Forbes

Does the Fed Funds Rate Still Matter?

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October 17, 2017

At last Sunday's Group of 30 international banking seminar, Federal Reserve Chair Janet Yellen delivered a classically bland, central-banker speech. It was all the standard stuff: When will the Fed hike rates? Will inflation reach the Fed's 2 percent target?

But as far as I can tell, nobody asked Yellen how the Fed's new operating framework has changed the bank's ability to influence interest rates and inflation. Even more bizarre is that reporters still uncritically refer to the federal funds rate as the Fed's benchmark rate.
This lack of inquisitiveness is strange because the federal funds market remains dead relative to its pre 2008 crisis stature. It's even stranger because that market was the very foundation of the popular story of how monetary policy works.

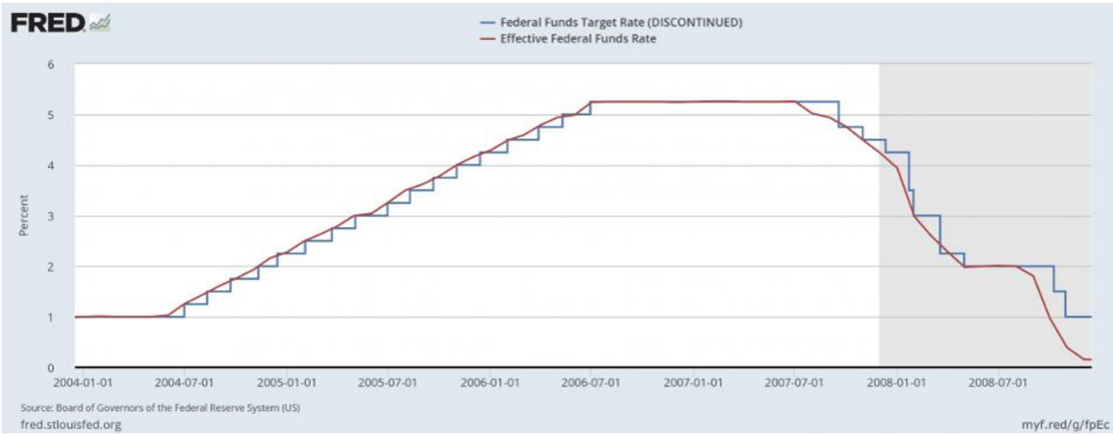
That tale, courtesy of the Federal Reserve, seems ingrained in all the news reports concerning Fed policy:

The Federal Reserve conducts the nation's monetary policy by managing the level of short-term interest rates and influencing the availability and cost of credit in the economy. Monetary policy directly affects interest rates; it indirectly affects stock prices, wealth, and currency exchange rates. Through these channels, monetary policy influences spending, investment, production, employment, and inflation in the United States.

For decades "short-term interest rates" have started with the federal funds rate, and this story helps explain why so many people think that the Fed "sets interest rates."

Leave aside the question of how well this story fits reality, and ignore that the Fed replaced setting a target fed funds rate with setting a *target range* for the fed funds rate. (Some might say it's a cop-out because it's far easier to hit a range than a single number.)

Also ignore the fact that, early in the crisis, the Fed reversed course like never before. After following rates up for two years, the Fed followed them down after September 2007, lowering its target federal funds rate from 5.25 percent to 1 percent in roughly one year. (See the nearby graph.) Why would rates would fall so far, so fast, if the Fed actually "sets interest rates" or even "manages" them?



The Fed's dramatic change.

But do *not* overlook that the foundation of this popular monetary policy story, the federal funds market, has been torn to shreds.

The federal funds rate was the benchmark rate because of what banks did in that market. Specifically, they lent and borrowed reserves to meet their reserve needs, thus enabling them to make more loans.

The Fed could tighten its policy stance by making reserves relatively more scarce, thus making it more difficult for banks to lend, eventually slowing down the economy. In reverse, the Fed could loosen its stance by making reserves relatively more plentiful, thus making it easier for banks to create money, ultimately speeding up the economy.

Starting in 2008, the Fed flooded the market with reserves and started paying an above-market interest rate on excess reserves. Banks naturally quit lending into the federal funds market, and the total activity dropped off a cliff.

So the standard process of managing interest rates through reserve management – the one that the Fed had been using for decades – simply cannot happen right now. The federal funds rate cannot possibly convey the type of information it used to, and there is no comparable short-term rate.

I can't recall a single beat reporter questioning the Fed Chair on this issue or even writing about this dramatic change. The Fed no longer depends on market forces to "manage the level of short-term interest rates." Instead, it is using strictly *administered* rates.

In other words, Fed officials are literally setting the interest rate it pays on reserves, and they're doing so at an above market rate. This new framework, explained thoroughly by the Cato Institute's George Selgin, is tied to all those reserves the Fed created during the crisis.
The Fed's bloated balance sheet and payment of interest on excess reserves (IOER) constitute a completely new operating framework--one that likely makes it harder for the Fed to meet its inflation goals.

There is little doubt that markets have changed during this regime shift.
Banks now hold a much larger portion of their total assets as cash, and a lower percentage of their assets as loans. There is also very little bank-to-bank repurchase (repo) activity, and the volume in commercial paper markets is nowhere near what it was before the crisis. All of these measures are available from the Fed. (David Beckworth and I both have papers forthcoming that look at some of these metrics, and I recently went through most of these at an AEI event.)
None of these differences should be incredibly surprising, because the Fed's new framework literally encourages banks to park funds at the Fed instead of investing in private securities and loans. Each dollar of excess reserves held at the Fed represents a dollar that banks fail to invest in the private market, thus detracting from economic growth.

The framework also detaches the size of the Fed's balance sheet – the assets it purchases and sells – from monetary policy. This change makes it much easier for the Fed to conduct stealthy fiscal policy by, for example, bailing out a failing pension fund, state government, or large private company.

This new structure makes it less likely the Fed can stay out of politics, and it can only lead to further distorted prices and interest rates.

If market interest rates rise before the Fed shrinks its balance sheet, the Fed will have no choice but to raise its own policy rates, making it a direct spigot of money unlike ever before. The list of advocacy groups petitioning the Fed for favors would top anything ever seen in Washington. And that says something.

Congress can implement a long list of reforms to improve monetary policy, but the immediate task should be getting back to normal.