BBVA | Research

Yellen steers the markets

Diario El País (Spain)

Sonsoles Castillo

19 Jun 2017

On Wednesday 14 June, the Federal Reserve stayed true to the script by raising interest rates to 1.25%, although there was more to the move than just the rate hike. There are at least three elements from the recent meeting on monetary policy which deserve special mention. Firstly, it represents a show of confidence in the American economy. Despite the recent pessimism as a result of the failure of Trump's expected policy measures to materialise and the disappointment on the publication of recent economic activity and inflation figures, the Fed's view remains unaltered: no change to growth forecasts (an average of 2% over the coming two years), a decline in unemployment to 4.2% and, although it has tempered inflation forecasts for this year, it has maintained its perspective of 2% for the next two years. Within this context, in which practically all slack in the labour market has been taken up, the Fed concludes that it is advisable to continue to normalise monetary policy.

Secondly and supported by this forecast, the Federal Reserve has anticipated the next steps to be taken as part of its normalisation plan. It has announced its intention to introduce a further increase to interest rates later in the year, serving as a warning to a market that continues to be misaligned with the Fed's rate rises. This begs the question: Is this the result of excessive complacency or more negative expectations? The Federal Reserve has also given advance details of its plan to shrink its balance sheet, that is to say, to start to drain off part of the abundant liquidity that it has injected into the system through its successive quantitative easing programmes. This is a finely-tuned plan which, looking further ahead, should bring about a significant reduction in the balance. The challenge in this new phase of the exit strategy is no less important: the Fed will need to see how it can combine the implementation of both instruments, interest rates and the balance sheet, in order to correctly calibrate the tone of its monetary policy. As short-term interest rates rise on the tail of higher official rates, we can also expect to see long-term rates, affected by adjustments to the balance sheet.

Thirdly, the Federal Reserve has implicitly strengthened two aspects that, in the current context, are essential to central banks: predictability and credibility. At the moment, no central bank wants to be caught napping, and as a result, they are all in constant discussion, outlining their strategies and making their decisions known to others. It hardly needs saying that nothing is set in stone, and the strategy may and should be adapted to reflect changing circumstances. Nevertheless, if this is not the case, credibility will be strengthened through the implementation of the plan.