JOINT ECONOMIC COMMITTEE
CHAIRMAN ERIK PAULSEN (R-MN)

November 14, 2018

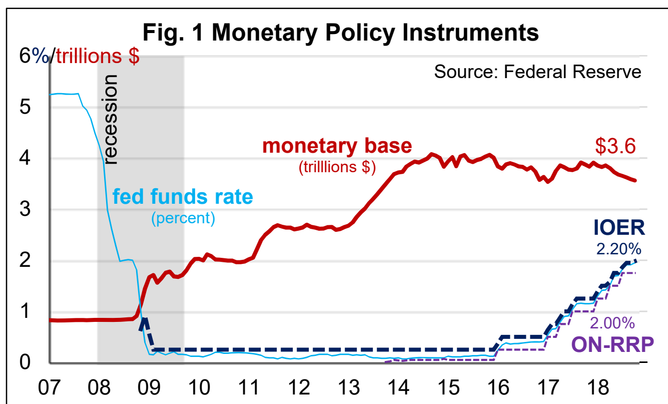
November FOMC Review

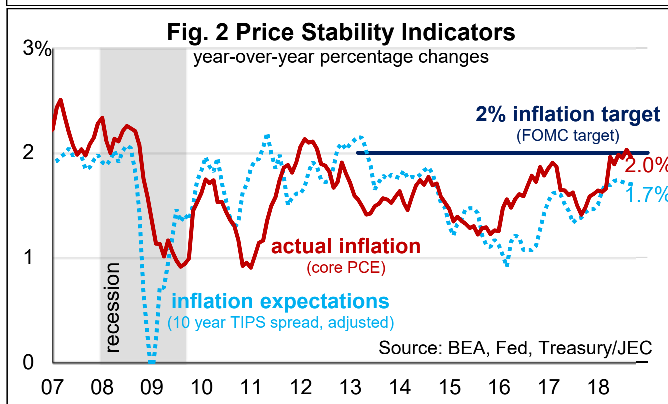
FOMC Review Snapshot

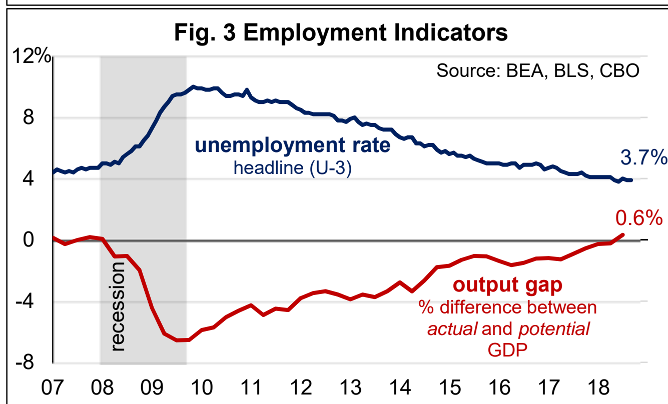
- The Fed held its key policy rate, the interest on excess reserves (IOER) rate, at 2.20% as expected.
- It is anticipated that the FOMC will raise the IOER rate at its next meeting, December 18-19.
- Federal Reserve Chairman Jerome Powell will testify before the JEC on December 5.

Details

The Fed's main interest rate for implementing monetary policy—the interest on excess reserves (IOER) rate—remained at 2.20%, following the Federal Open Market Committee (FOMC)'s decision to keep the federal funds rate target range unchanged at 2.00-2.25% (see Box 2). **Raising the IOER rate relative to market interest rates, would encourage banks to lend less of their excess reserves, reducing aggregate demand growth; lowering the IOER rate would produce the opposite effect.** Following a "small technical adjustment" in June 2018, the IOER rate was set 0.05 percentage point below the top of the fed funds rate target range (see Box 3).







The fed funds futures market anticipates that the FOMC will raise the fed funds target range one more time in 2018 at its last remaining meeting this year on December 18-19. The Fed has signaled that it may lower the IOER rate further within the target range.

Since October 2017, the Fed has continued with its plan to slowly wind down its balance sheet (see monetary base shown in Fig. 1).

The inflation rate has finally moved to the Fed's inflation target and is holding there (Fig. 2)**,** as measured by the core personal consumption expenditures (PCE) price index. (The Fed's 2% inflation target is not a ceiling but an average to be achieved over time.) Though most FOMC members expect some modest overshoot, which would make up for some of the five years of consistently undershooting the target, market-based measures continue to anticipate inflation will remain below the Fed's target over the next 10 years.[1]

Context

The economy's resurgence, driven by pro-growth regulatory reform and the *Tax Cuts and Jobs Act*, has enabled the Federal Reserve to normalize interest rates, i.e., get them to a level that is more consistent with historical norms, and to start shrinking its balance sheet. To realize the full effects of pro-growth policies, the Fed must essentially "thread the needle": Some additional interest rate hikes may be warranted as the economy continues to improve, but they should not be so rapid as to disrupt the recovery.

Noteworthy

Whether inflation ends up above or below the Fed's 2% inflation target largely depends on how the Fed's policy

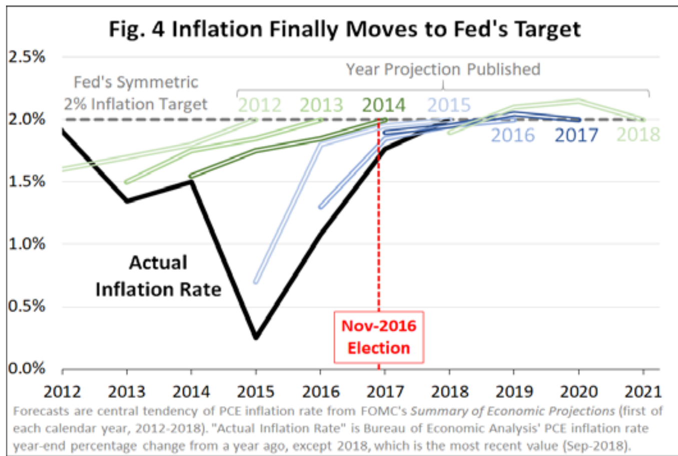


Fig. 4 Inflation Finally Moves to Fed's Target

Forecasts are central tendency of PCE inflation rate from FOMC's *Summary of Economic Projections* (first of each calendar year, 2012-2018). "Actual Inflation Rate" is Bureau of Economic Analysis' PCE inflation rate year-end percentage change from a year ago, except 2018, which is the most recent value (Sep-2018).

rate (currently the IOER rate) is set relative to the "natural rate of interest" (r*), which is not directly observable. The supply and demand for loanable funds, mostly determined by saving and investment, respectively, determine r*. The further the IOER rate is set below r*, the more inclined banks are to lend their excess reserves and stimulate aggregate demand growth in turn.

For most of the Obama Administration, business confidence was extremely low, suggesting a low r* relative to the Fed's IOER rate, leading to sluggish aggregate demand growth and below-target inflation (Fig. 4). However, following the November 2016 election, in anticipation of pro-growth regulatory and tax reforms, business confidence surged, which portended an increased demand for loanable funds, raising r* relative to the IOER rate. Thus, monetary conditions effectively eased, which in turn helped the Fed to reach its 2% inflation target.

For more details on monetary policy, see JEC's 2018 Joint Economic Report (pp. 51-65, 68-69, 85-90). The Joint Economic Committee will continue to examine this issue and others at its upcoming December 5 hearing with Federal Reserve Chairman Jerome Powell.

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 three 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: The IOER Rate Supplants the Fed Funds Rate

Up until 2008, banks were reluctant to hold more reserves than the Fed required as these earned no interest. Banks with excess reserves would lend to banks that were short on their required reserves at the fed funds rate, which the Fed manipulated by making small changes to the supply of reserves. Three rounds of "quantitative easing" by the Fed between 2008 and 2014 created a super abundance of reserves, which previously would have increased lending and aggregate demand. Concerned that this would cause too much inflation, the Fed started paying IOER at above market interest rates to encourage banks to hold excess reserves, removing their need to borrow on the fed funds market to satisfy their legal reserve requirements. GSEs (government-sponsored enterprises like the Federal Home Loan Banks) are ineligible to earn IOER, so they lend their idle cash to banks at the fed funds rate, which banks deposit to earn a higher IOER rate. **The appearance of an (insignificantly) active fed funds market, does not alter the fact that the IOER rate is currently the key monetary policy interest rate.**

Box 3: The Fed's "Small Technical Adjustment" to the IOER Rate

Although the IOER rate should set a *floor* for the fed funds rate in theory, residual fed funds market trading by the IOER-ineligible GSEs (see Box 2) led the floor to "leak". In recent months, however, short-term market rates have tended to be higher than the IOER rate. GSEs, now having better short-term investment opportunities available, have required a higher fed funds rate to lend their extra cash to banks, leading the effective fed funds rate to rise to the top of the Fed's target range. The Fed, desiring to keep the effective fed funds rate closer to the midpoint of its target range, set the IOER rate 0.05 percentage point below the top of the target range in June 2018. **This change has little bearing on the fact that the IOER rate is still the Fed's key monetary policy interest rate.**

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[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).