September 20, 2017

September FOMC Review

FOMC Review Snapshot

- The FOMC kept the federal funds rate target range at 1.00-1.25%, as expected.
- Inflation remains below the Fed's 2% target and is slowing, leading the Fed to pause after June's rate hike.
- The FOMC announced that it will start to reduce its balance sheet in October.

Fig. 1 Monetary Policy Instruments

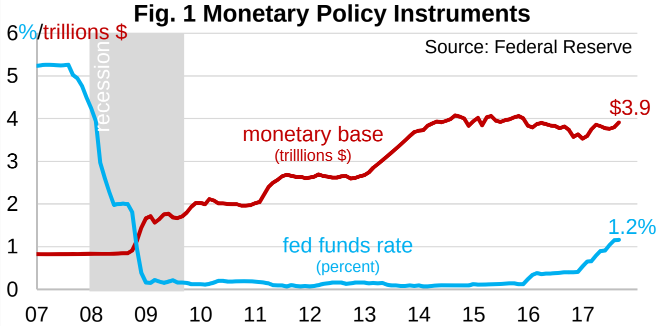


Fig. 2 Employment Indicators

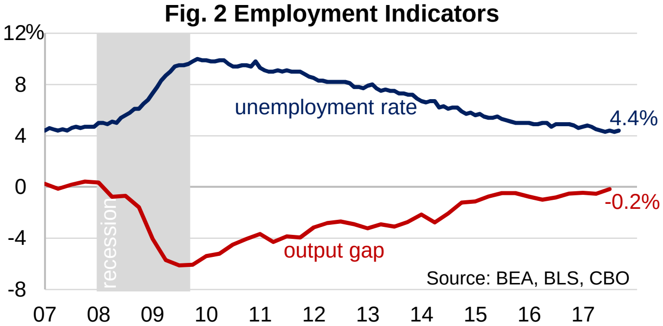
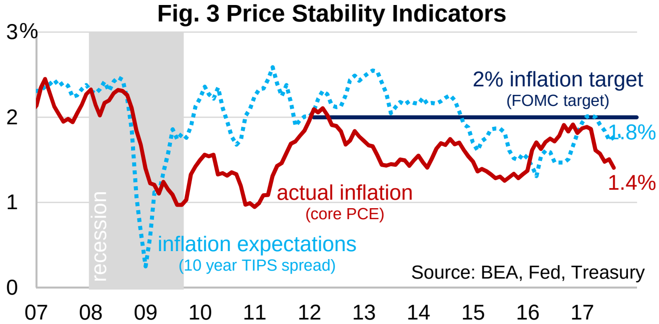


Fig. 3 Price Stability Indicators



Details

The Federal Reserve's Federal Open Market Committee (FOMC) held the federal funds rate target range at 1.00-1.25%. The Fed sets monetary policy to satisfy its dual mandate to maximize employment and maintain price stability.

The fed funds rate remains unusually low and its significance as a monetary policy tool is reduced by the interest the Fed pays on bank reserves,[1] particularly interest on excess reserves (IOER), currently at 1.25%.[2] The monetary base (part of the Fed's balance sheet) is enlarged at $3.9 trillion. Before the last recession began in December 2007, it was $0.8 trillion (Fig. 1). In June, the Fed explained how its balance sheet "normalization", which entails a reduction of the monetary base, would proceed. At this meeting, it announced the reduction would begin in October. Details of the program can be found in the "Noteworthy" section of JEC's July FOMC Review.

The actual inflation rate continued to decrease in recent months, while the expected[3] inflation rate ticked up. Both remain below the Fed's 2% inflation target (Fig. 3). Furthermore, although the unemployment rate (Fig. 2) implies the economy is near full employment, persistent below-target inflation and a low employment-to-population ratio suggest the American economy still has significant untapped growth potential.

The Federal Open Market Committee (FOMC)

The FOMC meets 8 times per year. It consists of the 7 governors from the Fed's Board of Governors in DC (3 seats are currently vacant), and 12 regional Fed bank presidents.

While all Fed governors have a vote on the FOMC, only 5 Fed bank presidents can vote. The NY Fed president is a permanent voting member, and 4 others can vote on a rotating basis.

Minutes of the FOMC meeting are released three weeks later.

The next FOMC meeting will be held October 31-November 1.

Context

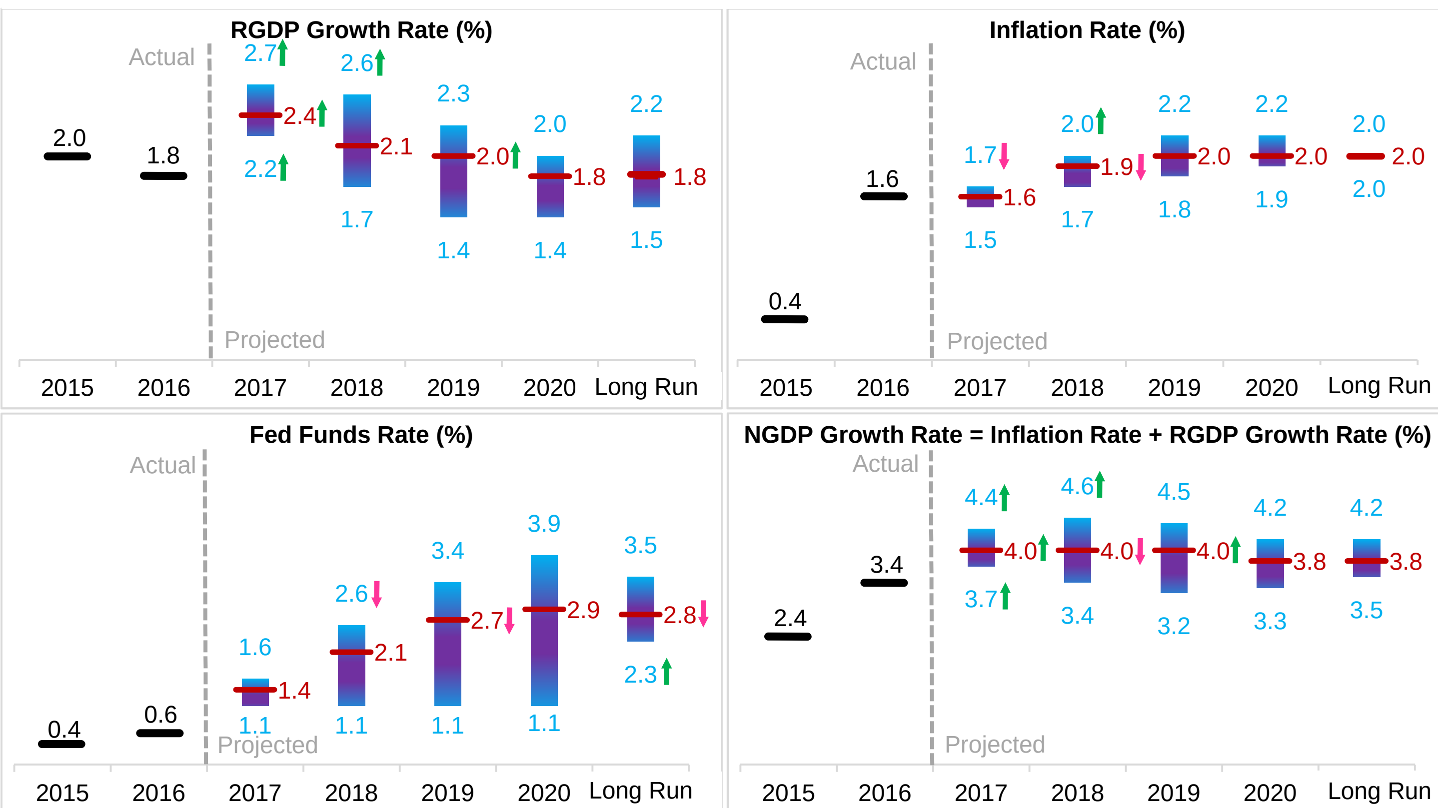
The FOMC decided to hold its interest rate target range constant and stated its balance sheet normalization program will commence in October. The fed funds futures market is anticipating one additional interest rate hike this year in December. The slowing inflation rate, which has persistently been below the Fed's 2% target rate since 2012, will likely tick upward as a result of Hurricanes Harvey and Irma. However, the Fed will likely wait to see if inflation moves up toward 2% before deciding to raise the fed funds rate again.

Noteworthy

Two weeks ago Federal Reserve vice chair Stanley Fischer announced his resignation effective October 13 (his vice chair term was set to expire June 12, 2018; Janet Yellen's term as chair is set to expire February 3, 2018). President Trump will now be able to fill a total of five vacant Fed governor positions during his first term in office.

Figure 4 shows the FOMC members' median year-end projection of real GDP (RGDP), inflation, the fed funds rate, and nominal GDP (NGDP). The numbers above the bars represent the highest projection, and those below the bar the lowest projection. Green arrows represent numbers that have increased since the most recent Summary of Economic Projections (SEP) (June 2017 SEP), while red arrows represent projections that have decreased since then. (The SEP is only updated at FOMC meetings in March, June, September, and December; the Fed does not provide a projection of its balance sheet size.) The most notable changes were an upward revision to projected RGDP growth for 2017 from 2.2% to 2.4% and a downward revision in the projected fed funds rate at 2019's end from 2.9% to 2.7%. Most FOMC members anticipate one more hike in the fed funds rate this year as indicated by the SEP, the same as markets expect, which is not always the case.

Fig. 4 Summary of Economic Projections (SEP)



Source: Federal Reserve

Green arrows represent increases since previous SEP; red arrows decreases.

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[1] In 2008, the Fed began to pay banks interest on reserves held at the Fed, both on required reserves (IORR) and excess reserves (IOER).

[2] Banks used to hold few excess reserves, choosing instead to lend these funds. If banks wanted more funds they would borrow from other banks at the fed funds rate. Since 2008, however, the Fed has been paying IOER and banks have been holding substantial excess reserves, currently about $2.2 trillion (56% of the monetary base. The other components of the monetary base are currency, 40%, and required reserves, 4%.

[3] The average expected inflation rate is measured by the difference between yields on Treasuries and Treasury Inflation Protected Securities (TIPS).