On the Other Hand…

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“Give me a one-handed economist!”

– Harry S. Truman

The minutes of the April 26-27 Federal Open Market Committee meeting has returned monetary policy to the list of financial market worries. However, while most Fed officials believe that a June rate hike could be in the cards, that doesn’t mean that rates will be raised next month. On the one hand, there are reasons to resume policy normalization. On the other hand, there are reasons to delay. The end results will depend on how the Fed balances the data and the risks.

“Participants agreed that their ongoing assessments of the data and other incoming information, as well as the implications for the outlook, would determine the timing and pace of future adjustments to the stance of monetary policy. Most participants judged that if incoming data were consistent with economic growth picking up in the second quarter, labor market conditions continuing to strengthen, and inflation making progress toward the Committee’s 2 percent objective, then it likely would be appropriate for the Committee to increase the target range for the federal funds rate in June. Participants expressed a range of views about the likelihood that incoming information would make it appropriate to adjust the stance of policy at the time of the next meeting.”

– FOMC Minutes (April 26-27)

As with recent monetary policy meetings, the June 14-15 FOMC meeting will be a “live” meeting. That means that Fed officials will discuss a possible increase in the federal funds target rate. However, the decision will depend on the economic data between now and then. A majority of Fed officials believe that if economic growth shows signs of picking up, the labor market continues to improve, and inflation appears likely to head higher, then it will be appropriate for the Fed to raise rates. However, officials differ in their expectations of whether that criteria will be met. It’s still a judgement call. The FOMC minutes showed that “several participants were concerned that the incoming information might not
provide sufficiently clear signals that a rate increase would be warranted. On the other hand, “some participants expressed more confidence that incoming data would prove broadly consistent with economic conditions that would make an increase in the target range in June appropriate.” Some officials thought that financial market participants had not properly assessed the likelihood of a June rate hike and stressed the importance of communicating clearly how the Fed would respond to economic and financial developments.

The risks of a policy error remain significant and one-sided. The upside potential for growth appears limited, but the Fed could easily tighten policy more rapidly if needed. While there are moderate downside risks to growth, there are limited policy options to address a weakening in the economic outlook. This is why the Fed has adopted a cautious stance on raising rates.

Market participants have consistently foreseen a much shallower glide path for short-term rates than Fed policymakers have expected. At the same time, the dots in the dot plot (Fed officials' expectations of the appropriate level of the federal funds rate for the next few years) have drifted lower quarter after quarter (the next update of the dot plot is set for June 15). In other words, the Fed has gradually moved
closer to market expectations rather than the other way around. Yet, the markets may be lured into a false sense of complacency, perhaps believing that rates can’t be raised because doing so would unsettle financial conditions. The Fed can try to have it both ways, by talking tough, but at some point it would have to follow through with an actual rate increase to insure credibility.

The Fed needs to normalize monetary policy over time, no doubt, but the arguments for tightening sooner rather than later are not especially compelling, while the arguments for delaying policy action are. One line of reasoning for delay is especially persuasive. It’s very difficult for the Fed to raise rates when business fixed investment (capital spending) is contracting.

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