Market Jitters that carry a Message*

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Mid-September saw some unusual developments in US money markets, which gave market players and monetary authorities the jitters. Over three days, a key short-term interest rate rose sharply to reach levels last touched about a decade ago, when the world was hit by the financial crisis. The overnight repo (or repurchase agreement) rate, which is normally expected to remain close to the benchmark Federal Funds rate set at between 2 and 2.25 per cent, suddenly and unexpectedly soared to 5 per cent and then peaked at 10 per cent, before being brought down through aggressive action by the US Fed.

The overnight repo market is where financial institutions and agents borrow money from each other, with borrowers transferring securities they own to lenders with the promise to buy them back on a specified date in the near future, which is usually the next day. The difference between the sale and purchase price captures the interest rate at which the loan or original transfer of cash was transacted.

The Federal funds rate, on the other hand, is a rate set by the Federal Reserve with a view to influencing short term interest rates, especially the rates at which banks borrow from each other to cover short term liquid cash requirements. Banks temporarily short of cash turn to those with excess reserves held in their own vaults or with the Federal Reserve, to borrow funds for brief periods. The Federal Funds rate is a benchmark for the rates that should be quoted in such transactions. In practice, however, short term rates are determined in the market, and the Fed aligns them with its target range by intervening and selling or buying securities to influence interest rates and ensure convergence. Being similar in nature, the Fed Funds rate is therefore expected to influence the repo rate as well. However, when the repo rate broke free and spiked in September, rates in the fed-funds market rose to 5 per cent, way above the Fed’s target range.

The proximate cause for this turmoil is easy to understand. When there are too many securities bidding for a limited supply of cash in the short-term market, borrowers are willing to pay more to lay their hands on cash. This pushes up interest rates, signalling a liquidity crunch. This is what seems to have transpired in the repo market. In a move that indicated that the US monetary authorities did not think that the repo rate spike over the week beginning September 16 was a freak, one-off event, the Fed stepped in, immediately injecting $53 billion into the system through repo operations with banks, hiked that to $75 billion the next day, and remained in the market for the next few days. Through its actions the Fed made clear that it would work to ease the stringent liquidity situation. Yet it took a few days to calm markets and bring short-term market interest rates down to levels close to the Fed funds rate.

There are three features of this episode that have left markets nervous. The first was the sudden and steep rise in the repo rate, which signals that the system is in a state where fears of a liquidity crunch are easily triggered. The second was the need for special and strong intervention by the Fed to ease the crunch and bring rates down. Such urgent action is unusual and signalled that something was amiss. Third was fact that despite Fed intervention, the markets took a few days to stabilise. This was no minor aberration. The fear that crept into and still pervades the markets is ominous because this is the first time since the 2008 crisis that rates had moved in this fashion and the Fed had intervened to ease a liquidity crunch in the market.

What is disconcerting is that there is no clarity regarding nor consensus on what caused the spike. Lazy explanations were in abundance. Corporates had dumped securities and withdrawn liquidity from the market because the next round of tax payments were due, some argued. Others attributed the spike to the increase in demand for liquidity induced by the sharp rise in oil prices in the wake of the drone attack on Saudi oil facilities that disrupted supplies. The Fed itself suggested that problem may be that available cash reserves, though adequate, are concentrated in the hands of a few banks, who may not be willing to accommodate multiple demand arising at once. Explanations like the first do not hold because they refer to routine events that markets are regularly absorbing and cannot underlie the exceptional spike that occurred. The oil shock is an event of a kind that the Fed should allow for and the markets should price in. And, while skewed distribution of reserves may be a reality, that cannot be true only of the moment this event occurred, and the desire of banks to hold on to cash rather than earn a return is by outing to use idle reserves needs explaining. The kind of jitters that reports from the markets revealed must have other sources.

The spike was clearly being seen as the result of a potentially destabilising development, such as large losses in systemically significant institutions that were sucking liquidity out of the market, which may have ripple effects that can drag a sputtering economy into recession. It also was seen as flagging the trap into which post-crisis monetary policy had taken the system. Central to the policy response to the crisis in the US and elsewhere were a set of unconventional monetary policies that involved, besides near zero interest rates, a massive infusion of liquidity into the system. In the US alone, the Federal Reserve had bought up massive amounts of securities in return for cash, so much so that assets on its balance sheet rose from $800 million at the time of the crisis to more than $4 trillion a few years later. This cheap money allowed banks and financial institutions to return to solvency and make large profits by borrowing cheap and lending at rates attractive to borrowers or investing in instruments offering reasonable returns. What was ignored was that this access to cheap money was simultaneously triggering speculative price increases in asset markets and inflating the volume of high-risk corporate debt. Stock markets experienced a long boom and some real estate prices displayed unusual buoyancy. Already leveraged businesses were borrowing even more.

A structure of this kind possibly requires continuous access to cheap liquidity to reproduce itself. When debts that back further lending or investments mature, they need to be rolled over. The Fed on the other hand decided that its “unconventional monetary policies” were no more needed because growth had revived, and because their effects on asset markets were leading to excessive accumulation of risk in the system. It decided to put a halt to its quantitative easing programme and not buy replacements for securities it held when they matured. Together with measures that withdrew money from the system by lending out or selling parts of its security hoard, it was signalling an end to the easy money era. For a time, it even experimented with raising interest rates from their long-term lows.

The challenge this poses to the speculative edifice created by the long years of quantitative easing is immense. If the withdrawal of liquidity warrants unwinding of speculative bets, markets are bound to turn bearish and slide too fast for comfort. Moreover, in a context of shrinking liquidity, small shocks can precipitate a liquidity crunch. An alarmist response in markets to such a turn can lead to an unwinding of positions that can trigger developments similar to that seen in 2008. Shocks to the system have been many. The trade, technology and investment war launched by the US against China; the chaos that the Brexit process has generated in the UK and Europe; and the sharp rise in oil prices triggered by geopolitical turmoil in West Asia. Not surprisingly, the Fed decided that it was not enough to just promise interest rate reductions to address the global economic gloom, but that there was need to pump more money into the system.

In sum, the Fed is trapped in the 'quantitative easing' net in which it is entangled. It is not clear whether its recent intervention, that helped calm repo markets, is enough to soothe market nerves for the medium term. If it is not, the Fed would have to promise to work the mint to stabilise the system. But even that may not prevent panic and the worst fears of the markets may yet be realized.

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