Joint Economic Committee
Representative Pat Tiberi, Chairman
Senator Mike Lee, Vice Chairman

May 3, 2017

May FOMC Review

FOMC Review Snapshot

- The FOMC held its federal funds rate target range at 0.75-1.00% as expected.
- The market continues to anticipate a rate hike at the next FOMC meeting held on June 13-14.

Fig. 1 Monetary Policy Instruments

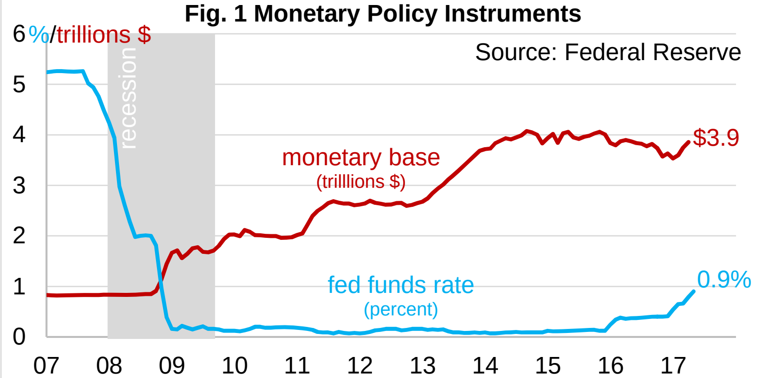


Fig. 2 Employment Indicators

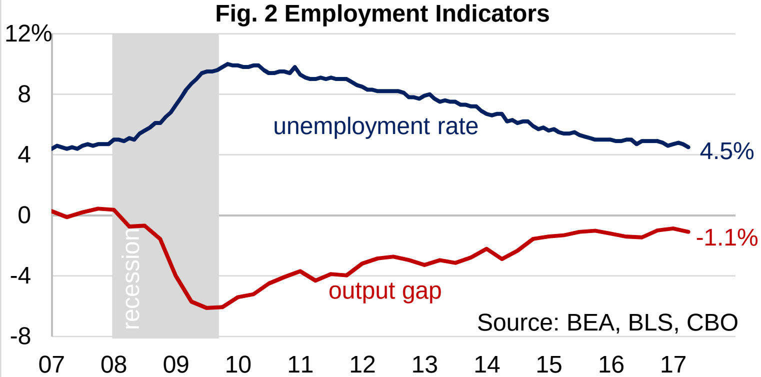
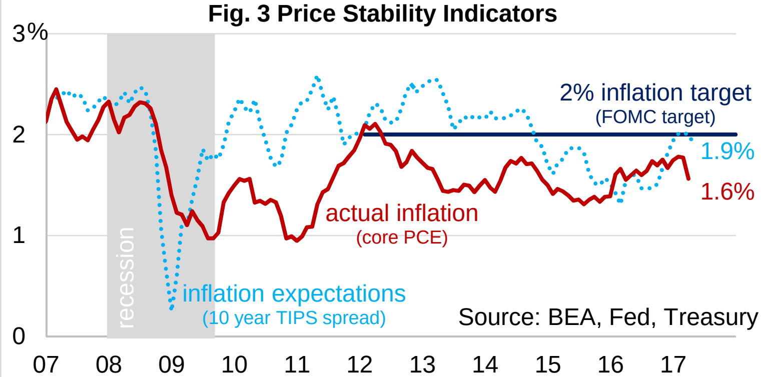


Fig. 3 Price Stability Indicators



Details

The Federal Reserve's Federal Open Market Committee (FOMC) unanimously voted to maintain its federal funds rate target range at 0.75-1.00%.[1] During its March 2017 meeting, it increased its target range from 0.50-0.75% to 0.75-1.00%. The Fed seeks to maximize employment and maintain price stability (the dual mandate) in setting monetary policy.

The Fed's policy instruments (Fig. 1) remain at unusual levels: Despite recent increases, the fed funds rate remains at historic lows. Before the last recession it was 5.25%. In addition, the fed funds rate is now secondary to interest paid on bank reserves,[2] particularly interest on excess reserves (IOER). Banks typically held small excess reserves, choosing to lend these funds. If banks wanted more funds they would borrow from other banks at the fed funds rate. Since 2008, banks have been holding substantial excess reserves at the Fed, currently about $2.2 trillion (56% of the monetary base; the other parts are currency, 40%, and required reserves, 4%). The monetary base (i.e., the Fed's balance sheet) is enlarged at $3.9 trillion. Prior to 2008 it was $0.8 trillion.

Employment indicators (Fig. 2) suggest the economy is nearing full employment as the unemployment rate fell to 4.5%, and the output gap—the percentage by which actual real gross domestic product (RGDP) falls short of potential RGDP—has shrunk, although it slightly increased from -0.9% last quarter to -1.1%.[3] The JEC majority believes America has a lot of room to grow because the previous Administration's policies constrained economic potential.

Actual inflation reversed its upward trend (Fig. 3). It remains below the Fed's 2% inflation target. Last year, the FOMC attributed low inflation to declines in energy

[1] The Taylor rule currently prescribes a fed funds rate of 3.4% (source: Haver Analytics).
[2] In 2008, the Fed began to pay banks interest on reserves held at the Fed, both on required reserves (IORR) and excess reserves (IOER).
[3] Potential RGDP is the maximum sustainable output possible for a given inflation rate.

prices and import prices. The expected average annual inflation rate for the next 10 years recently moved up toward 2% but turned downward in April.[4]

The next FOMC meeting is scheduled for June 13-14.

Context

The FOMC statement reaffirmed that it does not plan to allow its balance sheet to shrink until the fed funds rate reaches a higher level. The Fed will reinvest proceeds from its holdings of Treasury securities and GSE mortgage-backed securities. The FOMC did not provide any further guidance at this meeting as to how it would proceed with the normalization of monetary policy.

The Fed stated it believes the lackluster Q1-2017 GDP report and the weak jobs number in March were likely transitory.

Markets are anticipating the Fed will hike rates at its next meeting.

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 (2 seats are currently vacant), and 12 regional Fed bank presidents.

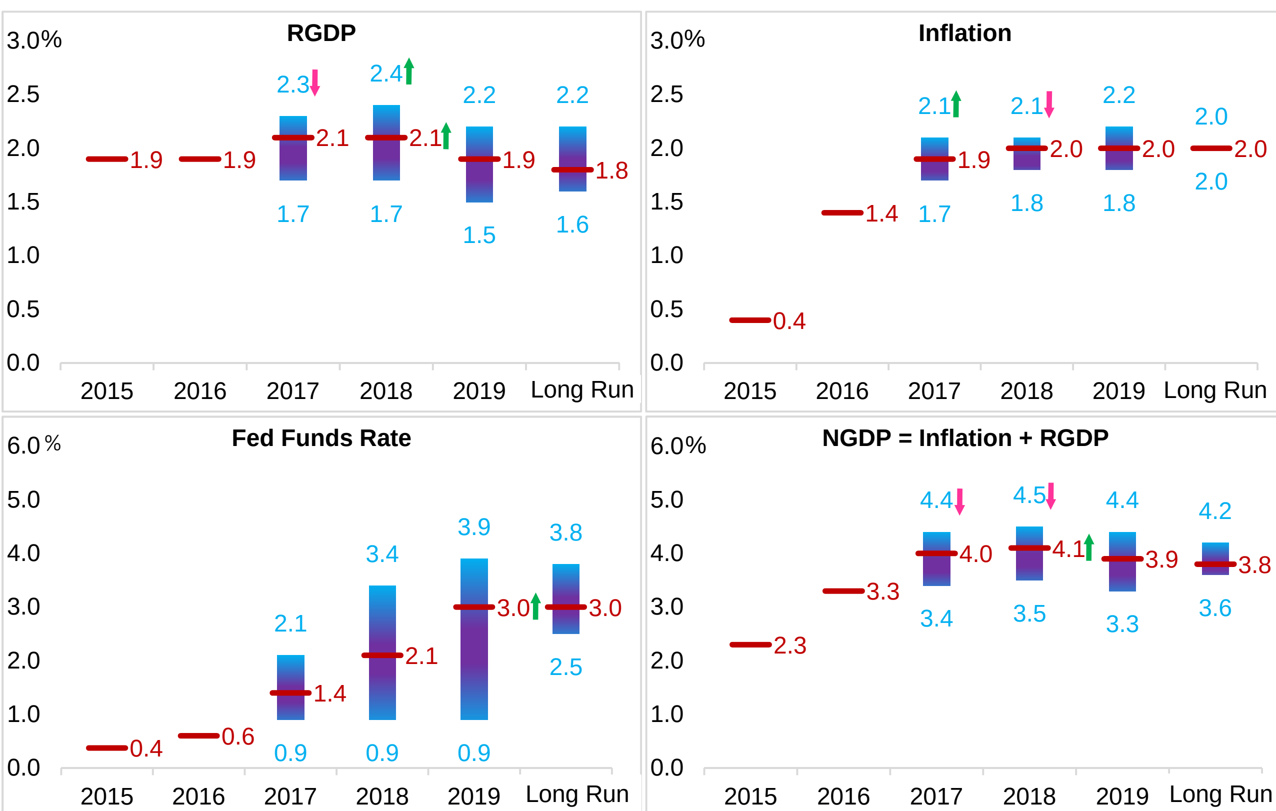
While all Fed governors have a vote on the FOMC, only 5 Fed bank presidents can vote. The NY Fed president is a permanent voting member, and 4 others can vote on a rotating basis.

Minutes of the FOMC meeting are released three weeks later.

Noteworthy

Figure 4 shows the FOMC members' median projection from their previous meeting in March of RGDP, inflation, the fed funds rate, and nominal GDP (NGDP) for the given year's end. 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 December 2016 Summary of Economic Projections (SEP), while red arrows represent projections that have decreased since then. The Fed does not provide a projection of its balance sheet size. The SEP is only updated at FOMC meetings in March, June, September, and December; thus the next update will be at the June meeting.

Fig. 4 Summary of Economic Projections (from March 14-15 meeting)



Source: Federal Reserve

[4] The difference between yields on Treasuries and Treasury Inflation Protected Securities (TIPS) measures the average expected inflation rate.