U.S. FOMC Review

- FOMC: stable economic forecasts; apparently no assumption of fiscal stimulus…
- …nevertheless, more tightening envisioned next year

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December FOMC

The increase of 25 basis points in the federal funds rate was well anticipated by market participants, but the Federal Open Market Committee provided a surprise with a dot plot implying three tightenings next year rather than two evident in the September results (chart, left next page). The upward shift in the median rate (1.375 percent versus 1.125 percent) largely reflected an upward shift by dovish members of the Fed system. No Fed official expects policy to remain unchanged next year -- even the most dovish policymakers see one hike. Hawkish officials, in contrast, tempered their views to a degree. While one official still sees the federal funds rate moving to 2.125 percent by the end of 2017, the next highest expectation is for a funds rate is 1.75 percent. In September, two officials saw the funds rate at 1.875 percent. With doves moving up and hawks becoming less aggressive, the range of views for next year tightened. The spread between highest and lowest now totals 1.25 percentage points rather than 1.50 percentage points. The tightening of views also was evident in the standard deviation of the distribution of views (now 0.32 percentage point rather than 0.44 percentage point). We view the dispersion of dots as important; tighter dispersions suggest more uniformity of views and therefore a higher probability of a policy change. Views for 2017 are still far from uniform, but they are closer than they were in September.

Reporters at the press conference naturally asked about the shift in the rate outlook, and Chair Yellen emphasized that the changes were modest. She also noted that several factors played a role in the adjustment. The unemployment rate is lower than it was in September, and inflation has stepped higher. She also noted that some officials had incorporated some degree of fiscal easing under the new administration and Congress.

While some officials may have built fiscal easing into their views, their numbers must have been few or their assumptions modest because changes to the economic projections were trivial. The median estimate of GDP growth next year moved only 0.1 percentage point higher (2.1 percent versus 2.0 percent); there was no change to the 2018 view and 2019 also was only 0.1 percentage point higher (1.9 percent versus 1.8 percent). Projections for the unemployment rate also changed by trivial amounts and inflation views showed no change (see table on p. 2).

The policy statement published by the Federal Open Market Committee changed only marginally, with the new statement showing a slightly more upbeat assessment of the economy. Activity is now described as expanding at a “moderate” pace rather than a “modest” one (see table on p. 3). The Committee also tweaked its description of the inflation setting, noting that inflation had increased (versus increased somewhat), and that market-based measures of inflation compensation had moved up considerably (considerably added for emphasis).

The press conference of Chair Yellen was not especially revealing. She fielded numerous questions about possible changes in fiscal policy. She was supportive of changes that would boost productivity, while her evasive responses implied that she would be less enthusiastic about applying fiscal stimulus to an economy already close to full employment. Two reporters asked about her previous comments on running a “high-pressure economy” (October 14 speech at FRB Boston). She indicated that she did not support such an experiment; rather she was raising an issue that was deserving of more research from the academic community.

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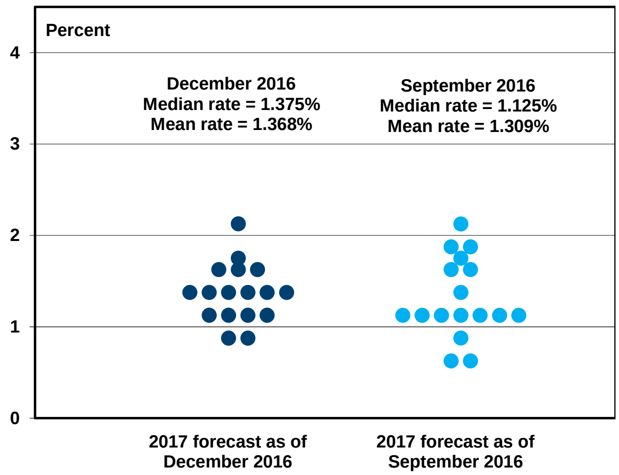
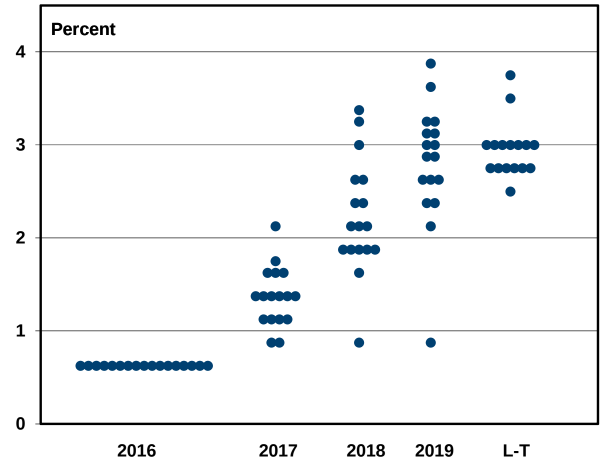
Expected Fed Funds Rate (Year-End 2017)*



** Each dot represents the expected federal funds rate of a Fed official. Normally, this graph would contain 19 projections (seven governors of the Federal Reserve Board and 12 reserve bank presidents), but two governorships were open at the time of the December meeting.*

Source: Federal Open Market Committee

Expected Fed Funds Rate (Year End)*



** Each dot represents the expected federal funds rate of a Fed official. Normally, this graph would contain 19 projections (seven governors of the Federal Reserve Board and 12 reserve bank presidents), but two governorships were open at the time of the September meeting. The longer-run projection contains only 16 forecasts.*

Source: Federal Open Market Committee

Economic Projections of the FOMC, December 2016*

	2016	2017	2018	2019	Longer Run
Change in Real GDP	1.9	2.1	2.0	1.9	1.8
September projection	1.8	2.0	2.0	1.8	1.8
Unemp. Rate	4.7	4.5	4.5	4.5	4.8
September projection	4.8	4.6	4.5	4.6	4.8
PCE Inflation	1.5	1.9	2.0	2.0	2.0
September projection	1.3	1.9	2.0	2.0	2.0
Core PCE Inflation	1.7	1.8	2.0	2.0	--
September projection	1.7	1.8	2.0	2.0	--
Federal funds rate	0.6	1.4	2.1	2.9	3.0
September projection	0.6	1.1	1.9	2.6	2.9

** Median projections*

Source: Supplemental materials released with the December 14, 2016 FOMC Statement

FOMC Statement Comparison

Statement Component	November 2, 2016	December 14, 2016
1. Assessment of the Economy		
Economic activity	Modest	Moderate
Job gains	Solid	Same
Household spending	Rising moderately	Same
Business fixed investment	Soft	Same
Inflation	Increased somewhat	Increased
Market-based infl. expectations	Moved up	Moved up considerably
Survey-based infl. expectations	Little changed	Same
2. The Outlook		
Economic activity	Expand at moderate pace	Same
Labor market conditions	Will strengthen somewhat further	Same
Inflation	Expected to rise to 2 percent	Same
Near-term risks	Roughly balanced	Same
Items to monitor	Inflation indicators; global economic and financial developments	Same
3. Forward Guidance		
Criteria for policy change	Labor market conditions, inflation, inflation expectations, and financial and international developments.	Same
Emphasis	…the Committee will carefully monitor actual and expected progress toward its inflation goal.	Same
4. Reinvestment Policy		
Policy	Maintaining its existing policy of reinvesting	Same
Timing	End reinvestment when normalization is “well underway”	Same

Source: Federal Open Market Committee; Daiwa Capital Markets America