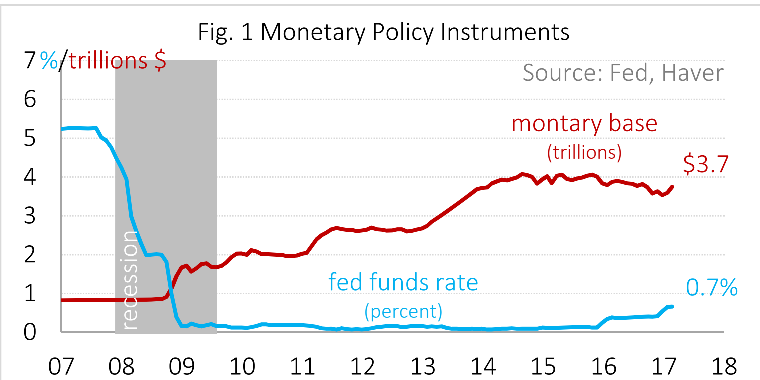
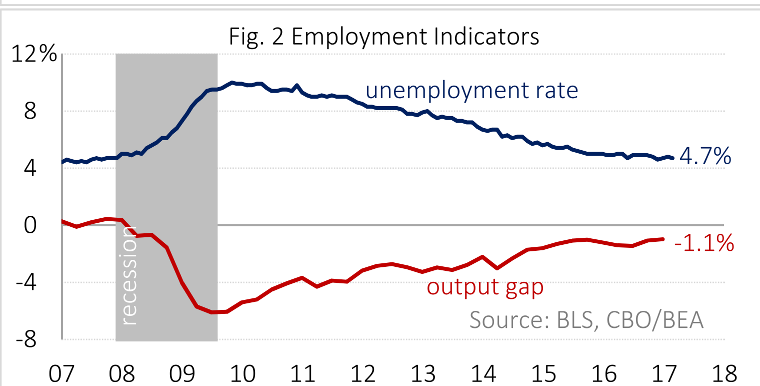
March 15, 2017

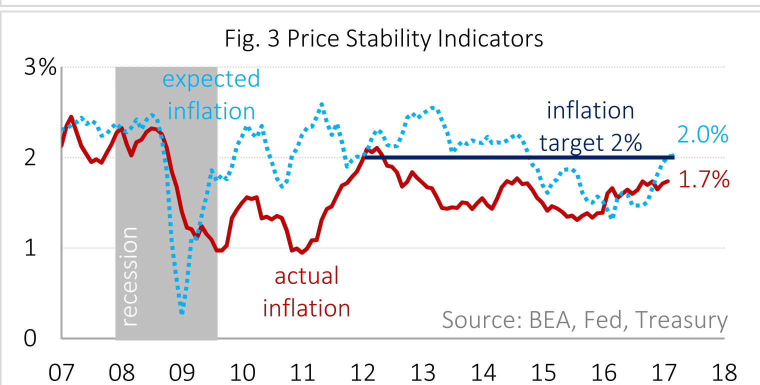
March FOMC Review

FOMC Review Snapshot

- The FOMC raised its federal funds rate target range from 0.50-0.75% to 0.75-1.00%.
- Although current economic data are largely unchanged, equity markets have surged on optimism of policy changes.
- As growth-constraining policies are removed, the Fed will no longer need to prop up the economy with extraordinarily low interest rates.







Details

The Federal Reserve's Federal Open Market Committee (FOMC) voted to increase its federal funds rate target range from 0.50-0.75% to 0.75-1.00%.[1] One FOMC member dissented, preferring to keep the interest rate target unchanged. Its last increase was December 2016. The Fed seeks to maximize employment and maintain price stability (the dual mandate) in setting monetary policy.

The Fed's policy instruments (Fig. 1) remain at unusual levels: Even with the increase, the fed funds rate remains at historic lows. Before the last recession it was 5.25%. The monetary base (i.e., the Fed's balance sheet) is enlarged at $3.7 trillion. Prior to the crisis it was $0.8 trillion.

Employment indicators (Fig. 2) suggest the economy is near full employment and the output gap—the percentage by which actual real gross domestic product (RGDP) falls short of potential RGDP—has shrunk to -1.1%.[2] JEC believes America has a lot of room to grow because the previous Administration's policies constrained economic potential. However, recovering this untapped potential requires supply-side policies, which monetary policy cannot implement.

Actual inflation continues to trend upward (Fig. 3). However, it remains below the Fed's 2% inflation target. Last year, the FOMC attributed low inflation to declines in energy prices and import prices. The expected average annual inflation rate for the next 10 years recently reached 2%.[3]

The next FOMC meeting is scheduled for May 2-3.

[1] The Taylor rule currently prescribes a fed funds rate of 2.7%.
[2] When the economy is at full employment it has reached potential RGDP, which is the maximum sustainable output that can be produced for a given inflation rate.
[3] The difference between yields on Treasuries and Treasury Inflation Protected Securities (TIPS) measures the average expected inflation rate.

Context

Last year, when the Fed announced it would raise the federal funds rate four times in 2016, equity markets swooned. One year later, the employment and inflation data have not changed much, but the economic outlook has changed dramatically following the election outcome in November 2016. The Fed signaled the current rate hike in advance as well as at least two more planned for this year, but this time equity markets continue to rise.

With the data essentially the same, the major change was in *expectations* of the economy's future performance following the election. Surveys of consumer, small business, and business executive sentiments have surged. Equity markets—whose valuations are based on *expectations* of future economic performance—have been unfazed by the Fed's rate increase. So why the higher expectations?

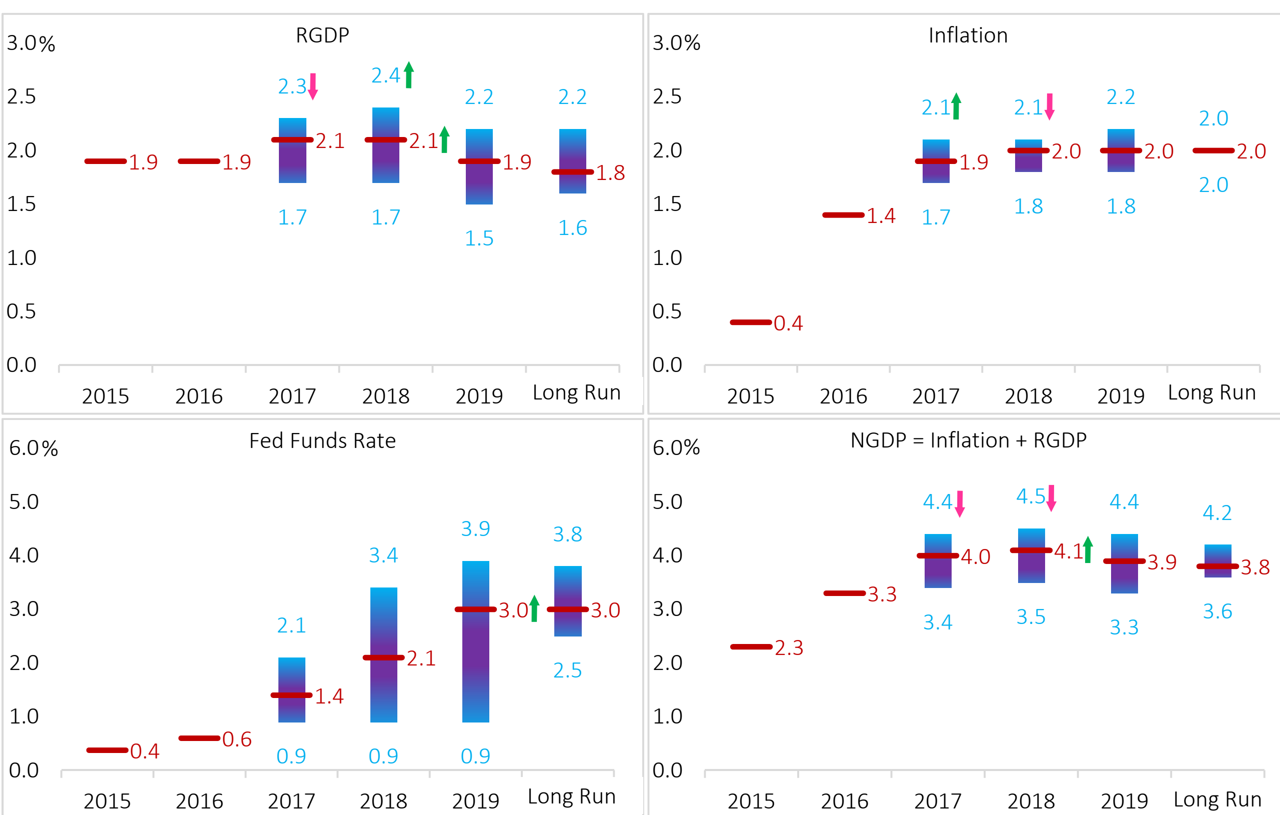
> **The Federal Open Market Committee (FOMC)**
>
> The FOMC meets 8 times per year. It consists of the 7 governors from the Fed's Board of Governors in DC (2 seats are currently vacant), and 12 regional Fed bank presidents.
>
> While all Fed governors have a vote on the FOMC, only 5 Fed bank presidents can vote. The NY Fed president is a permanent voting member, and 4 others can vote on a rotating basis.
>
> Minutes of the FOMC meeting are released three weeks later.

The JEC majority argues Obama-era policies constrained America's economic potential. In 2016, monetary policy was propping up a weak economy, and therefore, the market reacted negatively to anticipated increases in the fed funds rate. Now, increased market optimism indicates that America has a lot of room to grow.

Noteworthy

The FOMC issued its Summary of Economic Projections (SEP) (updated during FOMC meetings in March, June, September, and December). Figure 4 shows the FOMC members' median projection of RGDP, inflation, the fed funds rate, and nominal GDP (NGDP) for the given year's end. The numbers above the bars represent the highest projection, and those below the bar the lowest projection. Green arrows represent numbers that have increased since the December 2016 SEP, while red arrows represent projections that have decreased since then.

Fig. 4 Summary of Economic Projections



Source: Federal Reserve