Fed’s Anti-Inflation Fire Drills Employ ‘Reverse Repos’

By Editor Test *Wed, Oct 21, 2009*

In theory, the Fed will be able to remove excess cash from the banking system by selling Treasuries to banks with the agreement to buy them back later at a higher price.

The Federal Reserve Bank of New York said October 19 that it has been working on a market tool it could use to withdraw cash from the banking system but stressed that it was not about to use it.

The New York Fed, the operational arm of the Federal Reserve, said it had been working during the last year to ensure that “this tool will be ready when and if” the policy-setting Federal Open Market Committee decides to use it.

The tool—reverse repurchase agreements, or reverse repos—would be used to help drain excess reserves from the banks and help to avert the risk of inflation created by the central bank’s emergency bailouts and quantitative easing policies.

“This work is a matter of prudent advance planning by the Federal Reserve, and no inference should be drawn about the timing of monetary policy tightening,” the New York Fed said in a release.

In a reverse repurchase agreement, the Fed sells assets like Treasuries for cash with an agreement to buy them back later at a higher price, thus removing cash from the system.

The focus of the Fed’s recent discussions and tests was to put documentation and systems in place to conduct three-party reverse repos, the New York Fed said. The Fed has been conducting three-party repos with primary dealers since 1999.

In the three-party repo market, the clearing banks JPMorgan Chase and Bank of New York Mellon as intermediaries, which allows for a wider range of instruments to be used in a transaction.

The New York Fed said “it is likely that the Federal Reserve will engage in additional tests in the future,” and that no actual operations have been conducted as part of these tests.