

SUPPLEMENTAL COMMENTARY NUMBER 779-A
Declining Monetary Base and Reserves

January 10, 2016

**Monetary-Base Decline Largely Has Reflected the New York Federal Reserve's
Open Market Operations in Targeting the New Federal Funds Rate**

Post-FOMC Meeting, a Monetary System Still in Flux. Further to yesterday's [*Commentary No. 779*](#), about 70% of the explanation for the sharp decline in the monetary base, subsequent to the FOMC's December 16th rate-hike announcement, appears to lie with the open-market operations of the New York Fed in maintaining the federal funds rate. Many thanks to the subscriber who noted the issue of a recent jump in reverse repos, instruments that the New York Fed uses in managing the level of the federal funds rate, holding it within the newly-specified range of 0.25% to 0.50%.

Per the New York Federal Reserve Bank, a reverse repo is a transaction in which its Open Market Desk "sells a security to an eligible counterparty with an agreement to repurchase that same security at a specified price at a specific time in the future. The difference between the sale price and the repurchase price, together with the length of time between the sale and purchase, implies a rate of interest paid by the Federal Reserve on the transaction."

From an accounting standpoint, the use of Treasury securities in these transactions does not affect the size of the reported holdings of same by the Federal Reserve, but it does have the effect of shifting "some of the liabilities on the Federal Reserve's balance sheet from deposits held by depository institutions (also known as bank reserves) to reverse repos while the trade is outstanding." Discussed in [*No. 779*](#), excess bank reserves, at present, are the largest part of the monetary base.

While reverse repos are a regular part of the New York Fed's open market transactions throughout the year, it appears that about 70% of the sharp decline noted for reserve levels in the last several weeks can be accounted for by sharp increases in the level of reverse repurchase agreements, post-FOMC.

Of the possibilities discussed in [No. 779](#), odds have shifted somewhat towards favoring the large decline in reserves reflecting “some post-FOMC systemic instability, which could right itself fairly rapidly.” Additional commentary will follow, subsequent to further Federal Reserve and the St. Louis Fed reporting, or as other related issues arise.

Best wishes to all – John Williams

Noted in the [FOMC Policy Change Implementation - December 16, 2015](#):

“As part of its policy decision, the Federal Open Market Committee voted to authorize and direct the Open Market Desk at the Federal Reserve Bank of New York, until instructed otherwise, to execute transactions in the System Open Market Account in accordance with the following domestic policy directive:

“Effective December 17, 2015, the Federal Open Market Committee directs the Desk to undertake open market operations as necessary to maintain the federal funds rate in a target range of 1/4 to 1/2 percent, including: (1) overnight reverse repurchase operations (and reverse repurchase operations with maturities of more than one day when necessary to accommodate weekend, holiday, or similar trading conventions) at an offering rate of 0.25 percent, in amounts limited only by the value of Treasury securities held outright in the System Open Market Account that are available for such operations and by a per-counterparty limit of \$30 billion per day; and (2) term reverse repurchase operations to the extent approved in the resolution on term RRP operations approved by the Committee at its March 17-18, 2015, meeting. ...”

Described by the [New York Fed](#):

“A reverse repurchase agreement conducted by the Desk, also called a ‘reverse repo’ or ‘RRP,’ is a transaction in which the Desk sells a security to an eligible counterparty with an agreement to repurchase that same security at a specified price at a specific time in the future. The difference between the sale price and the repurchase price, together with the length of time between the sale and purchase, implies a rate of interest paid by the Federal Reserve on the transaction.

“When the Desk conducts RRP open market operations, it sells securities held in the System Open Market Account (SOMA) to eligible RRP counterparties, with an agreement to buy the assets back on the RRP’s specified maturity date. This leaves the SOMA portfolio [effectively the Fed’s holdings of Treasury securities] the same size, as securities sold temporarily under repurchase agreements continue to be shown as assets held by the SOMA in accordance with generally accepted accounting principles, but the transaction shifts some of the liabilities on the Federal Reserve’s balance sheet from deposits held by depository institutions (also known as bank reserves) to reverse repos while the trade is outstanding. These RRP operations may be for overnight maturity or for a specified term...”