

A background image showing a city skyline at sunset or dusk, viewed from a boat on the water. The sky is a mix of blue, orange, and grey, with clouds. The city lights are visible in the distance.

Economic Flash

The Real Misreading of the FOMC: A Response to Benn Steil's WSJ Commentary

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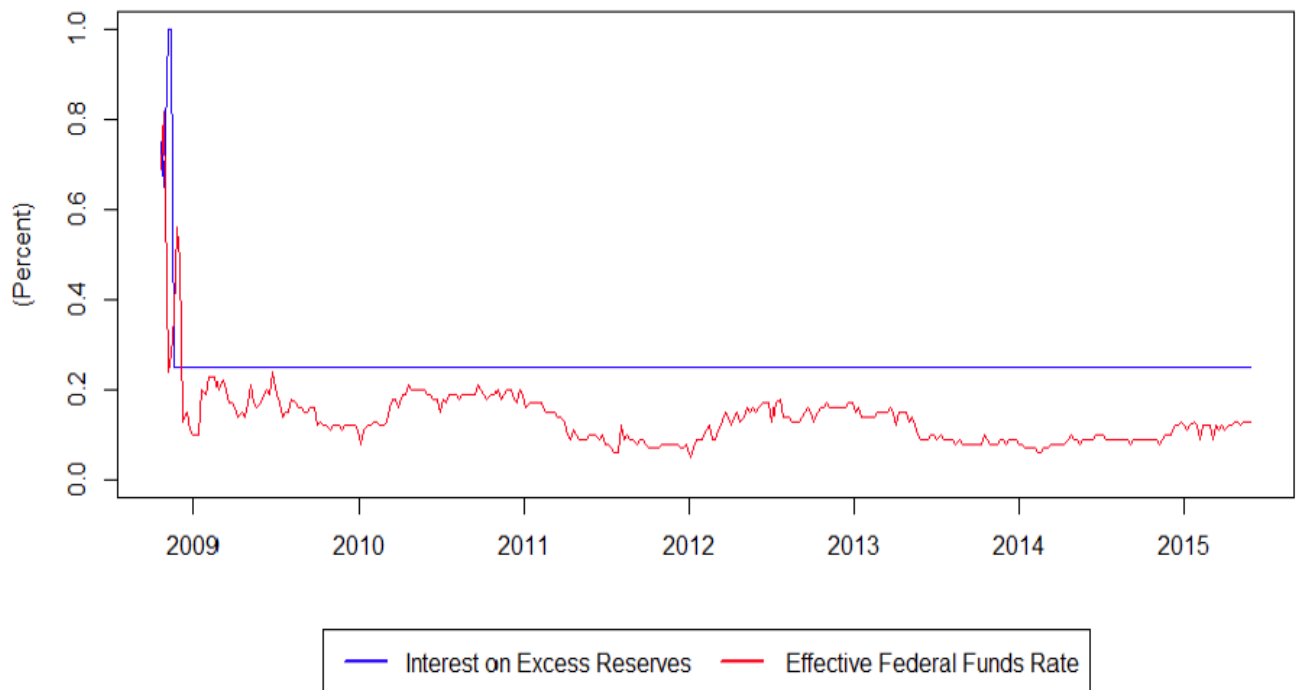
A Response to Benn Steil's WSJ Commentary, Part 1

In his Wall Street Journal article regarding monetary policy normalization (“Misreading the Fed on a Rate Increase,” 6/9/2015), we believe that Benn Steil provides a misleading depiction of the empirical evidence on overnight interest rates and grossly overestimates the potential for a factional conflict between “hawks” and “doves” of the FOMC. This seems to be more the result of a desire to discredit the Fed rather than to offer any type of factual analysis, which we attempt to provide here.

The initial problem with the article is Steil's claim that: “Paying interest on reserves helps set a floor

under short-term rates because banks that can earn interest at the Fed won't lend to others below the rate the Fed is paying.” In fact, we have observed the opposite to be true in the more than six years in which the Fed has been paying interest on excess reserves (IOER). As seen in the figure¹, in all but the first three weeks in which the IOER was first implemented the IOER has been above the effective federal funds rate (EFFR). Theoretical results based on the particular supply and demand dynamics of overnight lending markets provide further support to the above

¹ Data taken from St. Louis Federal Reserve FRED database

Figure 1: Weekly IOER and Weekly Average EFFR

observations.² Understanding these arguments, we believe the Fed intends to adjust the IOER as an upper bound to the EFFR, according to the choice of federal funds rate target range. In fact, the Federal Reserve has told this to anyone that will listen, in an effort to provide for smooth transition to normalized policy. This leads us to our second point.

The minutes to the March 17-18, 2015 FOMC meeting offer the most detailed look yet at the committee’s approach to policy normalization. At the March meeting “All participants agreed” that “the Federal Reserve intends to...set the IOER rate equal to the top of the [federal funds rate] target

range.”³ Notice that no distinction is made between the FOMC and Board of Governors, as the idea that these two groups would decide on competing policy is unthinkable. While disagreement on other policy issues is prevalent in the minutes, the committee is unanimous on the IOER issue. There is certainly no evidence for the scenario presented by Steil that the “dovish” Board of Governors could use their power over the IOER to counteract the more “hawkish” rate hikes by the FOMC. When deciding policy, a primary concern expressed by FOMC members is whether a particular policy action might lead to financial instability⁴. We find it hard to think of a more devastating blow to financial stability than the emergence of a battle

² Gagnon, Joseph E., and Brian Sack. Monetary policy with abundant liquidity: a new operating framework for the Federal Reserve. Peterson Institute for International Economics, 2014.

³ Federal Open Market Committee. (2015, March 17-18). Minutes of the Federal Open Market Committee.

⁴ Federal Open Market Committee. (2015, April 28-29). Minutes of the Federal Open Market Committee.

between factions within the Federal Reserve, in which the IOER and federal funds rate target range are used in competition with each other. The results of such a rift would be dire and everyone at the Fed knows this.

While there are interesting questions regarding how monetary policy tightening will function in the current environment (the role of reverse repurchase agreements, the effects of balance sheet roll-off etc.), whether the Board of Governors will use its power over IOER to counteract the actions of the FOMC is not one of them.

A Response to Benn Steil's WSJ Commentary, Part 2

We stand by our report on the function of interest on excess reserves (IOER), written in response to Benn Steil's op-ed in the Wall Street Journal. We are mainly concerned with the lack of clarity in Mr. Steil's argument just as the public must begin to adjust to the new policy tools of IOER, effective federal funds rate (EFFR), and reverse repurchase agreement rate (RRPR) as we approach the next tightening cycle. Mr. Steil does not differentiate between rates on the various money market vehicles available in the economy when he suggests that: "Paying interest on reserves helps set a floor under short-term rates."⁵ We believe this oversight is potentially misleading for the general public, as the EFFR and the yield on 3-month Treasury bills have been observed to be below IOER for some time as shown in Figure 2, below. In this piece, we aim to clear up the potential confusion on this subject, explain the

importance of the IOER and RRPR as the key monetary policy tools of the Fed since the onset of the credit crisis, and to further address our difference of opinion with Mr. Steil concerning the history of the Fed Board of Governors.

First, over the years, the general public has been conditioned to believe that the Fed Funds rate is the key monetary policy tool used by the Fed to set short term interest rates. Given the enormous increase in bank excess reserves since the credit crisis, it is important to understand that the level of the IOER set by the Board of Governors in concert with the FOMC, along with the RRPR set by the FOMC, is now the primary monetary policy tool for the Fed. Next, in order to understand how monetary policy works, it is important to be clear on the technicalities and empirical evidence regarding short-term interest rates in the post credit crisis market. In his response to our initial report, Mr. Steil seems to agree that EFFR has been below IOER beginning shortly after IOER was introduced. This is logical, because banks are assessed a fee of 10-15bp on IOER (on average) by the FDIC when depositing their reserves at the Fed⁶. This implies that the EFFR should be approximately 10-15bp below IOER so that no arbitrage opportunities exist from borrowing in the fed funds market and holding these funds as reserves. This is consistent with the evidence in Figure 2. Other short term interest rates (Mr. Steil unfortunately does not distinguish among them) are then determined relative to the EFFR,

⁵ Steil, Benn. "Misreading the Fed on a Rate Increase." Wall Street Journal. Published 6/8/2015. Accessed 6/8/2015.

⁶ Gagnon, Joseph E., and Brian Sack. Monetary policy with abundant liquidity: a new operating framework for the Federal Reserve. Peterson Institute for International Economics, 2014

Figure 2: Short Term Interest Rates⁷

depending on credit spreads for each particular money market vehicle. For this reason, other short-term rates may fall above or below IOER. This is clearly seen in Figure 2, where the yield on 3-month Treasuries has in fact been below the EFFR since 2010. The 1-month Libor carries a positive risk premium relative to fed funds and has therefore been slightly above EFFR since 2010, but below the IOER since 2013. We believe these observations adequately refute Mr. Steil's assertion that IOER acts as a floor on short-term rates. In fact, it is the RRPR, not the IOER that has acted as a floor on short-term rates, as it has thus far been set at 5bp with the potential to go lower if market demand exceeds \$300 billion in a given day. Taken together, the IOER and RRPR are intended to set a possible range for EFFR.

On the functioning of the FOMC and Board of Governors, we continue to agree with Ben Bernanke in that the Board of Governors has no incentive to use its power over the IOER to contradict FOMC decisions, as Mr. Steil suggests. We discussed in our original report that the resultant financial instability from such an action should be apparent to all FOMC members⁸. Moreover, historically there is no indication that the Board of Governors and FOMC have ever competed with each other for control of monetary policy via their respective policy tools. Chairman Bernanke has pointed out that the Board of Governors has for many years been in control of the rate at which banks can access funds via the discount window, yet at no point has the Board used this power to offset FOMC

⁷ Data taken from St. Louis Federal Reserve FRED database

⁸ "The Real Misreading of the FOMC: A Response to Benn Steil's WSJ Commentary". Gurtin Municipal Bond Management Publications

tightening⁹. There is therefore no reason to believe that the Board will behave any differently now that the IOER is under its control. Considering both the incentives of FOMC members and the history of monetary policy in this country, we believe the hypothesis put forward by Mr. Steil is not persuasive.

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⁹ Bernanke, Ben S. "The FOMC, the Board of Governors, and Fed interest rate policy". Ben Bernanke's Blog. Published 6/9/2015. Accessed 6/11/2015.

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