

Some Questions About the Fed's Monetary Policy Operating Regime

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Shadow Open Market Committee

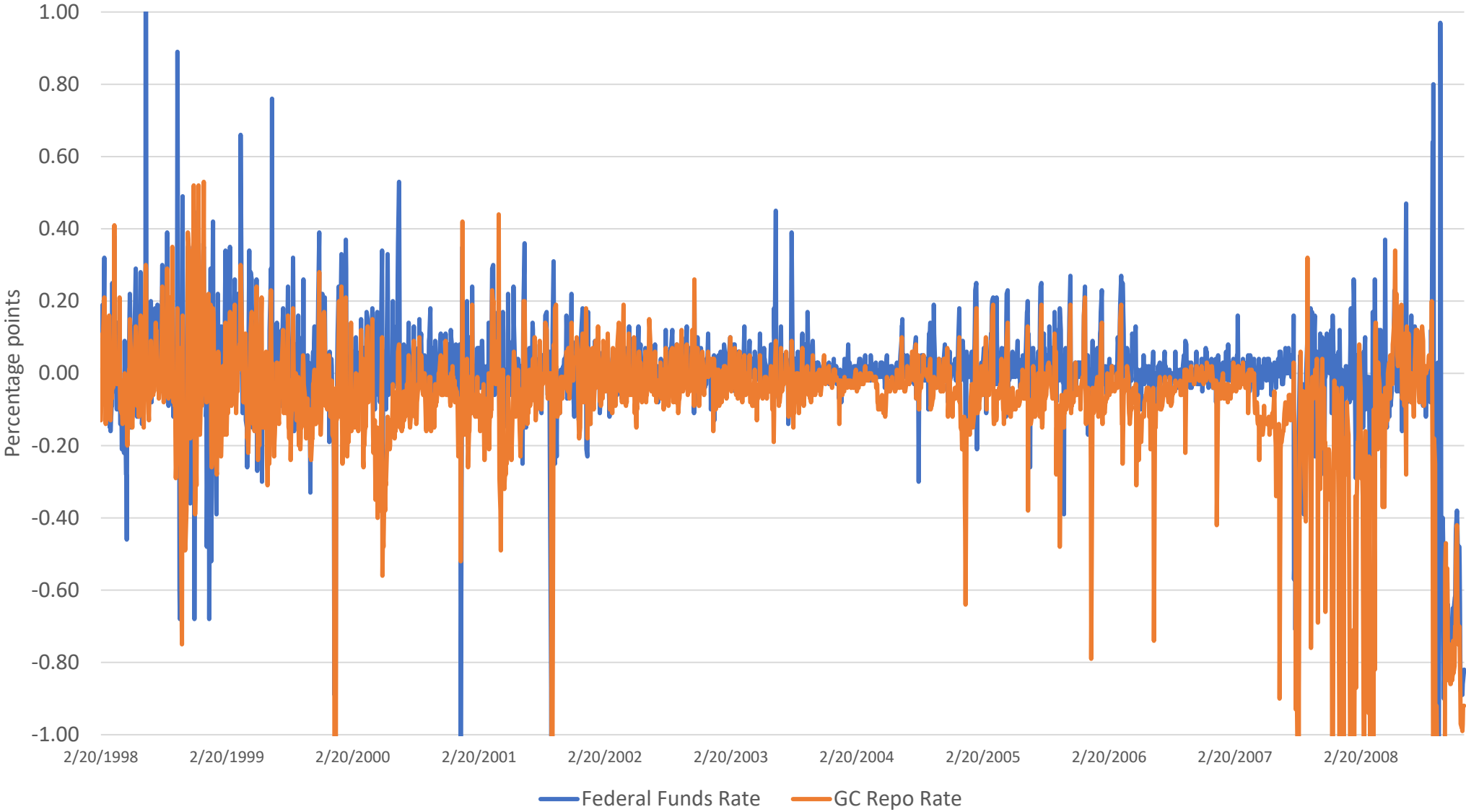
New York, NY

April 21, 2023

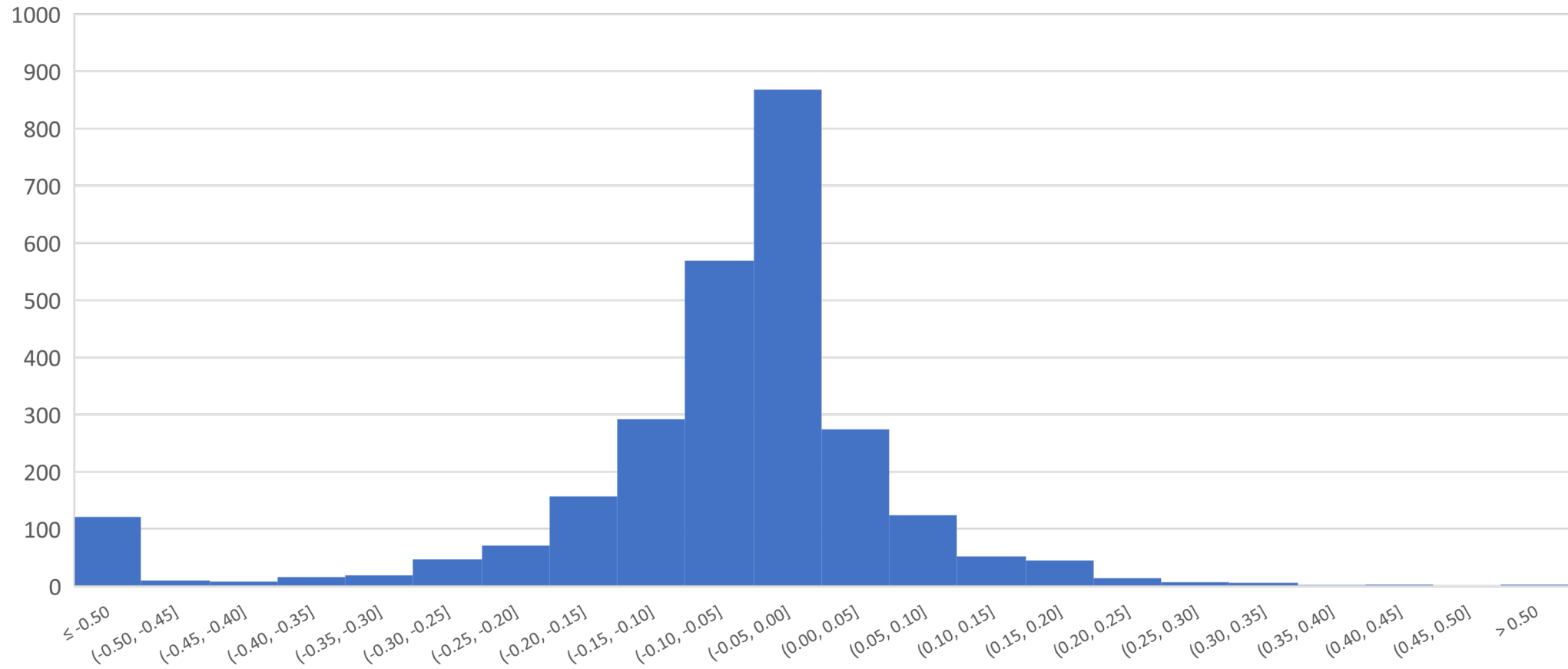
Before 2008, the Fed implemented monetary policy by setting essentially one interest rate

- The Fed paid no interest on banks' reserve account balances
- Supply and demand for overnight interbank loans of reserve balances determined the overnight "federal funds rate"
- FOMC set a target for the overnight federal funds rate
 - FRB NY manipulated the reserve supply via daily repo operations so that the FFR was expected to equal the FOMC's target that day
- Federal Reserve Banks loaned reserves at the discount rate
 - After 2002: DR > FFR target, loans were minimal; FRBNY routinely sterilized
 - The discount rate was not essential to interest rate control
- Repo rate fluctuated above and below the FFR target
 - ***Nobody seemed to mind***

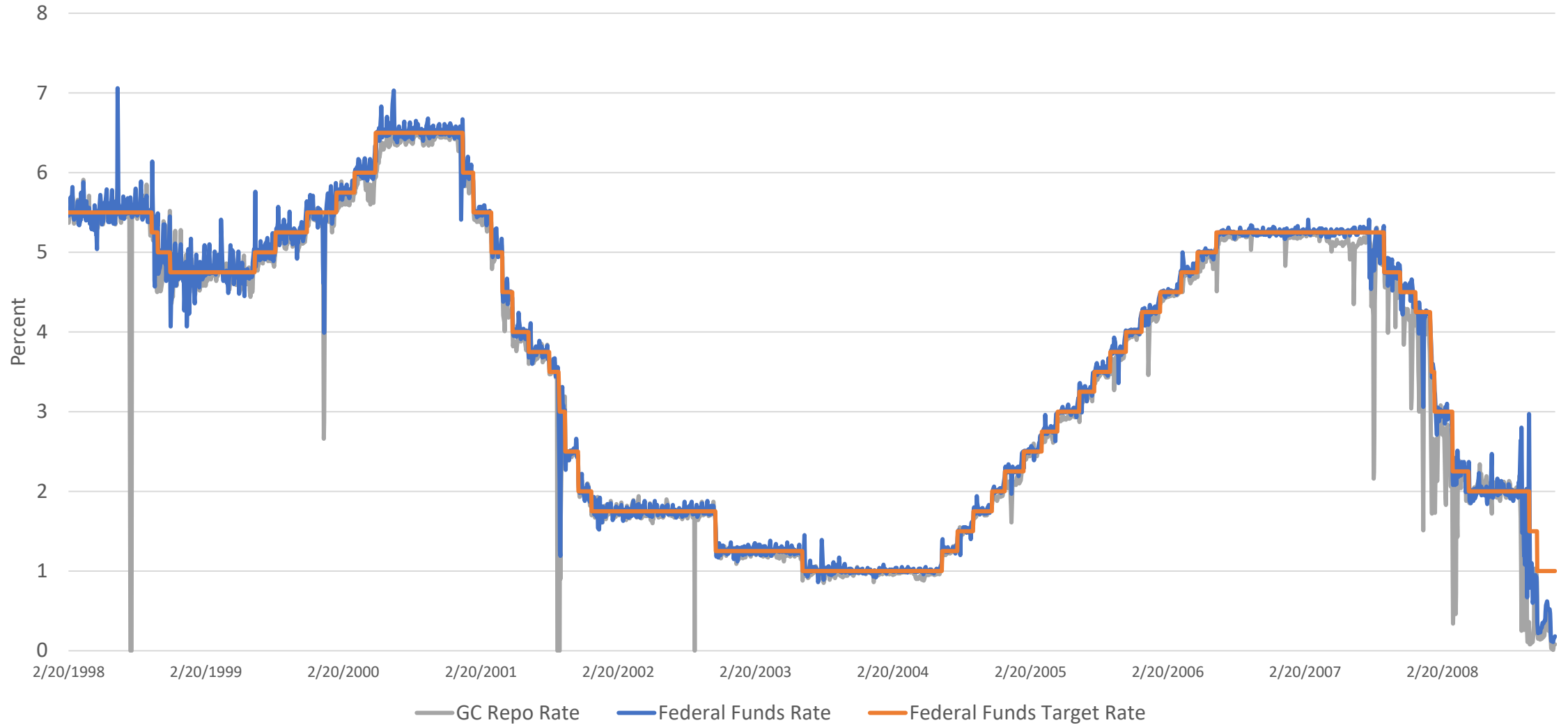
GC repo rate and effective federal funds rate relative to federal funds target rate, February 20, 1998 to December 15, 2008



Distribution of GC repo rate minus federal funds target rate,
February 20, 1998 to December 15, 2008 (2708 obs.)



GC repo, Federal Funds Rate and Federal Funds Target Rate, 1998-2008



The Fed now sets four interest rates

- 1) Board of Governors sets the interest rate on reserves (IOR)
 - Reserve supplies are “ample,” satiating the interbank loan market
- 2) FOMC sets the rate at the Overnight Reverse Repo (ONRRP) facility
 - Fed receives cash, sends securities—drains reserves from banking system
 - Reverses transaction the next day—sends securities and receives cash back
 - Counterparties are mostly money market mutual funds
- 3) FOMC sets the rate at the Standing Overnight Repurchase Agreement Facility (SRF)
 - Fed receives securities, sends out cash—adds reserves to banking system
 - Reverses the next day—sends out reserves for securities
- 4) FOMC still sets a target for the FFR—now a ¼ ppt wide target range

Why is it not enough to control one rate?

- Before October 2008, Fed relied on arbitrage to tie other interest rates to FFR
 - Banks can borrow or lend reserves, borrow or lend in the repo market, buy or sell treasury bills, buy or sell commercial paper, make business loans, or take deposits
- Intermediation costs and regulatory constraints may affect spreads between various rate pairs, in addition to risk considerations
- Nonetheless, all rates moved in tandem when the FOMC moved FFTR
- Fed was unconcerned about spreads; controlling one rate was deemed sufficient; target change could offset a change in spreads
- ***Why is control of one interest rate no longer sufficient?***

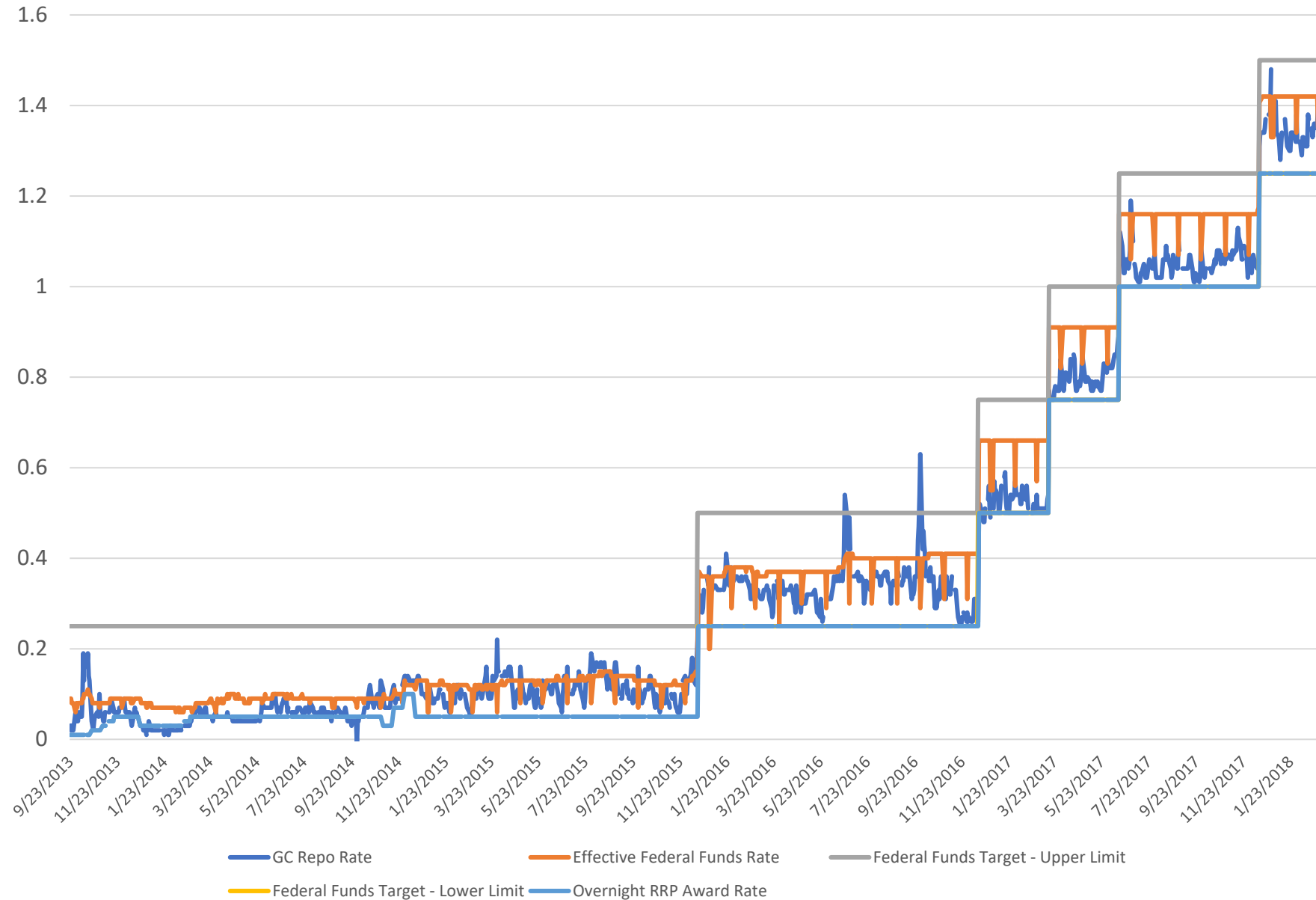
A natural, benchmark, one-rate operating regime

- The Fed sets the interest rate on reserve account balances
 - Board of Governors would agree to comply with FOMC direction on IOR, since the FOMC is responsible for monetary conditions
- No federal funds rate target: IOR is “the policy rate”
- No ONRRP or SRF – repo rates are market determined
- Rely, as they did pre-2008, on arbitrage to transmit interest rate changes to the broad array of other money market interest rates
- Would reduce market distortions, complexity, and the risk of rapid funds movements across programs
- ***Why go beyond a one-rate regime?***

Why do we need the ONRRP Facility?

- Introduced in 2013, in preparation for “lift off”
- Purpose: keep FFR within target range when the Fed raised the IOR
 - “another pair of suspenders” – Bernanke, Sept 2013
- Appears to subsidize MMFs relative to banks
 - Why do that? MMFs were viewed then (as now) as structurally unsound
 - SEC has recently proposed further regulatory changes
- Plan was to phase it out:
 - “The Committee stated that it would use an ON RRP facility only to the extent necessary and will phase it out when it is no longer needed to help control the funds rate.” – FOMC, September 16, 2014
 - As it turned out, ONRRP facility turned out to be unnecessary
- ***Why wasn't the ONRRP wound down in 2017, after successful lift off?***

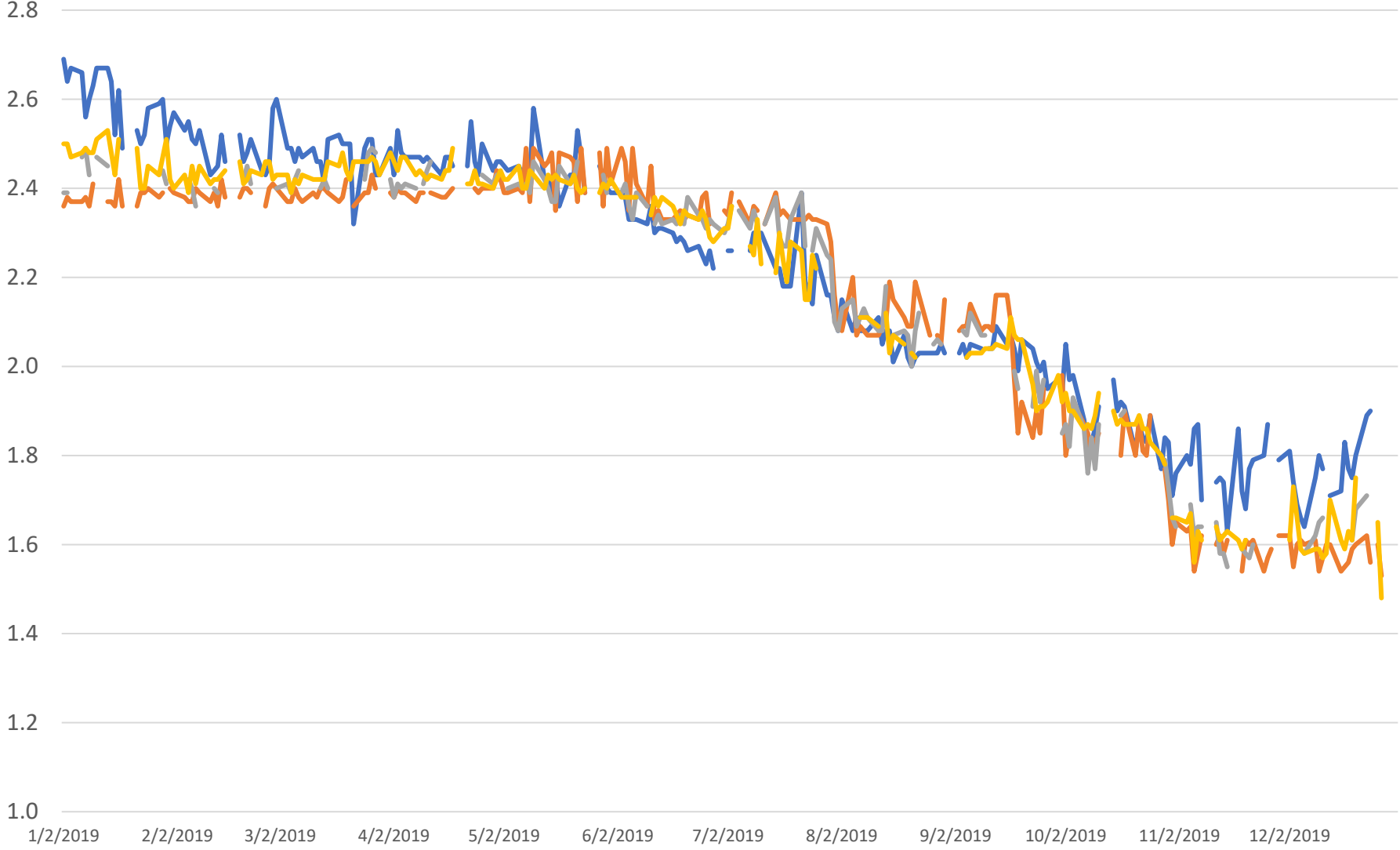
Federal Funds Rate and GC repo rate around lift off



Why do we need a Standing Repo Facility?

- Announced July 21, 2021
- Seems motivated by surge in repo rates on September 17, 2019
- Not obvious how economically meaningful that surge was:
 - Overnight rate spikes have long been common around quarter- and year-ends
 - Spikes are always transitory (even without Fed intervention), so markets generally look through them
 - Longer term (e.g. 3-month) rates are seldom affected at all
 - Not clear borrowing rates were materially affected for non-financial entities
- The SRF dampens market participants' incentive to build and maintain capacity to dampen rate surges
- ***What evidence is there of a need for the SRF?***

Commercial Paper Rates, 2019



— 90-Day AA Financial CP rate — 7-Day AA Financial CP rate
— 30-Day AA Financial CP rate — 30-Day AA Nonfinancial CP rate

Why target the Federal Funds Rate?

- The federal funds market is small and unrepresentative
- Most trades are loans by Fed accountholders that are not legally entitled to receive interest on reserves
 - GSEs: Fannie, Freddie and the Federal Home Loan Banks
- Arguably IOR does all the work of influencing all other rates
 - Should be sufficient
- One key difference: IOR set by the Board of Governors, the FFR target is set by the FOMC
- ***Does the Fed target the federal funds rate because the Board is unwilling to defer to the FOMC, as it does regarding the discount rate?***

Why control money market spreads?

- Implementing monetary policy requires managing (nominal) intertemporal terms of trade
 - Controlling one rate should move all rates
 - Controlling additional rates amounts to controlling interest rate spreads
 - Spreads presumably reflect microeconomic factors: risk, regulatory constraints, capital and liquidity requirements, settlement arrangements,...
- Market-making and arbitrage may be costly and imperfect
 - But so is Fed market-making, which reallocates costs and risks to taxpayers
- ***What would be economically unsatisfactory about the behavior of market spreads if the Fed went back to targeting just one rate?***
- ***Is there a limiting principle? Why not target other rates as well?***

The Fed should explain

- What would be economically unsatisfactory about outcomes if the Fed simply set one rate, such as the interest rate on reserves, and let market forces determine other interest rates, just as it did prior to October 2008?
- Existing Fed documents do not address seriously the questions raised above
- ***The Fed should provide a coherent economic rationale for its operating regime***