September 20, 2017

Fed upgrades growth forecasts and starts balance sheet normalization

As widely expected, the Federal Reserve kept unchanged the fed funds rate at 1.00-1.25%. The Fed acknowledged improving economic data such as a strengthening labour market, continued expansion in household spending and a pick-up of business investment. But it was still concerned about below-target inflation. It sees a temporary increase for inflation due to a hurricane-related gasoline price spike, but expects inflation will remain somewhat below 2% over the near term and stabilize around 2% "in the medium term". The Fed views risks to the economic outlook as "roughly balanced". There was mention of the devastation caused by hurricanes, but the Fed was quick to point out that "past experience suggests that the storms are unlikely to materially alter the course of the national economy over the medium term". The Fed continues to expect economic conditions will evolve in a manner that "will warrant gradual increases in the federal funds rate".

The Fed made it official in today's statement that it will start the process of reducing the size of its balance sheet in October. Proceeds received from principal payments on its bond holdings will be reinvested, but only to the extent that the principal payment exceeds gradually rising caps as detailed in a separate statement last June: For Treasuries, the cap is $6 bn/month, to be increased by $6 bn every three months until hitting $30 bn/month. For agency debt and MBS the cap is $4bn/month, but will increase in steps of $4 bn every three months until hitting $20 bn/month.

The decision was unanimous within the FOMC.

Fed's new economic projections:

The central tendency forecast for real GDP growth (Q4/Q4) was raised for 2017 to 2.2-2.5% (versus 2.1-2.2% previously) and for 2018 to 2.0-2.3% (versus 1.8-2.2% previously), and was little changed for 2019 at 1.7-2.1% (versus 1.8-2.2% previously). The central tendency projections for the unemployment rate was left little changed at 4.2-4.3% for 2017 (4.2-4.3% previously), 4.0-4.2% for 2018 (4.0-4.3% previously), but lowered for 2019 to 3.9-4.4% (4.1-4.4% previously). For the first time, the Fed presented its projections for 2020, with growth in that year expected to be in the range 1.6-2.0% while the unemployment rate is expected to be between 4.0 and 4.5%. Inflations forecasts were nudged down slightly for 2017.

The dot plots still point to one additional rate hike this year and three in 2018 (although there are now two members, up from just one last June, who see no rate hike next year). For 2019 and 2020, the dot plots show very little consensus among participants (see dot plots below).

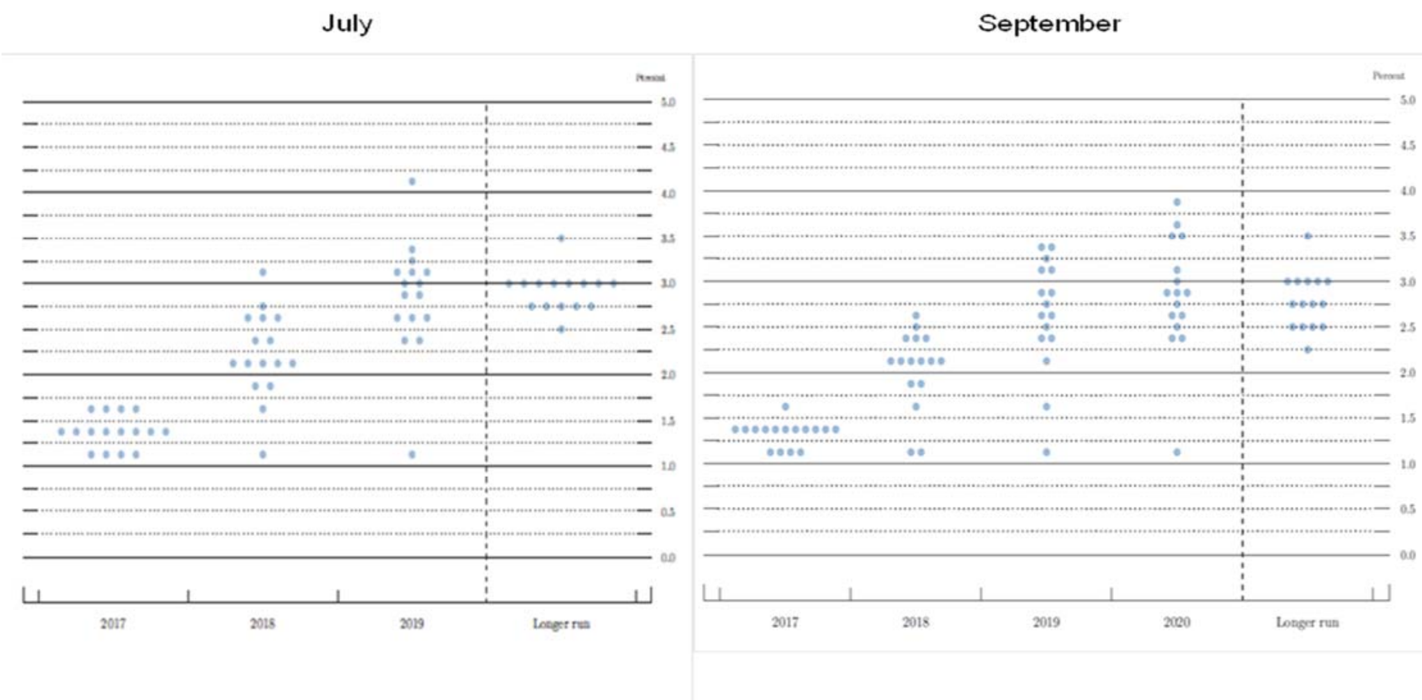
Press conference:

In her press conference, Chair Yellen pointed out that the decision to raise rates earlier this year and to announce that balance sheet normalization was taken because the FOMC is confident the economy is doing well and does not require as much monetary policy stimulus anymore. Yet, Chair Yellen, like many economists, was unsure why inflation remains low. If the factors that are keeping inflation low prove to be more permanent than expected, the path of the fed funds rate will be revised accordingly. However, according to Chair Yellen the bar is high to reverse the decision regarding the balance sheet shrinkage. The chair repeated that the fed funds rate remains the primary tool of monetary policy. Reinvestment would only be considered if there was a threat of returning to the zero lower bound. Chair Yellen also mentioned that the FOMC could use other tools such as forward guidance if needed. Regarding her own future, Chair Yellen limited herself to say that she intends to serve her full mandate.

Bottom line:

The decision to shrink the balance sheet and leave rates unchanged came as no surprise. The Fed maintained a positive view on the economy as evidenced by upgrades to its growth forecasts, and it left the door open for higher rates ahead. However, persistently low inflation remains a problem. The Fed is more optimistic than markets, expecting four rate hikes by the end of 2018 (versus just one expected by markets). Our own forecast is sandwiched between those two views, because we anticipate three additional hikes until the end of next year.

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, September 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	2.4	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
June projection	2.2	2.1	1.9	n.a.	1.8	2.1 – 2.2	1.8 – 2.2	1.8 – 2.0	n.a.	1.8 – 2.0	2.0 – 2.5	1.7 – 2.3	1.4 – 2.3	n.a.	1.5 – 2.2
Unemployment rate	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
June projection	4.3	4.2	4.2	n.a.	4.6	4.2 – 4.3	4.0 – 4.3	4.1 – 4.4	n.a.	4.5 – 4.8	4.1 – 4.5	3.9 – 4.5	3.8 – 4.5	n.a.	4.5 – 5.0
PCE inflation	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
June projection	1.6	2.0	2.0	n.a.	2.0	1.6 – 1.7	1.8 – 2.0	2.0 – 2.1	n.a.	2.0	1.5 – 1.8	1.7 – 2.1	1.8 – 2.2	n.a.	2.0
Core PCE inflation[4]	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	
June projection	1.7	2.0	2.0	n.a.		1.6 – 1.7	1.8 – 2.0	2.0 – 2.1	n.a.		1.6 – 1.8	1.7 – 2.1	1.8 – 2.2	n.a.	
Memo: Projected appropriate policy path															
Federal funds rate	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
June projection	1.4	2.1	2.9	n.a.	3.0	1.1 – 1.6	1.9 – 2.6	2.6 – 3.1	n.a.	2.8 – 3.0	1.1 – 1.6	1.1 – 3.1	1.1 – 4.1	n.a.	2.5 – 3.5

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

Information received since the Federal Open Market Committee met in July indicates that **the labor market has continued to strengthen and that economic activity has been rising moderately so far this year**. Job gains have remained solid in recent months, and the unemployment rate has stayed low. 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, **overall inflation and the measure excluding food and energy prices 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. Hurricanes Harvey, Irma, and Maria have devastated many communities, inflicting severe hardship. **Storm-related disruptions and rebuilding will affect economic activity in the near term, but past experience suggests that the storms are unlikely to materially alter the course of the national economy over the medium term.** 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 strengthen somewhat further. **Higher prices for gasoline and some other items in the aftermath of the hurricanes will likely boost inflation temporarily; apart from that effect, 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 maintain the target range for the federal funds rate at 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.

In October, the Committee will initiate the balance sheet normalization program described in the June 2017 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; Neel Kashkari; and Jerome H. Powell..

FED Policy Monitor

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