
JOINT ECONOMIC COMMITTEE
CHAIRMAN ERIK PAULSEN (R-MN)

June 19, 2018

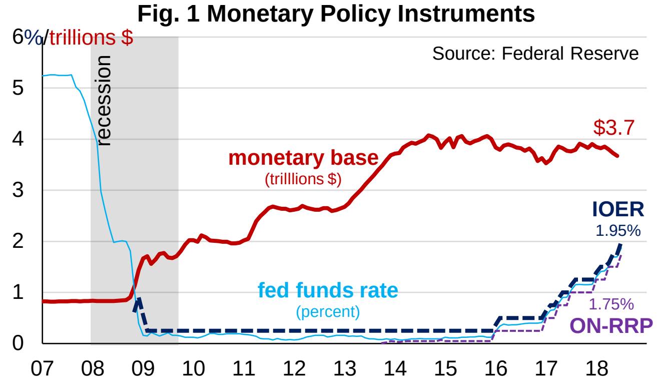
June FOMC Review: "The Economy is in Great Shape"

FOMC Review Snapshot
- The Fed raised its key policy rate, the interest on excess reserves (IOER) rate, to 1.95% as expected.
- Fed Chairman Jay Powell noted in his press conference that "the economy is in great shape."
- Thus, the IOER rate will likely be raised two more times this year instead of the previously expected one.

Details

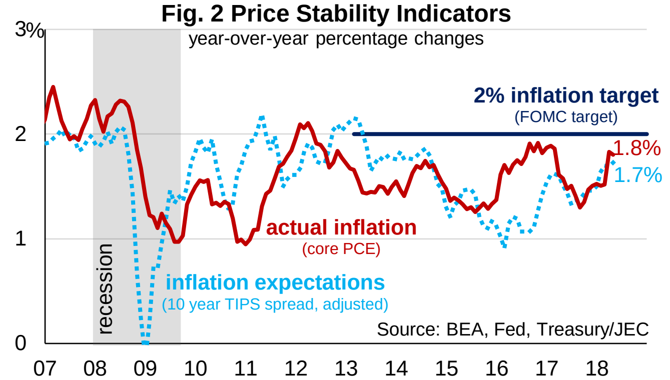
Following the Federal Open Market Committee (FOMC) meeting's conclusion last Wednesday**, the Fed raised its interest on excess reserves (IOER) rate to 1.95% from 1.75%.** The fed funds rate range increased to 1.75-2.00% from 1.50-1.75%. The top of the fed funds range is now nominally higher than the IOER rate, which the Fed described as a "small technical adjustment," but which 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 they 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



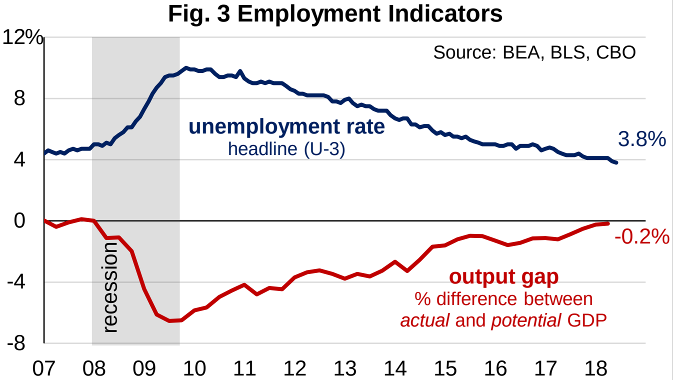
The Fed's balance sheet wind down, which began in October 2017, remains ongoing. The size of the Feds' balance sheet as represented by the monetary base, shown in Fig. 1, is shrinking slowly, as the Fed intended.

Fig. 2 Price Stability Indicators



The inflation rate remains below 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 some of the five years of consistent undershooting. Inflation is likely to undershoot the Fed's target over the next 10 years based on market-based measures.[1] The fed funds futures market now anticipates two more Fed interest rate hikes this year.

Fig. 3 Employment Indicators



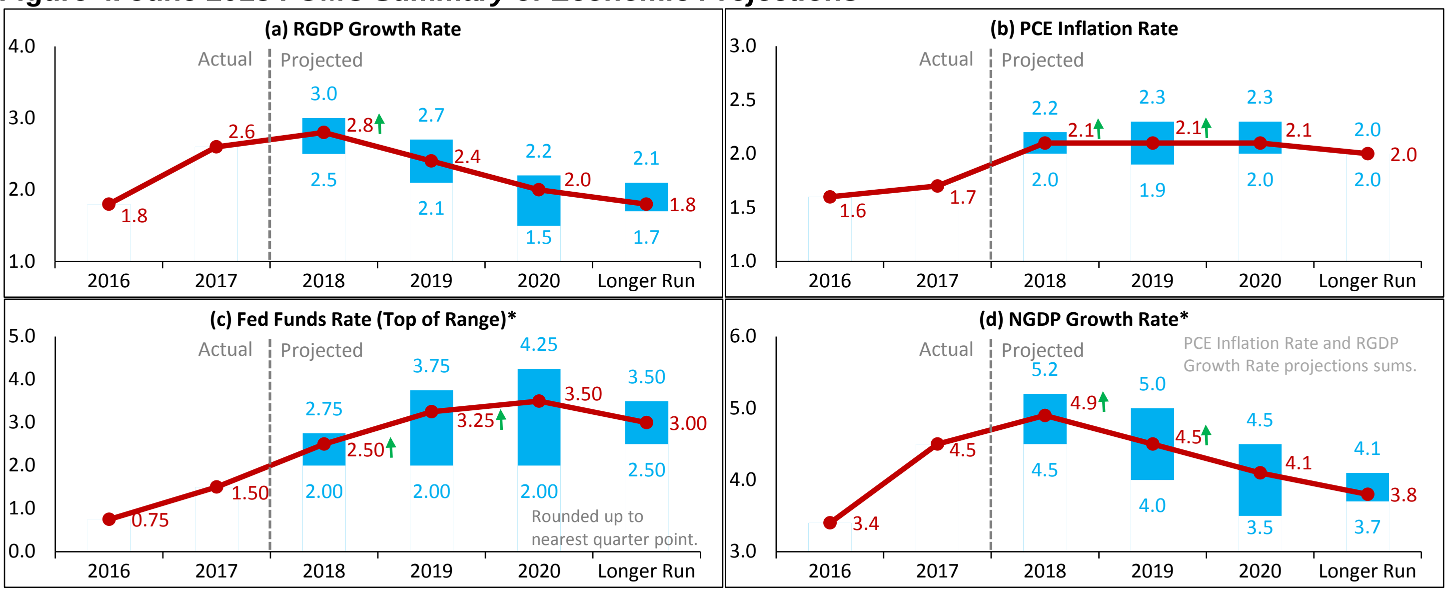
Context

Fed Chair Jay Powell noted "the economy is doing very well" and that "business investment continues to grow strongly" in his press conference. This has enabled the Fed to only gradually raise interest rates and allow the economy's improved trajectory to continue unimpeded. This is notable as the *Tax Cuts and Jobs Act* (*TCJA*) is often mischaracterized as possibly causing unsustainable economic growth and accelerating inflation, which would call for more aggressive Fed interest rate hikes. In reality, *TCJA* is designed to sustainably raise economic growth without stoking inflation.

Noteworthy

The FOMC projection for interest rate hikes for year end 2018 rose from 2.25% to 2.50% according to its new *Summary of Economic Projections* (SEP).[2] This appears to follow from stronger real GDP (RGDP) growth projections for 2018 and inflation modestly above 2%. Figure 4 illustrates the FOMC members' median year-end projection of real GDP (RGDP), inflation, the IOER rate, and nominal GDP (NGDP). Blue numbers above and below the red lines represent the range of estimates. Green (red) arrows represent median projections that have increased (decreased) since the most recent SEP.

Figure 4. June 2018 FOMC *Summary of Economic Projections*



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.

[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.