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Economics Group

Interest Rate Weekly

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The Fed's New Tools: Design Matters for Effectiveness

Part of the Federal Reserve's new tools to lift rates when the time is right is the Overnight Reverse Repo (ON RRP) facility but as we highlight this week, the final design is very important to ensure effectiveness.

An Overview of the Fed's New Tool: ON RRP Facility

Among the Federal Reserve's new tools for controlling short-term interest rates is the overnight reverse repo facility (ON RRP). The stated purpose of this new facility is to provide another mechanism beyond the payment of interest on excess reserves (IOER) to help the Fed control short-term interest rates. Recent evidence suggests that payment of interest on excess reserves (IOER) may not be enough to set a floor for short-term rates. This can be seen clearly in the top graph where the effective fed funds rate is consistently below the IOER rate. The main reason for this disparity is the limited number of parties that are allowed to trade in the fed funds market. In addition, there has been a downshift in activity in the fed funds market (middle graph). The introduction of the ON RRP facility will expand the set of counterparties and thus establish the ON RRP rate as the lower bound for rates. The challenge is that this facility, once it begins to be used to control short-term rates, will need to dramatically expand in size in order to exert influence on rates. The current testing phase limits show that the ON RRP has not been nearly large enough to set a floor on rates, given that the 1-month treasury yield has been consistently below this rate since March 2014.

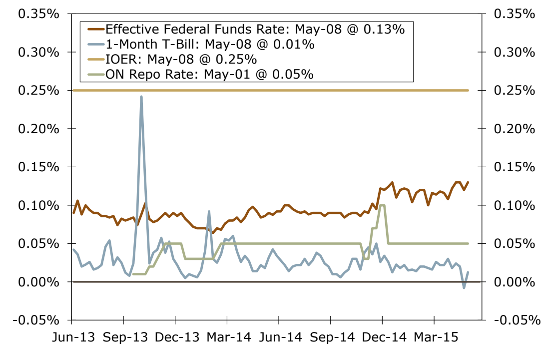
Risks of a Large Fed-Backed ON RRP Facility

Given that it appears the overnight reverse repo facility will need to be quite large in order to exert control over short-term rates, it is important to note some of the potential consequences of a large ON RRP facility. In particular, when global or domestic shocks send investors to safe haven securities, a large ON RRP facility, serving as a risk-free asset backed by the Federal Reserve, could become the new instrument that investors seek in addition to U.S. Treasury securities and other money market instruments which could create disruptions in the short-term funding markets.* Another issue that would arise would be the need for the Fed to expand the size of the ON RRP facility during these flight-to-quality periods in order to maintain the intended floor on short-term interest rates.

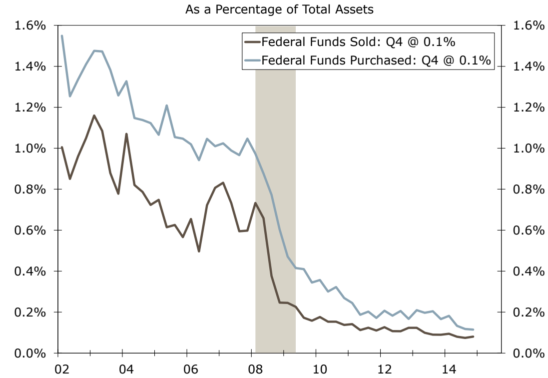
While there is a risk of the facility being too large, there is also a risk of the Fed making the facility too small by capping the size of transactions. Should the market become too constrained, money market investors would look elsewhere for lending opportunities and thus would be willing to invest at rates below the ON RRP rate, which would make the rate floor established by the facility ineffective.[1]

Thus, as the Fed moves from the testing phase to the implementation phase of the ON RRP facility this fall (bottom graph), the effectiveness of the facility will rest in its size, something that cannot be readily tested in advance. It is entirely possible that it will take time to find the ideal size of the ON RRP facility to maintain the needed control over short-term rates.

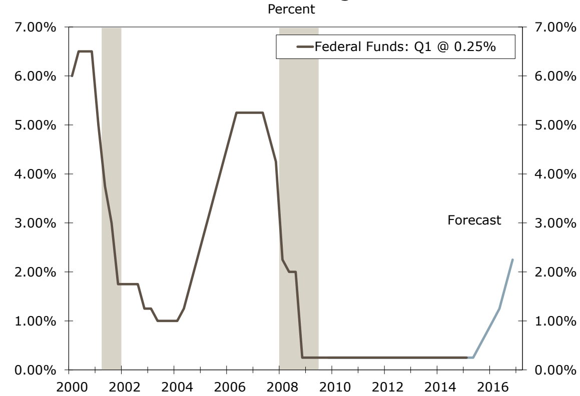
Money Market Rates



Federal Funds Sold and Purchased at Banks
As a Percentage of Total Assets



Federal Funds Target Rate
Percent



Source: IHS Global Insight, Federal Reserve System and Wells Fargo Securities, LLC

[1] Frost, et al. (2015). *"Overnight RRP Operations as a Monetary Policy Tool: Some Design Considerations."* Finance and Economics Discussion Series, Division of Research & Statistics and Monetary Affairs. Federal Reserve Board.

Wells Fargo U.S. Interest Rate Forecast

	Actual 2014				Forecast 2015				2016			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Quarter End Interest Rates												
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.75	1.00	1.25	1.75	2.25
3 Month LIBOR	0.23	0.23	0.24	0.26	0.27	0.30	0.70	0.95	1.20	1.45	1.95	2.45
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.50	3.75	4.00	4.25	4.75	5.25
Conventional Mortgage Rate	4.34	4.16	4.16	3.86	3.77	3.95	4.15	4.23	4.28	4.37	4.63	4.75
3 Month Bill	0.05	0.04	0.02	0.04	0.03	0.13	0.55	0.86	1.15	1.43	1.81	2.28
6 Month Bill	0.07	0.07	0.03	0.12	0.14	0.27	0.63	0.91	1.22	1.52	1.85	2.35
1 Year Bill	0.13	0.11	0.13	0.25	0.26	0.30	0.69	0.99	1.24	1.57	1.89	2.43
2 Year Note	0.44	0.47	0.58	0.67	0.56	0.70	0.87	1.07	1.26	1.71	2.00	2.46
5 Year Note	1.73	1.62	1.78	1.65	1.37	1.68	1.78	1.89	2.01	2.19	2.31	2.59
10 Year Note	2.73	2.53	2.52	2.17	1.94	2.19	2.35	2.41	2.46	2.53	2.77	2.89
30 Year Bond	3.56	3.34	3.21	2.75	2.54	2.77	2.89	2.99	3.09	3.18	3.39	3.58

Forecast as of: May 13, 2015

Wells Fargo U.S. Economic Forecast and FOMC Central Tendency Projections

	2015	2016	2017
Change in Real Gross Domestic Product			
Wells Fargo	2.1	2.9	N/A
FOMC	2.3 to 2.7	2.3 to 2.7	2.0 to 2.4
Unemployment Rate			
Wells Fargo	5.2	4.8	N/A
FOMC	5.0 to 5.2	4.9 to 5.1	4.8 to 5.1
PCE Inflation			
Wells Fargo	0.9	2.1	N/A
FOMC	0.6 to 0.8	1.7 to 1.9	1.9 to 2.0

Forecast as of: May 13, 2015

NOTE: Projections of change in real gross domestic product (GDP) and in inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation is the percentage rate of change in the price index for personal consumption expenditures (PCE). Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated.

Fed Data as of: March 18, 2015

Source: IHS Global Insight, Federal Reserve Board and Wells Fargo Securities, LLC

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