BARRON'S

INVESTORS' SOAPBOX

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The Fed Will Move Slowly Next Year, Economist Predicts

Bernard Baumohl writes that the central bank will raise rates only twice, taking the fed funds rate to just 1% by next December.

The Economic Outlook Group

The Federal Reserve finally ripped off the band-aid on an economic wound that actually healed long ago.

The one-quarter point increase lifts the effective fed funds benchmark rate from about 0.125% to 0.375% and raises the penalty rate at the discount window a quarter point, to 1%.

Moreover, the Fed crafted its statement to be so unambiguously dovish, it used the term “gradual” twice and followed up with other synonyms to hammer the point home that the upward slope of short-term rates will be extremely shallow.

They acknowledged the economy was “expanding at a moderate pace” and that the slack in the labor force had “appreciably diminished.” The Fed also was “reasonably confident that inflation will rise over the medium, to its 2% objective” — though it seemed to pull back from that last point a bit when it added “some measures of longer term inflation expectation have edged down.”

In the end, however, the central bank closed on its key theme: “The committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the fed funds rate.”

So what’s next?

Our forecast calls for the Fed to lift rates twice more in 2016, once in March and a second time in mid-December, ending the year with an effective fed funds rate just below 1%. Since core CPI inflation is 2%, the real fed funds rate will remain well into negative territory next year — and by definition that means monetary policy will stay exceptionally accommodative. Describing today’s Fed action as “monetary tightening” is thus really a poor characterization.

Nevertheless, some analysts recommended against a rate increase at this time because of an emerging liquidity crisis in the high-yield debt market and the risk it will further destabilize the economies of China and other emerging countries. Others have opposed any action now because the Fed’s two mandates have not been met.

Both these arguments really have little merit in our opinion.

Frankly, the Fed should have acted earlier this year. What prevented them from doing so had more to do with events overseas, specifically the potential spillover effects from the slowdown in China and the potential fracturing of the eurozone. The U.S. economy, however, has been on a steady recovery track since 2010, averaging more than 2% growth a year during this time. And while that pace may not impress many, let’s recall the three major headwinds that cooled economic activity here: (1) sliding U.S. exports due to weak growth overseas, the strong dollar, (2) fiscal restraint from Washington due to sequestration, and (3) plummeting oil prices, which slashed capital spending in the energy sector.

In spite of these counterforces, domestic demand, which represents 85% of the U.S. economy, has been strong.

-- Bernard Baumohl, chief global economist