Joint Economic Committee
Chairman Erik Paulsen (R-MN)

May 3, 2018

May FOMC Review

FOMC Review Snapshot

- As expected the Fed left its key monetary policy rate, the interest on excess reserves (IOER) rate, unchanged at 1.75%.
- Markets anticipate the Fed will increase its policy rate to 2.00% at its upcoming June meeting.
- The Fed had signaled two additional rate hikes by year-end (to 2.25%), but stronger economic growth is making three additional rate hikes by year-end (to 2.50%) more likely.

Fig. 1 Monetary Policy Instruments

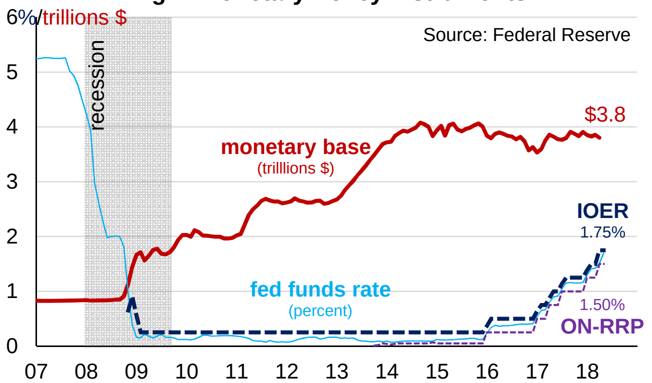


Fig. 2 Price Stability Indicators

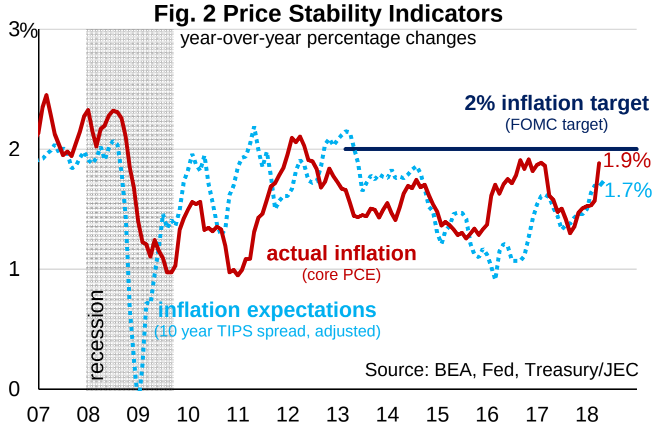
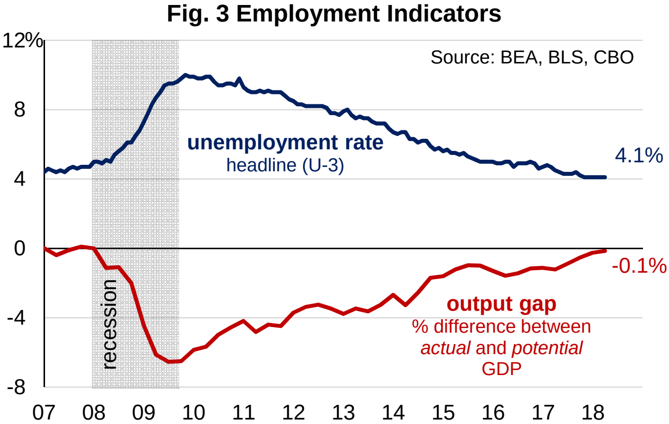


Fig. 3 Employment Indicators



Details

Following the Federal Open Market Committee (FOMC)'s meeting, **the Fed left its interest on excess reserves (IOER) rate unchanged at 1.75%.** The fed funds rate will continue to trade between 1.75% and an overnight-reverse repurchase (ON-RRP) rate of 1.50% (see Box 2 below). The Fed's current normalization plans include continuing to raise the IOER rate from its low of 0.25% at year-end 2008, and gradually reducing the size of its balance sheet, which remains enlarged at $3.8 trillion. Before the last recession, the Fed interest rate target was 5.25% and its balance sheet was $0.8 billion (Fig. 1).

The inflation rate moved up but remains below the Fed's symmetric 2% inflation target (Fig. 2)**,** as measured by the core personal consumption expenditures (PCE) price index. ("Symmetric" implies that 2% is not a ceiling but an average to be achieved over time.) After its last meeting, FOMC members projected for the first time that inflation may overshoot the target in the near-term, which would make up for only some of the five years of consistent undershooting. Market-based measures of expected inflation[1] continue to indicate inflation will undershoot the Fed's target over the next 10 years. The fed funds futures market anticipates a second Fed IOER rate hike for 2018 will occur following the next FOMC meeting.

Context

Since the enactment of the *Tax Cuts and Jobs Act* (TCJA) in December 2017, CBO has revised its potential GDP (an estimate of the economy's maximum *sustainable* output) projection upward, which leads to a measured output gap of -0.1% for Q1-2018 and implies that America's rekindled economic growth is sustainable. This takes some pressure off the Fed to hike interest rates faster. In its 2018 annual report (p. 86) JEC Republicans had anticipated the recent uptick in inflation, and noted that it is not necessarily a cause for concern as the supply-side effects of ongoing tax and regulatory reform should abate inflationary pressures in the longer term.

Noteworthy

President Trump has nominated Richard Clarida to be Vice Chair of the Federal Reserve Board and Michelle Bowman to serve as a Federal Reserve Board Governor. Clarida is a former George W. Bush Administration assistant Treasury secretary appointee and currently is a professor at Columbia University and an advisor at the investment firm PIMCO. He earned his Ph.D. in economics from Harvard University. Bowman currently serves as State Bank Commissioner of Kansas. She has extensive experience in the banking industry, especially among community banks. She served in numerous positions in the George W. Bush Administration. She holds a J.D. from the Washburn University School of Law in Topeka.


Clarida


Bowman


Williams

Also, in April, the New York Fed tapped San Francisco Fed president John Williams to replace William Dudley as president of the New York Fed/vice-chair of the FOMC beginning June 18. Powell (Chairman of the Board of Governors/FOMC Chairman), Clarida (nominee for Vice Chairman of the Board of Governors), and Williams (designate New York Fed President/FOMC Vice Chairman) complete the Fed's top leadership positions. Information on how these three top Fed officials complement one another can be found here.

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 a 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 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 Fed uses IOER as the key rate to conduct monetary policy.

[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).