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On the June FOMC

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All the dot-plots move down one rate-hike, as the Fed becomes "an object at rest."

As we have expected, today's FOMC's statement brought few surprises with policy standing pat in every way. Judging by immediate market reactions -- both stocks and bonds have rallied somewhat -- there was some degree of relief at the elimination of the outside chance that "liftoff" would come today, or be strongly indicated for the near future.

In our view, if anything, the policy outlook just got somewhat more dovish.

- *The FOMC participants' average estimate of the appropriate target funds rate -- the so-called "dot plots" -- fell by about one rate-hike at every maturity versus the March FOMC projections* (see "Data Insights: Federal Reserve" June 17, 2015).
- For 2015, the average fell from 0.77% to 0.57%; for 2016, from 2.01% to 1.81%; for 2017, from 3.18% to 3.00%.
- The "longer run" rate fell a single basis point, from 3.66% to 3.65%.
- Putting it all together, we see the FOMC coalescing around a consensus that the economy is still years away from equilibrium, and thus years away from an equilibrium funds rate.
- But even at equilibrium, the funds rate will be lower than anybody would have expected based on historical relationships (see "The Fed's Growth-Friendly 'Dot' Gap" September 19, 2014).
- This all converges on yet another reiteration, word for word, of what we have come to call "the Yellen Rule" (see "The Yellen Rule is Taylor Minus Two" May 19, 2014) -- just as it has appeared since Yellen's first FOMC meeting a year ago. Those familiar 38 words are below, with the essence of the policy message called out in red.

> **The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run.**

In the meantime, the Fed will keep markets on their toes, keep them from becoming complacent that rates will stay zero forever. Thus Chair Janet

Update to strategic view

US FED: A dovish FOMC, with the "dot plots" coming down across the board. The Fed has become Newtonian -- an "object at rest" that "stays at rest unless acted upon by an unbalanced force." With no inflationary or asset bubble imbalances present, the Fed will not bear any opportunity cost in jobs or growth by tightening policy, nor the risks of attempting to normalize with a massive balance sheet and policy tools never before utilized. Even when the Fed becomes an "object in motion" it will be languid, adjusting policy only gently and opportunistically, terminating at an equilibrium policy rate under the "Yellen Rule," which holds that when the economy is normal the funds rate won't be.

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Yellen's warnings that liftoff could come "at any meeting" and that equity valuations are "quite high." For all such talk, we have to view the Fed in Newtonian terms -- that is, "an object at rest stays at rest unless acted upon by an unbalanced force."

- In other words, unless the FOMC faces some imbalance -- say, an inflation outbreak or a highly visible asset bubble -- it has no real reason to bear the opportunity cost on jobs or growth of any form of tightening, or to bear the many risks of attempting policy normalization with a massive balance sheet and using new tools with which the Fed has no operating experience (see "On the April Jobs Report" May 8, 2015).
- At the same time, with constant chatter in the marketplace about the risks to non-US economies following liftoff -- and now facing an escalation of the Greece crisis into the possibility that Greece would leave the European Union, not just the euro currency -- the Fed is going to need a strong and tangible reason to act.
- And when liftoff finally comes -- when the Fed finally becomes an "object in motion" -- for whatever reason, we expect that it will not herald a typical "hiking regime."
- In the press conference following today's FOMC statement, chair Janet Yellen took another opportunity to repeat almost word for word what she said in a March speech:

> What matters for financial conditions and the broader economy is the entire expected path of short-term interest rates and not the precise timing of the first rate increase. Let me first be clear that the FOMC does not intend to embark on any predetermined course of tightening following an initial decision to raise the funds rate target range -- one that, for example, would involve similarly sized rate increases at every meeting or on some other schedule.

Bottom line

A dovish FOMC, with the "dot plots" coming down across the board. The Fed has become Newtonian -- an "object at rest" that "stays at rest unless acted upon by an unbalanced force." With no inflationary or asset bubble imbalances present, the Fed will not bear any opportunity cost in jobs or growth by tightening policy, nor the risks of attempting to normalize with a massive balance sheet and policy tools never before utilized. Even when the Fed becomes an "object in motion" it will be languid, adjusting policy only gently and opportunistically, terminating at an equilibrium policy rate under the "Yellen Rule," which holds that when the economy is normal the funds rate won't be.

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Recommended Reading

The Role of the Central Bank Balance Sheet in Monetary Policy
ECB *Economic Bulletin*
June, 2015

The Labor Share of Income and Equilibrium Unemployment
Andrew Figura and David Ratner
FEDS Notes
June 8, 2015

Early Childhood Education by MOOC: Lessons from Sesame Street
Melissa S. Kearney and Phillip B. Levine
NBER Working Paper No. 21229
June 2015