Strategic Report

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Replenishing the U.S. Treasury General Account – What impact on liquidity?

After keeping markets on edge in May, the saga of the U.S. debt ceiling came to a favourable conclusion in early June, with an agreement reached between Republicans and Democrats. Investors greeted the news with enthusiasm and the market environment has become decidedly more optimistic in recent weeks, with U.S. equities performing very well.

However, the suspension of the debt ceiling also implies a marked increase in bill and bond issuance over the coming months, not only to cover Federal government spending, but also to refill the Treasury General Account (TGA). The TGA is the U.S. Treasury's bank account, into which the government deposits its revenues and the proceeds of debt issuance, which it then uses to pay its expenses.

Unable to issue new debt for several months, the TGA was almost exhausted at the end of May, and it is now estimated the U.S. Treasury is aiming to replenish it to around US$600 billion by September (**Chart 1**).

1 | The U.S. government is refilling its bank account

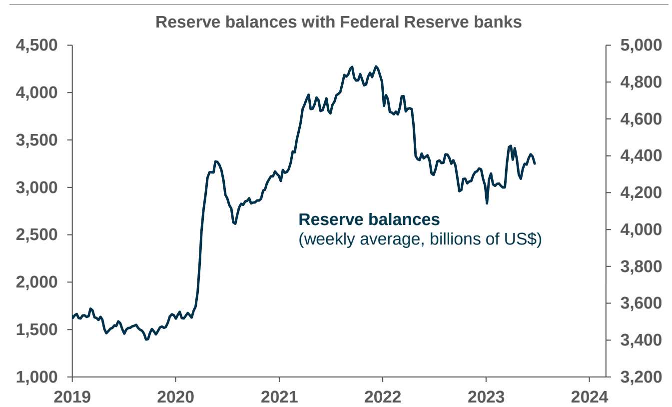
CIO Office (data via Refinitiv).

The impact of this sizable debt issuance from the Treasury (which, in fact, already began two weeks ago) in such a short amount of time raises questions. Some experts argue that it could drain liquidity from the financial system, representing a considerable headwind for risky assets. Are those fears justified? And, what do we mean exactly by "liquidity?”

A matter of bank reserves

“Liquidity” in the financial system is a vague concept that can quickly become complex. A simple and relatively common definition – at least when it comes to the U.S. financial system – uses bank reserves[1] as an indicator of liquidity (**Chart 2**).

2 | Bank reserves: a liquidity measure to monitor



CIO Office (data via Refinitiv).

[1] Bank reserves are the cash minimums which financial institutions must have on hand in order to meet Central Bank requirements. In the United States, they are mainly kept in the financial institution’s account at one of the 12 regional Federal Reserve Banks.

NATIONAL BANK INVESTMENTS

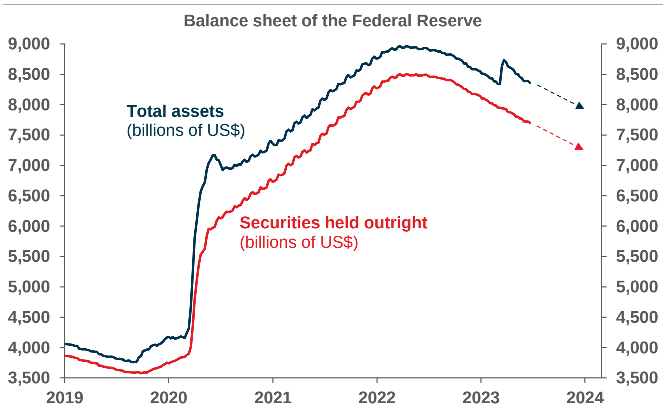
How exactly is the level of bank reserves determined? In simple[2] terms, it is merely a matter of using the assets on the Federal Reserve's balance sheet as a starting point and then subtracting three categories, as illustrated below:

$$\begin{aligned} \textit{Bank reserves} = {} & \textit{Total assets on Fed balance sheet} \\ & - \textit{Currency in circulation} \\ & - \textit{TGA} \\ & - \textit{Reverse repurchase agreements} \end{aligned}$$

So, ignoring currency in circulation, there are three options for keeping the above equation in equilibrium following an increase in the TGA: 1) an increase in total assets on the Fed's balance sheet, 2) a decrease in reverse repurchase agreements (reverse repo), or 3) a decrease in bank reserves.

First, Option 1, where the Fed would buy newly issued Treasury debt to put on its balance sheet, can be ruled out straight away. While this is essentially what happened back in 2020 when the TGA rose to US$1.8 trillion at the start of the pandemic, the current situation is quite different. Instead, the Federal Reserve is in the midst of a quantitative tightening process, i.e., reducing the size of its balance sheet by allowing the financial securities it holds to mature at a predetermined rate (**Chart 3**).

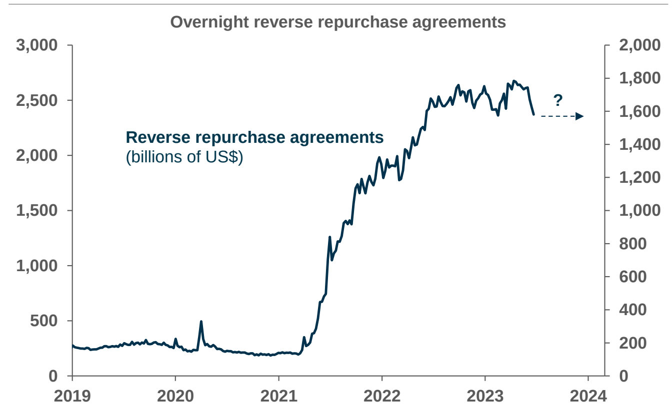
3 | The Fed won't be buying this time…



CIO Office (data via Refinitiv).

Option 2, where money would flow out of the reverse repo facility to buy newly-issued Treasury debt, is much more realistic. The Fed's reverse repo facility is used by money market funds, among others, to earn a risk-free return (currently 5.05%) linked to the Fed funds rate. These funds may decide to withdraw from this facility and buy Treasury bills instead, if the risk/return ratio offered is more attractive. This has been the case recently, with reverse repurchase agreements down by US$245 billion since May 31 (**Chart 4**).

4 | … but money market funds should be



CIO Office (data via Refinitiv).

On the other hand, it is important to note that this dynamic will never completely neutralize the negative impact on bank reserves, since money market funds are only interested in very short-term Treasury bills; the issuance of medium- to long-term bonds will necessarily require a certain reduction in reserves.

The bottom line

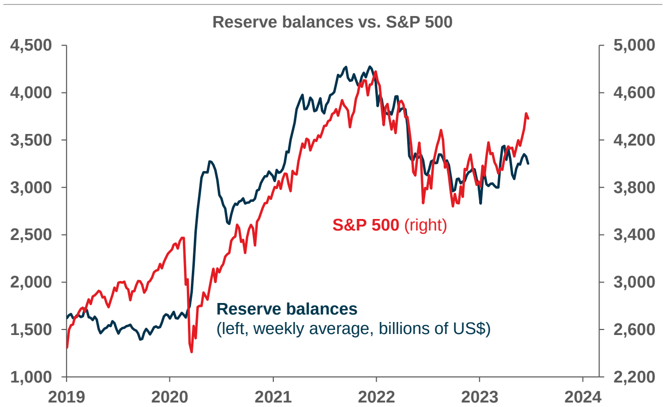
In itself, the issuance of debt to fill the TGA over the next few months should have a mixed impact on financial markets. Indeed, money market funds are, at least for the time being, partially limiting the reduction in reserves by using money currently located at the Fed's reverse repo facility to purchase newly-issued Treasuries. What's more, demand for

[2] For the sake of simplicity, we omit a few minor categories which must also be subtracted from total Fed assets. See the Fed's weekly H.4.1 publication for more details.

Treasuries seems to be holding up well, and rate volatility is continuing to fade since suspension of the debt ceiling.

However, the combined effect of the TGA increase and the Federal Reserve's quantitative tightening program which more directly reduces bank reserves – closely correlated with the S&P 500 since 2020 (**Chart 5**) – remains a significant source of uncertainty.

5 | Liquidity and equities: closely linked since 2020



CIO Office (data via Refinitiv).

In the end, the liquidity environment is no harbinger of disaster to come, but the upcoming decline in reserves adds to the list of headwinds with which risky assets will have to contend over the coming months.

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