

Cash will keep pouring in. Since last spring the Treasury has issued more debt than it has needed to fund its enormous emergency stimulus in 2020. As a result the "Treasury general account" (TGA)—the government's current (or checking) account at the Fed—grew from about $350bn in early 2020 to about $1.3trn on March 11th. But much of this money will soon be spent on President Biden's new stimulus programme, which includes cheques of $1,400 to most Americans. The Treasury has signalled that the TGA balance will fall to $500bn by the end of June. And current law, passed the last time America's debt ceiling was lifted, requires the balance to fall to about $120bn by August. Any rundown in the account means still more deposits and reserves for banks, in addition to those infused by the Fed.

The abundance of cash has two main effects. The first is that it has caused interest rates in the federal-funds market, in which banks lend reserves to one another overnight, to drift down. The Fed aims to keep the federal-funds rate between zero and 0.25%, but it has been falling within the band, and is now about 0.07%. As banks have abundant reserves, the federal-funds rate is economically insignificant. But rates in secured lending or "repo" markets, which matter much more to the real economy, have been approaching negative territory too. The benchmark secured-financing rate is just 0.01%. One-month Treasury bills yield only 0.03%.

The second effect is that banks are left with a lower ratio of equity capital to assets, making it harder to comply with minimum capital requirements set by regulators. One rule is the "supplementary leverage ratio" (SLR), which requires big banks to fund themselves with equity worth at least 5% of their total assets. In March 2020 regulators exempted both cash reserves and Treasuries from the SLR, recognising that the Fed's emergency actions, by expanding bank assets, had made it bind more tightly. The exemption, however, expires at the end of March.

Left unchecked, both factors could cause markets to behave strangely. If short-term

Left unchecked, both factors could cause markets to behave strangely. If short-term interest rates go negative, then supposedly safe money-market funds might be forced to “break the buck”, returning to investors less than was put in. Facing a change to the SLR, banks might turn away new deposits—a strategy JPMorgan floated in January. (The alternative, raising expensive capital to fund holdings of low-yielding cash, is unattractive.) The biggest worry concerns Treasury markets. An easy way for a bank to shrink its balance-sheet quickly is by selling assets to investors. Were a big bank or two to approach regulatory capital limits and start shunning Treasuries, the market could go into a tailspin. An early sign of this may have been in late February, when, amid a global bond-market sell-off, an auction of seven-year Treasuries suffered record low demand.

What to do? To fight the downward drift in interest rates, the Fed could marginally raise the rate it pays on reserves, currently 0.1%, though it declined to do so after its monetary-policy meeting ended on March 17th. Regulators might soon extend the exemption of reserves from the SLR (Jerome Powell, the Fed’s chairman, hinted that an announcement regarding the rule was imminent). Extending the exemption, however, would be controversial. On February 26th Elizabeth Warren and Sherrod Brown, two Democratic senators, wrote to regulators urging them to restore the SLR “as quickly as possible”, fearing that the pandemic was being used as an excuse to weaken reforms made after the global financial crisis.

In any case, renewing the SLR exemption will not solve the problem, argues Zoltan Pozsar of Credit Suisse, a bank. A more binding constraint might be the extra capital requirements that so-called “globally systemically important” banks incur as they grow. By the end of 2020 JPMorgan was on the cusp of seeing its SLR surcharge rise from 4% to 4.5% of risk-weighted assets, creating another regulatory cliff-edge. Other big banks face constraints, too: Wells Fargo, America’s third-largest bank, has had its total assets capped since 2018 as punishment for a mis-selling scandal.

The inadequacy of the SLR exemption may explain why the Fed has expanded another of its programmes. The “overnight reverse-repo facility” allows investors to park cash overnight at the central bank in exchange for Treasuries. At its meeting the Fed lifted the maximum exchange with each counterparty from $30bn to $80bn. If investors park more money at the central bank directly, then banks’ balance-sheets should shrink. The facility is barely being used but the Fed, says Mr Pozsar, is “foaming the runway”.

The usual worry about letting investors have direct access to a central bank’s balance-sheet is that it disintermediates the banks, and, by providing a new haven for cash, makes bank runs easier. Today, though, draining banks of liquidity might be precisely what is needed for financial stability—the latest example of the mind-bending monetary economics brought about by the pandemic. ■

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