The Daily Dish

The Fed Surprises

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Eakinomics: The Fed Surprises

Yesterday the Federal Open Market Committee (FOMC) — the policymaking body of the Federal Reserve system — concluded its December meeting by announcing it was raising the target range for the federal funds rate (its policy rate). Specifically, "In view of realized and expected labor market conditions and inflation, the Committee decided to raise the target range for the federal funds rate to 1-1/4 to 1?1/2 percent. The stance of monetary policy remains accommodative, thereby supporting strong labor market conditions and a sustained return to 2 percent inflation." Further, the FOMC released its economic projections indicating that it anticipates three additional boosts to the rate in 2018.

This was exactly as expected.

The surprise was in the economic projections. While the (median) prediction of growth in Gross Domestic Product (GDP) for 2018 was 2.5 percent, growth then falls off to 2.1 percent in 2019, 2.0 percent in 2020, and 1.8 percent in the long term. This raises two immediate questions. First, hasn't the Fed been paying attention? Even as the FOMC was meeting, the conference committee was finalizing an agreement on tax reform that is expected to pass the House and Senate by Christmas. Chairman Yellen explained in her final press conference that members of the FOMC have been monitoring the evolving tax situation. They simply give the reform low marks: "The kind of tax changes that are likely to be enacted would tend to provide some modest lift to GDP growth."

In short, the Fed isn't buying that tax reform will boost productivity and, thus, the long-run trend growth of the economy. (Although it is not ruling it out either: Yellen said, "While there are a range of estimates and uncertainty about how much stimulus that will provide to investment, in general, I would see some stimulus to investment. In terms of aggregate supply effects, stronger pace of investment could boost capital formation and thereby raise productivity growth and potential GDP or output to some extent.") GDP growth is, in the end, growth in the number of workers and growth in their productivity. If we don't change either, we are stuck in the miserable sub-2 percent economy over the long term.

This raises the second question. If the economy is not going to rev up significantly and inflation remains below the Fed's 2 percent target, why is the FOMC raising rates now and planning to do more in the future? To my eye, there are two reasons. The first is that sub-normal rates have not boosted growth significantly, so the Fed might as well get back to normal (and is unlikely to affect growth in the process). Second, and more important, the key price inflation that has mattered in the past two recessions is asset price inflation. Both the bursting of the dot-com bubble and the financial crisis showed the danger of keeping rates too low for too long. The Fed is actually reducing the downside risk to the economy by normalizing rates and plans to continue to do so.

Once the full tax reform is public and if it is enacted, it will be interesting to see if the Fed revises its outlook.