

DECEMBER FOMC MINUTES STRESS UNCERTAINTY ABOUT OUTLOOK

The minutes of the December FOMC meeting suggest clearly that Fed members are **thinking about impending fiscal policy changes, but the FOMC's median forecast of real GDP and the unemployment rate barely nudged over the projection period:**

“Moreover, participants generally made only modest changes to their forecasts for real GDP growth, the unemployment rate, and inflation. About half of the participants incorporated an assumption of more expansionary fiscal policy in their forecasts.”

However, at the same time, the median forecast of the appropriate Federal funds rate for end-2017 rose to 1.4% from 1.1%, implying a 3rd rate increase during the year.

These minutes reflect that the Fed acknowledges that an economic regime shift may be unfolding, but the FOMC members are not yet prepared to alter their economic or inflation forecasts. That's understandable, insofar as at the time of the Fed's December meeting, President-elect Trump had not even taken office and the new Congress had not begun. However, looking forward it does open the door for large changes in the Fed's forecasts that will be updated in March and June. In a sign of things to come, the minutes showed that more Fed participants judged risks to the economic forecasts to be higher in their December projections and more saw higher uncertainty (see Chart below).

Given that this higher median forecasted fed funds rate for year-end 2017 generated a turbulent financial market reaction – the yield on the US 10yr Treasury jumped 10bp – what will happen when all of the participants incorporate fiscal policy reform assumptions into projections? The Fed will revise up its economic forecasts, even if it has a tendency to underestimate the positive impacts of corporate tax and regulatory reform (see [“Critical Current Issues Facing the US in 2017”](#), January 4, 2017). This will raise the Fed's estimate of the natural rate of interest and lead the FOMC members to raise their December Fed funds rate forecasts of 2.1% at end-2018 and 2.9% at end-2019.

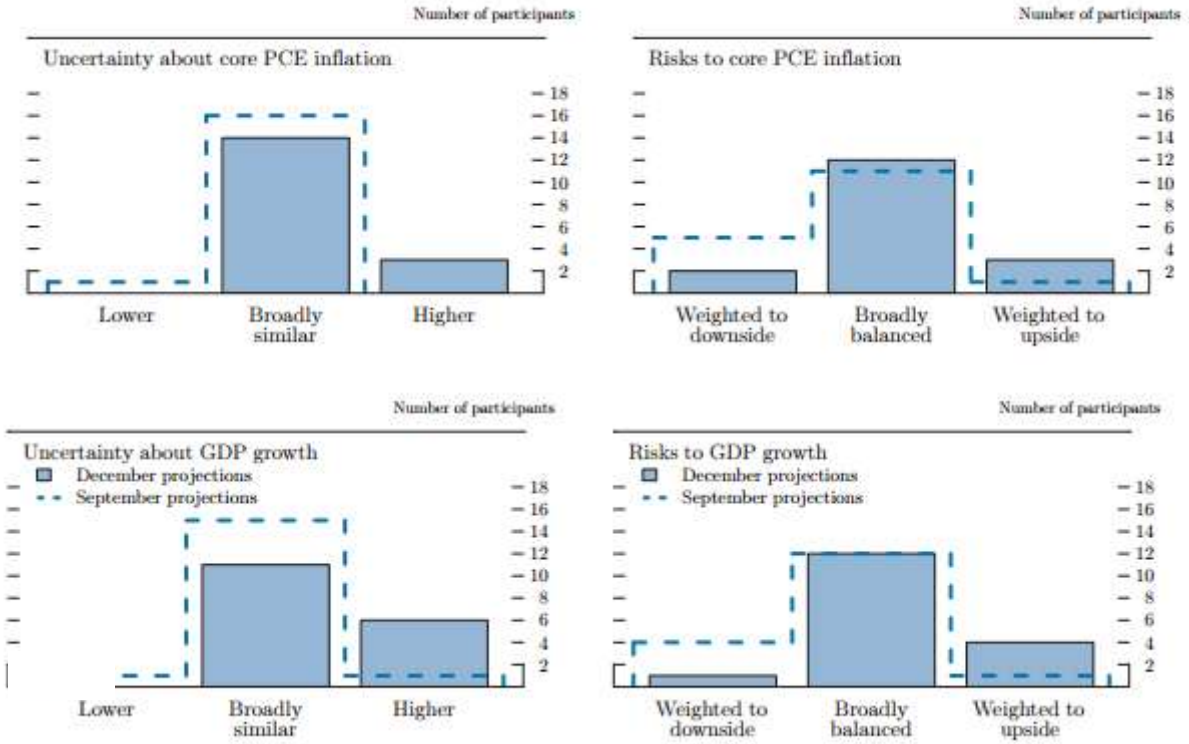
*When fiscal reforms are enacted and the economy improves, financial markets will **become even more sensitive to inflation and to the Fed's forecasts of inflation. This may put the Fed in a bind. If inflation begins to edge to 2% or modestly above and even if Chair Yellen and other doves on the Committee express a willingness to allow inflation to temporarily rise above 2%, the Fed will likely continue to forecast core inflation near its 2% target in the medium term. That will force attention on the appropriate path of the Fed funds rates needed to keep core inflation near 2%.***

The Fed is in a real quagmire, especially if it sticks with its data-dependent policy rule which will place it squarely behind the curve if economic policies boost growth. Moreover, because the Fed has employed exceptionally easy policies over the years and allowed various imbalances to build up, any sudden and drastic policy reversal may jar **markets. If the economy overheats, and the Fed isn't prepared, it will have to raise rates aggressively (see [“The Fed: So What's Next?”](#), December 14, 2016).**

Remember that economic policy change aimed at stronger growth will unfold as the Fed faces a massive transition in leadership. The next couple of years is setting up to be exciting on all fronts.

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Chart 1: **FOMC participants' assessment of uncertainty and risks** for GDP growth and core PCE inflation forecasts



Source: Federal Open Market Committee

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