The Daily Dish

Steady….for the Moment

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Eakinomics: Steady….for the moment

The Federal Reserve's policy-making body (the Federal Open Market Committee or FOMC) concluded its meeting yesterday by leaving interest rates unchanged. The target federal funds rate — the rate at which overnight funds are lent and borrowed — was kept in the range of 1.00 percent to 1.25 percent (that is up a percentage point since 2015). In its statement the FOMC said: "The Committee continues to expect that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace, and labor market conditions will strengthen somewhat further. Inflation on a 12-month basis is expected to remain somewhat below 2 percent in the near term but to stabilize around the Committee's 2 percent objective over the medium term." Put differently, even though interest rates have been raised, overall monetary policy has a bias toward demand growth and inflation.

So, steady as she goes on steadily normalizing interest rate policy, at least until the data show more sustained inflation weakness or a dramatic labor market tightness.

The other major wild card is when the Federal Reserve will begin to unwind its large portfolio of Treasury securities and mortgage-backed securities (MBS). With regard to the portfolio, recall that the Fed believes the net monetary impetus is determined by the size (or "stock" holdings) of the portfolio; not the rate at which it was accumulated or wound down. The easiest way to see this is to imagine the Fed dumping the securities overnight. It would take a large rise in interest rates to get investors to absorb the full portfolio. Thus, the size of the portfolio measures the implicit reducing in interest rates.

The statement indicated: "For the time being, the Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction. The Committee expects to begin implementing its balance sheet normalization program relatively soon, provided that the economy evolves broadly as anticipated".

So, steady as she goes on the size of the portfolio, but get ready for some unwinding in the future.

On balance, the economy continues to expand at a moderate 2 percentish rate. Until there is a dramatic change in pro-growth policy or a private-sector productivity boom, there will be little reason for the Fed to change its game plan.