JOINT ECONOMIC COMMITTEE
CHAIRMAN ERIK PAULSEN (R-MN)

September 26, 2018

September FOMC Review

FOMC Review Snapshot
- The Fed's statement described job gains, investment, and household spending as strong.
- It raised its key policy rate, the interest on excess reserves (IOER) rate, to 2.20% as expected.
- It also raised the fed funds target range to 2.00-2.25%.
- As the economy continues to strengthen, the Fed will likely raise the IOER rate once more this year.

Details

Following the Federal Open Market Committee (FOMC) meeting's conclusion Wednesday**, the Fed raised its interest on excess reserves (IOER) rate to 2.20%.** The fed funds rate range was increased to 2.00-2.25%. The IOER rate once was set equal to the top of the fed funds rate range, but the FOMC made a "small technical adjustment" following its June 2018 meeting so that the IOER rate would be 5 basis points below the upper bound of the target range. Nonetheless, this has no practical relevance as banks continue to hold large excess reserves at the Fed and have no need to borrow in the fed funds market (see Box 2). The IOER rate largely influences how much of their excess reserves banks are inclined to lend. Hence, the **key monetary policy interest rate continues to be the administratively determined IOER rate, not the fed funds rate.**

Fig. 1 Monetary Policy Instruments

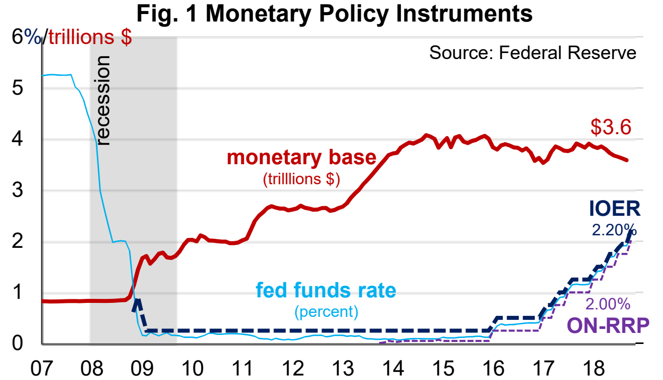


Fig. 2 Price Stability Indicators

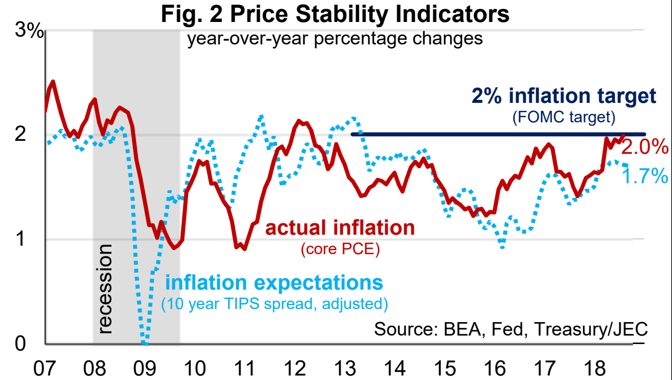
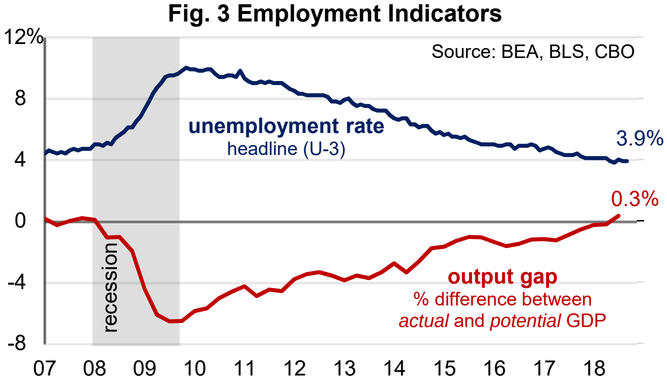


Fig. 3 Employment Indicators



Since October 2017, the Fed has continued to wind down its balance sheet, which is shrinking slowly, as planned (represented by the monetary base shown in Fig. 1).

The inflation rate has finally moved to the Fed's symmetric 2% inflation target (Fig. 2)**,** as measured by the core personal consumption expenditures (PCE) price index. (Two percent is not a ceiling but an average to be achieved over time.) Most FOMC members expect some modest overshoot, which would make up for some of the five years of consistently undershooting the target. However, market-based measures suggest inflation is expected to remain below the Fed's target over the next 10 years.[1] The fed funds futures market anticipates one more Fed interest rate hike in December as does the FOMC, based on projections released at this meeting (see Noteworthy section below).

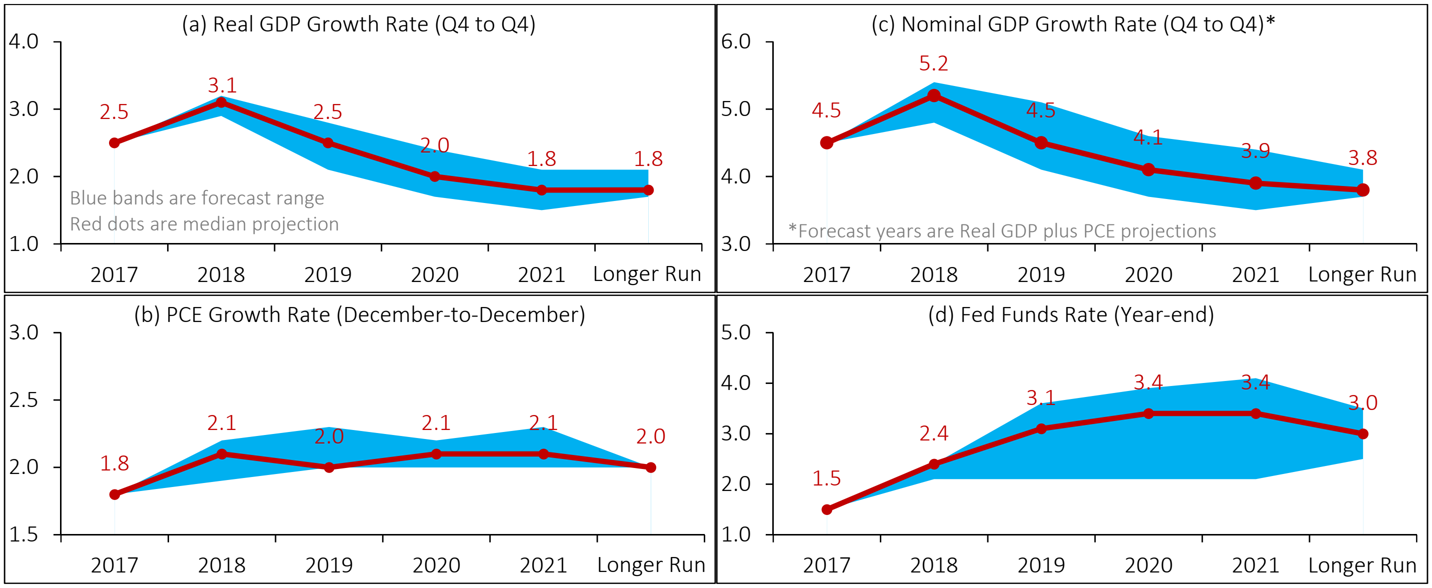
Context

The FOMC's September statement, noted that "the labor market has continued to strengthen." It also described economic activity, job gains, household spending and business investment as strong or growing strongly. Meanwhile, inflation remains at the Fed's desired 2% rate. These outcomes indicate tax reform is working as planned—low inflation and faster economic growth are signaling sustainable progress, not just a "sugar high" as some critics claim.

Noteworthy

The FOMC projection for interest rates is unchanged. The FOMC projections imply that the IOER rate will be 2.45% at year-end (one more rate hike in December), and that three rate hikes are anticipated in 2019 according to its new *Summary of Economic Projections* (*SEP*).[2] Expectations for real GDP growth were revised up for 2018 and 2019, while anticipated inflation in 2019 was revised down. Figure 4 illustrates the FOMC members' median year-end projection of real GDP (RGDP), inflation, the fed funds rate, and nominal GDP. Blue shading represents the range of all projections while the red line represents the median projection.

Figure 4: September 2018 FOMC *Summary of Economic Projections (SEP)*



[1] The 10-year "TIPS spread" measures expected inflation by taking the difference between the market yields on 10-year U.S. Treasury notes and 10-year Treasury Inflation Protected Securities. "TIPS" compensate holders for changes in money's purchasing power as measured by the consumer price index, CPI. Historical data and the Congressional Budget Office (CBO)'s average projections of 2.4% CPI inflation and 2.0% personal consumption expenditures (PCE) inflation over the next 10 years indicate that CPI overstates inflation by 0.4 percentage point on average. JEC adjusted the TIPS spread by subtracting 0.4 percentage point to make the measures comparable to the Fed's preferred inflation indicator (PCE).

[2] *SEPs* are only updated at FOMC meetings in March, June, September, and December; these do not contain projections of its balance sheet size.

Box 1: The Federal Open Market Committee (FOMC)

The FOMC typically meets eight times per year. It consists of the seven governors from the Fed's Board of Governors in D.C. (with four current vacancies), and 12 regional Fed bank presidents.

While all Fed governors have a vote on the FOMC, only five Fed bank presidents can vote. The New York Fed president is a permanent voting member, and four others can vote on an annually rotating basis.

Box 2: IOER and ON-RRP

In 2008, the administratively determined interest on excess reserves (IOER) became the Fed's key policy interest rate, supplanting a market-determined federal funds rate, which the Fed would influence by making small interventions in the fed funds market. The Fed pays IOER on funds banks keep on deposit (i.e., excess reserves) with the Fed that might otherwise have been lent to consumers or businesses. All else equal, a higher IOER rate portends a tighter monetary policy, because it encourages banks to hold reserves rather than make more loans, which tends to slow inflation.

A much-reduced level of trading still occurs in the federal funds market because GSEs (government-sponsored enterprises like Fannie Mae and Freddie Mac) are ineligible to earn IOER. GSEs lend their idle cash to banks at the fed funds rate, which banks deposit to earn a higher IOER rate. To prop up the fed funds rate as the Fed raises the IOER rate, the Fed withdraws cash from the market by temporarily selling some of its securities for cash at its overnight-reverse repurchase (ON-RRP) rate, which sets a floor on the fed funds rate.

The continued existence of the federal funds market and the ON-RRP facility should not distract from the fact that the IOER rate is currently the key monetary policy interest rate.