# Tim Duy's Fed Watch

SEPTEMBER 25, 2017

**The immediate policy outcomes of the FOMC meeting were largely as expected.** Central bankers left interest rates unchanged while announcing that the reduction of the balance sheet will begin in October as earlier outlined in June. The real action was in the Summary of Economic Projections. Policymakers continue to anticipate one more rate hike this year and three next. **This policy stance looks inconsistent with the downward revisions to projections of inflation and the neutral rate; under the Fed's earlier reaction function, the combination of the two would drive down rate projections.** Arguably, policy is thus no longer as data dependent as the Fed would like us to believe. That or the reaction function has changed.

The FOMC statement was fairly straightforward. The statement identified the busy hurricane season as a source of potential instability in the data in upcoming months, but policymakers anticipate no impact to the underlying pace of economic activity. The clear implication for policy: Don't expect us to deviate from our expected path on the basis of hurricane-induced weak data.

The economic forecasts were somewhat confounding. Policymakers edged up their growth forecasts, but still anticipate that unemployment will end the year at 4.3%.

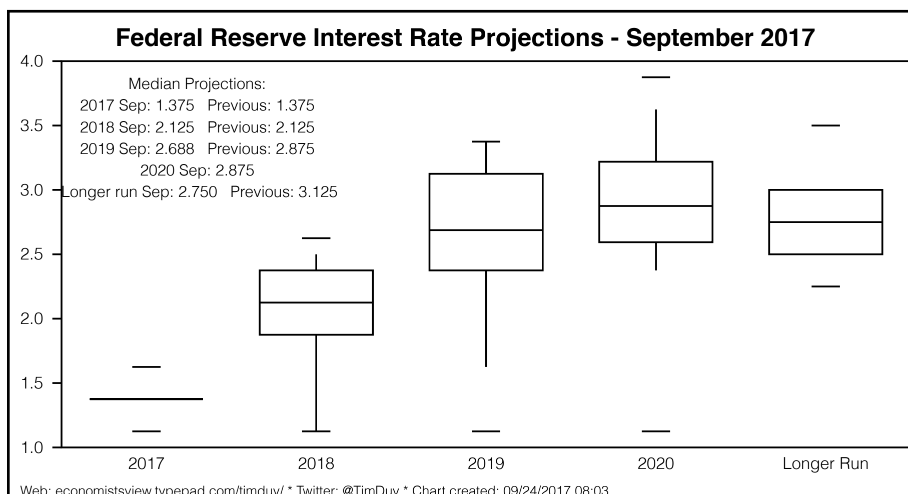


Table 1: FOMC Economic Projections

| Sept. 2017 | 2017 | 2018 | 2019 | 2020 | Long Run |
|---|---|---|---|---|---|
| Real GDP growth | 2.4 | 2.1 | 2 | 1.8 | 1.8 |
| Unemployment Rate | 4.3 | 4.1 | 4.1 | 4.2 | 4.6 |
| Inflation | 1.6 | 1.9 | 2.0 | 2.0 | 2.0 |
| Core inflation | 1.5 | 1.9 | 2.0 | 2.0 | |
| Fed funds rate | 1.4 | 2.1 | 2.7 | 2.9 | 2.8 |

| June 2017 | 2017 | 2018 | 2019 | 2020 | Long Run |
|---|---|---|---|---|---|
| Real GDP growth | 2.2 | 2.1 | 1.9 | NA | 1.8 |
| Unemployment Rate | 4.3 | 4.2 | 4.2 | NA | 4.6 |
| Inflation | 1.6 | 2.0 | 2.0 | NA | 2.0 |
| Core inflation | 1.7 | 2.0 | 2.0 | NA | |
| Fed funds rate | 1.4 | 2.1 | 2.9 | NA | 3.0 |

The unemployment forecast for the next two years edged down 0.1 percentage point, but this relative stability is somewhat confusing given that growth is expected to exceed potential growth until 2020 (remember, the Fed believes that labor force participation is more likely to fall than rise, so strong growth should induce downward pressure on unemployment).

Despite a fairly substantial unemployment gap of -0.5 percentage points, inflation remains below the 2.0% target until 2020. That seems odd for an institution that remains committed to a Phillips curve framework; one would think that such a long-period of low unemployment would be expected to push inflation higher. Interestingly, the inflation forecast makes more sense if inflation expectations have sunk closer to 1.75% than 2.0%. Federal Reserve Governor Lael Brainard recently suggested low inflation expectations accounts for soft inflation numbers.

UNIVERSITY OF OREGON

The "dots" representing the FOMC participants assessment of monetary policy edged down, but the median rate projection for this year and next remained unchanged. Indeed, the number of policymakers anticipating no additional rate hike this year held at just four, surprising given the decline in both the inflation forecast and the estimate of the neutral rate (the longer run rate forecast, which decline 25bp relative to June). Note that a lower neutral rate implies that policy is actually less accommodative than policy makers believed in June.

Should we be surprised by the strength of conviction that the economy needs another rate hike this year? To consider this question, I find it helpful to use the framework described by San Francisco Federal Reserve economists Fernanda Nechio and Glenn Rudebusch late last year. They show that a widely used policy rule can explain the change in the Fed's 2016 rate forecast. Specifically, they apply the equation:

> Funds rate revision = neutral rate revision + (1.5 × inflation revision) – (2 × unemployment gap revision).

Table 2 follows the Nechio and Rudebusch methodology of comparing the current forecast for year end 2017 with the forecast from last December. Using the rule followed by the Fed in 2016, the projection for the federal funds rate would have fallen by 0.65 percentage points this year. Instead, it remains unchanged.

Table 3 repeats the analysis for 2018. For next year, the wider unemployment gap largely offsets the decline in the projections for inflation and the neutral rate, leaving the expected revision at just 0.05 percentage points.

The real mystery then is the stability of the 2017 projection. But really perhaps it is not much of a mystery; with unemployment below the Fed's estimate of the natural rate of unemployment, policymakers fear falling behind the curve. Federal Reserve Chair Janet Yellen repeated the basic story during last week's press conference:

> ***Monetary policy also operates with the lag and experience suggests that tightness in the labor market gradually and with the lag tends to push up wage and price inflation and that's also a risk, that we want to be careful not to allow the economy to overheat in a way that would force us later on, somewhere down the road to have to tighten monetary policy rapidly which could cause a recession and threaten the very desirable labor market conditions that we have now.***

| **Table 2: 2017 Projections** | Date of forecast | |
|---|---|---|
| | Dec-16 | Sep-17 |
| For 2017, year end, % | | |
| Fed funds rate | 1.4 | 1.4 |
| Real GDP growth | 2.1 | 2.4 |
| Unemployment Rate | 4.5 | 4.3 |
| Inflation | 1.9 | 1.6 |
| Core inflation | 1.8 | 1.5 |
| For longer run, % | | |
| Fed funds rate | 3.0 | 2.8 |
| Real GDP growth | 1.8 | 1.8 |
| Unemployment rate | 4.8 | 4.6 |
| Inflation | 2.0 | 2.0 |

| | Change Dec-16 to Sep-17 |
|---|---|
| For 2017, year end, % | |
| Federal funds rate | 0 |
| Core inflation | -0.3 |
| Unemployment gap | 0 |
| Neutral rate | -0.2 |
| **Rule implied change in fed funds rate** | **-0.65** |

| **Table 3: 2018 Projections** | Date of forecast | |
|---|---|---|
| | Dec-16 | Sep-17 |
| For 2018, year end, % | | |
| Fed funds rate | 2.1 | 2.1 |
| Real GDP growth | 2.0 | 2.1 |
| Unemployment Rate | 4.5 | 4.1 |
| Inflation | 2.0 | 1.9 |
| Core inflation | 2.0 | 1.9 |
| For longer run, % | | |
| Fed funds rate | 3.0 | 2.8 |
| Real GDP growth | 1.8 | 1.8 |
| Unemployment rate | 4.8 | 4.6 |
| Inflation | 2.0 | 2.0 |

| | Change Dec-16 to Sep-17 |
|---|---|
| For 2018, year end, % | |
| Federal funds rate | 0 |
| Core inflation | -0.1 |
| Unemployment gap | -0.2 |
| Neutral rate | -0.2 |
| **Rule implied change in fed funds rate** | **0.05** |

© 2017 University of Oregon; Tim Duy. All rights reserved.

So what's going on here? The forecast revisions suggest that the Fed should stop hiking rates this year (or, really, cut rates) and then be prepared to accelerate the pace of hikes in 2018 should conditions warrant. But that is exactly what the Fed wants to avoid because they fear that a more rapid pace of rate hikes would induce a recession. They believe that only through a recession can they maintain control of inflation if unemployment dips too low. Arguably, the have reason to hold this view; most of the Fed's tightening cycles end in recession.

Still, the Fed's reluctance to abandon their gradual path is not without it's own risks. First, it suggests that the Fed is path dependent, not data dependent. That leads to the land of policy mistakes. Indeed, arguably the recent path holds such a lesson; the rate hike in December 2015 looked ill-advised at the time and done mostly because policy makers believed they had "promised" a rate hike that year.

Second, if you wanted to entrench expectations that 2% is a ceiling, not a target, this is exactly how you would do it. It doesn't really inspire any confidence that the central bank intends to hit its target when it fails to change course in the face of falling inflation forecasts. In fact, a persistent period of below target inflation that raises concerns about the stability of inflation expectations calls for exactly the opposite strategy – a clear commitment to running above target inflation to revive expectations.

**Bottom line: The Fed is strongly committed to rate hikes. The don't appear to be following their earlier reaction function; policy feels path dependent at the moment. Indeed, given the Fed's expectation of low inflation and volatile and possibly weak data due to the hurricanes, it is difficult to see what stops the Fed from hiking in December.**

**In other news, the Financial Times reports that at least one central banker, San Francisco Federal Reserve President John Williams, doesn't see any problem with the inflation data:**

> *"I push back against this 'mystery,' or other arguments," he said. "What we actually see is that some specific prices have been hit by some downward movements. In certain categories, including healthcare, inflation has been much lower than it had been in the past."*

Williams may be in the minority holding such a strong position. Yellen took a more cautious stance in her testimony, acknowledging that there is some mystery to be solved:

> *Now I recognize and it's important that inflation has been running under our 2 percent objective for a number of years and that is a concern, particularly if it were to translate into lower inflation expectations. For a number of years there were very understandable reasons for that shortfall and they included quite a lot of slack in the labor market, which my judgment would be his largely disappeared, very large reductions in energy prices and a large appreciation of the dollar that lowered import prices starting in mid-2014. This year, the shortfall of inflation from 2 percent, when none of those factors is operative is more of a mystery, and I will not say that the committee clearly understands what the causes are of that.*

Williams rotates back into a voting position next year, adding a bit of a hawkish tilt in the current environment. **Will Yellen still be voting next year as chair? Maybe. Maybe not. According to the New York Times, she is still in the running for the job:**

> *The White House has created a list of about a half-dozen candidates to be the next leader of the Federal Reserve, including its current chairwoman, Janet L. Yellen, and the president's chief economic adviser, Gary D. Cohn, according to two administration officials and a third person with knowledge of the process.*
>
> *The list also includes Jerome H. Powell, a member of the Fed's board of governors; Kevin Warsh, a former Fed governor; and the Stanford University economist John B. Taylor, the officials said. Preliminary interviews with some candidates have already begun with an eye toward presenting finalists to President Trump later this year.*

Yellen deserves to hold onto the job if she wants it, but I still have trouble believing it will happen. The Trump administration seems driven to erase as much of the Obama administration as possible. Moreover, the top spot at the Fed seems like too good a reward for some loyal supporter to let go of so easily. Regardless of the nominee, a choice needs to be made soon; Yellen's term as chair ends in February.

**And, finally, it looks like a fairly busy week ahead, with by my count twelve Fed presentations on the board, including Yellen on Tuesday.** Sprinkled throughout the week are a number of manufacturing updates, preparing us for next week's Institute of Supply Management survey. Other data of note: Case-Shiller home prices and new homes sales on Tuesday, durable goods orders and pending home sales on Wednesday, the third estimate of second quarter GDP, international trade, and jobless claims on Thursday, and, to end the weak, the Personal Income and Outlays report for August on Friday. Obviously, the Fed will be closing watching the inflation numbers on that day.

**Enjoy the week!**

© 2017 University of Oregon; Tim Duy. All rights reserved.

**TIMOTHY A. DUY**
**PROFESSOR OF PRACTICE**
**OREGON ECONOMIC FORUM, SENIOR DIRECTOR**
**DEPARTMENT OF ECONOMICS**
**UNIVERSITY OF OREGON**

Professor Duy received his B.A. in Economics in 1991 from the University of Puget Sound, and his M.S. and Ph.D. in Economics in 1998 from the University of Oregon. Following graduate school, Tim worked in Washington, D.C. for the United States Department of Treasury as an economist in the International Affairs division and later with the G7 Group, a political and economic consultancy for clients in the financial industry. In the latter position, he was responsible for monitoring the activities of the Federal Reserve and currency markets. Tim returned to the University of Oregon in 2002. He is the Senior Director of the Oregon Economic Forum and the author of the University of Oregon Statewide Economic Indicators, Regional Economic Indicators, and the Central Oregon Business Index. Tim has published in the Journal of Economics and Business and is currently a member of the Oregon Governor's Council of Economic Advisors and the State Debt Policy Advisory Commission. Tim is a prominent commentator on the Federal Reserve. MarketWatch describes his blog and "influencial," the Huffington Post identified him has one of the top 26 economists to follow on Twitter, and he is listed on StreetEye as one of the top 100 people to follow to discover finance news on Twitter. Major national and international news outlets frequently quote him, including the *New York Times*, the *Washington Post*, the *Financial Times*, the *Wall Street Journal*, and *Bloomberg*. He also writes a regular column for *Bloomberg Prophets*.

*Notice: This newsletter is commentary, not investment advice.*

duy@uoregon.edu

541-346-4660

@TimDuy

oregon economic forum

© 2017 University of Oregon; Tim Duy. All rights reserved.