U.S. FOMC Review

- FOMC: more optimistic on economy; modest shift in policy outlook

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Monetary Policy

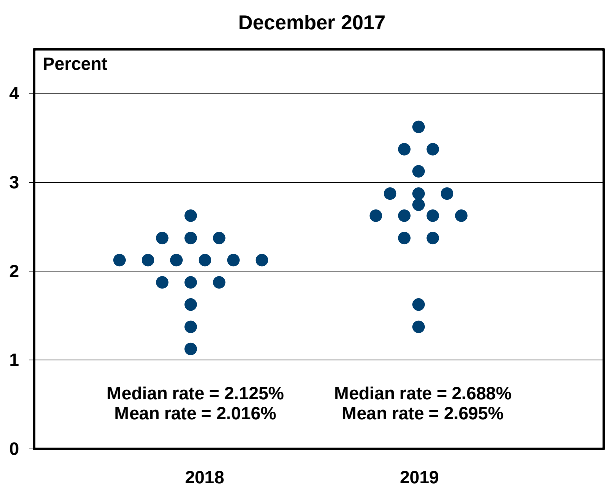
Despite another soft reading on core inflation, the Federal Open Market Committee raised short-term interest rates for the third time this year and the fifth time in the current cycle. In addition, the new dot plot released by the Committee continued to indicate three rate hikes of 25 basis points next year.

Although the subdued inflation rate this year did not affect policy plans meaningfully, it seemed to have an influence on the economic outlook. The median projections now show faster economic growth and lower unemployment, but projections for inflation next year and beyond were unrevised. The median projection for GDP growth next year now stands at 2.5 percent, up from 2.1 percent in September. With faster growth, the unemployment rate was seen as dipping below 4.0 percent next year. Growth in the next two years was nudged higher as well (table, next page).

Chair Yellen indicated in her press conference that most officials had incorporated fiscal stimulus (tax cuts) in their projections, although other factors also played a role in the forecast revisions, and thus the adjustments should not be viewed as an estimate of the impact of the tax package. Ms. Yellen also noted that the proposed changes in the tax code would affect the economy primarily from the demand side, but the changes also might affect aggregate supply -- that is, boost potential GDP.

The median expectation for the federal funds rate at the end of next year continued to suggest three changes of 25 basis points. While the median expectation was unchanged, the new set of dots for 2018 had a slight dovish tilt in that the mean rate eased slightly. From another perspective, the new dot plot has four officials with expectations

Expected Fed Funds Rate (Year-End ’18 & ’19)*



* Each dot represents the expected federal funds rate of a Fed official at the December 2017 FOMC meeting. Normally, this graph would contain 19 projections (seven governors of the Federal Reserve Board and 12 reserve bank presidents), but three governorships were open at the times of the September and December meetings.

Source: Federal Open Market Committee

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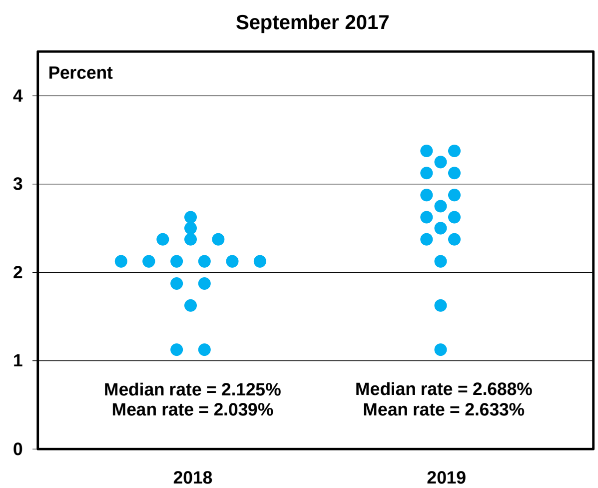

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above the median, down from five in September; also, the new plot has six officials below the median, up from 5 in September. Projections for 2019 and 2020 had a hawkish tilt in that the mean rate for year-end 2019 is higher than it was in September. For 2020, both the mean and median rates increased slightly.

In addition to questions about the tax package, the press conference was dominated by questions about potential financial exuberance. Specifically, reporters asked about elevated equity values and the remarkable rise in the price of Bitcoin. Chair Yellen indicated that she viewed equity valuations as elevated but not worrisome. She noted that higher valuations might be justified by low equilibrium interest rates. Similarly, she was not deeply concerned about the advance in Bitcoin. She noted that the volume of outstanding Bitcoin was a small portion of the global financial system, and that major financial institutions were not exposed to vulnerabilities. She also indicated that the Fed had no regulatory authority over the cryptocurrency, apparently trying to pass along responsibility in the event of a crash.

Economic Projections of the FOMC, December 2017*

	2017	2018	2019	2020	Longer Run
Change in Real GDP	2.5	2.5	2.1	2.0	1.8
September projection	2.4	2.1	2.0	1.8	1.8
Unemp. Rate	4.1	3.9	3.9	4.0	4.6
September projection	4.3	4.1	4.1	4.2	4.6
PCE Inflation	1.7	1.9	2.0	2.0	2.0
September projection	1.6	1.9	2.0	2.0	2.0
Core PCE Inflation	1.5	1.9	2.0	2.0	--
September projection	1.5	1.9	2.0	2.0	--
Federal funds rate	1.4	2.1	2.7	3.1	2.8
September projection	1.4	2.1	2.7	2.9	2.8

* *Median projections*

Source: Supplemental materials released with the December 13, 2017 FOMC Statement