THE WALL STREET JOURNAL.

Fed Could Move Again Soon to Keep Short-Term Rates in Check

Michael S Derby

November 7th, 2018

The Federal Reserve appears ready to make another tweak that will slow the rise of a key short-term interest rate by the end of the year, analysts say.

The central bank, in a move that would be largely technical in nature, could lower the interest rate it pays banks to park reserves on its books relative to the top end of its benchmark federal-funds rate.

The fed-funds rate target range now stands at 2% to 2.25%, while its interest on excess reserves, or IOER, rate is set at 2.2%. Until the Fed's June meeting, IOER was set to define the top end of the fed-funds target range.

The Fed bumped IOER down a touch in June because the fed-funds rate, which floats within the range and is set by market forces, had been grinding up near the top end of target rate range. The change in IOER aimed to push the fed-funds rate back toward the middle of the range.

The pressures that caused the Fed to act in June have returned. In recent weeks, the fed-funds rate has again been trading toward the top end of the range, and some analysts believe the Fed will act to tame this rate.

While some say the move could happen at this week's policy meeting, where no change in the fed-funds range is expected, more analysts say December's meeting is a better time, when the central bank is expected to lift the fed-funds target. They predict if the Fed moves its target rate range to between 2.25% and 2.5%, IOER will go to 2.4%.

A December tweak works best if only because it is easier to communicate.

"A stand-alone cut in the IOER relative to an unchanged target range would seem to run counter to the Fed's carefully-honed gradual-rate-hike message," forecasting firm Wrightson ICAP told clients in a message. "That would be difficult or, at least, complicated, to explain to the broader public even under the best of circumstances."

J.P. Morgan economist Michael Feroli agrees there is "a good chance" the change will happen with a December fed-funds increase.

The reasons for the upward drift in the fed-funds rate are complicated. In his September Federal Open Market Committee press conference, Fed Chairman Jerome Powell said the situation wasn't a big problem. "We think it's principally a function just of a number of things, but particularly high Treasury supply" is a notable force affecting short-term rates, he said.

In a speech late last month, Simon Potter, who leads the implementation of monetary policy at the New York Fed, pointed to technical market issues as putting upward pressure on the fed-funds rate. He said he didn't believe the level of reserves in the banking system had become scarce enough to cause the upward drift in the funds rate.

"I am confident that the Federal Reserve has the effective tools and is prepared to take measures as appropriate to ensure that short-term rates remain well-controlled and efficiently transmit the stance of policy into broader financial markets," Mr. Potter said. He also hinted a tweak would happen if the Fed deemed it necessary.

Changes in IOER highlight how complicated the Fed's control over interest rates has become. Before the financial crisis the Fed simply targeted the fed-funds rate and explained the stance of monetary policy in terms of this single rate.

Now, the Fed controls short-term rates by setting a high and low end for the range. The IOER rate was supposed to set the high end of the range, but now it doesn't. And while it isn't likely to have much real-world economic impact, lowering IOER relative to the top end of the range does mean in real terms short-term borrowing costs will rise at a slightly slower pace.

George Selgin, a scholar at the Cato Institute, is a skeptic of the Fed's rate-control regime, calling it Byzantine.

"Who needs Alan Greenspan" to offer obscure explanations for monetary policy, Mr. Selgin asked, referring to the former chairman of the Fed at a time when the central bank offered less transparency. With the current menu of short-term rates set by the Fed, "there's still plenty to keep it mysterious to the everyday person."