

THE PAYMENT SYSTEM PUTS A FLOOR ON THE FED'S BALANCE SHEET

BY DARRELL DUFFIE

Ricardo Reis
LSE

*26th of March, 2026
Discussion for the
Brookings Papers on Economic Activity*

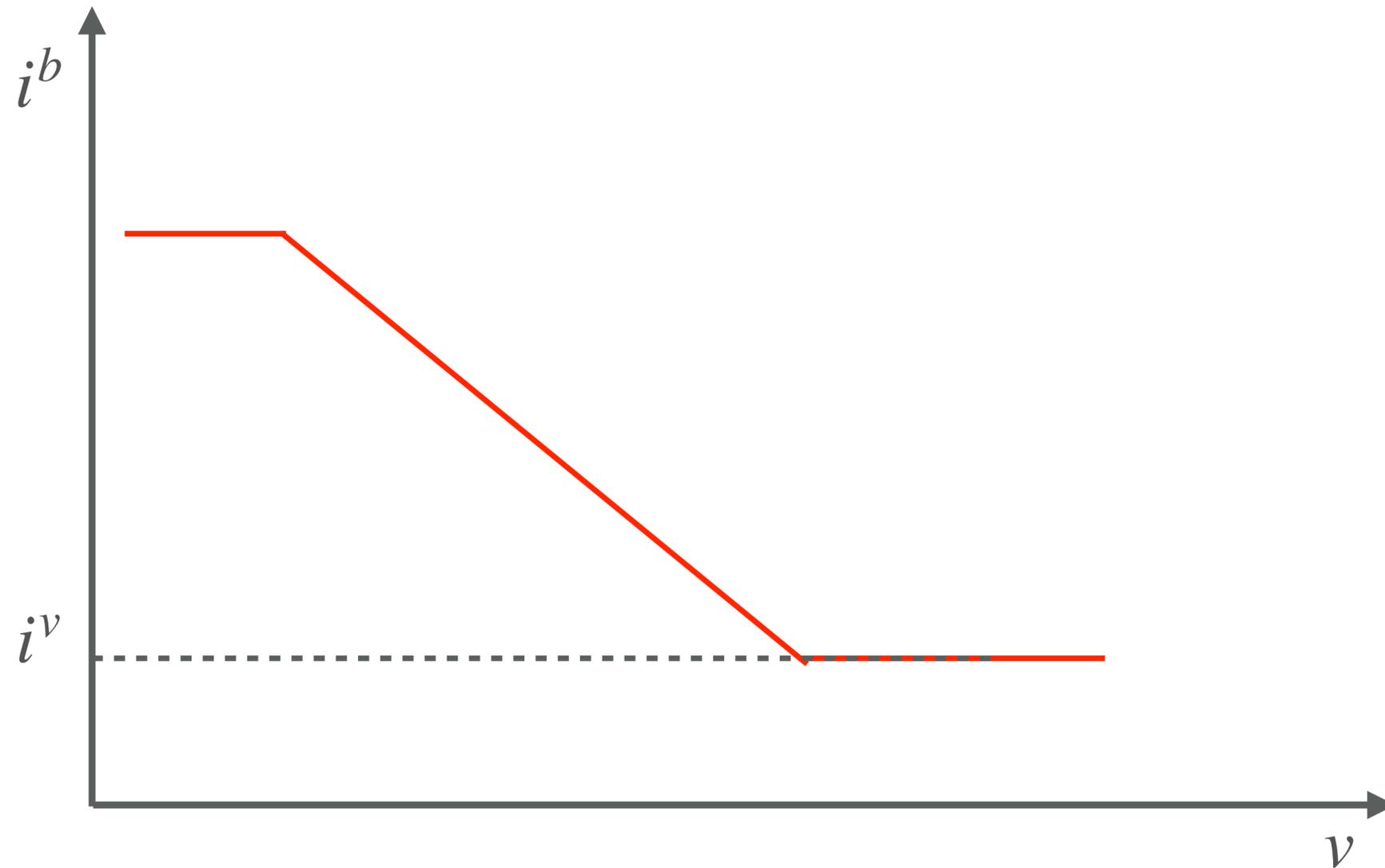


THE LONDON SCHOOL
OF ECONOMICS AND
POLITICAL SCIENCE ■

The ABCD of demand for reserves to make payments

- Consider the narrowest bank possible to focus on payments
 - Can hold T-bills paying i^b , or hold reserves paying i^v .
 - Payment frictions: must sell T-bills to get reserves to make a payment, so $i^b \geq i^v$
- The bank's problem after choosing is allocation of b and v :
 - Payment demands arrive, lower v .
 - Some other banks see their v rise, as closed system.
 - The A: regulators puts hard (or soft) minimum on v for banks with a v deficit
 - The B: banks with v surplus had previous unsatisfied demand, hold on to extra v
 - The C: the two have to meet and bargain for an interbank rate
 - The D: deficit banks can borrow from discount window at rate plus shadow penalty

The result

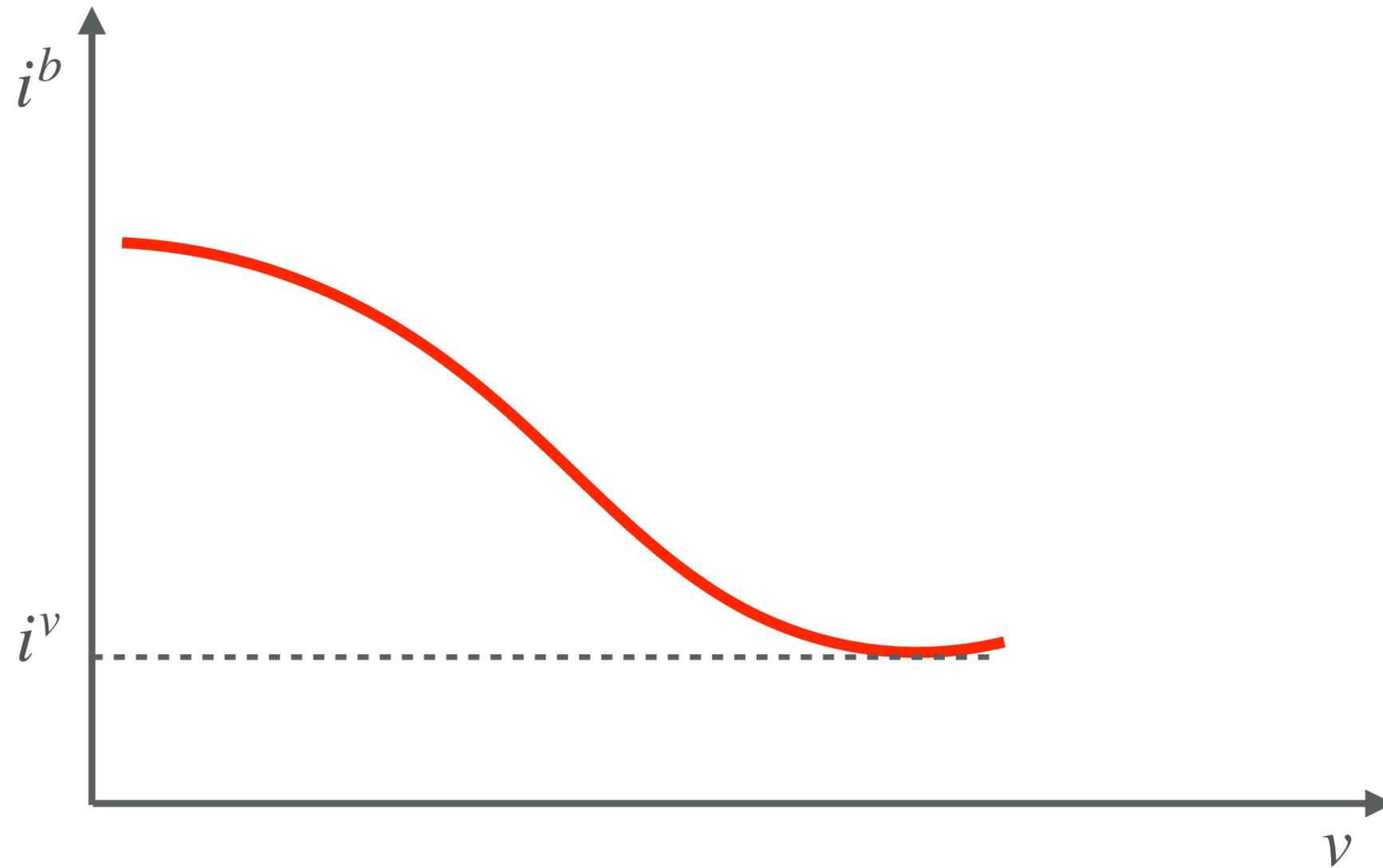


- There is desired level of reserves for each individual bank

$$v^*(i^b, i^v ; A, B, C, D)$$

- Maybe kinked, maybe smooth

The result

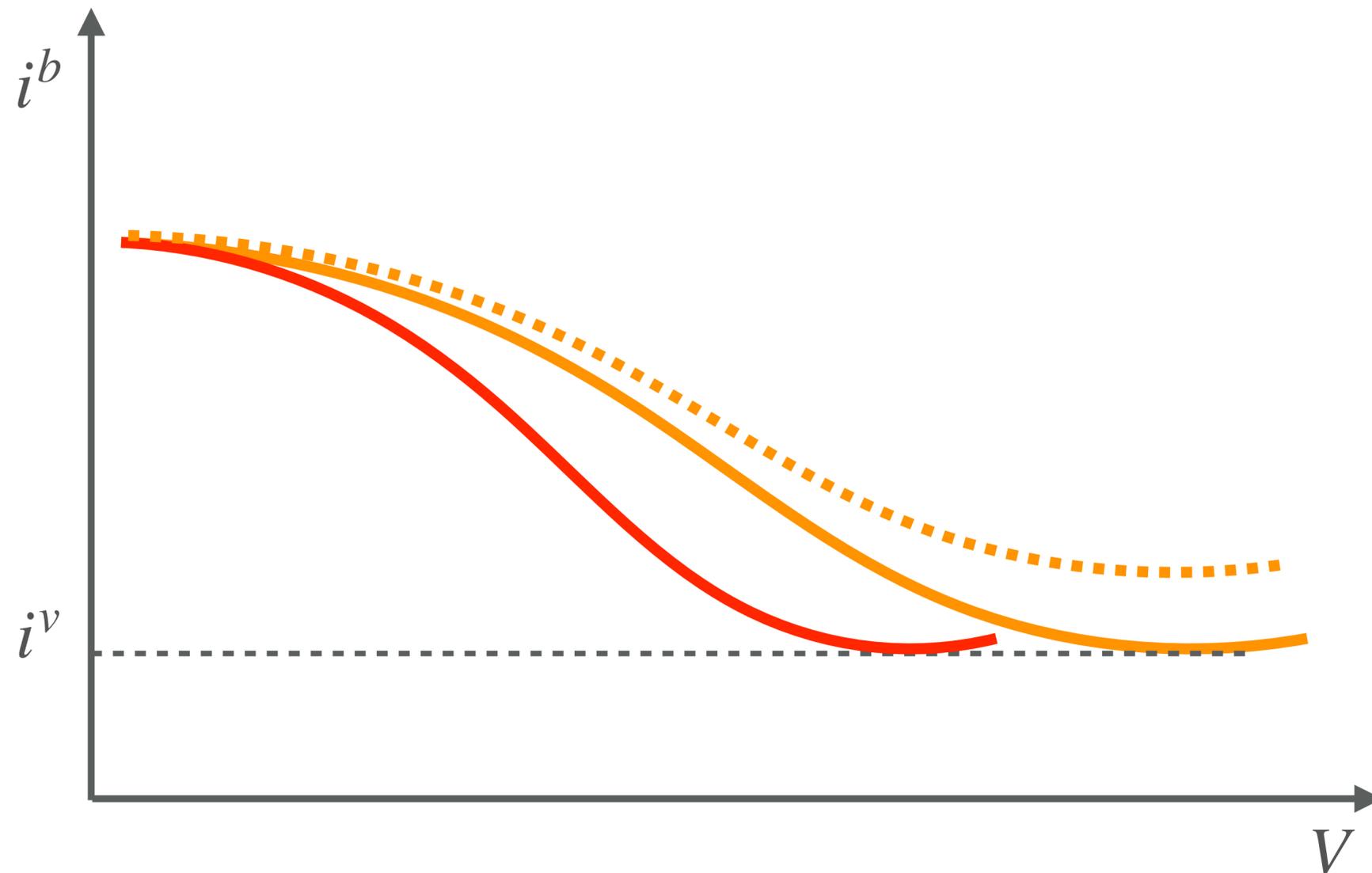


- There is desired level of reserves for each individual bank

$$v^*(i^b, i^v ; A, B, C, D)$$

- Maybe kinked, maybe smooth
- Aggregate across many banks, maybe with different strength of A, B, C, D forces, and get a smoother curve.

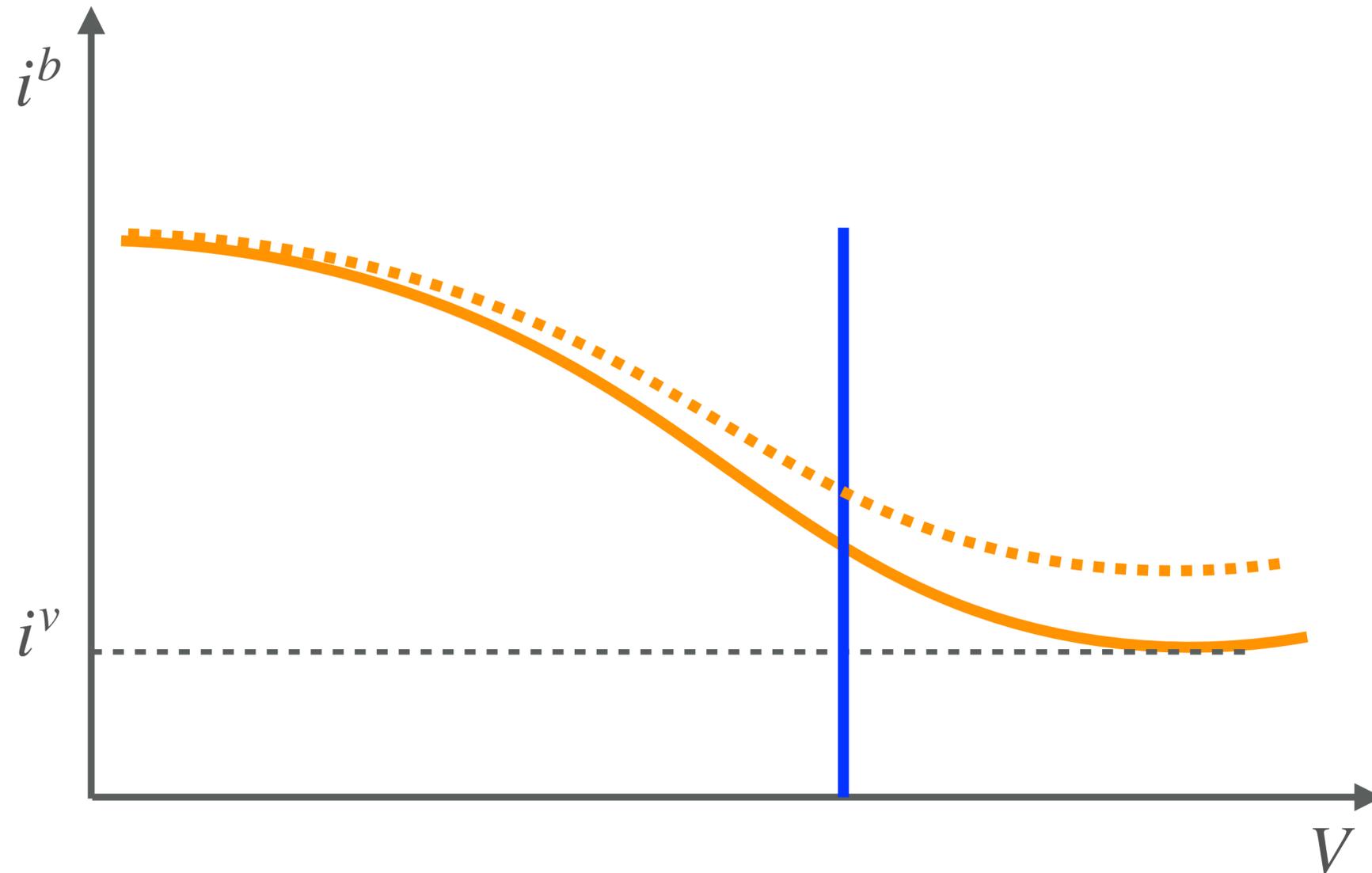
The change: demand shifted and more volatile



Since 2008, we had changes in

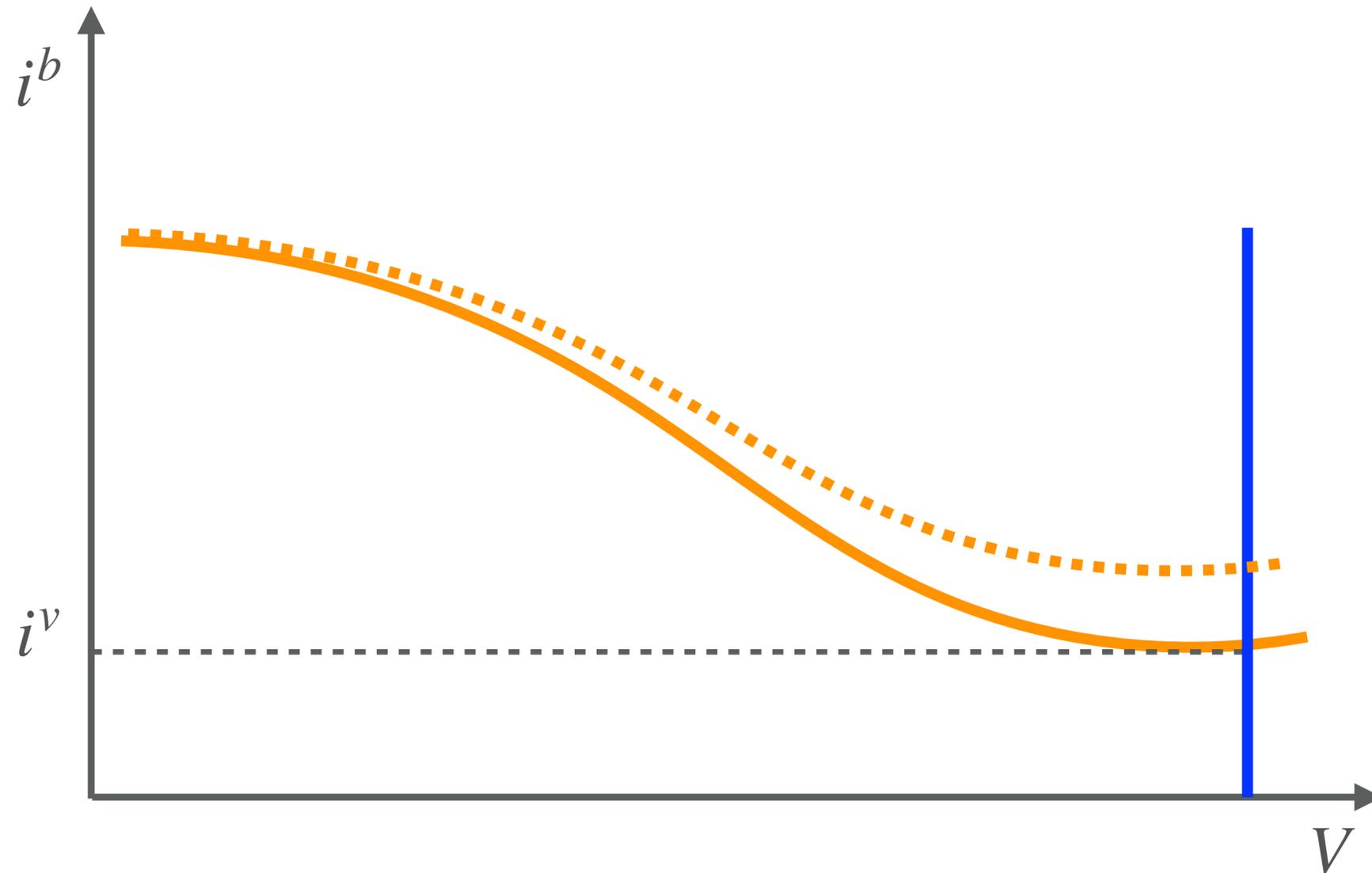
- (A) Regulation, requiring banks to have enough “own liquidity”
- (B) Surplus banks willingness to lend, partly regulation, partly $i^b - i^v$ small.
- (C) Frictional costs, less efficient bargaining, or tilted towards lender, through FDIC actions
- (D) Penalty on central bank borrowing especially for GSIPs and including now also intraday borrowing.

The problems: inelastic supply



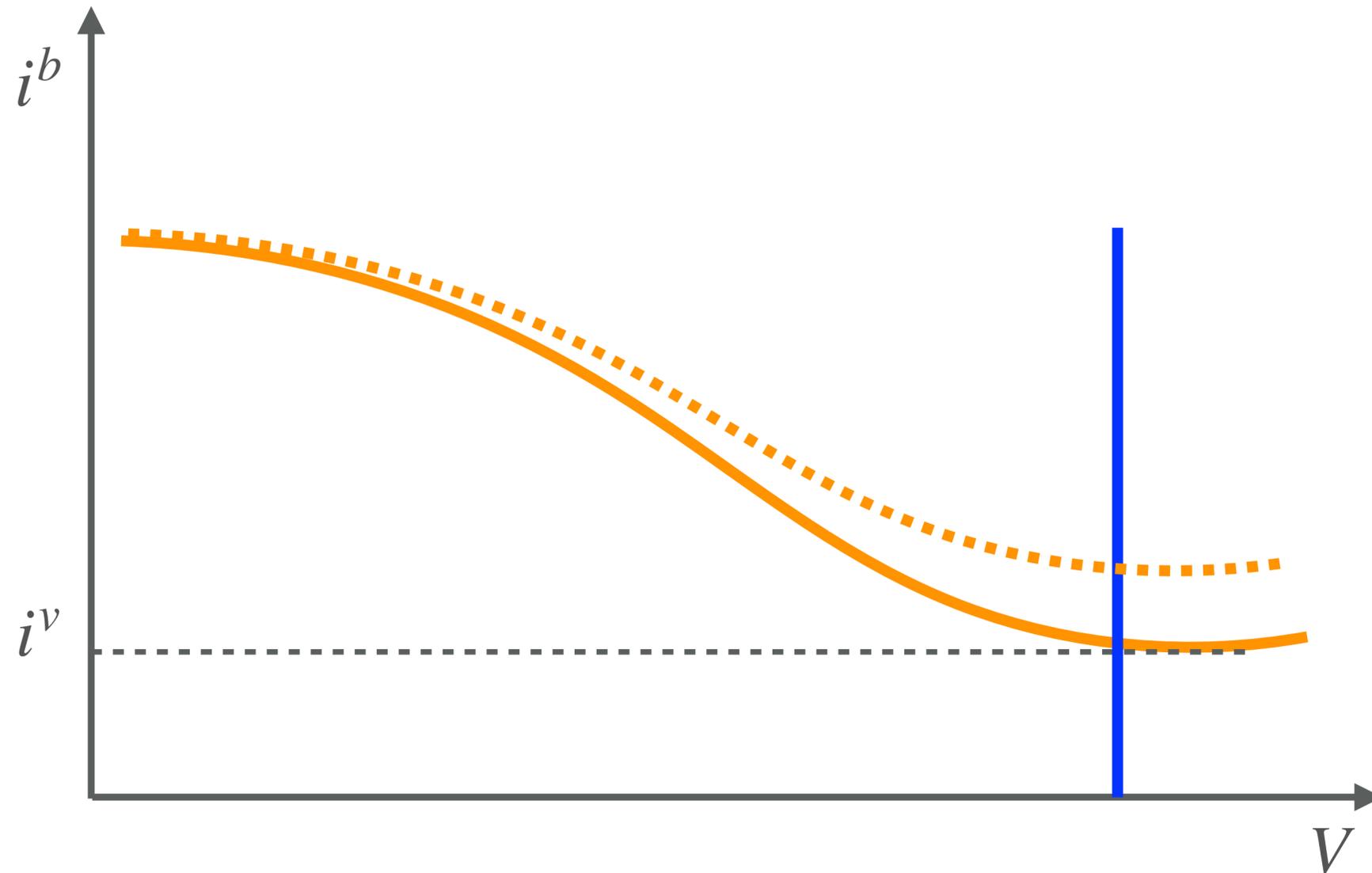
- (1) With a small balance sheet would have interest rates well above policy rates.
- (2) Calibrating quantity to supply to hit an interest rate target was always hard and has become harder
- (3) Friedman rule says should have this public service of liquidity for payments be abundant, so demand should be satiated.
- (4) Volatility and money market instability with demand shifts

The answer: increase supply of reserves



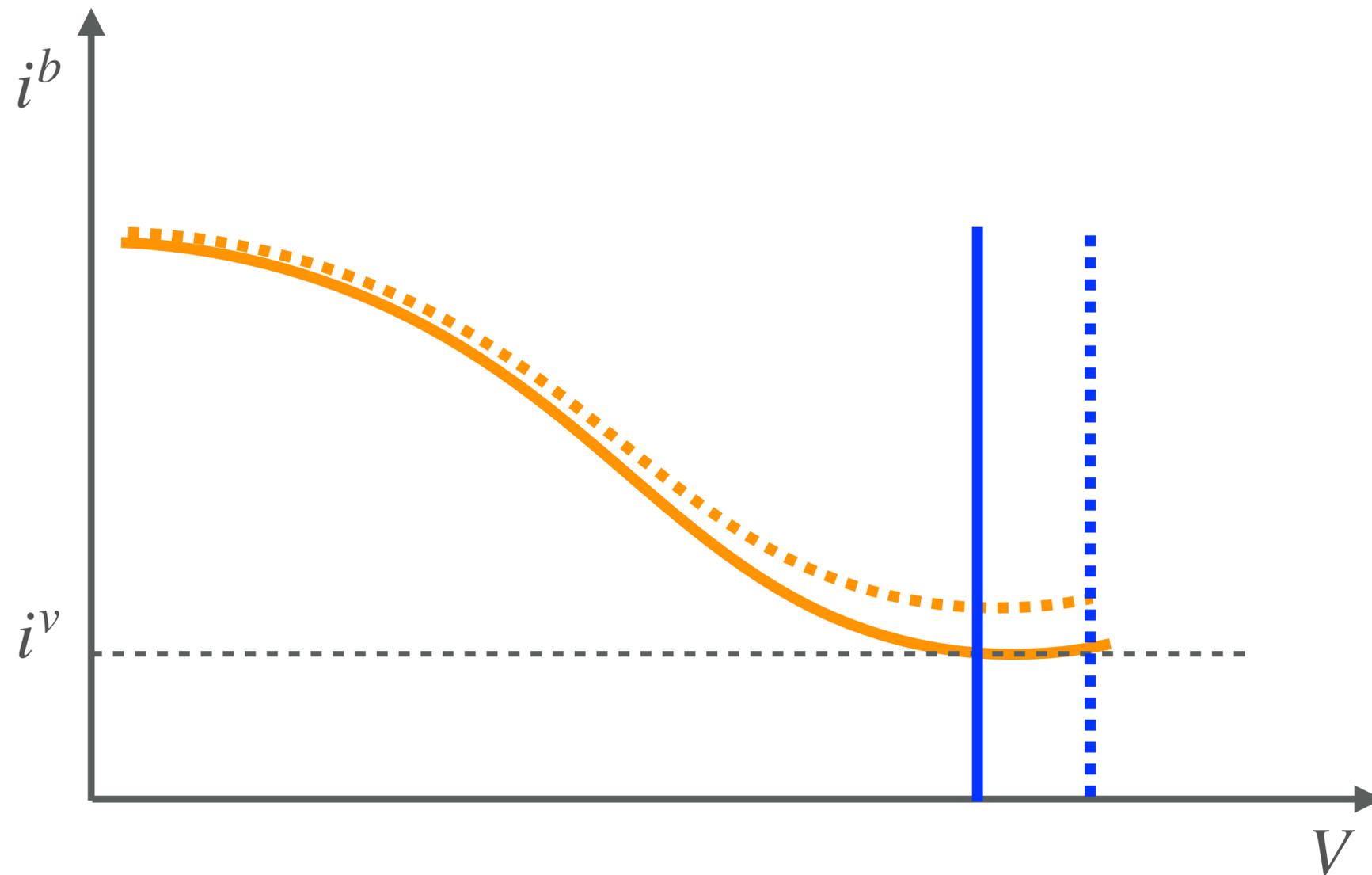
- Raise size of balance sheet
- Even go as far as volatility not being relevant
- Structural surplus. Abundant reserves. Floor system. Satiated demand. Saturated market.
- 2009-2026: got there with QE anyway
- Future: Some central banks choose to stay there

The new problem: want to shrink balance sheet



- Policy goals (which could dispute):
 - (1) Want to shift supply to the left because uncomfortable with size of balance sheet, partly through concerns with the asset side of it.
 - (2) Still want Friedman rule, so go to the kink point, the satiation point.
- Concern of this paper: then when get big shocks, will have spike in money market rates, financial instability.
- Need answers to avoid this

Paper's answer: shift demand bank left



Three ways to shift demand left

(A) scale back regulations

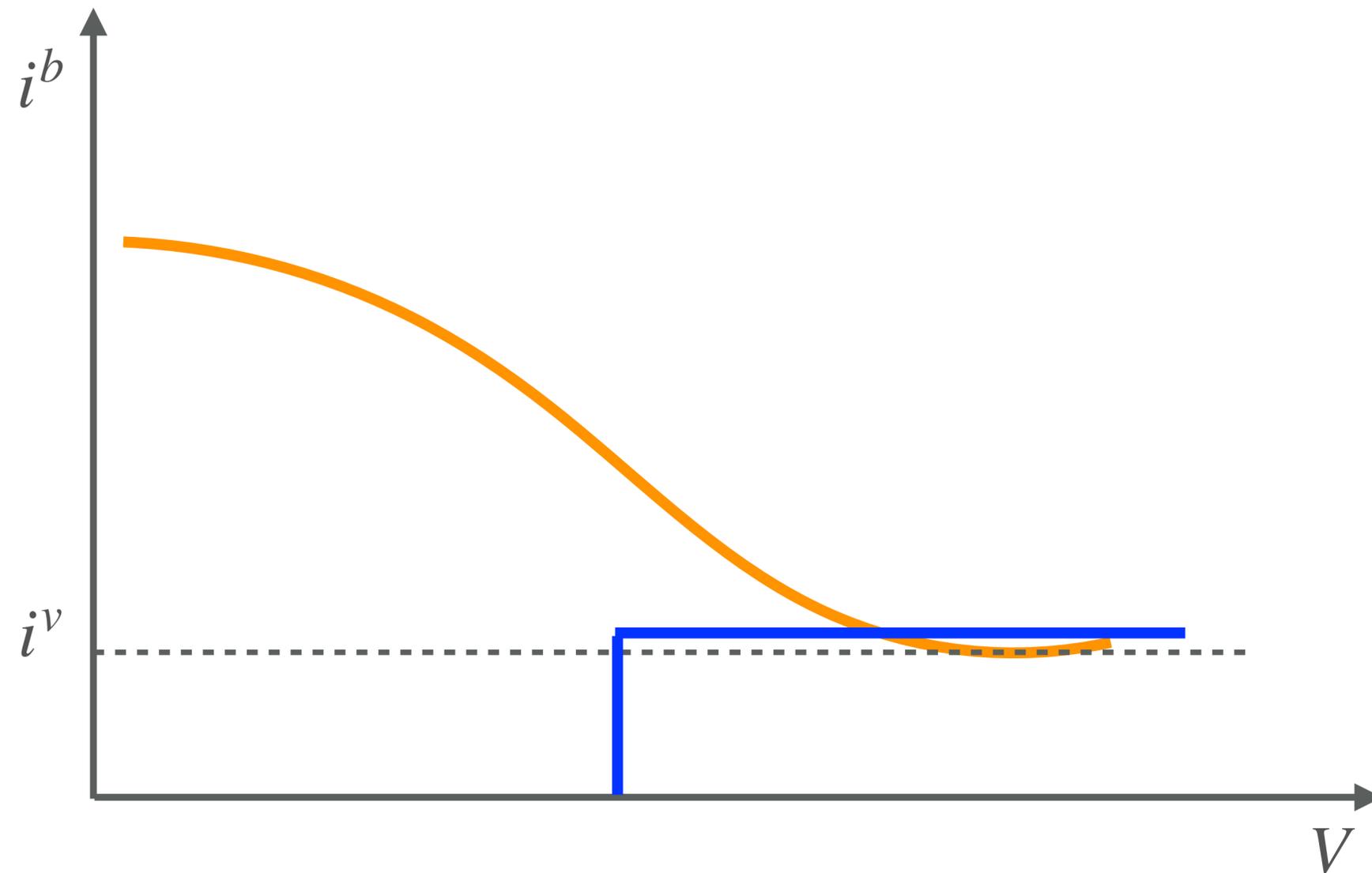
(B) tiering of reserves

(C) liquidity savings mechanisms

And then, when there are shocks

- Old fashioned OMO, shift supply to the right
- Since shocks are temporary, this is temporary as well.

But there is an elephant in the room



Why supply reserves inelastically!

- Federal Reserve Act of 1913: “*To furnish an elastic currency*”

How to do it? Standing repo program with full allotment at fixed rate.

- Bank can exchange b for v in a repo to make payments.
- Tiptoeing with TOMOs is effectively delivering this, but less accurately.

Delivers same size at kink all the same.
But solves shocks / volatility problem.

Different take on the problem

- **Commit to demand driven system**
 - Supply was chasing demand anyway. Even clearer once bring in TOMOs.
- **How it works: narrow corridor**
 - Every week (or day) banks can go to repo facility. When it is closed, then if demand is weaker, interest rates fall to interest on reserves, if it is stronger they rise to discount window rate. By choosing vertical quantity, choose frequency of the two, (T)OMOs.
- **Desire to shrink balance sheet is about shifting demand back left**
 - Shrinking the balance sheet is about demand, proposals here on how to do it
 - Regulations, tiering, liquidity savings mechanisms are not about money market volatility. They are about shrinking the size of the balance sheet.

Objections, echoed in the paper

- Stigma for banks of doing it this way
 - Sounds like “people just aren’t rational”. Not an acceptable answer.
- Nothing changes in banks’ balance sheet position and operations
 - An OMO lowers b raises v ; a repo lowers b raises v . Banks’ balance sheet is the same
 - As complicated as buying and selling Treasury bills (actually easier).

Objections, echoed in the paper

- **Stigma for banks of doing it this way**
 - Sounds like “people just aren’t rational”. Not an acceptable answer.
- **Nothing changes in banks’ balance sheet position and operations**
 - An OMO lowers b raises v ; a repo lowers b raises v . Banks’ balance sheet is the same
 - As complicated as buying and selling Treasury bills (actually easier).
- **This is regulatory failure**
 - Comprehensive Liquidity Analysis and Review (CLAR): preference to meeting liquidity requirements by holding reserves rather than Treasuries. No reason with repo facility
 - Fed does not centrally clear its repo operations. Can dealers cannot net Fed repos against customer reverse repos, so this uses capital. It shouldn’t.
 - Regulators treat “daylight overdrafts, the Discount Window, or Standing Repo Operations (SRPs)” as if they were the same. They aren’t.

Objections, echoed in the paper

- **Jamie Dimon**

- *As I said, we have \$120 billion in our checking account at the Fed, and it goes down to \$60 billion and then back to \$120 billion during the average day. **But we believe the requirement under CLAR and resolution and recovery** is that we need enough in that account, so if there's extreme stress during the course of the day, it doesn't go below zero.*
- Blaming stigma by banks is an excuse for regulatory failure. "This stigma is related in part to supervision of the Fed's liquidity regulations."

- **It is clearly feasible**

- "A successful demand-driven approach to reserves ampleness seems close to achievable for the Fed." Started with full allotment SRP in December 2025.
- Cross-country evidence: not about how much regulation, but its application.
- Schnabel: "They are there to be used by banks as part of their day-to-day liquidity management, which is also acknowledged by banking supervision."

Conclusion: my take

The Payment System Puts a Floor on the Fed's Balance Sheet

Conclusion: my take

The Payment System ~~Puts a Floor on the Fed's Balance Sheet~~

The Payment System **Requires moving to a Demand-Driven System**

Conclusion: my take

The Payment System ~~Puts a Floor on the Fed's Balance Sheet~~

The Payment System **Requires moving to a Demand-Driven System**

If the Fed were to aim for a smaller balance sheet, subject to effective monetary policy implementation, policies to consider include counteracting unintended shocks to the supply of reserve balances with temporary open market operations, adding a liquidity savings mechanism to the Fed's largest payment system, changing liquidity regulations, and ~~tying the remuneration of reserves~~ **and reform the clearing of its repos. These policies together would reduce the demand, while relying on active use of the standing repo program. Regulators must stop discriminating against the US Government's liabilities.**