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# THE FED: SO WHAT'S NEXT?

As we described in our pre-**FOMC note** ("Fed to Hike But Not Change Forecasts at December Meeting", **December 12, 2016**), the Fed raised its Federal funds rate target, but the FOMC members made virtually no changes to their economic or inflation forecasts. The median FOMC member's estimate of the appropriate Fed funds rate (the so-called "dots") at year-end 2017 was raised to 1.4% from 1.1%, suggesting three rate increases in 2017, and raised to 2.1% from 1.9% the 2018 year-end Fed funds rate. The table below shows the FOMC members' updated forecasts and those made in September, and the chart shows the latest dot plot.

The **rise in the Fed's assessment of the appropriate path of the Fed funds rate without** any changes to the forecasts of economic growth or inflation seems to reflect the Fed catching up to the post-election changes in the futures market. The dots of the FOMC members are more dispersed than in September, with a higher skew. That is, more members think a higher funds rate is appropriate, even though the range of forecasts of real GDP and inflation did not change. Obviously, they sense change is brewing.

*So what does the Fed do now? In one sense, the Fed fully understands that an economic policy regime shift is underway, but it really does not know what the course of monetary policy will be*. That depends on the economic policy changes that are enacted and the economic and inflation outcomes. In recent years, the disappointingly weak economic growth with inflation remaining below 2% has provided the Fed the flexibility to avoid normalizing interest rates, blaming its inaction on an evolving array of global and financial concerns that besides generating mounting financial distortions have added confusion about the conduct of monetary policy. Now, the potential for an exogenous regime shift in the form of a new thrust of economic policies may force the Fed to adjust its monetary policy. But that depends on what happens.

**Let's consider three scenarios:**

1) No regime shift. For whatever reason, fiscal and economic policies are not changed. Either the Trump Administration stumbles badly or Congress blocks most of what is proposed. The economy continues to grow tepidly around the Fed's 1.8% estimated path of potential growth and inflation drifts up ever so gradually to 2% and stops there.
2) Economic regime shift with only moderate inflation. Corporate tax reform, modest individual tax cuts and a sizeable increase in infrastructure spending are enacted, and some regulatory burdens are eased. Economic growth accelerates modestly in the second half of 2017 and rises to 3% in 2018. Inflation rises but only slightly above 2%.
3) Economic regime shift with inflation rising more significantly--an overheating situation--above 2.5% and toward 3% in the second half of 2018.

Under Scenario #1, the Fed would maintain its recent flexibility, and push against raising its policy rate. The Fed would not feel any pressure to raise its Federal funds rate from its new rate of 0.5-0.75%. That would leave it a full percentage point below inflation, which along with the Fed's bloated balance sheet, would involve extremely easy monetary policy even as the Fed has virtually achieved its dual mandate.

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The market's dramatic pricing in of three rate hikes by year-end 2017 since the Presidential elections would largely unwind as it became evident that the policy changes anticipated under President Trump were unlikely to be enacted or economic data provided no evidence of a shift toward either stronger growth or higher inflation. Bond yields would largely retrace their recent rise. Under this scenario, the Fed would likely raise rates once in 2017 and not much more in 2018. Under this scenario, the Fed likely lowers its dots further, arguing that it had further lowered its estimates of the natural rate of interest, while at the same time it would acknowledge that monetary policy has lost its stimulative punch.

Very low probability of this ho-hum scenario unfolding.

Under scenario #2, the Fed would be pushed into action, raising rates faster and clearly changing its forward guidance. According to the Fed's macroeconomic model (FRB-US), fiscal stimulus raises real interest rates, a point highlighted by Fed Vice Chairman Stanley Fischer in October, so that as the new Trump Administration begins to roll out its new policy proposals in early 2017, the Fed will be on alert that a shift toward fiscal stimulus is consistent with a higher Fed funds rate. *The Fed will respond to any stronger economic growth resulting from those policy changes more so than it will raise rates in response to the policy changes themselves. This suggests that the impetus toward a higher Fed funds rate will mount in 2018 as the policy-induced economic momentum takes hold.*

We anticipate that Congress will enact corporate tax reform, moderate individual income tax cuts and fairly sizeable increases in infrastructure spending along with more modest increases in budget authority for defense and national security (see "US: Stronger Growth, higher Rates, More Uncertainty", November 30, 2016) and that these changes will be signed into law as early as 2017Q3. Their positive economic impacts are expected to be felt beginning in 2017 and with a much bigger impact in 2018.

*It is noteworthy that the Fed's FRB-US model estimates fiscal stimulus largely by measuring the legislated change in the budget deficit and applying a multiplier to that change, even though such a methodology has had a poor historic track record. To the extent that fiscal reforms are enacted that do not involve changes in budget deficit--such as a deficit-neutral corporate tax reform or even increases in infrastructure spending that is offset by cuts in other government spending--that stimulates stronger investment and economic growth, the FRB-US model will underestimate the amount of stimulus.* Moreover, the Fed model tends to underestimate the economic impacts of changes in government regulations; this is one reason why the Fed has consistently overestimated real GDP growth so far this expansion, and a possible reason why it may underestimate growth in coming years if the Trump Administration were to ease regulatory burdens. History also shows that the Fed tends to be relatively slow to change its economic forecasts.

*These factors suggest that there may be a tendency for Fed policy to lag behind market expectations.*

*A moderate acceleration of real GDP growth, particularly if it is driven by stronger business investment, would have a natural tendency to raise real interest rates and put both the Fed and financial markets on high alert for signs of rising inflation.* Even if inflation followed the Fed's current forecast and drifted modestly toward 2%, there is the expectation this would lead the Fed to raise rates three times in 2017. This would result in a Fed funds rate of 1.5% at year-end 2017, sill leaving it negative in real terms. If wages accelerate, which seem likely with the unemployment rate 4.6%, or if other indicators of inflation signal caution, bond yields would rise and the Fed would lag markets.

*This scenario #2 is the highest probability.* Insofar as the economic growth generated by fiscal and economic reforms would gain momentum in 2018, the risks of higher Fed rate increases in 2018 are definitely to the upside. Remember, the three rate increases now considered appropriate by the Fed in 2017 would still maintain a negative real policy rate. Also anticipate that under this scenario the Fed would announce a change in policy to cease reinvesting the proceeds of maturing assets, thus allowing its portfolio to begin to gradually shrink.

Under scenario #3, the economy overheats with strong economic momentum and core PCE inflation rising decidedly above 2% and toward 3%. The Fed would be forced to raise rates significantly more quickly than it currently anticipates or is priced in by the markets. Under this scenario, even if the Fed raised rates fast--much quicker that its dots now project--it would lag far behind market concerns about higher inflation. With nominal GDP growth accelerating above 5% and toward 6%, bond yields would rise significantly. ***This would be the downside to the Fed's policies of recent years****--keeping monetary policy extremely easy for too long, far after it was apparent that the slow economic growth reflected the constraints of nonmonetary policies, including tax and regulatory policies that were deterring business investment, rather than insufficient demand as the Fed has argued. In a sense, the shift in policy regime toward more favorable fiscal and regulatory policies, particularly after 7 ½ years of economic expansion when the unemployment rate was at full employment, revealed the excesses of monetary policy that had to be reversed.*

As with scenario #2, the Fed's macroeconomic model would not predict an overheating situation in part because it focuses on changes in budget deficits as the primary measure of fiscal stimulus without adequately capturing the reform aspects of fiscal legislation, and because it does not fully capture the impacts of regulations on macroeconomic performance. Also, the current Fed under Chair Yellen has expressed a preference to allow the Fed to overheat, in part to lower unemployment

measures like U-6 and in part because it considers its 2% inflation target as a longer-run average.

*Such an overheating scenario would pose a significant challenge to the Fed that would have to weave a fine policy line between leaning monetary policy against an overheating economy without tightening too aggressively. Following a period of unprecedented ease that resulted in a bloated balance sheet that would prove to be a daunting task.*

Assume a fairly low probability on scenario #3, but higher than that for scenario #1.

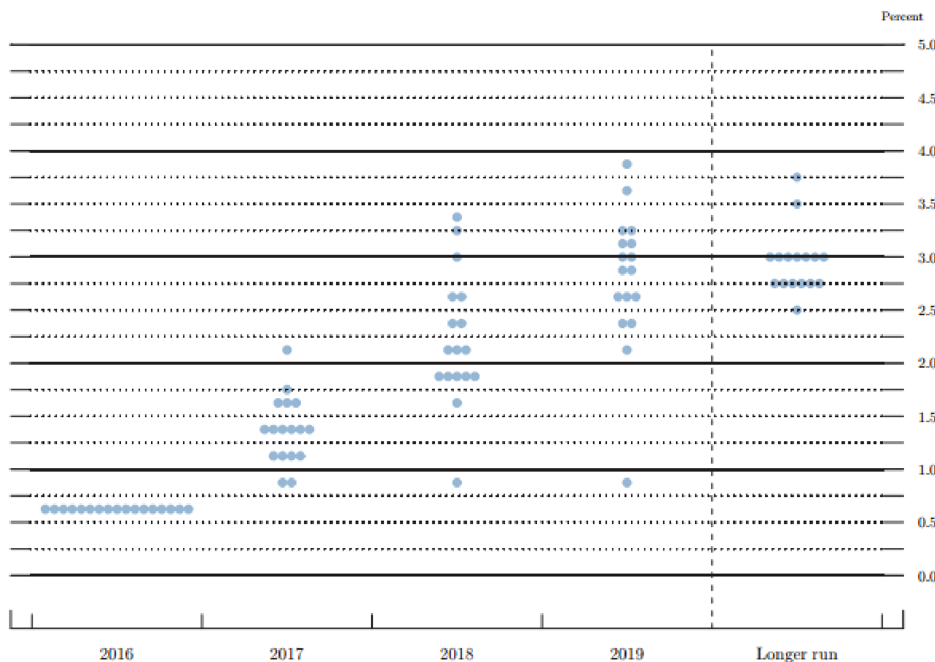
Chart 1: FOMC Summary of Economic Projections

Percent

| Variable | Median[1] | | | | | Central tendency[2] | | | | | Range[3] | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2016 | 2017 | 2018 | 2019 | Longer run | 2016 | 2017 | 2018 | 2019 | Longer run | 2016 | 2017 | 2018 | 2019 | Longer run |
| Change in real GDP | 1.9 | 2.1 | 2.0 | 1.9 | 1.8 | 1.8–1.9 | 1.9–2.3 | 1.8–2.2 | 1.8–2.0 | 1.8–2.0 | 1.8–2.0 | 1.7–2.4 | 1.7–2.3 | 1.5–2.2 | 1.6–2.2 |
| September projection | 1.8 | 2.0 | 2.0 | 1.8 | 1.8 | 1.7–1.9 | 1.9–2.2 | 1.8–2.1 | 1.7–2.0 | 1.7–2.0 | 1.7–2.0 | 1.6–2.5 | 1.5–2.3 | 1.6–2.2 | 1.6–2.2 |
| Unemployment rate | 4.7 | 4.5 | 4.5 | 4.5 | 4.8 | 4.7–4.8 | 4.5–4.6 | 4.3–4.7 | 4.3–4.8 | 4.7–5.0 | 4.7–4.8 | 4.4–4.7 | 4.2–4.7 | 4.1–4.8 | 4.5–5.0 |
| September projection | 4.8 | 4.6 | 4.5 | 4.6 | 4.8 | 4.7–4.9 | 4.5–4.7 | 4.4–4.7 | 4.4–4.8 | 4.7–5.0 | 4.7–4.9 | 4.4–4.8 | 4.3–4.9 | 4.2–5.0 | 4.5–5.0 |
| PCE inflation | 1.5 | 1.9 | 2.0 | 2.0 | 2.0 | 1.5 | 1.7–2.0 | 1.9–2.0 | 2.0–2.1 | 2.0 | 1.5–1.6 | 1.7–2.0 | 1.8–2.2 | 1.8–2.2 | 2.0 |
| September projection | 1.3 | 1.9 | 2.0 | 2.0 | 2.0 | 1.2–1.4 | 1.7–1.9 | 1.8–2.0 | 1.9–2.0 | 2.0 | 1.1–1.7 | 1.5–2.0 | 1.8–2.0 | 1.8–2.1 | 2.0 |
| Core PCE inflation[4] | 1.7 | 1.8 | 2.0 | 2.0 | | 1.7–1.8 | 1.8–1.9 | 1.9–2.0 | 2.0 | | 1.6–1.8 | 1.7–2.0 | 1.8–2.2 | 1.8–2.2 | |
| September projection | 1.7 | 1.8 | 2.0 | 2.0 | | 1.6–1.8 | 1.7–1.9 | 1.9–2.0 | 2.0 | | 1.5–2.0 | 1.6–2.0 | 1.8–2.0 | 1.8–2.1 | |
| Memo: Projected appropriate policy path | | | | | | | | | | | | | | | |
| Federal funds rate | 0.6 | 1.4 | 2.1 | 2.9 | 3.0 | 0.6 | 1.1–1.6 | 1.9–2.6 | 2.4–3.3 | 2.8–3.0 | 0.6 | 0.9–2.1 | 0.9–3.4 | 0.9–3.9 | 2.5–3.8 |
| September projection | 0.6 | 1.1 | 1.9 | 2.6 | 2.9 | 0.6–0.9 | 1.1–1.8 | 1.9–2.8 | 2.4–3.0 | 2.8–3.0 | 0.4–1.1 | 0.6–2.1 | 0.6–3.1 | 0.6–3.8 | 2.5–3.8 |

Source: Federal Open Market Committee

Chart 2: FOMC Participants' Projections for the Federal Funds Target Rate




Source: Federal Open Market Committee

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