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THE FED: ON THE VERGE OF AN OBVIOUS AND MINOR POLICY MOVE

Federal Reserve Chair Yellen has signaled in a speech she gave today the high probability that the Fed will raise its Fed funds rate target at its upcoming March 14-15 FOMC meeting. In her detailed assessment of the Fed's conduct of monetary policy in recent years amid progress toward its dual employment and inflation mandate, *perhaps the most insightful and meaningful part of the speech is its title: "From Adding Accommodation to Scaling It Back".*

It's about time: Chair Yellen has finally acknowledged that now that labor markets have tightened and wages are drifting up, inflation is pressing against its longer-run target, and that monetary policy is limited in what it is capable of achieving, it is time for the Fed to start moving toward normalizing monetary policy.

There's an important acknowledgment in a section toward the end of the speech entitled "Monetary Policy Is Not a Panacea". It describes in clear terms the limitations of monetary policy in correcting many of the "unwelcome developments in the economy", including "structural challenges that are beyond the reach of monetary policy", demographic factors, weak productivity and "Fiscal and regulatory policies--which are of course the responsibility of the Administration and the Congress." Both the title of this section and what it conveys in terms of the limitations of monetary policy is a significant reversal of the Fed's recent years' approach that as long as inflation is low and inflationary expectations are well anchored, more and more monetary stimulus is appropriate to stimulate the economy and address a wide array of unwelcomed characteristics like structural unemployment ant the low labor force participation rate. Three cheers for what has been obvious for several years. Among our recent reports, see "How the Fed should reset monetary policy", December 6, 2016, which describes the many factors constraining economic growth that are beyond the Fed's control, including the government's tax and regulatory policies.

*Even if the Fed does decide to raise rates in March--**a move we've predicted for a while, when the futures market's implied probability was less than one-third*** (see "March Fed rate hike seems most likely", February 17, 2017)*--such a move is far from monumental, and likely will be a minor decision for the Fed compared for what it is likely to encounter later this year and in 2018.* A rate hike that would lift the Fed funds target to 0.5%-0.75% would maintain a deeply negative real Fed funds rate and a bloated balance sheet when the Fed has achieved its dual mandate. More importantly, a looming significant regime shift in fiscal policy may significantly change the environment in which the Fed conducts its policies.

By itself, the negative funds rate is inconsistent with the current economic and inflation conditions. The $2.5 trillion of excess reserves that have resulted from the Fed's quantitative easing programs add an additional uncertain amount of accommodation. Even based on the Fed's current forecast of sustained modest growth around 2% drifting down to its 1.8% estimate of long-run potential growth, the unemployment rate actually remaining below the Fed's estimate of full employment in the next several years and inflation drifting up to 2% and stopping there, the Fed would need to normalize both its policy rate and its balance sheet.

But the highest likelihood is that the tax and fiscal reform proposals of the Trump administration and Congressional Republican leadership will be enacted in some form later in 2017, and these pro-growth reforms will boost economic growth, with momentum building in 2018. The stronger growth will boost the Fed's estimates of

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the natural rate of interest--so-called r*--and likely strengthen the US dollar. The stronger growth likely will heighten market sensitivities to signs of inflation. See "US: stronger growth, higher rates, more uncertainty", November 30, 2016, and "Critical current issues facing the US in 2017", January 4, 2016.

The Fed will face a difficult dilemma: at some point--its June meeting would be a good starting point--the Fed likely will start revising up its economic growth forecast. In its March forecasts, expect a wider variance of forecasts of the FOMC members around the median forecast, with a skew to the upside. A critical question is that with tight labor markets, rising wages and a drift up in inflation, will the Fed revise up its inflation forecast in the face of its 2% target? If yes, market expectations of inflation will rise. If not, markets will ask: with stronger growth, how high will the Fed need to raise rates to maintain inflation at 2%? In either case, the markets will start building in more rate hikes in 2018 when the economy is expected to build momentum, US dollar is likely to appreciate and bond yields rise.

The Fed, which has been very comfortable maintaining excessively easy monetary policy and lagging behind markets may quickly be put into a position of becoming uncomfortable in lagging economic and inflation realities. Later this year, the Fed will look back on this March decision to raise rates as a fairly easy call, and wish that it had taken the appropriate steps earlier to normalize monetary policy.

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