BBVA | Research

CENTRAL BANKS

FOMC Meeting December 12th-13th

Nathaniel Karp / Boyd Nash-Stacey

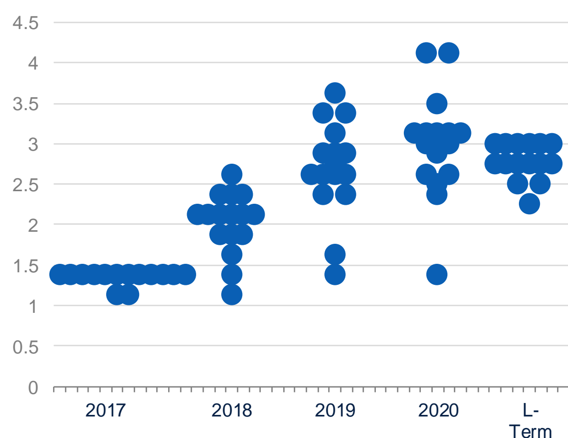
13 December 2017

FOMC: Passing the Baton for Final Phase of Normalization

As we expected, the FOMC increased the Fed funds rate to 1.25%-1.50%. This marked the fifth 25bp increase since December 2015, when the FOMC began to start the monetary policy normalization process. In the statement, the FOMC highlighted that "economic activity has been rising at a solid rate" and "job gains have been solid". In addition, despite inflation continuing below the FOMC target, the Fed echoed that inflation will converge with the 2% target.

Regarding the economic outlook, the Fed made nontrivial changes to the short-term but left the long-term unaltered. For 2018-2019, the median estimates for GDP improved significantly while those for inflation and federal funds remained unchanged. Meanwhile, the unemployment rate was revised downwards for 2018-2019, dipping below 4% for the first time. These changes suggest that most members incorporated positive short-term effects from tax cuts on GDP growth and unemployment but muted effects on inflation and interest rates. In part, this reflects that members embrace a longer period of undershooting the unemployment target to reduce remaining labor market slack and thus generate a bit more price pressures to facilitate a return to the 2% inflation target. In addition, it would seem that for most members the tax reform will not require a different monetary policy response than previously expected, implying that the tax cuts are not considered to pose risks to inflation while still able to boost economic growth in the short-run.

Figure 1. FOMC Dot Plot: Fed Funds Rate, eop, %



Source: BBVA Research & FRB

Figure 2. Fed Summary of Economic Projections

Median, %	2017	2018	2019	2020	Long-run
GDP	2.5	2.5	2.1	2.0	1.8
Previous	2.4	2.1	2.0	1.8	1.8
Unemployment Rate	4.1	3.9	3.9	4.0	4.6
Previous	4.3	4.1	4.1	4.2	4.6
PCE inflation	1.7	1.9	2.0	2.0	2.0
Previous	1.6	1.9	2.0	2.0	2.0

Source: FRB; GDP & PCE are 4Q/4Q, UR is 4Q avg.

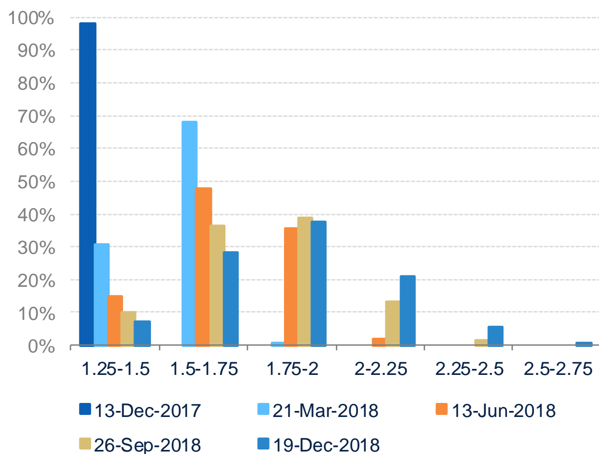
Source: BBVA Research & Bloomberg

During the press conference, Chair Yellen indicated that: "participants generally identified changes in tax policy as a factor supporting this modestly stronger outlook". This implies that if Congress passes new tax legislation the Fed is more likely to meet its projected path for normalization. Yellen also pointed out that "my colleagues and I continue to believe that the factors that are responsible this year for holding inflation down are likely to prove transitory". This is consistent with the view that the FOMC will continue raising interest rates and get closer to full policy normalization.

While our current baseline scenario assumes two additional rate increases in 2018, risks continue tilting to the upside. First, the estimate of the natural interest rate is likely to edge up as a result of strengthening economic fundamentals. Second, market expectations continue converging with the Fed's outlook for the appropriate pace of policy firming. Third, Congress eagerness to pass tax reform increases the upside risks to both GDP and inflation. Lastly, financial market conditions remain more accommodative than previously anticipated.

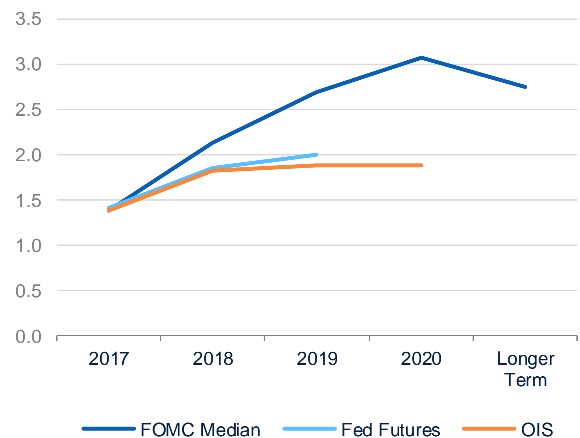
Nevertheless, many participants remain concerned that low inflation might reflect the influence of more persistent factors rather than temporary developments. In addition, some Fed officials are bringing attention to the possibility of an inverted yield curve if Fed funds continue on its expected path, which could impact business expectations. In addition, some members remain skeptical on the trade-offs brought about by the tax proposals.

Figure 3. Implied Fed Funds Probability, %



Source: BBVA Research & Bloomberg

Figure 4. Fed Funds Expectations, %



Source: BBVA Research & Bloomberg

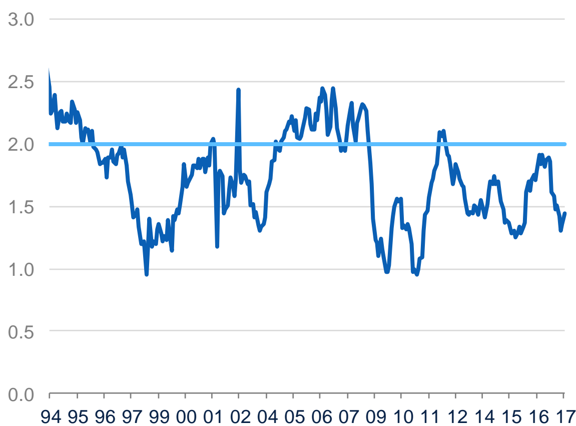
As Yellen steps down, the economy is at or near full employment and inflation is well anchored. In fact, the unemployment rate is at the lowest level since 2001, and since Yellen was named Fed Chair core PCE inflation has averaged 1.6% amid a standard deviation of one-half the historical average. In this regard, Yellen deserves high marks when it comes to achieving the Fed's dual mandate. This may not sound surprising given her strong academic record and long career at the Federal Reserve. Moreover, her expertise on labor economics proved to be one of her strongest assets given the sharp structural changes in the labor market that followed the Great Recession.

Critics would point out that according to alternative measures, labor market conditions may not be as healthy as they look. This is particularly the case when considering the share of people working part-time or holding two jobs, or the number of people that have stopped looking for a job and are not counted as part of the unemployed population. In this sense, critics would suggest that the Fed could have done more to improve labor conditions, particularly when considering the prolonged period of low inflation.

Others would highlight the Fed's failure to accurately distinguish cyclical vs. structural shocks, which lowered the Fed's credibility. For example, in early 2014 the Fed's long-run expectations for the unemployment rate and the policy interest rate were 5.4% and 3.9%, respectively. Since then, the FOMC has consistently revised down these forecasts and currently anticipates the unemployment rate to converge with 4.6% and the Fed funds to stabilize at around 2.8%. In a recent speech, Minneapolis Fed President N. Kashkari indicated that FOMC policy probably contributed to falling inflation expectations, and weaker job growth, wage growth and inflation.

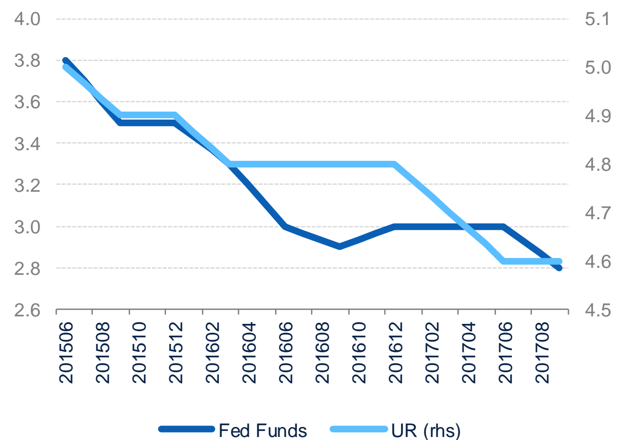
Nevertheless, using monetary policy to fix a structural problem has never been recommended or effective. In fact, during Yellen's tenure Congress failed to complement monetary policy with appropriate responses to deal with the structural challenges facing the economy. Thus, Yellen's performance has to be balanced with the hand she was dealt and the players sitting at the table. Last but not least, while the U.S is one of the most diverse central banks, Yellen was the first female Fed Chair highlighting the importance of enhancing diversity and inclusion within the Fed.

Figure 5. Core PCE Inflation and Fed Target, 12m % change & %



Source: BBVA Research & Haver

Figure 6. FOMC Long-Run Forecasts, % eop & % 4Q



Source: BBVA Research & FRB

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.