June 14, 2017

Fed: One more hike and start of balance sheet normalization in 2017

As widely expected, the Federal Reserve raised the fed funds rate by 25 basis points to 1.25%. The Fed supported its decision to hike by referring to improved economic data such as a pick-up in household spending and continued expansion of business investment. While bemoaning below-target inflation, the Fed continues to expect inflation to stabilize around the 2% objective over the medium term. The FOMC expects that economic conditions will evolve in a manner that "will warrant gradual increases in the federal funds rate". The Fed is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction. But it expects to begin implementing a balance sheet normalization program this year "provided that the economy evolves broadly as anticipated". When it starts to normalize the balance sheet, it will reinvest only to the extent that the principal payment exceeds gradually rising caps. For Treasuries, the cap is expected to be $6 bn/month, to be increased by $6 bn every three months until hitting $30 bn/month. For agency debt and MBS the cap will be $4bn/month initially and will increase in steps of $4 bn every three months until hitting $20 bn/month. Neel Kashkari, a known dove, was the only dissenter. He wanted the fed funds rate to remain unchanged.

Fed's new projections:

The central tendency forecast for GDP growth (Q4/Q4) was little changed: 2.1-2.2% for 2017 (versus 2.0-2.2% previously), 1.8 to 2.2% for 2018 (versus 1.8 to 2.3% previously), 1.8 to 2.0% for 2019 (unchanged). The central tendency projections for the unemployment rate were lowered quite a bit: 4.2-4.3% for 2017 (4.5 to 4.6% previously), 4.0 to 4.3% for 2018 (4.3 to 4.6% previously), 4.1 to 4.4% for 2019 (4.3 to 4.7% previously). Inflations forecasts were nudged down for 2017.

The dot plots, presented useful information about how participants feel about the pace of policy firming going forward. There are now no participants seeing rates above 2% by the end of 2017 (versus 1 previously). However, the dot plots still point to one additional hike this year. Participants' view of the "equilibrium interest rate" has fallen marginally, although the median was unchanged at 3.00%. Fourteen of the 17 participants see the nominal fed funds rate between 2.50% and 3.00% in the long run.

Press conference:

Chair Yellen said that it is important the FOMC achieves its inflation target. However, core inflation has been weak and it is expected to remain below target for some time due to base effects. However, she said the FOMC does not want to react to few data points that can be noisy. She pointed out that the FOMC is confident that the conditions are in place to achieve its 2% inflation target over time. The pace of job creation remains above what is needed to absorb new participants in the labor market. While the Philips curve is flat, it only means it will take more time and a lower unemployment rate to get the desired acceleration in wage inflation. Chair Yellen indicated the FOMC intends to proceed gradually in removing monetary accommodation, in order to keep the expansion on a sustainable path. The shrinkage of the balance sheet is expected to be gradual enough as to "play quietly in the background". In other words, interest rates will remain the primary tool for conducting monetary policy. The process of reducing the size of the balance sheet could start relatively soon according to Chair Yellen.

Bottom line:

The Fed expects to deliver one more rate hike this year (a forecast that we share) and to start reducing the size of its balance sheet. However, the FOMC's plans rest on the economy performing well and on its confidence that inflation will rise towards its 2% target over the medium term. The continuing downward revisions of forecasts for the jobless rate just highlights the Fed's struggles in estimating the non-accelerating inflation rate of unemployment (NAIRU), which explains why wage inflation and hence overall inflation have been much weaker than it expected. Should inflation remain stubbornly weak or unexpected shocks arise, the FOMC is likely to delay further tightening of monetary policy.

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Here is the Fed's statement (emphasis is ours):

Information received since the Federal Open Market Committee met in May indicates that **the labor market has continued to strengthen** and that economic activity has been rising moderately so far this year. Job gains have moderated but have been solid, on average, since the beginning of the year, and the unemployment rate has declined. **Household spending has picked up in recent months, and business fixed investment has continued to expand**. On a 12-month basis, inflation has declined recently and, like the measure excluding food and energy prices, is running somewhat below 2 percent. Market-based measures of inflation compensation remain low; survey-based measures of longer-term inflation expectations are little changed, on balance.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee continues to expect that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace, and labor market conditions will strengthen somewhat further. **Inflation on a 12-month basis is expected to remain somewhat below 2 percent in the near term but to stabilize around the Committee's 2 percent objective over the medium term.** Near term risks to the economic outlook appear roughly balanced, but the Committee is monitoring inflation developments closely.

In view of realized and expected labor market conditions and inflation, **the Committee decided to raise the target range for the federal funds rate to 1 to 1-1/4 percent**. The stance of monetary policy remains accommodative, thereby supporting some further strengthening in labor market conditions and a sustained return to 2 percent inflation.

In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its objectives of maximum employment and 2 percent inflation. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments. The Committee will carefully monitor actual and expected inflation developments relative to its symmetric inflation goal. The Committee expects that economic conditions will evolve in a manner that will warrant gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run. However, the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data.

The Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction. **The Committee currently expects to begin implementing a balance sheet normalization program this year, provided that the economy evolves broadly as anticipated.** This program, which would gradually reduce the Federal Reserve's securities holdings by decreasing reinvestment of principal payments from those securities, is described in the accompanying addendum to the Committee's Policy Normalization Principles and Plans.

Voting for the FOMC monetary policy action were: Janet L. Yellen, Chair; William C. Dudley, Vice Chairman; Lael Brainard; Charles L. Evans; Stanley Fischer; Patrick Harker; Robert S. Kaplan; and Jerome H. Powell. Voting against the action was Neel Kashkari, who preferred at this meeting to maintain the existing target range for the federal funds rate.

FED Policy Monitor

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