FOCUS · The Fed's strategy in 2017: firmer steps but still cautious

Last December the Federal Reserve (Fed) carried out what turned out to be the only hike in the fed funds rate in 2016. In addition to its decision to raise the benchmark rate by 25 bps to the range of 0.50%-0.75%, attention was also focused on the institution's upgrade of its forecasts regarding the appropriate fed funds level in 2017.

FOMC members are now planning three hikes in 2017 compared with the two predicted last September, which would bring the benchmark rate to 1.25%-1.50% by December 2017. The interesting feature of this more aggressive interest rate scenario is that it is does not come from higher growth or inflation forecasts by the monetary authority. Therefore, this adjustment in the interest rate outlook is more likely to be due to a shift in the balance of risks surrounding the expected scenario. The strength shown by activity indicators in the last few months, the upswing in oil prices and prospect of more expansionary fiscal policies have reduced the risk of inflation falling again and remaining low for any substantial period. A scenario which the markets seem to confirm, particularly now that expansionary fiscal policy is more likely thanks to Donald Trump's election. An approximate view of this situation can be seen in the first graph, showing the price (or premium) paid by investors to hedge scenarios with inflation below 2% and 1% over the next five years.

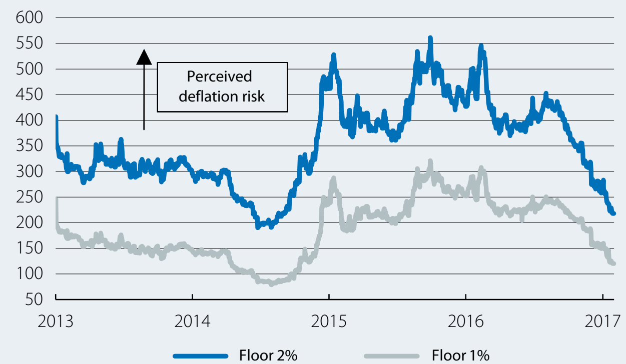
In fact, this potentially new direction for fiscal policy is becoming an important factor that might alter the central bank's interest rate policy in the coming quarters. CaixaBank Research expects the package of fiscal measures to have a modest effect on growth and inflation. However, as the US economy is very close to full employment, the impact of expansionary fiscal policy on growth may be lower than predicted and could, in turn, lead to higher inflationary pressure than expected.

The Fed is therefore likely to apply a more aggressive normalisation policy than the one discounted by the bond market, which predicts two hikes in 2017. The same conclusion can be drawn from the trend in the fed funds rate predicted by the Taylor rule. This rule suggests the level the benchmark rate should be at according to the macroeconomic conditions prevalent at any given time (essentially growth and inflation).

A traditional application of the rule's parameters indicates that the benchmark rate should be around 4%. However, an alternative interpretation, commonly known as the «Yellen rule», suggests the appropriate fed funds rate is currently much lower, around 1.75%, although still clearly higher than its actual rate.[1] What's more, the Yellen rule calls for the fed funds rate to rise over the next few quarters by around 75 bps, based on the forecast scenario published by the Fed last December.

US: 5Y inflation option premiums

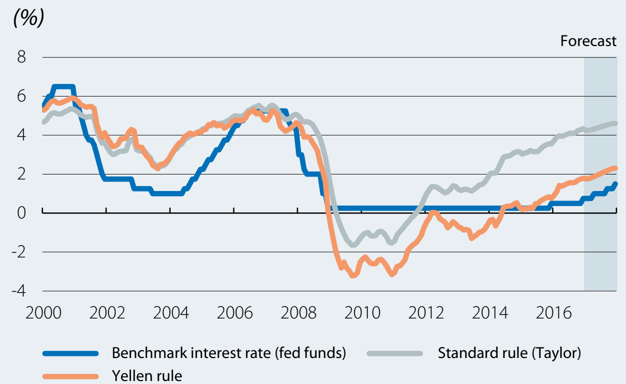
(bps)



Note: *For a description of inflation options, see the Focus «Inflation expectations and financial instruments: a valuable duo» in MR04/2014.*
Source: *CaixaBank Research, based on data from Bloomberg.*

*US: benchmark interest rate and predictions according to monetary policy rules **

(%)



Note: ** CaixaBank Research forecasts are used for the benchmark interest rate.*
Source: *CaixaBank Research, based on data from CBO, Federal Reserve and Bloomberg.*

1. The term «Yellen rule» refers to a Taylor rule using the inflation and output gap coefficients and parameters cited by the Fed's chairman in several of her speeches. See Yellen (2015): Normalizing Monetary Policy: Prospects and Perspectives.