Joint Economic Committee
Chairman Erik Paulsen (R-MN)

December 20, 2018

December FOMC Review

FOMC Review Snapshot

- The Fed raised its key policy rate, the interest on excess reserves (IOER) rate, to 2.40% as expected.
- FOMC participants lowered their anticipated number of 2019 policy rate hikes down from three to two.
- Futures markets are indicating an expectation of no additional rate hikes in 2019.

Details

The Fed's main interest rate for implementing monetary policy—the interest on excess reserves (IOER) rate—was increased to 2.40%, following the Federal Open Market Committee (FOMC)'s decision to raise the federal funds rate target range to 2.25-2.50% (see Box 2). **Raising the IOER rate relative to market interest rates, encourages banks to lend less of their excess reserves, reducing aggregate demand growth; lowering the IOER rate yields the opposite effect.** The Fed made another "small technical adjustment" to the IOER rate, moving it further from the upper part of the fed funds rate target range to the middle (see Box 3).

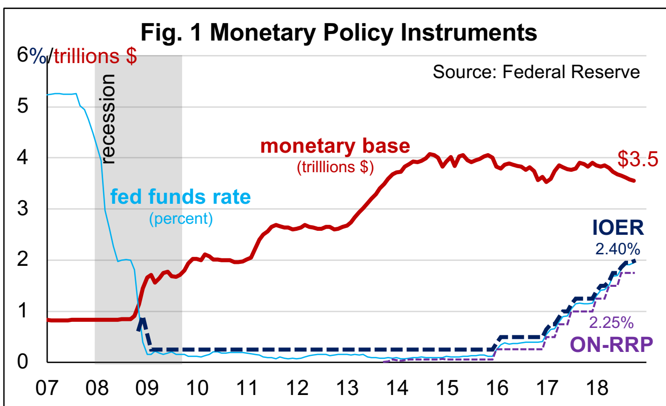


Fig. 1 Monetary Policy Instruments

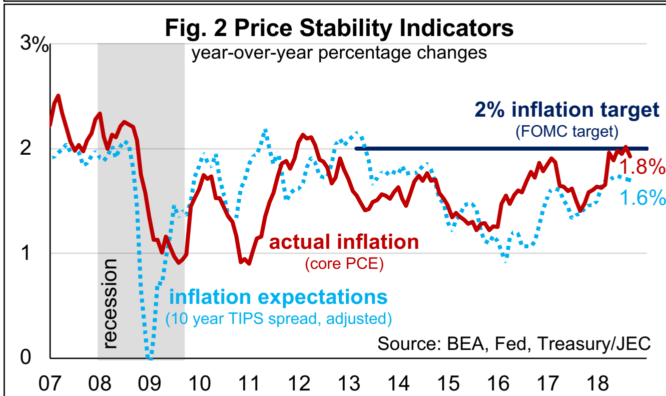


Fig. 2 Price Stability Indicators

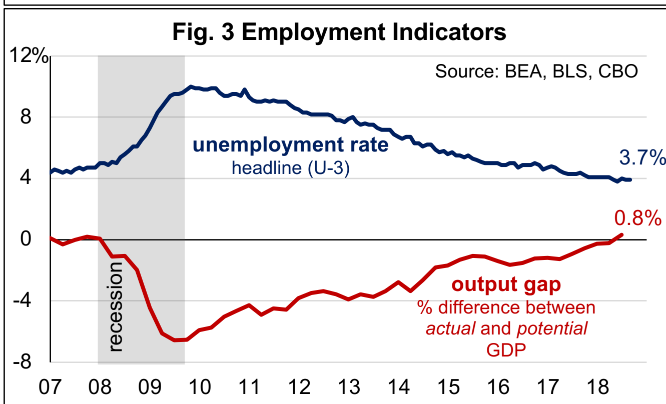


Fig. 3 Employment Indicators

Since October 2017, the Fed has continued with its plan to slowly wind down its balance sheet (see monetary base shown in Fig. 1). During his press conference, Chairman Powell noted he expected this process to continue.

The inflation rate, (Fig. 2) as measured by the core personal consumption expenditures (PCE) price index, had moved up to the Fed's inflation target, but fell in October. (The Fed's 2% inflation target is not a ceiling but an average to be achieved over time.) As late as September, most FOMC members expected some modest overshoot, which would make up for some of the five years of consistent below-target inflation, but now the FOMC projects inflation will be below target for 2018 and 2019. Market-based measures continue to anticipate inflation will remain below the Fed's target over the next 10 years.[1]

Context

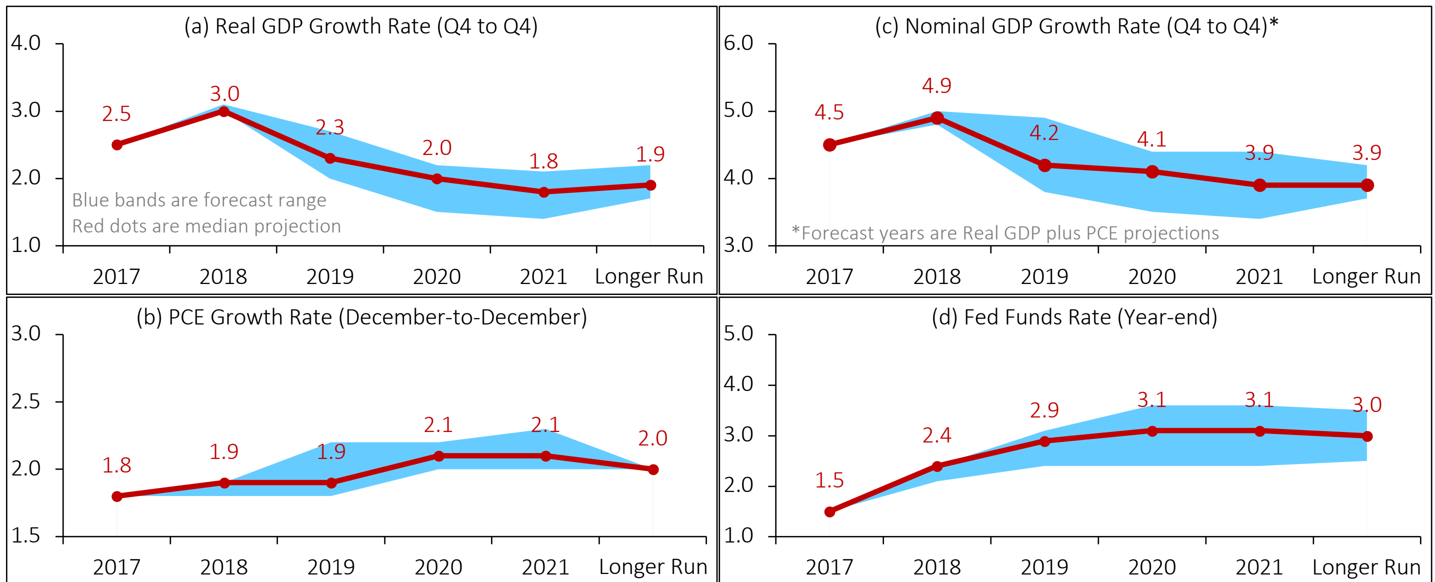
Tax and regulatory reform have lifted the U.S. economy's outlook since January 2017. This Fed rate hike was prompted by the ongoing stream of strong economic data. In recent months increased financial market volatility and declining market-based measures of expected inflation suggest the pace of policy rate hikes the Fed is signaling for 2019 is more aggressive than is warranted. Although FOMC members now project two rather than three rate hikes for 2019, the fed funds futures market currently suggests none will occur.

To realize the full effects of pro-growth policies, the Fed must essentially "thread the needle": 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

Figure 4 illustrates the FOMC members' year-end projections in the Fed's new *Summary of Economic Projections* (*SEP*)[2] for (a) real GDP, (b) inflation (PCE growth rate), (c) nominal GDP, and (d) the fed funds rate. Blue shading represents the range of all projections while the red line represents the median projection. The FOMC projections imply that the IOER rate will be 2.80% at year-end 2019, which would mean two additional rate hikes in 2019 (the previous SEP suggested three). Expectations for real GDP growth were slightly revised down for 2019 from 2.5% to 2.3%, as was inflation for 2018 and 2019. For more details on monetary policy, see JEC's 2018 Joint Economic Report (pp. 51-65, 68-69, and 85-90).

Figure 4: December FOMC Summary of Economic Projections (SEP)



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, and reduced it another 0.05 percentage point in December 2018. **This change has little bearing on the fact that the IOER rate is still the Fed's 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.