SPEECH

Money Markets and the Federal Funds Rate: The Path Forward

October 17, 2019

John C. Williams, President and Chief Executive Officer

Remarks at the MFA Outlook 2019, New York City

As prepared for delivery

Good afternoon, everyone. When I give a closing keynote I try to bear in mind that you've been listening for hours to complex and technical material. I wish I could say that I'm here to offer some light relief, but, alas, no.

The topic I'm going to address this afternoon is both complex *and* technical. It's the recent turmoil in the repo markets and the Fed's actions to address it.

I'm going to start by laying out the Fed's operating framework for carrying out monetary policy. This will take me into aspects of the "plumbing" of the financial system, which may seem like an esoteric topic to many, but it's one of critical importance, so please bear with me.

I will then go over the money market turmoil from a month ago that led the New York Fed to conduct open market operations to stabilize short-term interest rates. I'll conclude by describing the path forward as laid out in the Fed announcements this past Friday.[1]

Before I go any further, I should give the standard Fed disclaimer that the views I express today are mine alone and do not necessarily reflect those of the Federal Open Market Committee or others in the Federal Reserve System.

Monetary Policy, Interest Rates, and Ample Reserves

As a prelude, it's worthwhile to step back and remember how this all connects to the Fed's overarching monetary policy goals.

The Federal Reserve has two goals set by Congress: maximum employment and price stability. The main way we achieve these goals is by controlling the federal funds rate, the rate at which banks lend each other money overnight in the form of unsecured loans. This rate in turn affects overall financial conditions and thereby the wider economy.

At each of its meetings, the Federal Open Market Committee (FOMC) decides on the target range for the federal funds rate, which currently stands at 1-3/4 to 2 percent.[2]

But how does this work—that is, what keeps the federal funds rate within the target range? The Fed has an operational framework in place designed to keep interest rates where the FOMC wants them. We call this an "ample reserves" regime.

Back in January of this year, the FOMC communicated its intention to continue to implement policy according to this regime.[3]

The key benefit of this approach is that it's a simple, effective way of controlling the federal funds rate and thereby influencing other short-term interest rates.

The ample reserves framework has three elements designed to maintain the federal funds rate within the target range.

The first, not surprisingly, is supplying an amount of reserves that banks hold at the Federal Reserve that is "ample." By that, we mean that the supply of reserves is adequate to efficiently and effectively implement monetary policy. Here, "efficient" means that the level of reserves is not excessive, relative to what's needed to be effective. And "effective" means that typical temporary movements in the demand or supply of reserves don't cause large changes in the federal funds rate without active management of reserves. I'll come back to the challenge of knowing what constitutes "ample" later.

The second element consists of the interest rates that the Fed itself sets and that influence the federal funds rate. These "administered" rates, as they are known, include the interest rate paid to banks on their reserve balances and the overnight reverse repo rate that the Fed pays to a wider set of money market participants on a similar, risk-free overnight investment.

These first two elements—an ample quantity of reserves and administered interest rates—are meant to do the lion's share of work to keep the federal funds rate within the target range.

But there may be relatively infrequent situations when these two elements are not enough to keep the federal funds rate within the target range. Therefore, the third element is the directive from the FOMC for the New York Fed's Open Market Trading Desk (the Desk) to conduct open market operations as needed to keep the federal funds rate within the target range. For example, through repurchase agreements of Treasury and agency securities, the Fed can temporarily increase the amount of reserves in the system.

To support the economy in the aftermath of the financial crisis, the FOMC increased its long-term securities holdings dramatically. This led to a similarly large increase in reserves, which peaked at about $2.8 trillion in 2014. Subsequently, growth in non-reserve liabilities such as currency and reductions in the Fed's securities holdings caused reserve levels to decline.

As the level of reserves has come down, we stepped up our monitoring of the effect of reserve levels on interest rates. The level of reserves consistent with "ample" is inherently highly uncertain, so we have been actively looking for signs that reserves might be growing scarce. Along with in-depth analysis of conditions in money markets, we conduct surveys of banks and other outreach to market participants to understand the factors that influence the demand for reserves.[4]

To smooth the transition to a level of reserves consistent with the framework, the FOMC announced a slowing of the pace of the reduction in securities holdings at its March meeting this year and stopped it outright at the July meeting.[5]

Based on a variety of metrics and information, the supply of reserves appeared ample during the summer and into early September. The funds rate traded well within the target range and money markets functioned well.

Recent Developments in Money Markets

With the stage set, I'll turn to market conditions over the past month and the Fed's actions.

Conditions in money markets became highly volatile about a month ago. Secured and unsecured rates moved higher and became more disparate on Monday, September 16, and this intensified the following day.

We had expected a number of factors—including corporate tax payments and the settlement of newly issued Treasury securities—to put some upward pressure on short-term rates. However, the size of the reaction in repo rates, the spillover to the federal funds market, and the emergence of strains in market functioning were outside of recent experience.

In response to the simultaneous increase and widening dispersion in repo rates and the federal funds rate, on the morning of Tuesday, September 17, the Fed conducted the first non-test repo operations in many years, followed by daily operations. These actions had the desired effect of reducing strains in markets, narrowing the dispersion of rates, and fostering conditions in money markets to keep the federal funds rate within the target range. To ensure that the federal funds rate remained within the target range going forward, we announced daily overnight and regular term repo operations, which continue to this day.[6]

The Path Forward

Our open market operations have succeeded at keeping the federal funds rate within the target range and have stabilized conditions in short-term funding markets.

At the same time, recent experience has provided important lessons for the successful operation of the ample reserves framework.

A confluence of events contributed to the volatility in money markets a month ago. But one telling observation is that when increases in the Fed's non-reserve liabilities caused the level of reserves to fall well below those prevailing during summer and early September, strains in money markets emerged. And when the prior level of reserves was quickly restored through temporary open market operations, normal interest rates and market functioning returned.

In light of these events, we have learned that the ample reserves framework has worked smoothly with a level of reserves at least as large as we saw during summer and into early September. Although temporary open market operations are doing the trick for the time being, anticipated increases in non-reserve liabilities would cause reserves to decline in coming months without further actions.

Based on these considerations, last Friday the FOMC announced that the Fed will be purchasing U.S. Treasury bills at least into the second quarter of next year.[7] Specifically, the Desk announced an initial monthly pace of purchases of $60 billion. These permanent purchases will, over time, bring the underlying level of reserves—by which I mean absent temporary open market operations—to a level consistent with the ample reserves framework on a sustained basis.

In concert with these purchases, the FOMC announced that the Desk will continue temporary overnight and term open market operations at least through January of next year.[8] This combination of permanent Treasury bill purchases and ongoing temporary open market operations is designed to provide effective control of the federal funds rate over the next several months.

I should emphasize that all of these actions are aimed at the implementation of monetary policy and do not in any way represent a change in the stance of monetary policy. The goal is to make sure that the federal funds rate stays within the target range set by the FOMC.

As we move forward, we will continue to learn about demand for reserves and other Federal Reserve liabilities and market functioning, and may adjust the specifics of the plan as appropriate.

What Does All of This Mean for SOFR?

That's a lot on monetary policy, interest rates, reserves, and repos.

But before I close, I'd like to emphasize an important point about a particularly important repo benchmark rate, and that's the Secured Overnight Financing Rate, or SOFR. SOFR is the reference rate that the Alternative Reference Rates Committee (ARRC) has selected as the preferred replacement for LIBOR.

At the same time that we saw turmoil in the repo market, we saw a temporary spike in SOFR. As market participants make preparations to transition away from LIBOR, they're understandably watching SOFR very closely.

There are a few things I'd like to highlight with respect to SOFR. First, a temporary spike is not surprising, given that SOFR reflects rates on real-world transactions. Second, the very fact that we saw a spike in SOFR is an indication of how representative of its underlying market it is. It's based on actual transactions, rather than judgment (like LIBOR), which is part of what makes SOFR so robust. Third and final, is that in the vast majority of use cases, the relevant metric for SOFR is an average over time. Focusing on overnight SOFR isn't particularly useful in this context, as financial contracts will generally refer to an average of SOFR over many weeks or months.

My message to you is: Don't let last month's temporary spike in SOFR, or hope for the creation of some other replacement reference rate, become an excuse for delaying your transition away from LIBOR. I've said it before and I'll say it again: like death and taxes, the end of LIBOR is unavoidable, and we must do all that it takes to prepare for a LIBOR-less future.[9] And the existence of LIBOR is only guaranteed for another 807 days.[10]

Conclusion

I've talked through a lot of important issues this afternoon, and I greatly appreciate your attention.

The events I've described are an apt reminder of the importance of well-functioning financial markets and the vital role the Federal Reserve plays in providing liquidity. They are also a demonstration of our ability to act swiftly and effectively to execute our monetary policy implementation goals and keep the federal funds rate within in the target range.

Thank you.

---

[1] Board of Governors of the Federal Reserve System, Statement Regarding Monetary Policy Implementation, October 11, 2019; Federal Reserve Bank of New York, Statement Regarding Treasury Bill Purchases and Repurchase Operations, October 11, 2019.

[2] Board of Governors of the Federal Reserve System, Statement Regarding Monetary Policy Implementation, October 11, 2019.

[3] Board of Governors of the Federal Reserve System, Statement Regarding Monetary Policy Implementation and Balance Sheet Normalization, January 30, 2019. Further details were announced in Board of Governors of the Federal Reserve System, Balance Sheet Normalization Principles and Plans, March 20, 2019.

[4] For an example of such a survey of banks, see Board of Governors of the Federal Reserve System, February 2019 Senior Financial Officer Survey.

[5] Board of Governors of the Federal Reserve System, Balance Sheet Normalization Principles and Plans, March 20, 2019; Board of Governors of the Federal Reserve System, FOMC Statement, July 31, 2019.

[6] Federal Reserve Bank of New York, Statement Regarding Repurchase Operations, September 20, 2019.

[7] Board of Governors of the Federal Reserve System, Statement Regarding Monetary Policy Implementation, October 11, 2019.

[8] Board of Governors of the Federal Reserve System, Statement Regarding Monetary Policy Implementation, October 11, 2019.

[9] John C. Williams, LIBOR: The Clock Is Ticking, Remarks at the 2019 U.S. Treasury Market Conference, New York (September 23, 2019).

[10] John C. Williams, 901 Days, Remarks at the Securities Industry and Financial Markets Association, New York (July 15, 2019).