July 26, 2017

July FOMC Review

FOMC Review Snapshot
- The FOMC kept the federal funds rate target range at 1.00-1.25%, as expected.
- Inflation remains below the Fed's 2% target and is slowing, leading the Fed to pause after June's rate hike.
- The FOMC stated it plans to implement its balance sheet normalization program relatively soon.

Fig. 1 Monetary Policy Instruments

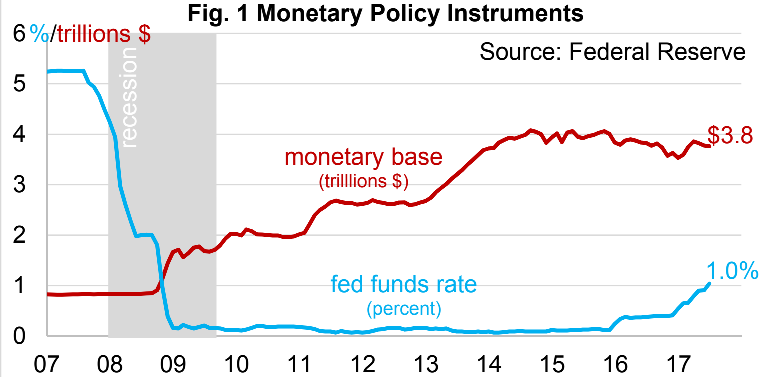


Fig. 2 Employment Indicators

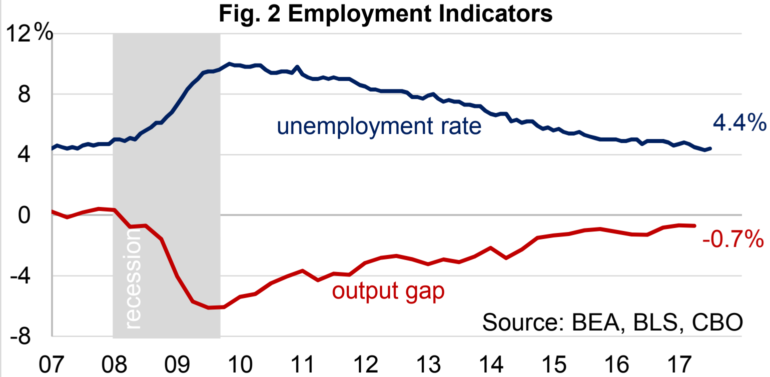
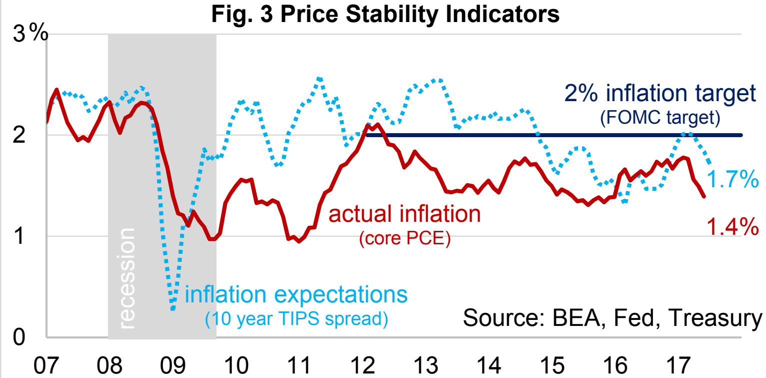


Fig. 3 Price Stability Indicators



Details

The Federal Reserve's Federal Open Market Committee (FOMC) held the federal funds rate target range at 1.00-1.25%. The Fed sets monetary policy to satisfy its dual mandate to maximize employment and maintain price stability.

The fed funds rate remains unusually low and its significance as a monetary policy tool is reduced by the interest the Fed pays on bank reserves,[1] particularly interest on excess reserves (IOER), currently at 1.25%. Banks used to hold 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 IOER and banks have been holding substantial excess reserves, currently about $2 trillion (55% of the monetary base.[2] The monetary base (part of the Fed's balance sheet) is enlarged at $3.8 trillion. Before the last recession began in December 2007, it was $0.8 trillion (Fig. 1).

The actual (and expected[3]) inflation rate continued to decrease in recent months, and remains below the Fed's 2% inflation target (Fig. 3). The unemployment rate (Fig. 2) has fallen to lows not seen since 2001. Normally, this implies the economy is near full employment. However, persistently below-target inflation and a low employment-to-population ratio suggest the American economy still has significant untapped growth potential.

[1] In 2008, the Fed began to pay banks interest on reserves held at the Fed, both on required reserves (IORR) and excess reserves (IOER).
[2] The other components of the monetary base are currency, 40%, and required reserves, 5%.
[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 will be held on September 19-20.

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.

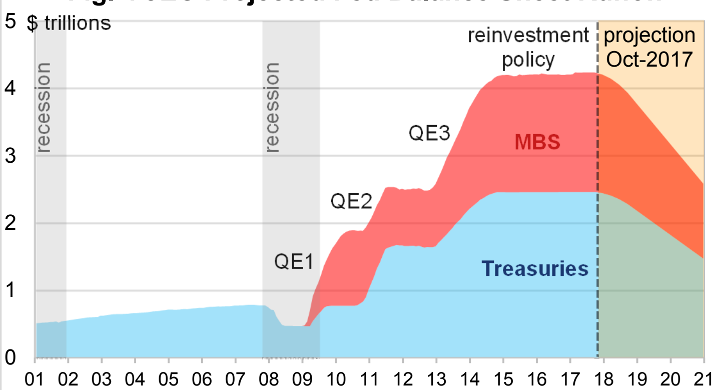
Context

The FOMC decided to hold its interest rate target range constant and stated its balance sheet normalization program would begin relatively soon, although it did not give a specific date. The fed funds futures market is not anticipating another interest rate hike until at least January 2018. The slowing inflation rate, which has persistently been below the Fed's 2% target rate since 2012, is the key variable to watch.

Noteworthy

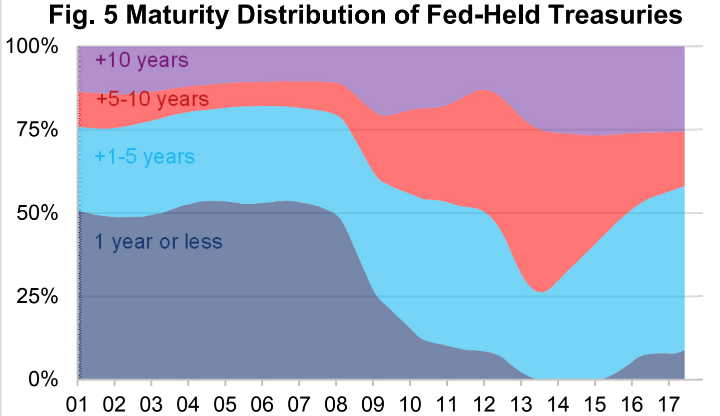
In response to the 2008 financial crisis and the subsequent lackluster recovery, the Fed purchased massive quantities of Treasury securities and GSE-issued mortgage-backed securities (MBS) through three quantitative easing (QE) programs. Since the QE3's conclusion in 2014, the Fed's policy has been to reinvest the proceeds accruing from maturing securities to maintain the size of its balance sheet. Following the prior FOMC meeting, a plan to reduce the enlarged balance sheet was announced. The program applies incrementally rising runoff caps starting at $6 billion/month for Treasuries and $4 billion/month for MBS. If, for example, the Fed receives $15 billion from the Treasury, it will reinvest $9 billion into Treasuries, and allow $6 billion to "run off" its balance sheet. Every three months, for one year, these runoff caps will incrementally rise by $6 billion for Treasuries and $4 billion for MBS, until they reach maximum caps of $30 billion/month and $20 billion/month, respectively.

Fig. 4 JEC Projected Fed Balance Sheet Runoff



Source: Federal Reserve/JEC calculations

Fig. 5 Maturity Distribution of Fed-Held Treasuries



Source: Federal Reserve/Haver Analytics

Figure 4 shows JEC's projection of Fed-held Treasuries and MBS. These account for 95% of the Fed's $4.5 trillion balance sheet. Assuming normalization begins in October 2017 and the runoff caps are always binding, the balance sheet will shrink from $4.5 trillion to $2.7 trillion by the end of 2020.

However, this might occur more slowly than shown in Figure 4 as the runoff caps may not always bind. 99% of Fed-held MBS have maturities of 10 years or more. The pace of the MBS runoff the next few years will depend on the rate at which people refinance their mortgages and pay them off early. Hence, it is not clear whether the MBS runoff caps will be met. It is more likely that the runoff of the Fed's Treasury holdings will consistently meet the caps, because Treasuries have definite payoff dates and 60% mature within 5 years.

Before 2008, over 50% had maturities of 1 year or less, but now less than 10% do. The Fed has stated that it plans to return to using Treasuries exclusively to execute monetary policy rather than also using MBS. However, it has not clarified whether it will return to the pre-2008 maturity distribution.

Lastly, the Fed has not specified what it intends the steady-state size of its balance sheet to be, or how long it will take to get there.