FED RAISES POLICY RATE, PROJECTS TWO MORE HIKES THIS YEAR

The Fed raised its policy rate range to 1.75-2.00% as expected at its June 12-13 FOMC meeting and announced the next step in its balance sheet normalization policy. Participants raised their real GDP and inflation forecasts and lowered unemployment rate forecasts, marking to incoming data (Figure 1). In response, the median estimate for the appropriate number of total 2018 Fed funds rate hikes increased to four from three (Figure 2). The changes to the FOMC’s official post-meeting statement reflected a more upbeat assessment of economic and labor market conditions, and continued progress with its normalization plans.

The actions taken at this meeting were unanimously approved by FOMC members, with no dissents.

Overall, the changes to the official policy statement and policy rate projections are being viewed as more hawkish by markets, but these changes were necessary given the strong economic momentum, sub-4% unemployment, 2% inflation and fiscal stimulus.

The Fed’s forecasts of the appropriate path of the Fed funds rate: The split between the number of FOMC participants expecting three and four total rate hikes in 2018 remained very close, with a shift up in the forecast of one participant to three from four, pushing the median to four. The projected appropriate policy rate at the end of 2019 increased to 3.1% with two more participants expecting at least 3.1%. The median projection for the long-run appropriate policy rate was unchanged at 2.9%, but we expect that, after consistent downward revisions to this estimate since 2012, it will be revised up going forward (Figure 3).

Regarding the economy: The median 2018 real GDP (Q4/Q4) forecast rose slightly to 2.8% from 2.7%. Given the pick-up in economic momentum since Q1, this revision is not surprising to us. We forecast that Q2 real GDP will increase 3.5-4.0% annualized and 3.1% in 2018 (Q4/Q4). Real GDP forecasts for 2019, 2020, and the long-run were unchanged at 2.4%, 2.0% and 1.8%, respectively.

Regarding inflation: The FOMC’s median 2018 and 2019 PCE inflation forecasts increased to 2.1% from 1.9% and 2.0%, respectively, as we expected. The Fed had no choice but to bump up the inflation forecasts given that PCE inflation is already at 2.0% and likely to have increased to 2.2% in May (based on the already-released May CPI). The median 2018 core PCE inflation forecast rose to 2.0% from 1.9% previously (as of April core PCE inflation was 1.8%).

Regarding unemployment: The FOMC median forecast for the unemployment rate at year-end 2018 fell to 3.6% from 3.8% and to 3.5% from 3.6% in 2019 and 2020. The Fed’s “full employment estimate” was unchanged at 4.5%. With the unemployment rate expected to be almost a full percentage point below 4.5% for the next three years, wage pressures should continue to build.

The Fed also voted to modify its policy of paying interest on excess reserves (IOER), raising it by only 20 basis points, setting it 5 basis points below the top of the target range for the federal funds rate. This change was expected, as it was discussed in the minutes to the May FOMC meeting. Although this is generally considered to be a technical operation, it is nevertheless important. In October 2008, the Fed instituted IOER, setting the rate it pays at the upper band of the 25 basis point range of its Federal funds policy rate. The Fed implemented IOER because, in anticipation of its quantitative easing programs that would create a large amount of excess reserves, it

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would not be able to manage its effective Federal funds rate through normal open market operations (the so-called “corridor system” that adjusted the supply of reserves to demand to achieve a desired rate) and would pay IOER to create a ceiling above which the effective funds rate would not rise. One key concern about the Fed’s IOER policy is that it provides financial encouragement to commercial banks to lend excess reserves back to the Fed rather than making loans, thereby dulling the intended stimulus of the Fed’s quantitative easing programs. Until recently, the effective Fed funds rate has been comfortably below the upper band of the Fed’s target rate. But recently, as the Fed has begun to unwind its portfolio by not reinvesting all of the maturing assets in its portfolio, the effective funds rate has risen toward the upper band. Facing the perverse incentives this involves, the Fed’s actions to lower the rate it pays on IOER is a step in the right direction.

The Fed revised the forward-guidance language in its statement by removing “federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run.” This change was appropriate because the Fed is only four policy rate hikes away from its estimate of the appropriate long-run policy rate.

The Fed announced that it will hold a press conference at every meeting starting in January. This new communications approach will enable them to more freely announce policy changes at every meeting rather than quarterly.

**Figure 1:** FOMC’s Summary of Economic Projections at its June meeting

<table>
<thead>
<tr>
<th>Percent</th>
<th>Median</th>
<th>Central tendency</th>
<th>Range</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in real GDP</td>
<td>2.8</td>
<td>2.4</td>
<td>2.6</td>
</tr>
<tr>
<td>March projection</td>
<td>2.7</td>
<td>2.4</td>
<td>2.6</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>3.6</td>
<td>3.5</td>
<td>3.5</td>
</tr>
<tr>
<td>March projection</td>
<td>3.8</td>
<td>3.6</td>
<td>3.6</td>
</tr>
<tr>
<td>PCE inflation</td>
<td>2.1</td>
<td>2.1</td>
<td>2.1</td>
</tr>
<tr>
<td>March projection</td>
<td>1.9</td>
<td>2.0</td>
<td>2.1</td>
</tr>
<tr>
<td>Core PCE inflation</td>
<td>2.0</td>
<td>2.1</td>
<td>2.1</td>
</tr>
<tr>
<td>March projection</td>
<td>1.9</td>
<td>2.1</td>
<td>2.1</td>
</tr>
</tbody>
</table>

Memo: Projected appropriate policy path

| Federal funds rate | 2.4 | 3.1 | 3.4 | 2.9 | 2.1 | 2.4 | 2.9 | 3.4 | 3.3 | 3.5 | 2.8 | 3.0 | 1.9 | 2.6 | 1.9 | 3.6 | 1.9 | 4.1 | 2.3 | 3.5 |
| March projection | 2.1 | 2.9 | 3.4 | 2.9 | 2.1 | 2.4 | 2.8 | 3.4 | 3.1 | 3.5 | 2.8 | 3.0 | 1.6 | 2.6 | 1.6 | 3.9 | 1.6 | 4.9 | 2.3 | 3.5 |

Source: Federal Reserve
Figure 2: FOMC Participants’ Assessments of Appropriate Monetary Policy Rate

Source: Federal Reserve
Figure 3: Evolution of FOMC Participants’ Assessments of the Appropriate Longer Run Federal Funds Rate

Source: Federal Reserve and Berenberg Capital Markets
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