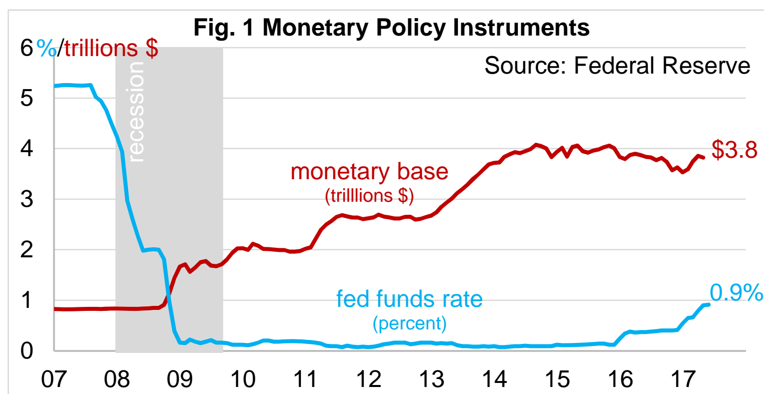
Joint Economic Committee
Representative Pat Tiberi, Chairman
Senator Mike Lee, Vice-Chairman

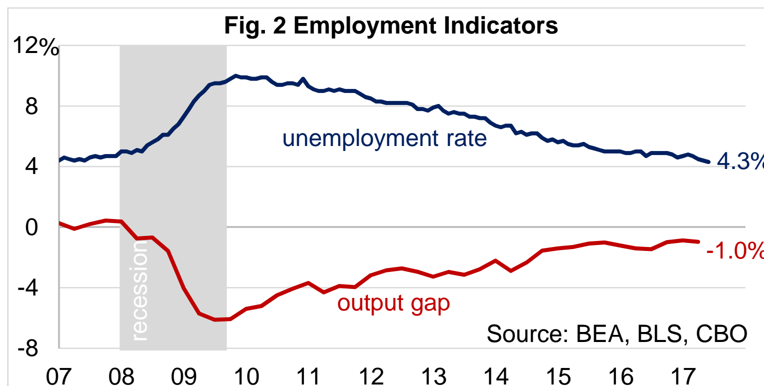
June 15, 2017

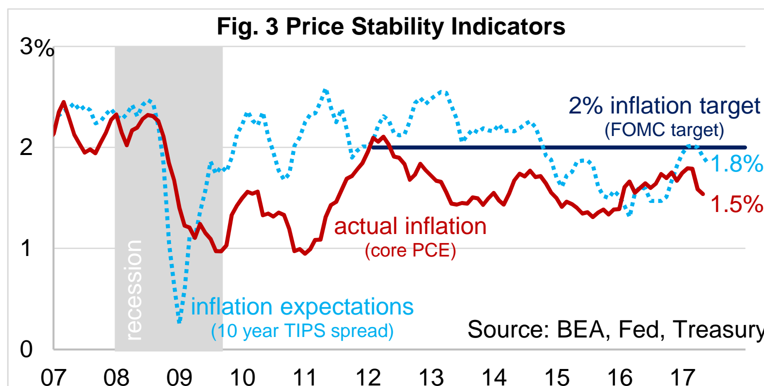
June FOMC Review

FOMC Review Snapshot

- The FOMC increased the federal funds rate target range from 0.75-1.00% to 1.00-1.25% as expected.
- The Fed announced it plans to reduce its balance sheet this year.
- Fed Chair Yellen indicated the Fed may review its 2% inflation target.







Details

The Federal Reserve's Federal Open Market Committee (FOMC) increased the federal funds rate target range by 25 basis points (0.25%) to 1.00-1.25%.[1] This was the fourth increase since it fell to 0.00-0.50% on December 16, 2008. (In contrast, there were seventeen rate hikes from 2004 to 2006.) The Fed sets monetary policy to satisfy its dual mandate to maximize employment and maintain price stability.

The fed funds rate remains unusually low; before the last recession it was 5.25%. Furthermore, its significance is reduced by the interest the Fed pays on bank reserves,[2] particularly interest on excess reserves (IOER), currently 1.25%. Typically, banks held 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 them interest and they have been holding substantial excess reserves, currently about $2 trillion (54% of the monetary base; the other parts are currency, 41%, and required reserves, 5%). The monetary base (representing the Fed's balance sheet) is enlarged at $3.8 trillion. Prior to 2008 it was $0.8 trillion.

The actual (and expected[3]) inflation rate has decreased in recent months (Fig. 3), and remains below the Fed's 2% inflation target. The unemployment rate fell to 4.3% (Fig. 2), the lowest rate since 2001, suggesting the economy is near full employment. However, the employment-to-population ratio is still far below its pre-recession level and inflation is persistently low, implying America has a lot of room to grow. This suggests the previous Administration's policies constrained economic potential.

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[1] The Taylor rule currently prescribes a fed funds rate of 3.5% (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] The average expected inflation rate is measured by the difference between yields on Treasuries and Treasury Inflation Protected Securities (TIPS).

The next FOMC meeting is scheduled for July 25-26.

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.

Context

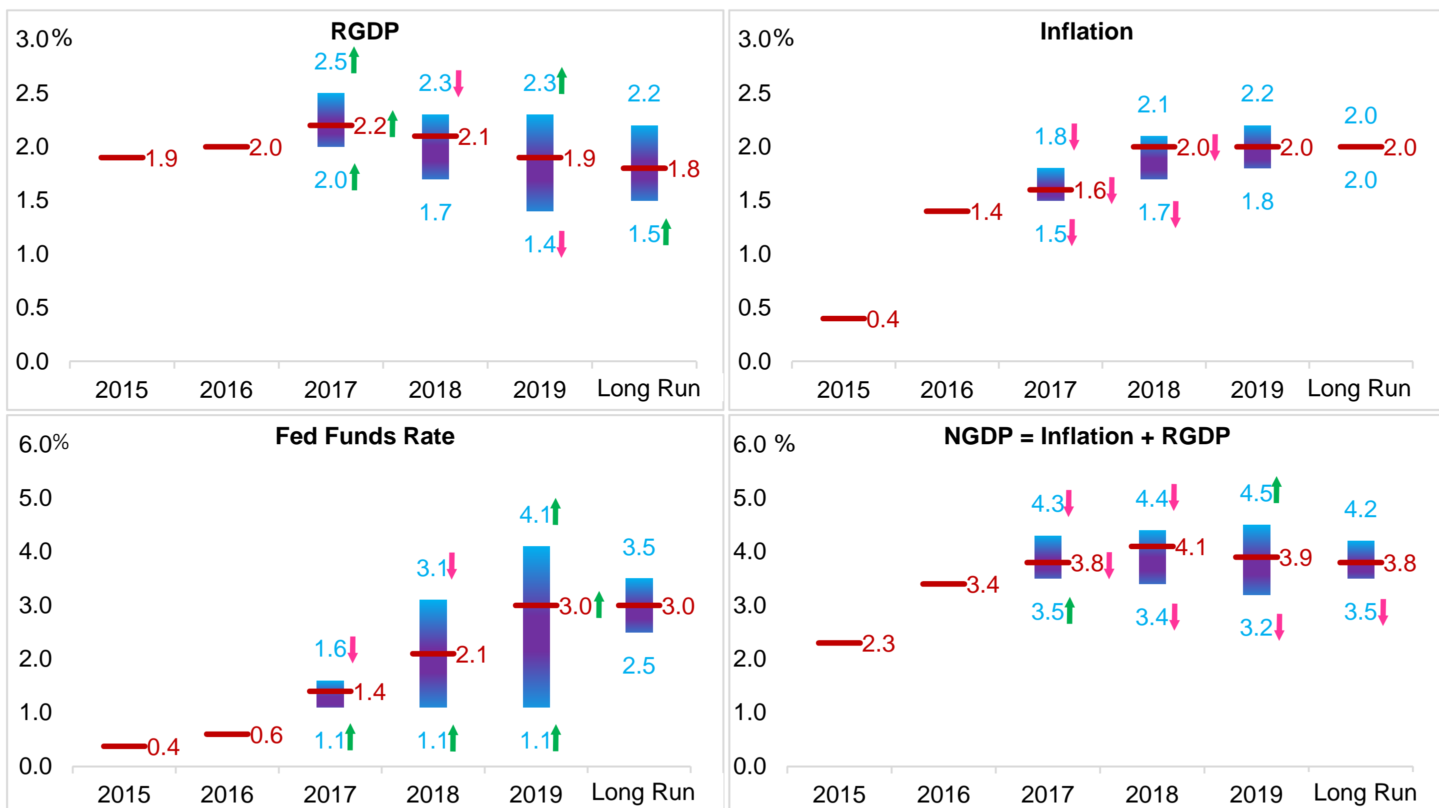
Aside from the rate hike, the Fed provided details regarding its plan to normalize its unusually large balance sheet—the result of its quantitative easing (QE) programs, in which the Fed bought government-issued debt securities (Treasuries and GSE-issued mortgage-backed securities), by creating new bank reserves (i.e., "printing money"). This resulted in the balance sheet being nearly five times larger than it was just before the 2007-2009 recession. As Fed-owned debts mature (i.e., are repaid by the Treasury/GSEs), money flows into the Fed. When money flows into the Fed, it is essentially removed from circulation, and the Fed's balance sheet shrinks. However, the Fed's ongoing policy is to reinvest money inflows (i.e., buy government-issued debt that has not yet matured) to maintain the size of its balance sheet. The Fed announced plans to phase out reinvesting its cash inflows from maturing debts beginning this year (assuming the economy performs according to the Fed's outlook). However, it did not specify the duration of the normalization program nor the balance sheet size it considers "normal".

Noteworthy

At the post-FOMC meeting press conference, Chair Yellen stated, regarding the Fed's 2% inflation target, "It's one that we will be reconsidering at some future time."

Figure 4 shows the FOMC members' median projection 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 most recent Summary of Economic Projections (SEP) (March 2017), while red arrows represent projections that have decreased since then. (The Fed does not provide a projection of its balance sheet size.) The largest change was the decrease in the median inflation projection for 2017 falling from 1.9% in March 2017 to 1.6%. Additionally, while markets are anticipating the Fed will hold interest rates in the current range through at least December 2017, the median FOMC member expects one more increase. The SEP is only updated at FOMC meetings in March, June, September, and December.

Fig. 4 Summary of Economic Projections (SEP)



Source: Federal Reserve

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