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A Viewpoint from Joshua N. Feinman

FOMC decision

As we expected, the Federal Open Market Committee (FOMC) raised the federal funds rate target by 25 basis points (bps), to 2-1/4% to 2-1/2%, the ninth such hike in this cycle. Of key importance is the messaging that accompanied today's move. Here, I see several important takeaways:

FOMC participants still judge the economy as performing quite well, and see the economic outlook as solid, consistent with achieving their dual-mandate objectives (if not a bit beyond in terms of full employment). And they still judge monetary policy as (slightly) accommodative. That's why they felt it appropriate to take another modest step to reduce that accommodation today.

But they also acknowledged a number of developing crosscurrents – most notably, the recent tightening of financial conditions, and some moderation or uncertainties abroad – that, if sustained, may weigh slightly on the base-case outlook for the U.S. economy, and raise some downside risks. Also, after today's move they now judge the federal funds rate to be back at least at the bottom of the (admittedly uncertain) range of estimates of neutral. These developments imply two main things going forward: policymakers expect they will need to do slightly less in terms of rate hikes from here (largely because of the impact of the recent tightening of financial conditions and moderation abroad); and they are apt to be even more data dependent than before. Of course, the U.S. Federal Reserve (Fed) policy is never on a pre-set course. But with the increased uncertainties caused by tighter financial conditions and developments abroad, and with policy no longer so clearly accommodative, the case for treading carefully, monitoring developments closely, and letting incoming information dictate the pace and timing of future moves, is even stronger. Little sign of an inflation overshoot gives the Fed still greater latitude to be patient.

A few more details reinforce these conclusions. In the statement, the Committee now "judges" rather than "expects" that "some further gradual increases in the target range for the funds rate…" - adding the modifier “some" to the prior meeting's statement. These changes are Fedspeak[1] for slightly tempering the pace, magnitude, and likelihood of hikes they anticipate. Consistent with that, the median "dots" slipped to two hikes from three in 2019 (the average fell as well), and though holding at one further hike in 2020, the long-run median estimate of neutral edged down slightly.

Also, the statement added that the FOMC "… will continue to monitor global economic and financial developments and assess their implications for the economic outlook." This is a nod to acknowledging the recent tightening of financial conditions and moderation or uncertainty abroad, which was why the median

In a nutshell

- FOMC participants still judge the economy as performing quite well
- The FOMC also acknowledges the recent tightening of financial conditions and moderation / uncertainty abroad
- I continue to expect the Fed balance sheet to run off passively in the background, according to the schedule the Fed laid out more than a year ago

[1] Informal term which is used to refer to the statements and the language that the Federal Reserve uses to describe future changes in Federal Reserve Policy.

expectation for gross-domestic-product (GDP) growth came down 0.2% in 2019 to 2.3% (albeit unchanged beyond that). The forecast for core inflation was trimmed 0.1% for each year of the forecast (reaching but no longer exceeding the 2% target). Growth is still expected to be strong enough next year to edge the unemployment rate lower, before beginning a gradual modest rise beyond that (albeit remaining below the median estimate of the natural rate, though that edged down 0.1%, suggesting they judge the labor market overshoot to be a shade smaller).

Finally, in a purely technical move, with no policy import, the Fed raised the interest rate paid on reserves by just 20 basis points, to 2.40%, 10 basis points below the top of the federal funds rate target range, the better to ensure that the funds rate trades within that range, rather than near the upper end, as has been the case of late.

I continue to expect the Fed balance sheet to run off passively in the background, according to the schedule the Fed laid out more than a year ago. The federal funds rate will remain the primary active tool used to adjust the stance of policy. That is, the first line of response to changes in the outlook will be changes in the funds rate path. Barring a shock, I expect the balance runoff to continue into early 2020 or so, by which time about $1 trillion of securities will have been shed cumulatively (about 2/3 Treasuries), leaving the Fed with still a bit more than $3 trillion. That will take reserve balances down to about $1 trillion or so, and if the Fed judges that to be roughly what banks want to hold, they will stop the runoff. The key driver of when the runoff stops – barring a shock where the Fed has to go back into "all hands on deck rate slashing/balance sheet expanding" mode again – is when the Fed judges reserve levels to be in line with banks' demand.

As for markets, I am not sure why they would suddenly focus on balance sheet runoff as a concern as this plan has been known about for over a year, and has proceeded methodically. And when it is all over, the Fed will likely still end up holding a lot more securities than suggested by pre-crisis trends.

As for the federal funds rate, I think the Fed will hold steady for a while, waiting for greater clarity on how the tug of war between still-sound economic fundamentals and the tightening of financial conditions plays out. Also, with the federal funds rate now back at least within the range of estimates of neutral, and inflation in check, policymakers can afford to be patient. But when the dust settles, we still expect the economy to perform in a way that induces the Fed to raise rates modestly further.

Glossary

Accommodative

The aim of an **accommodative** monetary policy is to support the economy by means of monetary expansion.

Balance sheet

A **balance sheet** summarizes a company's assets, liabilities and shareholder equity.

Basis point

One **basis point** equals 1/100 of a percentage point.

Federal funds rate

The **federal funds rate** is the interest rate, set by the Fed, at which banks lend money to each other, usually on an overnight basis.

Federal Open Market Committee (FOMC)

The **Federal Open Market Committee (FOMC)** is the committee that oversees the open-market operations (purchases and sales of securities that are intended to steer interest rates and market liquidity) of the U.S. Federal Reserve.

Gross domestic product (GDP)

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Inflation

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Monetary policy

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

U.S. Federal Reserve (Fed)

The **U.S. Federal Reserve**, often referred to as "**the Fed**", is the central bank of the United States.

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