NATIONAL BANK OF CANADA
FINANCIAL MARKETS

FED Policy Monitor

Economics and Strategy

December 13, 2017

A rate hike for Christmas

As widely expected, the Federal Reserve increased the fed funds rate by 25 basis points to 1.25-1.50%. The Fed will continue to reduce the size of its balance sheet as announced earlier. It was encouraged by a strengthening labour market and the fact that economic activity "has been rising at a solid rate". Inflation is expected to remain below 2% in the near term but the Fed still expects it to stabilize around 2% "over the medium term". The FOMC thinks near-term risks to the economic outlook is roughly balanced.

The decision was not unanimous within the FOMC as both Charles Evans and Neel Kashkari preferred to keep rates unchanged.

Fed's new economic projections:

The central tendency forecast for real GDP growth (Q4/Q4) was raised for 2018 to 2.2-2.6% (versus 2.0-2.3% previously), and for 2019 at 1.9-2.3% (versus 1.7-2.1% previously), while 2020 growth was little changed at 1.7-2.0%. As a result, the central tendency projections for the unemployment rate was revised down quite substantially (to 3.7-4.0% in 2018). However, inflation forecasts were little changed.

The dot plots still point to three rate hikes in 2018. For 2019 and 2020, the dot plots are slightly less dispersed than last September. Participants' estimate of the "equilibrium interest rate" has dropped again to 2.25%-3.00% (25 bps trimmed from the upper range). The majority of FOMC participants expect to reach the median of 2.75% by 2019 before rising above 3% by 2020 (i.e. overshooting the long-run equilibrium).

Press conference:

A large portion of the press conference dealt with the tax cuts and their potential implications for the economy and the monetary policy outlook. Chair Yellen mentioned that for some time FOMC participants had already included in their projections some view about the tax proposals. Consequently, one cannot look at the revised median GDP growth rate as being an indication of what participants believe the impact of tax cuts will be. Still, Yellen acknowledged that tax cuts will support modestly economic growth and could contribute to lift potential GDP. However, she was quick to say there was considerable uncertainty regarding the effective impact they will have over time. Chair Yellen reiterated that the inflation undershoot in 2017 could be explained by transitory factors not related to the macroeconomic situation, but recognised that NAIRU may have come down more than the Fed believed. So the Committee will watch inflation closely and may revise its policy stance if needed. To a question about what should be read from the slope of the yield curve, Chair Yellen pointed out that while the correlation between inverted yield curves and recessions has been high, correlation does not mean causality. The 10-year yield can be broken down between the expected average short rate over the term to maturity and the term premium. She noted that currently the term premium is quite low and this is contributing to the shape of the yield curve. So, even if monetary policy was to become marginally tight, the curve could become inverted although the policy stance would not be a source of concern for economic growth. According to Chair Yellen, market participants see the odds of a recession as being quite low.

Bottom line:

The Fed's decision to raise interest rates was based on a strengthening economy and confidence that inflation will eventually pick up. Interestingly, while growth was revised up and the jobless rate was revised down, inflation was left basically unchanged, highlighting the Fed's continuing difficulties in gauging price pressures. As such, one cannot rule out that the Fed's models and hence its view about the pace of monetary tightening will be revised in the future as additional data and research become available. The median FOMC participants projections still point to three rate hikes in 2018, which is one more than what we currently anticipate.

Krishen Rangasamy/Paul-André Pinsonnault

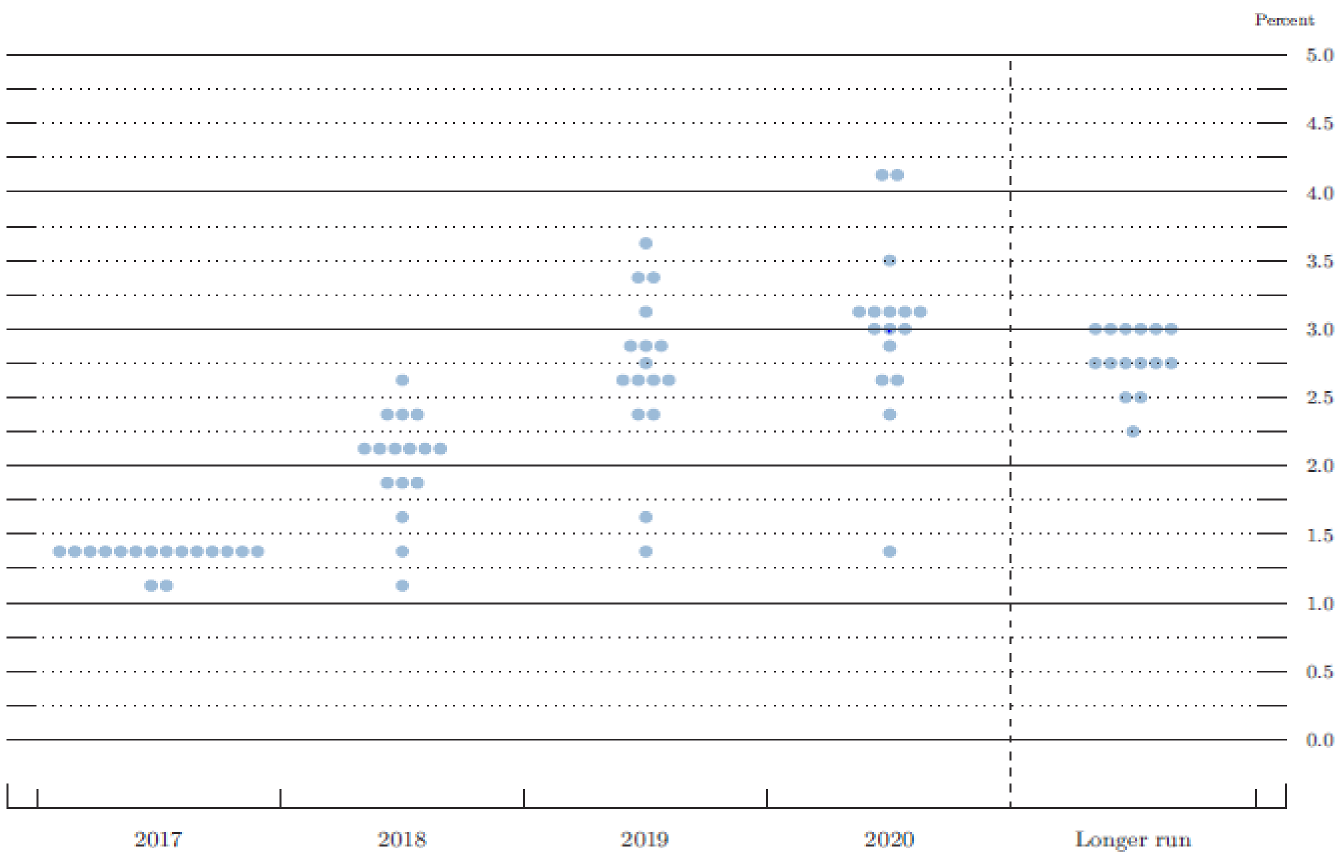
Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents under their individual assessments of projected appropriate monetary policy, December 2017

Advance release of table 1 of the Summary of Economic Projections to be released with the FOMC minutes

Percent

Variable	Median[1]					Central tendency[2]					Range[3]				
	2017	2018	2019	2020	Longer run	2017	2018	2019	2020	Longer run	2017	2018	2019	2020	Longer run
Change in real GDP	2.5	2.5	2.1	2.0	1.8	2.4 – 2.5	2.2 – 2.6	1.9 – 2.3	1.7 – 2.0	1.8 – 1.9	2.4 – 2.6	2.2 – 2.8	1.7 – 2.4	1.1 – 2.2	1.7 – 2.2
September projection	2.4	2.1	2.0	1.8	1.8	2.2 – 2.5	2.0 – 2.3	1.7 – 2.1	1.6 – 2.0	1.8 – 2.0	2.2 – 2.7	1.7 – 2.6	1.4 – 2.3	1.4 – 2.0	1.5 – 2.2
Unemployment rate	4.1	3.9	3.9	4.0	4.6	4.1	3.7 – 4.0	3.6 – 4.0	3.6 – 4.2	4.4 – 4.7	4.1	3.6 – 4.0	3.5 – 4.2	3.5 – 4.5	4.3 – 5.0
September projection	4.3	4.1	4.1	4.2	4.6	4.2 – 4.3	4.0 – 4.2	3.9 – 4.4	4.0 – 4.5	4.5 – 4.8	4.2 – 4.5	3.9 – 4.5	3.8 – 4.5	3.8 – 4.8	4.4 – 5.0
PCE inflation	1.7	1.9	2.0	2.0	2.0	1.6 – 1.7	1.7 – 1.9	2.0	2.0 – 2.1	2.0	1.5 – 1.7	1.7 – 2.1	1.8 – 2.3	1.9 – 2.2	2.0
September projection	1.6	1.9	2.0	2.0	2.0	1.5 – 1.6	1.8 – 2.0	2.0	2.0 – 2.1	2.0	1.5 – 1.7	1.7 – 2.0	1.8 – 2.2	1.9 – 2.2	2.0
Core PCE inflation[4]	1.5	1.9	2.0	2.0		1.5	1.7 – 1.9	2.0	2.0 – 2.1		1.4 – 1.5	1.7 – 2.0	1.8 – 2.3	1.9 – 2.3	
September projection	1.5	1.9	2.0	2.0		1.5 – 1.6	1.8 – 2.0	2.0	2.0 – 2.1		1.4 – 1.7	1.7 – 2.0	1.8 – 2.2	1.9 – 2.2	
Memo: Projected appropriate policy path															
Federal funds rate	1.4	2.1	2.7	3.1	2.8	1.4	1.9 – 2.4	2.4 – 3.1	2.6 – 3.1	2.8 – 3.0	1.1 – 1.4	1.1 – 2.6	1.4 – 3.6	1.4 – 4.1	2.3 – 3.0
September projection	1.4	2.1	2.7	2.9	2.8	1.1 – 1.4	1.9 – 2.4	2.4 – 3.1	2.5 – 3.5	2.5 – 3.0	1.1 – 1.6	1.1 – 2.6	1.1 – 3.4	1.1 – 3.9	2.3 – 3.5

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



Here is the Fed's statement:

Information received since the Federal Open Market Committee met in November indicates that the labor market has continued to strengthen and that economic activity has been rising at a solid rate. Averaging through hurricane-related fluctuations, job gains have been solid, and the unemployment rate declined further. Household spending has been expanding at a moderate rate, and growth in business fixed investment has picked up in recent quarters. On a 12-month basis, both overall inflation and inflation for items other than food and energy have declined this year and are running 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. Hurricane-related disruptions and rebuilding have affected economic activity, employment, and inflation in recent months but have not materially altered the outlook for the national economy. Consequently, 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 remain strong. 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 1-1/4 to 1-1/2 percent. The stance of monetary policy remains accommodative, thereby supporting strong 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.

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

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