First Trust
Monday Morning OUTLOOK
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Fed Funds Rate An Anachronism

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During Fed Chair Janet Yellen's first press conference last week, some analysts said she made a major mistake. Supposedly, she put an actual time limit on when the Fed may start to lift the federal funds rate.

She said it would be "around six months" after the Fed ended any further purchases of bonds for its Quantitative Easing program. This could be true, but she used enough qualifiers that it became clear six months is not a hard target.

The Fed dropped its 6.5% jobless rate as a trigger point for raising rates, and will now follow a long list of indicators to determine when the job market is functioning well. In other words, when Janet Yellen says she wants "full employment," we assume she means for Fed Watchers.

Even Minneapolis Fed President Kocherlakota, a dove when it comes to monetary policy, had a problem with this. He dissented with his vote, saying, "If you're not specific in the statement, then market participants are just grasping for scraps of information." He wanted an explicit, but lower, unemployment rate target before raising interest rates.

But all of this is becoming moot. The federal funds rate has rapidly become a non-issue for monetary policy. In the past, the Fed manipulated the funds rate by making reserves "scarce" or "plentiful." It withdrew reserves to push rates up and added reserves to push rates down – a simple "supply and demand" calculation.

So, when rates went up, the Fed was tightening and when rates went down, the Fed was easing. This was a classic monetarist view of the world. However, now that the Fed has injected $2.6 trillion in "excess reserves" via QE, there is no way to make reserves "scarce" without completely unwinding the Fed's balance sheet.

As long as banks have excess reserves, they do not need to borrow reserves from other banks to meet their reserve requirements. In fact, over the past few years, as excess reserves have piled up, the amount of actual trading in the overnight reserve market has contracted sharply.

The Fed debated this problem way back in 2008. Fed Governor Donald Kohn thought the Fed had lost control of the funds rate. However, Janet Yellen, then the President of the San Francisco Fed, said the Fed could control the funds rate by raising the interest rate it paid on excess reserves (currently 25 bps). The idea was that by raising the rate on excess reserves, the few banks who were participating in the overnight reserve market would demand higher rates.

The only problem is that most of the lending in the overnight reserve market is done by Fannie Mae, Freddie Mac, and the Federal Home Loan Banks who, by law, are not allowed to be paid interest by the Fed on excess reserves.

So, while it is possible that lifting the interest rate on excess reserves could lift the federal funds rate, too, it is not 100% clear that this will work. Nor is it clear that it will change monetary policy all that much.

With so many excess reserves in the system, higher interest rates would not, in themselves, tighten money in the system. Only if the Fed paid banks more to hold reserves at the Fed than they could earn by lending them to customers could the Fed affect money growth. If banks decided to lend excess reserves anyway, the Fed would be forced to shrink its balance sheet, or face an explosion of money growth.

In other words, the federal funds rate has become an anachronism. Six months? Twelve months? Twelve years?. Who cares? Excess reserves are all that matters.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-25 / 9:00 am	New Home Sales - Feb	0.445 Mil	**0.460 Mil**		0.468 Mil
9:00 am	Consumer Confidence – Mar	78.8	**79.4**		78.1
3-26 / 7:30 am	Durable Goods – Feb	+0.8%	**+0.1%**		-1.0%
7:30 am	Durable Goods (Ex-Trans) – Feb	+0.3%	**-0.1%**		+1.1%
3-27 / 7:30 am	Initial Claims Mar 23	324K	**326K**		320K
7:30 am	Q4 GDP Final Report	2.7%	**3.0%**		2.4%
7:30 am	Q4 GDP Chain Price Index	1.6%	**1.6%**		1.6%
3-28 / 7:30 am	Personal Income – Feb	+0.2%	**+0.2%**		+0.3%
7:30 am	Personal Spending – Feb	+0.2%	**+0.3%**		+0.4%
8:55 am	U. Mich Consumer Sentiment- Mar	80.5	**80.0**		79.9