

Economist Insights

Rate of Change

The waiting game continues. Yet again, the Fed have deferred the decision to raise rates and yet again, analysts and commentators are scrutinising the signals which their decision sends out. But in focusing on the short-term timings of a rate move, are markets paying sufficient attention to the bigger picture? The most dovish, and arguably noteworthy aspect of the FOMC's deliberations is the ongoing trend towards pessimism in their long-run expectations and what that says about the outlook for US GDP growth over the next few years.



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So it is finally over, or rather, it is about to begin again. The question of whether the Fed will hike in September or December has finally been settled, and the market can move on to the equally important question of whether the Fed will hike in December or March. Many more column inches, and many more hours of video, will now be devoted to this question. Yet when the history books are written it will probably warrant a footnote at best. Who, with the benefit of hindsight, thinks that it really made a huge difference for either the US or the global economy that the Fed decided to taper its quantitative easing programme in December of 2013 instead of September 2013?

Markets care, of course, because some investors were positioned to profit if the Fed delayed hiking, while others were positioned to lose. But in the end this is transitory: some benefited at the expense of others, time to move onto the next risk position.

The Fed's statement this week was definitely dovish, but the market is focusing on the less important aspect of that dovishness. The 'dot plots' show where members of the Federal Open Market Committee (FOMC) think rates will be at the end of each of the coming years. These dot plots moved down, but the average move down of 27 basis points in 2016 can entirely be explained by a lower rate at the end of 2015. If FOMC members are forecasting the same pace of rate hikes, but starting later, the expected Fed Funds rate at the end of each year must move down by 25 basis points. And Fed Chair Janet Yellen has repeatedly made clear that the FOMC thinks the pace of tightening is more important than the timing of the first hike. Nonetheless, those who were most hawkish for 2017 reduced their expectation by more than just one rate hike.

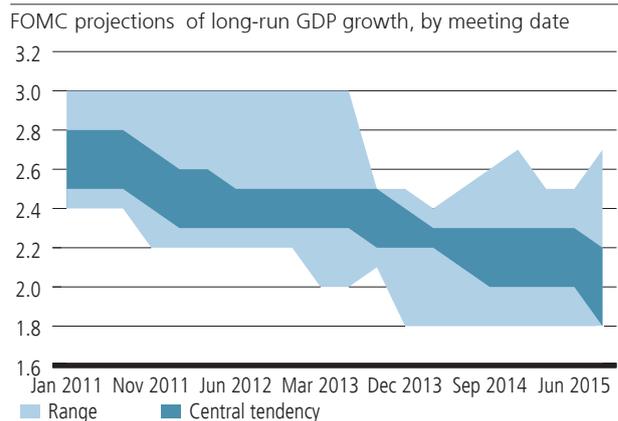
Perhaps the most overtly dovish, albeit least important, signal was that one FOMC member voted for negative rates this year and next. In the press conference following the decision, Chair Yellen was keen to point out that nobody else in the

FOMC discussed it. And it is hardly historic; the Eurozone, Switzerland, Denmark and Sweden have not only discussed negative rates but implemented them.

Even the willingness to let foreign developments affect the timing of rate rises is hardly historic. The Fed cited "recent global economic and financial developments" as a reason to delay hiking, but this is hardly unsurprising. We live in an era of globalisation, and although the size of the US economy makes it one of the most insulated against external shocks, it is hardly invulnerable (see *Economist Insights* Silk Road Block, 24 August).

What is both dovish and historic is the ongoing trend towards pessimism in the FOMC's long-run expectations. Each meeting the FOMC gets marginally more pessimistic on growth (chart 1), each incremental downgrade hardly being newsworthy but cumulatively very important. Long-run GDP growth expectations are down to 2%, from 2.5% just two or three years ago. This sounds small, but cumulatively it would make the US economy 5% smaller a decade from now. That is USD 1 trillion smaller in real terms.

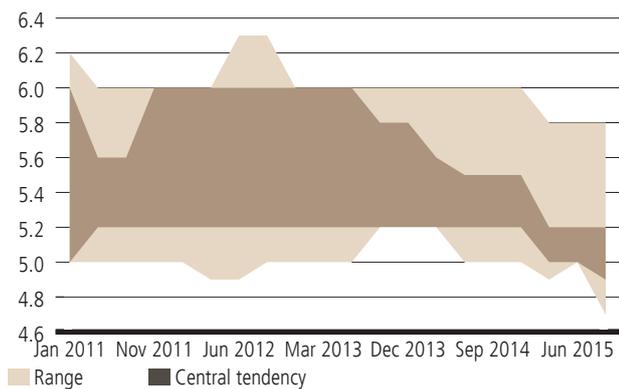
Chart 1: Growing pains



The FOMC has not become more dovish on long-term inflation, but then it hardly can be. If the FOMC has interpreted “price stability” as a 2% inflation rate it would be difficult to forecast anything else. To do so would be equivalent to forecasting that the Fed is going to fail. But there is a dovishness on inflation, and that is creeping in through the forecasts of the long-run unemployment rate. If the long-run, or neutral, unemployment rate is lower, then the current unemployment rate will have to drop even further before wages, and hence inflation, are likely to accelerate. If we take under-utilisation into account (those working part-time who would rather work more hours), the spare capacity may be even larger and inflation even harder to achieve.

Chart 2: Jobs for all

FOMC projections of long-run unemployment rate, by meeting date

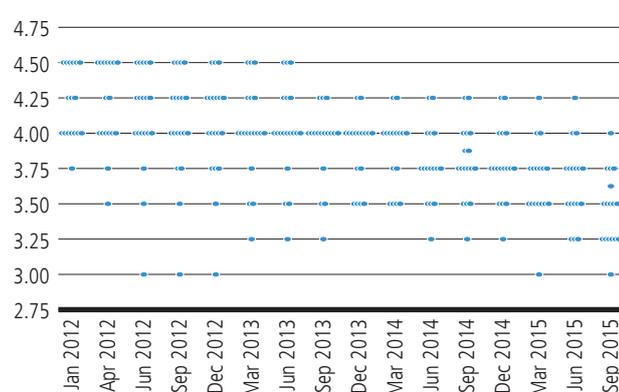


Source: Federal Reserve

Taken together, these two long-run trends have pushed down the FOMC’s expectation for the long-run neutral rate. This is the rate at which, when the economy is growing at trend and unemployment is at the neutral rate, inflation will be on target. If rates are higher than this neutral rate, then the Fed is tightening; if below, it is being accommodative. The median of the FOMC’s expected long-run neutral rate has dropped to 3.5% today from 4.25% when they started projections in 2012. It is likely that the most influential decision-makers are slightly lower, closer to 3.25%.

Chart 3: Net neutrality

FOMC projections of long-run interest rate, by meeting date



Source: Federal Reserve

While the timing of rate hikes may be important for money markets, and the pace of tightening crucial for the short-end of the curve, at the longer-end of the yield curve the only thing that really matters is the long rate (see *Economist Insights On the Dot*, 15 June 2015). The difference between what is implied for 10-year yields by the more dovish end of the FOMC (represented by the fifth most dovish dot) and what the market is pricing has only shrunk a little, from about 60 basis points to 50 basis points. This is because market pricing has become dovish at the same time that the Fed has, so the difference remains with the market still a lot more dovish.

It now looks likely that the Fed will hike in December, despite Chair Yellen’s insistence that the October meeting is still ‘live’. It is often argued that the Fed will only start its rate hikes when it has a press conference to explain, but there are procedures to call an ad hoc press conference after any meeting so that is not really a limitation. What is a limitation is that the “global economic and financial developments” are unlikely to be resolved enough in the next six weeks for the Fed to feel more confident. Also the most important measure of wages, the employment cost index, is released after the next Fed meeting. This index took a surprise drop, and many on the FOMC will want to see it bounce back before they hike rates (although the FOMC may get early sight of the data).

Whether it is December, or October or even March, ultimately the far more important factor is what the Fed is saying about the long-run pace of rate rises and the ultimate long-run rate. When asked during the press conference if the USA risked ending up like Japan, in true economist fashion she admitted it was possible but was a very small tail risk. But if the FOMC long-run forecasts keep dropping, after another year or two their long-run vision for the US economy might not be that different from Japan.

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