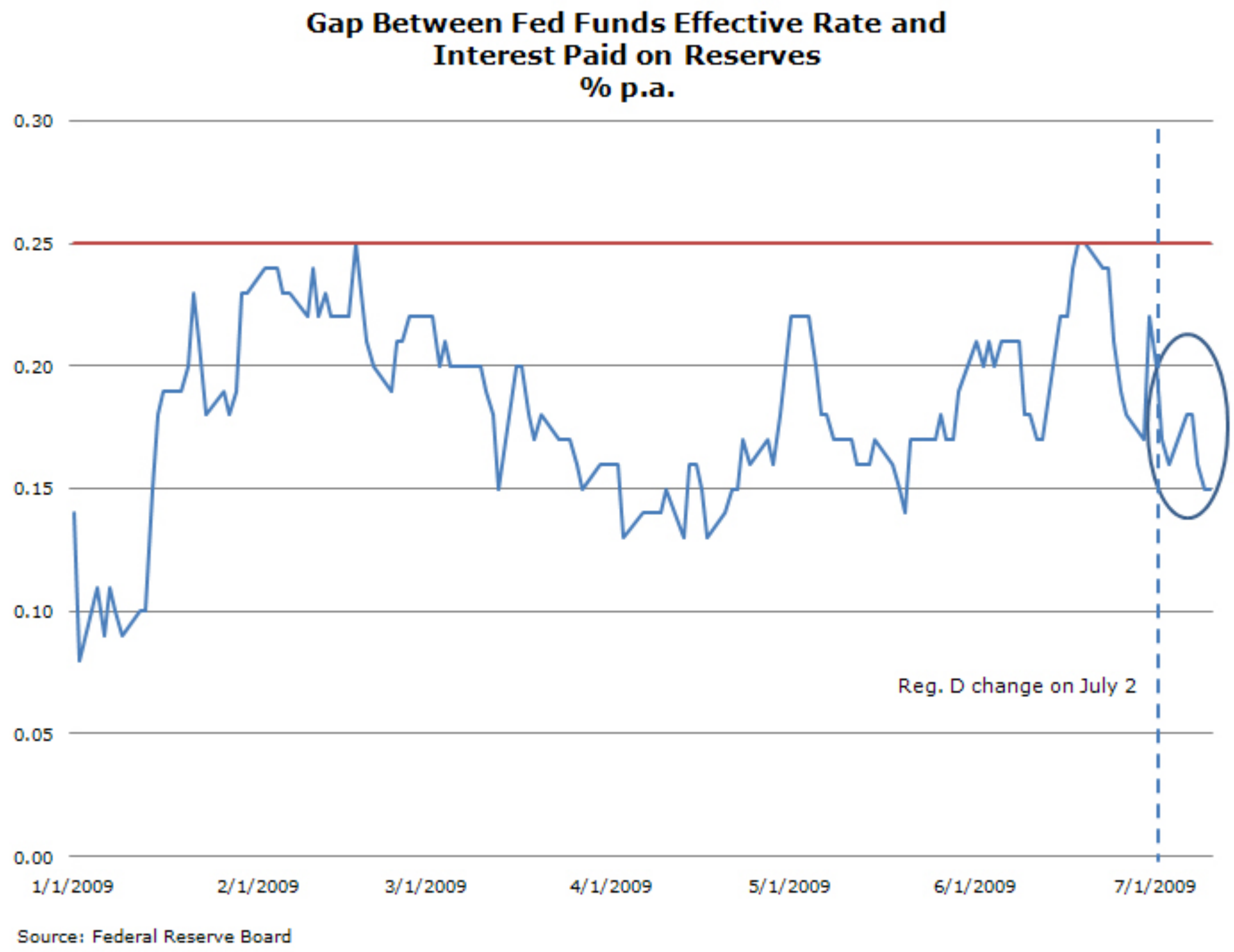
July 14, 2009

A funny thing happened update

More than a week has passed since the Regulation D changes went into effect, and it appears that the changes are having a noticeable, if not dramatic, impact on pricing in the funds market—see the updated effective funds rate chart below.



The funds rate did fall last week, and it is possible that the softening was related to an increased supply of fed funds by Federal Home Loan Banks as they sought to reduce their excess reserve balances because they no longer earned interest on those balances. But if that is in fact the explanation, the effect was not large: Fed funds are still trading in a relatively narrow range between about 5 and 40 basis points each day. Though, as the chart shows, the effective fed funds rate has drifted lower so far in July—it was at 15 basis points on Friday, July 10, down from 20 basis points on July 1. The current rate is well above the January low of 8 basis points.

Despite the large increase in supply of funds in the market that might have resulted from the Reg D change, it seems to me that the opportunity for arbitrage profits is helping keep the effective funds rate hovering in the neighborhood of the interest rate paid by the Fed to eligible institutions on their reserve balances.

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