The Daily Dish

The Economy Gets a Vote of Confidence from the Fed

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Yesterday the Environmental Protection Agency (EPA) released its proposal to lower the biofuels mandate in 2018. The proposal calls for refiners to use 19.24 billion gallons of renewable fuels under the Renewable Fuels Standard (RFS). This new mandate is 25 percent lower than the goal set by Congress in 2007. The EPA will finalize its proposal later this year.

Last week the federal government was able to reduce total compliance costs by $9 million, with more than 177,000 fewer paperwork burden hours, via a trio of deregulatory proposals. President Trump has vowed to make regulatory modernization a top priority, and to date, his administration has cut more than 23 million paperwork burden hours. The Department of Defense is leading the charge with $400 million in regulatory cost savings.

Eakinomics: The Economy Gets a Vote of Confidence from the Fed

Yesterday the Federal Reserve released the minutes of the June 13-14 meeting of its policy committee (the Federal Open Market Committee or FOMC). There were two main issues on the table: (1) would the Fed raise the target short-term interest rate for the 3rd time in 2017 and would it be in September or December, and (2) how and when would the Fed begin to unwind its holdings of $4.5 trillion in Treasury and mortgage-backed securities (MBS), which were acquired as a result of its extraordinary monetary policies. The upshot is that the timing is unclear, but it looks like both will occur during the second half of 2017. This is a vote of confidence in the outlook for growth and inflation, as the Fed has chosen to stay the course.

To review, the economy has been growing steadily (if unspectacularly) for years and the unemployment rate has stayed below 5 percent on a consistent basis. Accordingly, the Fed should be able to have a more normal monetary policy. That normalization will imply higher rates. One route to higher rates is to raise the federal funds rate — the short-term policy rate. As those rates rise, the cost of acquiring funds is increased, and interest rates as a whole will increase as well. This is a primary avenue for monetary policy.

The enormous portfolio of Treasuries and MBS represent an artificial reduction in interest rates. To see this, imagine that the Fed "dumped" all of these on the market. The large rise in the supply of these securities would depress prices, thus raising interest rates. (Lower prices mean higher effective interest rates because the same payment from the bond issuer — say $25 — represents a higher return if the bond's price os $400 (6.3 percent) than if the bond's price is $600 (4.2 percent).) The Fed plans a much milder version of this, starting by allowing up to $6 billion in Treasuries and $4 billion in MBS to mature and leave the portfolio. This would rise over time to $30 billion and $20 billion, respectively, each month.

So, the main issue is timing. One of the wild cards is the pace of inflation, which has been lower than the Fed expected but which it expects to rebound. A second issue is the expiring term of Chair Janet Yellen. It would be wise for the Fed to have both programs in motion in the near future. That would allow it to judge market reaction to additional rate hikes and the start of shrinking the portfolio, without having that impact confounded

by the choice of a new Chair (or a Yellen reappointment).

The bottom line, however, seems simple. The Fed believes the economy is in good enough shape to undertake these moves to more normal policy.