

Flash Comment

FOMC: Fed on hold till mid-2014

- The Fed surprised the market by announcing that rates are expected to be exceptionally low at least through late 2014 – almost three years from now! This was one year later than we expected. However, exceptionally low does not necessarily mean unchanged rates, as 11 out of 18 members see the rate higher than the current rate in late 2014. This was a bit of a surprise.
- There is a wide dispersion between Fed members' estimates of the first hike with three members wanting a rate hike already in 2012 while two members want to wait until 2016.
- The Fed also announced a new explicit longer-run goal on inflation at 2%. This is slightly higher than the previous longer-run projection of inflation at 1.75%-2% that was part of the economic projections, but not stated as explicit goal.
- Despite the recent improvement in the economy the Fed is still very cautious on the outlook in the statement. The Fed sees modest growth in the coming quarters and still significant downside risks to the outlook. The Fed also gave the inflation outlook a dovish twist by removing the sentence that it will pay close attention to inflation and inflation expectations
- The more dovish statement may be due to a change in voting rights with three hawks no longer being voters and only replaced by one hawk, Jeffrey Lacker, who dissented. The projections reveal a more hawkish tilt among non-voters.
- Based on the new FOMC projections, we now look for the first rate hike in mid-2014 (instead of late 2013).

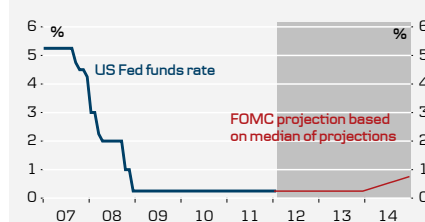
The Fed's new forecast

First hike: The Fed in its statement now sees exceptionally low rates *at least* through late 2014. This is on the surface *very dovish*. However, the members' projections revealed a high degree of dispersion, with three expecting a rate increase in 2012, three in 2013, five in 2014, four in 2015 and two in 2016. This leaves a less dovish picture than the statement. At the press conference, Bernanke said he suggested to use the median of estimates. The median in Q4 14 is 0.75% - see [link to projections](#).

Hiking pace: Only six out of the 18 members see rates unchanged through the end of 2014. This indicates that exceptionally low rates is not equal to unchanged rates but rather at or below 1% as 11 members have this projection.

The Fed has now given itself a new tool to keep long-term yields low without increasing its balance. Instead of buying bonds to get longer yields down, it is now keeping yields low by predicting to keep rates low for a very long time. On the one hand, this seems smart as they do not have to print more money. On the other hand, it can backfire if it turns out they end up raising rates earlier than predicted. Then this weapon would not be credible in the future.

Fed funds rate expectations (median projection)



Source: Federal Reserve

New economic projections

% , mid-point of estimates	2012	2013	2014	Longer run
GDP (q4/q4)	2.5	3.0	3.7	2.5
November fcst	2.70	3.3		2.6
Unemployment (q4)	8.4	7.7	7.2	5.6
November fcst	8.6	8.0		5.6
PCE inflation (q4/q4)	1.6	1.7	1.8	2.0
November fcst	1.7	1.8		1.85
Core PCE inflation (q4/q4)	1.7	1.8	1.8	
November fcst	1.8	1.7		

Source: Federal Reserve

Chief Analyst
Allan von Mehren
+45 45 12 80 55
alvo@danskebank.dk

The statement

Growth: The growth section is broadly unchanged. Only added a “further” in front of improvement in overall labour market indicators. Changed description of outlook for growth to modest from moderate pace. The Fed still expects unemployment to decline only gradually towards the level consistent with its’ mandate. The Fed also continues to see “significant downside risks to the economic outlook” due to financial strains. Again, a bit dovish given the recent improvement in indicators.

Inflation: The Fed gave the inflation part a clearly dovish twist. Inflation is now described as having “been subdued in recent months” instead of “moderated”. The Fed has also skipped the sentence ““However, the Committee will keep close attention to the evolution of inflation and inflation expectations”, a sentence that has been there for a long time

Policy: The Fed moved up the paragraph on the policy outlook and changed the timing of how long rates are likely to stay at exceptionally low levels to “at least through late 2014” from “through mid-2013”. The Fed kept the paragraph on asset purchases unchanged and repeated that it will regularly review the size and composition of its security holdings and is prepared to adjust those holdings as appropriate. Hence the Fed is keeping the door open for more QE if necessary.

Dissenters: Jeffrey Lacker dissented. He got voting rights in 2012. The three hawks who have previously voted against easing (Narayana Kocherlakota, Charles Plosser and Richard Fisher) are no longer voters. In addition to Lacker, new voters are Sandra Pianalto, John Williams and Dennis Lockhart – more centrist/dovish voters.

Assessment and outlook

It is not totally clear what the Fed means by exceptionally low level of Fed funds rate now given that 11 out of 17 members see the Fed funds rate higher than the current rate by late 2014. So far, the interpretation would have been to see exceptionally low rates as unchanged rates. But now it may seem that it means below 1% or lower.

On the back of this, we now see the first rate hike in mid-2014, moved from our previous estimate of late 2013.

New statement in comparison with previous statement

Information received since the Federal Open Market Committee met in ~~November~~December suggests that the economy has been expanding moderately, notwithstanding some ~~apparent~~ slowing in global growth. While indicators point to some further improvement in overall labor market conditions, the unemployment rate remains elevated. Household spending has continued to advance, but growth in business fixed investment ~~appears to be increasing less rapidly~~has slowed, and the housing sector remains depressed. Inflation has ~~moderated since earlier in the year~~been subdued in recent months, and longer-term inflation expectations have remained stable.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee ~~continues to expect a moderate pace of~~expects economic growth over coming quarters to be modest and consequently anticipates that the unemployment rate will decline only gradually toward levels that the Committee judges to be consistent with its dual mandate. Strains in global financial markets continue to pose significant downside risks to the economic outlook. The Committee also anticipates that ~~inflation will settle~~, over coming quarters, inflation will run at levels at or below those consistent with the ~~Committee’s~~Committee’s dual mandate. ~~However, the Committee will continue to pay close attention to the evolution of inflation and inflation expectations.~~

To support a stronger economic recovery and to help ensure that inflation, over time, is at levels consistent with the dual mandate, the Committee ~~decided today~~expects to maintain a highly accommodative stance for monetary policy. In particular, the Committee decided today to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that economic conditions--including low rates of resource utilization and a subdued outlook for inflation over the medium run--are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014.

The Committee also decided to continue its program to extend the average maturity of its holdings of securities as announced in September. The Committee is maintaining its existing policies of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction. The Committee will regularly review the size and composition of its securities holdings and is prepared to adjust those holdings as appropriate.

~~The Committee also decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that economic conditions including low rates of resource utilization and a subdued outlook for inflation over the medium run are likely to warrant exceptionally low levels for the federal funds rate at least through mid 2013.~~

~~The Committee will continue to assess the economic outlook in light of incoming information and is prepared to employ its tools~~ to promote a stronger economic recovery in a context of price stability.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; Elizabeth A. Duke; ~~Richard W. Fisher; Narayana Kocherlakota; Charles I. Plosser~~Dennis P. Lockhart; Sandra Pianalto; Sarah Bloom Raskin; Daniel K. Tarullo; John C. Williams; and Janet L. Yellen. ~~Voting against the action was Charles L. Evans~~Jeffrey M. Lacker, who ~~supported additional policy accommodation at this~~preferred to omit the description of the time period over which economic conditions are likely to warrant exceptionally low levels of the federal funds rate.

Fed statement on long run goals

Following careful deliberations at its recent meetings, the Federal Open Market Committee (FOMC) has reached broad agreement on the following principles regarding its longer-run goals and monetary policy strategy. The Committee intends to reaffirm these principles and to make adjustments as appropriate at its annual organizational meeting each January.

The FOMC is firmly committed to fulfilling its statutory mandate from the Congress of promoting maximum employment, stable prices, and moderate long-term interest rates. The Committee seeks to explain its monetary policy decisions to the public as clearly as possible. Such clarity facilitates well-informed decision making by households and businesses, reduces economic and financial uncertainty, increases the effectiveness of monetary policy, and enhances transparency and accountability, which are essential in a democratic society.

Inflation, employment, and long-term interest rates fluctuate over time in response to economic and financial disturbances. Moreover, monetary policy actions tend to influence economic activity and prices with a lag. Therefore, the Committee's policy decisions reflect its longer-run goals, its medium-term outlook, and its assessments of the balance of risks, including risks to the financial system that could impede the attainment of the Committee's goals.

The inflation rate over the longer run is primarily determined by monetary policy, and hence the Committee has the ability to specify a longer-run goal for inflation. The Committee judges that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate. Communicating this inflation goal clearly to the public helps keep longer-term inflation expectations firmly anchored, thereby fostering price stability and moderate long-term interest rates and enhancing the Committee's ability to promote maximum employment in the face of significant economic disturbances.

The maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market. These factors may change over time and may not be directly measurable. Consequently, it would not be appropriate to specify a fixed goal for employment; rather, the Committee's policy decisions must be informed by assessments of the maximum level of employment, recognizing that such assessments are necessarily uncertain and subject to revision. The Committee considers a wide range of indicators in making these assessments. Information about Committee participants' estimates of the longer-run normal rates of output growth and unemployment is published four times per year in the FOMC's Summary of Economic Projections. For example, in the most recent projections, FOMC participants' estimates of the longer-run normal rate of unemployment had a central tendency of 5.2 percent to 6.0 percent, roughly unchanged from last January but substantially higher than the corresponding interval several years earlier.

In setting monetary policy, the Committee seeks to mitigate deviations of inflation from its longer-run goal and deviations of employment from the Committee's assessments of its maximum level. These objectives are generally complementary. However, under circumstances in which the Committee judges that the objectives are not complementary, it follows a balanced approach in promoting them, taking into account the magnitude of the deviations and the potentially different time horizons over which employment and inflation are projected to return to levels judged consistent with its mandate.

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