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The Federal Reserve, Inflation, and the State of Interest Rates and Quantitative Easing

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Introduction

Economically, we are certainly in unchartered territory these days. Recovering from a global pandemic, we now face rising inflation pressures coupled with lackluster economic growth as evidenced by the negative 1.4% growth in the U.S. first quarter GDP. Central Banks worldwide are now dealing with the growing pressures of stagflation. Trying to balance the opposing forces of rising inflation coupled with deteriorating growth will prove to be a challenge for most central banks, the U.S. Federal Reserve being no exception. Only recently has the Fed acknowledged that we had evolved from "transitory" inflation to a growing and systemic issue with which they now must deal. Accordingly, the Fed started raising various interest rates at their March 2022 FOMC meeting and addressed their large asset purchase program commonly known as quantitative easing (QE). Let's first look at the recent interest rate changes and then QE.

Interest Rate Increases

Most significantly, and perhaps most widely covered by the financial press, is the Federal Funds rate. In fact, at the March meeting, the Fed minutes stated "…ongoing increases in the target range would be appropriate."[1] At the most recent May 2022 meeting, the Fed raised the Federal Funds target range by 50 basis points. Here is a review of some of the more important rates that have been raised.[2]

Federal Funds Rate Target Range: Is the "interbank rate", the rate at which banks borrow excess reserves from each other. The Fed sets a range at which they want banks to borrow these reserves. The Fed Funds target range is a key monetary tool used by the Fed. In March, the Fed raised the then current range of 0.00% – 0.25% by .25%, increasing it to .25% – .50%. Later, in May, they raised the target range by 50 basis points. The following table summarizes the increases:

Date	Increase in Basis Points	Target Range (%)
May 4, 2022	50	0.75 – 1.00%
March 17, 2022	25	0.25 – 0.50%

The March 17, 2022 hike was the first hike since 2018!

Discount Rate/Primary Rate: Is the rate at which banks can borrow funds from the Federal Reserve directly. The following table summarizes the increases for the primary credit rate:

Date	Increase in Basis Points	Primary Credit Rate (%)
May 4, 2022	50	1.00%
March 17, 2022	25	0.50%

Interest on Reserve Balances (IORB): Prior to the pandemic, banks were required to keep a certain amount of reserves on deposit at the Fed. At that time, the central bank paid these banks a certain interest rate on those required reserves, namely the interest on required reserves, (IORR). Should banks have deposited more reserves than necessary, they were paid a separate interest rate on those balances commonly referred to as interest on excess reserves (IOER). However, starting July 28, 2021, the interest rate on required reserves (IORR) and the interest rate on excess reserves (IOER) were replaced with a single rate, the interest rate on reserve balances (IORB). This too, has become an important monetary tool.

The following table summarizes the increases for IORB:

Date	Increase in Basis Points	IORB
May 4, 2022	50	0.90%
March 17, 2022	25	0.40%

Reverse Repo Facility: To support its policy objectives, the FOMC has established repo and reverse repo facilities. In a reverse repurchase agreement (reverse repo), the Fed sells securities to a counterparty, such as primary government dealers, banks, GSEs, or money market funds, subject to an agreement to repurchase the securities at a later date (usually the next day). Reverse repo transactions temporarily reduce the supply of reserve balances in the banking system by pulling money out of the banking system. The following table summarizes the rate increases for the reverse repo facility:

Date	Increase in Basis Points	Reverse Repo Rate
May 4, 2022	50	0.80%
March 17, 2022	25	0.30%

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Since the March meeting, the Fed has been effectively rolling over more than $1.5 trillion in this reverse repo facility.

Quantitative Tapering Demystified

Now that the Fed has shifted their primary focus to fighting inflation, in addition to the anticipated rate hikes described above, they have introduced Quantitative Tapering (QT), which has been anticipated by the marketplace. Simply put, QT is reversing the monetary policy of Quantitative Easing (QE). Since the pandemic, the Fed implemented over $4 trillion of QE, by creating over $4 trillion of new cash, and using that cash to buy U.S. Treasuries and Agency MBS. The goal of QE was twofold: to inject more liquidity into the US economy, and to drive down long-term interest rates by driving up prices. This monetary tool was broadly accepted by most mature economies during the great recession, and re-implemented during the pandemic. As a monetary tool, QE was designed to help stimulate the economy.

Now the primary focus of the Fed is not growing the economy, but rather halting the rapid rise in inflation. The result is QT, whereby the Fed will start reducing the size of their bond portfolio (often referred to as their balance sheet), and pulling cash from the economy. At the March meeting the Fed statement stated:

> "Roll over at auction all principal payments from the Federal Reserve's holdings of Treasury Securities and reinvest all principal payments from the Federal Reserve's holdings of agency debt and agency mortgage-backed securities (MBS) in agency MBS."

However, at the May meeting, the Fed implemented caps on the amount they will purchase. Their statement said the following:

- Roll over at auction the amount of principal payments from the Federal Reserve's holdings of Treasury securities maturing in the calendar month of June that exceeds a monthly cap of $30 billion. Redeem Treasury coupon securities up to this monthly cap and Treasury bills to the extent that coupon principal payments are less than the monthly cap.
- Reinvest into agency mortgage-backed securities (MBS) the amount of principal payments from the Federal Reserve's holdings of agency debt and agency MBS received in the calendar month of June that exceeds a monthly cap of $17.5 billion.

Conclusion

This balancing act of trying to mute inflation without causing too much damage to the economy, if successfully accomplished, is often referred to as a "soft landing." Market observers know that, while admirable, a soft landing has historically been a very difficult objective to achieve. Central

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banks worldwide are now dealing with many of these same pressures, and working on achieving the proper monetary balance. Time will tell!

References

[1] Minutes of the Federal Open Market Committee March 15-16, 2022

[2] For a more detailed definition and analysis of these rates, please go to https://www.gfmi.com/articles/the-federal-reserves-tools-to-manage-monetary-policy/

About the Author

With over 24 years of managerial background in the financial industry, William "Bill" Addiss has been a professional designer and deliverer of custom financial learning events for 15 years. Prior to founding his own consulting service, Bill spent his first 23 years in the markets at Lehman Brothers, and its predecessor firms: Shearson and E.F. Hutton. As a Managing Director, Executive VP, Bill headed up the Fixed Income division of the firm. During his tenure there, he evolved through numerous responsibilities including National Sales Manager for Fixed Income, National Marketing Director, and Commodity Specialist. His first 4 years were in the Operations side of the business, before moving to Capital Markets front office responsibilities. As MD/EVP at Lehman, Bill managed a division of 257 professionals including Traders, and Trade Support Professionals.

He resigned from Lehman in 1999 to establish his own consulting/training firm, which designs, develops and delivers on-site and web-based programs for various international clients in the financial industry. Utilizing his managerial and industry experience, Bill has designed and delivered engaging programs focusing on Capital Markets, Fixed Income, Derivatives and other related topics. Accordingly, he has instructed programs for a wide variety of institutional clients, including Multi-National Banks, Investment Banks, Regulatory Agencies, Rating Agencies and Asset Managers. He is known for his inter-active manner of addressing current topics and applying the course materials in a relevant way to the participants' interests.

A speaker and lecturer as well, Bill has delivered for the Wharton/Arresty Institute and briefly served as the president of Community Securities in Rochester, NY, a regional broker dealer.

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