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Economia & Finanza con Bloomberg

Anomalies in the “repo” market and the Fed pumping money. Questions and answers: the whys and wherefores

(reuters)

MILAN - The Federal reserve has reached its fourth day of interventions to inject liquidity into the market. We asked Luca Riboldi, Head of Investments at Banor SIM to explain what is happening.

- **What exactly is the Fed doing these days?**

Given that there was a rise in overnight interest rates (i.e. the interest rates that banks pay when they lend money to each other) due to lack of liquidity, the Fed is buying Government bonds from American banks in exchange for liquidity in dollars so that there is enough circulation of liquidity in the banking system (the so called “repo”) to keep interest rates in line with Fed rates.

- **How does the “repo” market work and what purpose does it serve?**

Essentially the “repo” market is the interbank market, through which banks finance each other on a daily basis. Usually the interest rate that banks pay on this market is the very short-term interest rate and, if there is enough liquidity, it should be aligned to Fed rates. Conversely, there can be sharp rises in the cost of money.

- **Why did interest rates suddenly rise so much, and what risks are involved if the situation does not go back to normal?**

More than anything it is a matter of technical factors. The main issue is that at the end of July / beginning of August the US government revised the debt ceiling (the overall level of debt) upwards. From August until the end of November this will lead the Treasury to issue more securities and absorb liquidity at the Fed. This liquidity had already shrunk through quantitative tightening (reduction in the Fed’s balance sheet) that was adopted and which ended at the end of July. In addition, the banks' excess reserves with the Fed had diminished even through the payment of tax. All of this caused a lack of liquidity on the interbank dollar market, which led to a sharp rise in interest rates.

The situation is already going back to normal thanks to the Fed's injections of liquidity which should continue at least until the end of November, to coincide with reabsorption by the US government. It is therefore a temporary factor. Should this situation last for several weeks and should interest rates remain well above Fed rates, the risk is that the banks will ask for a significant increase in interest rates on loans to companies and private individuals, and as a result the entire economic system would end up with an increase in the cost of financing. That would be a rather problematic situation but we believe that it is a technical factor that will only last until the end of November.

- **Some people are asking the Fed to find a more lasting solution. What is the Central Bank being asked to do?**

The upward revision of the debt ceiling is an element that has been overlooked by many. I believe that the situation is not structural; in any case the Fed is also assessing whether to restart with QE (Quantitative Easing) and some other system to provide liquidity in the medium term in the same way as the ECB is doing now. However, in our opinion the issue is more technical and it should be resolved by the end of November.

- **How do these dynamics impact the "everyday life" of savers and investors?**

If the situation had not been dealt with promptly by the Fed through the "repo" operation to feed liquidity into the interbank system, we would have run the risk of sharp adjustments of the financial markets due to lack of liquidity. That is a very dangerous scenario: "air pockets" could have formed both on the stock market as well as on the bond market and volatility could have greatly increased.

The sudden rise in the interbank interest rate causing a consequent scare among market operators, could give rise to a sudden wave of sales due to panic for fear that the scenario of low interest rates and high availability of liquidity would be interrupted. This could induce investors to liquidate their positions, by selling the shares and bonds they hold in their portfolios which would in turn cause sudden market crashes. We ran the risk of growing system instability but luckily the Fed immediately sprang into action.