THE ECONOMIC OUTLOOK GROUP

475 Wall Street
PRINCETON, NEW JERSEY 08540 Tel: 609 - 529 - 1300
www.economicoutlookgroup.com

ECONOMIC TALKING POINTS

Bernard Baumohl
Chief Global Economist

March 19, 2013

The Fed: Steady As She Goes, With Some Clarifications…and One Slight Slip

With the latest FOMC statement, Janet Yellen, in her first meeting as Fed chair has conveyed one overriding theme: the dovish policies pursued by Ben Bernanke will continue, perhaps even longer than many had first thought.

What changes there were from January's FOMC statements have been minor and largely anticipated. For example, gone are references to linking an unemployment rate of 6.5% as a possible threshold to consider raising short-term rates. Instead, the Fed's statement noted, it will *"take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments."*

To further underscore the Fed's course to keep short term rates near zero was its belief that *"it likely will be appropriate to maintain the current target range for the federal funds rate for a considerable time after the asset purchase program ends, especially if projected inflation continues to run* *below the Committee's 2 percent longer-run goal, and provided that longer-term inflation expectations remain well anchored."*

When all is said and done, the message from today's meeting was the continuity of US monetary policy. And that should not come as a surprise.

After all, the US has begun to show signs of recovering from the unusually harsh winter this season. Retail sales, employment, industrial production and new single-family home construction have all turned up lately. The economy is in the process of being re-energized. Nor are there signs a dangerous asset price bubble is in the works.

As a result, there is no urgent need to change the current path of tapering by the Federal Reserve. The FOMC has chosen to maintain its course of gradual tapering. Treasury purchases will be scaled back by another $10 billion, from $65 billion to $55 billion, beginning next month.

(Specifically, the Fed will now buy $30 billion in treasuries (down from $35 billion), and $25 billion in mortgage-backed securities (instead of $30 billion) beginning in April.)

The same can be said about policy guidance over the fed funds rate. There is no reason to diverge from the current zero-bound interest rate policy. The level of unemployment is still historically high and inflation remains only half the 2% pace the Fed prefers to see.

But let's be clear. Yellen knows the most daunting challenge the Federal Reserve will face under her leadership is how to unwind the more than $4 trillion in assets on the Fed's balance sheets. Pursuing a loose monetary policy has always been the easy part. Where the central bank most often miscalculates is not from being too easy, but by waiting too long to tighten monetary policy. That will be great test and, ultimately, the legacy of the Yellen Fed.

What was not mentioned in the FOMC statement are the external geopolitical threats swirling around the US economy. For example, might escalating tensions between West and Russia over its actions in Crimea soon hurt consumer and business spending in the US? What if sanctions against Russia forces the Kremlin to retaliate by disrupting the flow of natural gas to Europe? Is the Eurozone, which has been growing at a scant 0.3% a quarter, too vulnerable to absorb such a shock? Could damage to the European economy and banking system spill over to the US?

How destabilizing is China's financial crisis? Could growth slow far below 7% and how will that disrupt global trade and capital flows? What contingency plans should the Fed prepare in the event China's domestic debt problems mushroom into a global systemic event?

The new Chair of the Federal Reserve clearly has her hands full given the state of the domestic economy and the numerous exogenous shocks that can affect the US. Fortunately, Yellen is a seasoned and well-balanced economist who is extraordinarily qualified to guide the country through the perils ahead.

The one slight misstep by Yellen occurred during her first press conference. She made an extemporaneous comment in response to a question and said (quite hesitantly and I sense instantly regretted) that the fed funds rate might be lifted "something on the order of six months" after QE purchases ended. The financial markets instantly sold off on those words. But this was an over reaction by investors. Remember, Hi-Frequency traders operate on algorithms that buy and sell on the utterance of single every word by the Fed Chair. Frankly, we do not attach much weight to the specificity of that comment, nor view it as a reflection of Fed policy.

Federal Feserve Projections – FOMC Meeting March 19, 2014

Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, March 2014

Advance release of table 1 of the Summary of Economic Projections to be released with the FOMC minutes

Percent

Variable	Central tendency[1]				Range[2]			
	2014	2015	2016	Longer run	2014	2015	2016	Longer run
Change in real GDP	2.8 to 3.0	3.0 to 3.2	2.5 to 3.0	2.2 to 2.3	2.1 to 3.0	2.2 to 3.5	2.2 to 3.4	1.8 to 2.4
December projection	2.8 to 3.2	3.0 to 3.4	2.5 to 3.2	2.2 to 2.4	2.2 to 3.3	2.2 to 3.6	2.1 to 3.5	1.8 to 2.5
Unemployment rate	6.1 to 6.3	5.6 to 5.9	5.2 to 5.6	5.2 to 5.6	6.0 to 6.5	5.4 to 5.9	5.1 to 5.8	5.2 to 6.0
December projection	6.3 to 6.6	5.8 to 6.1	5.3 to 5.8	5.2 to 5.8	6.2 to 6.7	5.5 to 6.2	5.0 to 6.0	5.2 to 6.0
PCE inflation	1.5 to 1.6	1.5 to 2.0	1.7 to 2.0	2.0	1.3 to 1.8	1.5 to 2.4	1.6 to 2.0	2.0
December projection	1.4 to 1.6	1.5 to 2.0	1.7 to 2.0	2.0	1.3 to 1.8	1.4 to 2.3	1.6 to 2.2	2.0
Core PCE inflation[3]	1.4 to 1.6	1.7 to 2.0	1.8 to 2.0		1.3 to 1.8	1.5 to 2.4	1.6 to 2.0	
December projection	1.4 to 1.6	1.6 to 2.0	1.8 to 2.0		1.3 to 1.8	1.5 to 2.3	1.6 to 2.2	

NOTE: Projections of change in real gross domestic product (GDP) and projections for both measures of inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation and core PCE inflation are the percentage rates of change in, respectively, the price index for personal consumption expenditures (PCE) and the price index for PCE excluding food and energy. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy. The December projections were made in conjunction with the meeting of the Federal Open Market Committee on December 17–18, 2013.

1. The central tendency excludes the three highest and three lowest projections for each variable in each year.
2. The range for a variable in a given year includes all participants' projections, from lowest to highest, for that variable in that year.
3. Longer-run projections for core PCE inflation are not collected.

==================================
