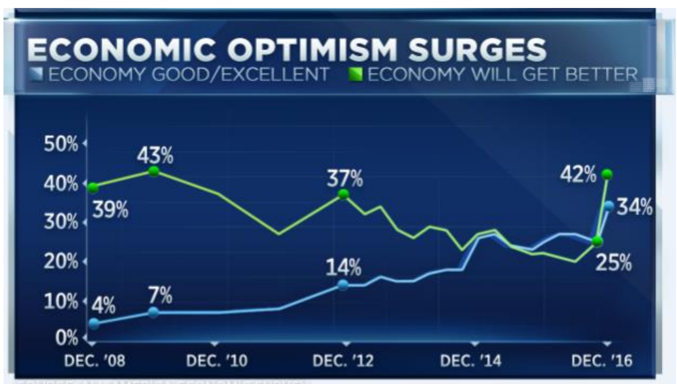
December 2016 Federal Open Market Committee Announcement Review

The Federal Open Market Committee (FOMC) voted unanimously to raise its target range for the fed funds rate by 0.25 percentage points to between 0.50 and 0.75 percent. This was the second increase since the financial crisis of 2008. The previous increase occurred in December 2015.

In the six weeks since the last FOMC meeting, economic expectations have changed substantially. Economic optimism – the percentage of Americans who believe the economy will improve over the next year – has surged in the last month, following Donald Trump's unexpected presidential victory. Consumer sentiment has seen a similar positive surge.



The "dot plot" projections that accompany the FOMC's press release also reflect a change in expectations. Projections for both GDP growth and inflation rose slightly. FOMC members now expect the fed funds rate to rise to over 2 percent in two years:

December Projection	2016	2017	2018	Previous Sept. Projection	2016	2017	2018
Change in Real GDP	1.9%	2.1%	2.0%	Change in Real GDP	1.8%	2.0%	2.0%
Unemployment Rate	4.7%	4.5%	4.5%	Unemployment Rate	4.8%	4.6%	4.5%
PCE Inflation	1.5%	1.9%	2.0%	PCE Inflation	1.3%	1.9%	2.0%
Core PCE Inflation	1.7%	1.8%	2.0%	Core PCE Inflation	1.7%	1.8%	2.0%
Fed Funds Rate	0.6%	1.4%	2.1%	Fed Funds Rate	0.6%	1.1%	1.9%

Note: Median projection; Source: Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents

Context

Improvements in several economic indicators have buoyed economic optimism:

- The unemployment rate fell from 4.9 percent to 4.6 percent from October to November, though this was partially due to a continued fall in labor force participation.
- After prolonged sluggish growth, third-quarter GDP growth broke 3 percent, achieving a revised 3.2 percent – the highest quarterly increase seen since 2014. The Federal Reserve Bank of Atlanta's GDPNow forecast currently predicts a 2.4 percent increase in real GDP for the fourth quarter.
- Worker productivity rose in the third quarter, reversing three quarters of decline.
- The Labor Market Conditions Index (LMCI) has been positive since June. Wage growth also remained high in November, contributing to improved labor market conditions.

What will the Fed be watching in 2017?

Earlier this year, Chair Yellen lamented the lack of fiscal policy actions to boost the economy, commenting, "There's no getting around the fact that monetary policy in the United States and many other advanced countries has been under a substantial burden and has not gotten a lot of help from fiscal policy." Considering President-elect Trump's plans for tax reform and infrastructure investment, some of the Fed's "burden" may be relieved. The dominant debate among FOMC members may become, "What is the proper pace for rate increases?" The Fed may choose less activism and focus on its statutory dual mandate of maximum employment and price stability. Regarding employment, Chair Yellen has indicated that labor market improvements have exceeded Fed expectations.

Meanwhile, inflation is not consistently reaching the Fed target, but the Fed names both inflation and global economic developments as the risks to be monitored. The prospect of growth in federal spending programs may change inflation's trajectory. During a hearing before the Joint Economic Committee on November 17, Chair Yellen warned that large government spending programs fuel inflation and federal debt. In October, consumer prices rose for the third consecutive month, posting the highest increase in two years, so inflation concerns may get more attention going forward.

Federal Debt and the Fed's Balance Sheet

Eight years after the financial crisis, U.S. economic growth has fallen into a "new normal" of 2 percent, while federal debt continues to rise. The Congressional Budget Office estimates the FY16 deficit to be $587 billion—one-third higher than the year before. Publicly held federal debt totals $14 trillion (gross federal debt, including intragovernmental holdings, amounts to nearly $20 trillion). As of December 8, the Fed's balance sheet reported total assets of $4.5 trillion, approximately the same level as it has been for the past two years. The Fed owns $2.5 trillion of Treasury securities — making it the world's second-largest owner of Treasuries, behind the Social Security trust fund's $2.8 trillion Treasury holdings.

In recent speeches, Chair Janet Yellen has been clear that Fed asset holdings are not falling anytime soon. The Fed is not the only central bank facing decisions about how to handle the new responsibility of managing large asset portfolios. As described in the recent JEC publication *Breaking the Conventional Mold*, central bank balance sheets have expanded substantially all over the world, and none are announcing "exit strategies" to bring asset holdings down to pre-crisis levels.

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