

US: FED STANDS PAT BUT SAYS CASE FOR HIKE HAS STRENGTHENED

The FOMC's vote to keep the policy rate unchanged was highlighted by three official dissents, reflecting the growing split within the FOMC and the growing concerns that its sustained monetary ease is creating mounting financial and economic **distortions. Based on the FOMC's upgrading of both the description of current** economic conditions and assessment of risks, and acknowledgment that the case for a rate increase has strengthened, a hike is possible by year-end. On forecasts, the median estimate of potential growth was lowered by 0.2pp to 1.8%, consistent with the decline in the median longer run federal funds rate to 2.9%.

*The three official dissents – largest in recent history – is particularly striking because Eric Rosengren, a noted dove, is clearly expressing concern about the mounting distortions generated by the low policy rate.

*The FOMC projection of one hike this year and changes to its statement suggest that if economic data comes in line with its expectations, a hike at the December FOMC meeting is likely. *(The recent softness in economic data, if sustained, reduces the chance of a year-end hike and serves as a reminder that the Committee has placed themselves in a difficult situation by not hiking earlier).* A change at the November meeting is not expected, as it takes place a week before the US presidential elections.

*The Committee acknowledged that although the case for a federal funds rate increase **has strengthened, it would prefer to wait for more evidence of “continued progress toward its objectives.”** This statement was included to satisfy those in favor of immediate rate increases.

*The Committee upgraded its assessment of economic activity to having “picked up from the modest pace seen in the first half of this year” from “expanding at a moderate rate” previously. The assessment of near-term risks was upgraded to being “roughly balanced” - a similar assessment of risks before the last hike.

*The FOMC participants lowered estimates of GDP for end-2016 and median potential growth was lowered by 0.2pp to 1.8%, a reflection of disappointing productivity gains since the “Great Recession” and lower expectations for future productivity growth.

*The FOMC raised its forecast for the unemployment rate for end-2016 by one-tenth to 4.8%, realigning its expectations with incoming data which show the unemployment rate unchanged at 4.9% since June.

*The Committee's forecasts for inflation were not much changed, as they lowered the forecast for headline PCE inflation by 0.1pp to 1.3% at the end-2016 and core PCE inflation by 0.1pp to 1.8% in 2017.

*The FOMC lowered expectations for the federal funds rate across the board, with a shallower path of rate increases - clearly seen in the newly added 2019 forecasts where the federal funds rate is expected to still be below its long-run rate. The “dot plot” showed that the Committee expects one hike this year, two hikes in 2017, three hikes in 2018 and 2019, compared to June when they expected two hikes this year, three hikes in 2017 and 2018:

21 September 2016

Median rate forecasts

2016: 0.6% down from 0.9%

2017: 1.1% down from 1.6%

2018: 1.9% down from 2.4%

2019: 2.6% (1st time being released)

Longer run: 2.9% down from 3.0%

The reduction in the expected rate path is consistent with the lower potential GDP growth estimate. The labor force is expected to increase by 0.6%, **so implicit in the FOMC's estimate of potential growth is productivity ~ 1.2%** - stronger than observed in recent years. Productivity growth near 1% implies positive real rates of return on capital and that long-run r^* (natural rate of interest) is positive. **Given that the current real federal funds rate is negative, the Fed's policy is still very accommodative**, so a 25bp increase in interest rates should not hinder the progress of economic activity.

The growing dissent among the Committee and the forecast of a hike this year suggest that the FOMC may be finally acknowledging that monetary policy is not stimulating the economy.

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