Central Banks

FOMC Statement: December 13-14th Meeting

Boyd Nash-Stacey

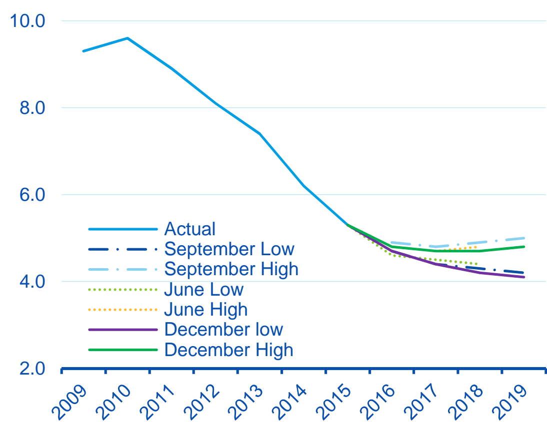
Committee seeing white of eyes, but not pulling the eggnog… yet

- **After a yearlong pause FOMC unanimously votes to raise interest rates 25bp**
- **Press conference and SEP suggest committee will have limited tolerance for unneeded fiscal policy**
- **Meeting opens the door to an additional three rate increases in 2017**
- **However, next year's FOMC voting rotation amplifies dovish bias**

The FOMC at its December meeting increased the Fed funds rate 25bp to 0.75% "in view of realized and expected labor market conditions and inflation." With market expectations fully pricing in a rate increase, positive financial developments in the post-election period, and employment and inflation edging closer to its targets, the move resuming policy normalization was consistent with its data dependent strategy. Following the announcement the S&P was up slightly, with the largest move coming in FX markets with the dollar appreciating across a broad set of major currencies, particularly those with accommodative monetary policy. Ten-year yields closed at 2.57%, reaching their highest level in more than two years.

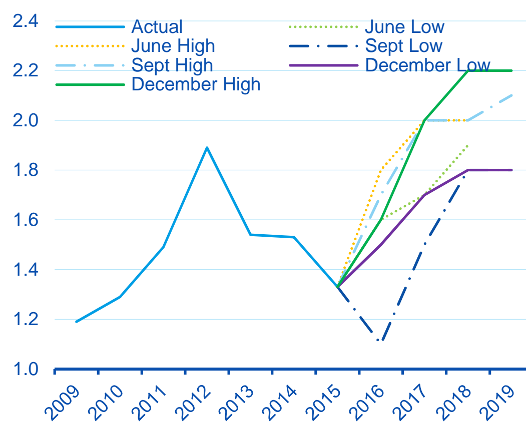
Based on the Summary of Economic Projections (SEP) it seems the recent market exuberance has not diverted the FOMC from its current strategy for a gradual increase in the near future. In fact, the SEP was little changed from the last meeting with only slight downward revision to the unemployment rate (UR) and upward revision to GDP; long-run ranges for inflation, GDP and UR were unchanged. The median projected path of the Federal Funds rate of the so-called dot plot moved up slightly to 1.4, implying 3 rate increases next year, one more than in the previous projections.

Chart 1
SEP Unemployment Rate



Source: FRB & BBVA Research

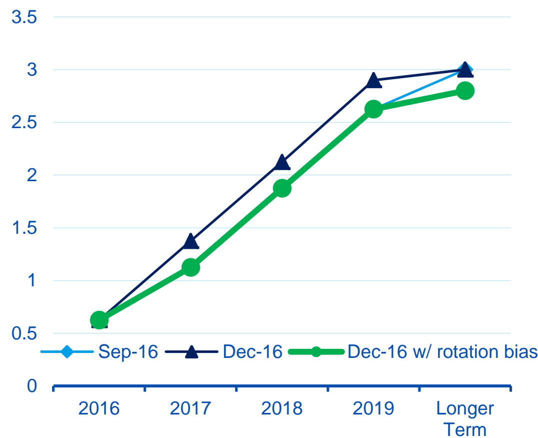
Chart 2
SEP Inflation



Source: FRB & BBVA Research

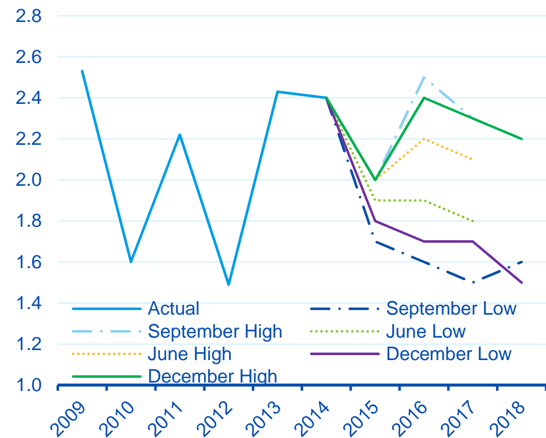
Some of the ambiguities left from the minor revisions to FOMC's outlook were cleared during the Q&A. At the press conference, Yellen responded to a question about the reasons for the committee's projections for steeper implied rate saying that the change was due to lower unemployment, but also to some member's expectations for a greater impact from fiscal policy. In more direct questioning about how tolerant the Fed would be to pro-cyclical fiscal policy, Yellen stated that she favored polices focused on education and training, workforce participation, public-private partnerships and innovation and competition, as a way to boost productivity and well-being. This is consistent with the idea that the committee may be somewhat tolerant to higher inflation and undershooting unemployment due to the perceived stance of monetary being only "moderately" accommodative and that the economy was on a "good path", but that it would like to see fiscal policy directed at boosting productivity rather than stimulating the economy. At one point Yellen clarified that the call by Bernanke and herself for greater support from fiscal policy was at a time when the UR was substantially higher. In fact, she said that the labor market today looks "a lot" like the pre-recession period.

Chart 3
SEP Dot Plot (Median)



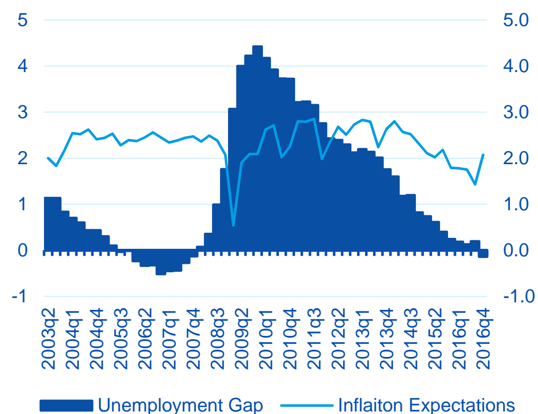
Source: FRB & BBVA Research

Chart 4
GDP Growth



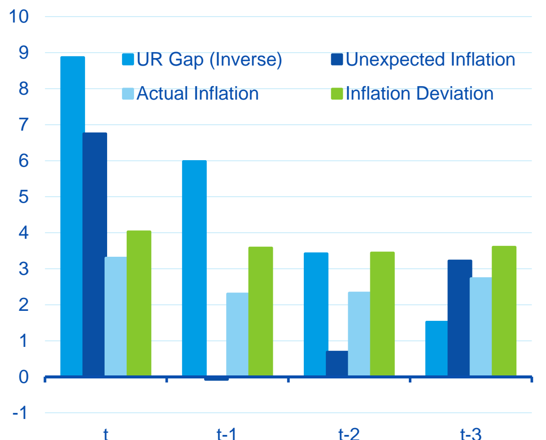
Source: FRB & BBVA Research

Chart 5
UR Gap and Inflation Expectations, PP & %



Source: Haver Analytics & BBVA Research

Chart 6
Marginal Probability of Fed Rate Increase, %



Source: BBVA Research

Nevertheless, if Trump is successful in implementing his fiscal agenda the Fed will have to confront the likelihood of an accelerated narrowing of the output gap and the prospects of higher inflation, unless the level of slack remaining is greater than originally expected or the economy experiences a productivity shock.

Based on past tightening cycles, it seems the Fed will have little tolerance for unexpected inflation shocks or a significant overshooting of the output gap. In fact, all else equal, a one percent change in unexpected inflation or undershooting of the long-term UR increases the probability of a rate hike by ~15%. The task of remaining patient will also be complicated by the fact that the current UR is at 4.6%, which is below the committee's long-run projections and most current NAIRU estimates. In addition, wages are rising, energy prices are edging up, and a handful of inflation measures are running at or slightly below the Fed's benchmark, suggesting that being overly patient could lower the FOMC's credibility of data dependency strategy.

Some committee members seem open to the prospects of a bounce out of the zero lower bound. In fact, Bullard's recent comments hinted that the "end of divided government", deregulation and tax reform could support structural shifts away from the low r* environment. How much this shift translates into short-term growth will depend on the Fed's response. If Dudley's comments provided roadmap for the committee's mood, the space for overly aggressive fiscal policy is limited given where the Fed is in terms of its tightening cycle.

Moreover, the FOMC reshuffle in January will amplify the committee's dovishness, likely giving Trump some running room in his first term. In fact, the three 2016 dissenters (Rosengren, Mester, George) will all rotate out in 2017 while one centrist, two doves and a moderate hawk rotate in. In 2018, however, the bias will swing back to one that stands to be the most hawkish in years. Trump will have the ability to appoint two new board members, suggesting that the committee's appetite for tightening could strengthen in 2018–although, dovish appointees would likely compliment his fiscal agenda. Taken together, the risks to a faster tightening cycle have increased modestly in the post-election period, but we maintain our forecasts for two 25bp rate increases in 2017.

Bottom Line

After a yearlong pause the FOMC voted unanimously to raise interest rates 25bp to 0.5-0.75%. Based on the Summary of Economic Projections (SEP) and Yellen's press conference it seems the recent market exuberance has not diverted the Fed from its current strategy for a gradual increases. The press conference reinforced the idea that the committee may be somewhat tolerant in the short-run, but that it would like to see fiscal policy directed at boosting productivity rather than stimulating the economy. Nevertheless, based on the Fed's historical reaction function, it also seems the Fed will have limited tolerance for unexpected inflation shocks, and significant undershooting of the long-term unemployment rate. The FOMC reshuffle in January will add to the dovish zeitgeist lowering the probability of three rate increases in 2017 and giving Trump some running room in early term. Regardless, we don't think this meeting suggests Christmas has come early for Trump's economic agenda and thus we maintain our baseline for two 25bp increase in 2017.

DISCLAIMER

This document was prepared by Banco Bilbao Vizcaya Argentaria's (BBVA) BBVA Research U.S. on behalf of itself and its affiliated companies (each BBVA Group Company) for distribution in the United States and the rest of the world and is provided for information purposes only. Within the US, BBVA operates primarily through its subsidiary Compass Bank. The information, opinions, estimates and forecasts contained herein refer to the specific date and are subject to changes without notice due to market fluctuations. The information, opinions, estimates and forecasts contained in this document have been gathered or obtained from public sources, believed to be correct by the Company concerning their accuracy, completeness, and/or correctness. This document is not an offer to sell or a solicitation to acquire or dispose of an interest in securities.