US Fed policy: Fed remains on track; shrugs off inflation woes

- In line with our expectations, US Fed increased the Fed funds rate (FFR) target range by 25 bps to 1.00%-1.25%.
- The median FFR remained unchanged for all years, while the distribution of the ‘dots’ in the ‘dot plot’ moved down slightly for 2017 and 2018. Details were announced on the balance sheet front.
- While the committee acknowledged the recent cooling in inflation, it was attributed to one-off factors. But the FOMC revised its inflation projections substantially downward.
- Fed’s forward guidance and Janet Yellen’s commentary continued to signal ‘gradual’ policy move. However, we were surprised by the relatively hawkish tone adopted by the Fed.

Fed move marks second rate hike in 2017
In line with our expectations, the US Federal Reserve increased the Fed funds rate target range by 25 bps to 1.00-1.25%. The policy action marked the fourth rate hike in this policy tightening cycle that commenced in 2015, and the second move for this year. The only dissenter was Neel Kashkari.

Fed continues to see 3 hikes each in 2017, 2018
- The policy statement highlighted that the future course of policy normalisation will be gradual, adding that the current stance of monetary policy remains accommodative. Fed Chair Janet Yellen stated in the press conference that the intention to reduce policy accommodation indicates the pickup in economic growth.
- The median Fed funds rate (FFR) projections for 2017 and 2018 were unchanged, indicating the FOMC’s continued intention to hike once more in 2017. However, for 2018, the distribution of dots seemed more dovish, even as the median dot is unchanged. This signals an increase in the number of participants revising their confidence in the economic outlook downwards for next year.
- FOMC participants also voted to raise the interest rate paid on required and excess reserve balances (IOER) to 1.25% (prior: 1.00%). The Board of Governors authorised the use of overnight reverse repurchase facility (ON RRP) and set the offering rate at 1.00%. Further, the discount rate (primary credit rate) was raised by 0.25 percentage points to 1.75%. (See Annexure for details).

FOMC bullish on growth, while acknowledging soft inflation
- The Fed acknowledged the continued strength in the labour market. The wording used by the FOMC changed slightly to ‘job gains have moderated, but have been solid’ from ‘job gains were solid’, indicating a tightening market. Ms. Yellen said that the unemployment rate has fallen to near historic-lows. She said that the steady participation rate is a positive, given the ageing US population and adverse demographics.
- In line with Fed expectations in May, the Committee felt household spending has picked up in recent months, and business fixed investment has continued to expand, the latter being more bullish than the earlier perception of investment simply firming. Ms. Yellen said that economic growth appears to have rebounded in Q2 2017, supported by high levels of consumer sentiment. She iterated that the Fed expects economic growth to be moderate over the next few years.
- While the Fed acknowledged the cooling of inflation, Ms. Yellen said that it was largely guided by a one-off softening of inflation for components like wireless telephone services and prescription drugs. She stressed that, with employment near maximum sustainable levels, the FOMC expects inflation to move up and stabilise at 2% over the next few years.
Forecasts see changes from March projections
In the Summary of Economic Projections (SEP) that accompanied the statement, the FOMC made the following changes:

- GDP growth projection for 2017 was revised upwards to 2.2% from 2.1% seen in March, while remaining unchanged for the remaining years.
- The unemployment rate was revised downwards for all periods, with the expected rate being 4.3% in 2017. The long term rate is expected to be lower at 4.6% (4.7% seen in March).
- In line with our expectations, the FOMC brought down their headline PCE deflator projection for 2017 (to 1.6% from 1.9%), while core inflation is seen at 1.7% now (1.9% seen in March).

Balance sheet normalisation details presented
- In its May meeting minutes, the FOMC had detailed to some extent its plans for the winding down of its USD 4.5 tn balance sheet. The Committee planned to announce a set of gradually increasing caps on the Dollar amounts of Treasury and agency securities that would be allowed to run off each month, and only the amounts of securities repayments that exceeded the caps would be reinvested each month. The final values of the caps would then be maintained until the size of the balance sheet was normalized. Further details on the same were available tonight:
  - For principal payments from maturing Treasury securities, the Committee anticipates that the cap will be USD 6 bn per month initially and will increase in steps of USD 6 bn at three-month intervals over 12 months until it reaches USD 30 bn per month.
  - For principal payments from its holdings of agency debt and mortgage-backed securities, the Committee anticipates that the cap will be USD 4 bn per month initially and will increase in steps of USD 4 bn at three-month intervals over 12 months until it reaches USD 20 bn per month.
- The Committee will continue its policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities and of rolling over maturing Treasury securities at auction. The FOMC expects balance sheet reduction to start this year, provided the economy evolves as anticipated.

Markets react to hawkish Fed commentary
In the run up to the Fed meeting, a certain amount of market turmoil was seen amid a soft CPI inflation print from the US for May. Post the 25 bps hike delivered by the Federal Reserve, the Treasury yields fell somewhat before rallying again. The US 2Y and 10Y yields are trading at 1.34% and 2.15% currently as against 1.29% and 2.11% before the policy. The Dollar index saw a sharp fall to 96.34 from 96.49 in the immediate aftermath of the policy. Subsequently, it recovered to 97.02 levels, amid unfavourable data prints. The 5Y IRS also fell to -1.76% post policy, before recovering to 1.82% post Yellen’s press conference. Stock markets have shown mixed reactions to the policy. (Market rates are as of IST 1.01 A.M)

The price reactions have shown that markets perceived Yellen’s commentary to be substantially more hawkish than expected, which supported an already hawkish policy statement. The Fed’s insistence on the ebbing of inflation being transitory, as well as announcing definite details of balance sheet normalization are much more hawkish developments than factored in by markets pre-policy.

Monetary tightening to remain on track in 2017
The current dot plot indicates one more rate hike in 2017. Incoming data, especially on the inflation front, will remain key in guiding policy, in the absence of fiscal policy support. For now, we maintain our base case view of one more hike this year, contingent on better inflation prints.

Chart 2: Inflation and unemployment projections saw sizeable downward revisions
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<tbody>
<tr>
<td>GDP (%YoY)</td>
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<td></td>
<td></td>
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<tr>
<td>Mar 2017</td>
<td>2.1</td>
<td>2.1</td>
<td>1.9</td>
<td>1.8</td>
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<tr>
<td>Jun 2017</td>
<td>2.2</td>
<td>2.1</td>
<td>1.9</td>
<td>1.8</td>
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<tr>
<td>Unemployment Rate (%)</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Mar 2017</td>
<td>4.5</td>
<td>4.5</td>
<td>4.5</td>
<td>4.7</td>
</tr>
<tr>
<td>Jun 2017</td>
<td>4.3</td>
<td>4.2</td>
<td>4.2</td>
<td>4.6</td>
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<tr>
<td>PCE inflation (%YoY)</td>
<td></td>
<td></td>
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<tr>
<td>Mar 2017</td>
<td>1.9</td>
<td>2.0</td>
<td>2.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Jun 2017</td>
<td>1.6</td>
<td>2.0</td>
<td>2.0</td>
<td>2.0</td>
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<tr>
<td>Core PCE inflation (%YoY)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mar 2017</td>
<td>1.9</td>
<td>2.0</td>
<td>2.0</td>
<td>n.a.</td>
</tr>
<tr>
<td>Jun 2017</td>
<td>1.7</td>
<td>2.0</td>
<td>2.0</td>
<td>n.a.</td>
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<tr>
<td>Median Fed funds rate (%)</td>
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<td></td>
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</tr>
<tr>
<td>Mar 2017</td>
<td>1.375</td>
<td>2.125</td>
<td>3.000</td>
<td>3.000</td>
</tr>
<tr>
<td>Jun 2017</td>
<td>1.375</td>
<td>2.125</td>
<td>3.000</td>
<td>3.000</td>
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Source: US Federal Reserve
## A. FOMC statement comparison

<table>
<thead>
<tr>
<th></th>
<th>May 3rd, 2017</th>
<th>June 14th, 2017</th>
<th>Our assessment</th>
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<tbody>
<tr>
<td><strong>Growth</strong></td>
<td>Labor market has continued to strengthen even as growth in economic activity slowed.</td>
<td>Labor market has continued to strengthen and that economic activity has been rising moderately so far this year</td>
<td>Hawkish</td>
</tr>
<tr>
<td><strong>Labour market</strong></td>
<td>Job gains were solid, on average, in recent months, and the unemployment rate declined.</td>
<td>Job gains have moderated but have been solid, on average, since the beginning of the year, and the unemployment rate has declined</td>
<td>Neutral</td>
</tr>
<tr>
<td><strong>Other sectors</strong></td>
<td>Household spending rose only modestly, but the fundamentals underpinning the continued growth of consumption remained solid. Business fixed investment firmed.</td>
<td>Household spending has picked up in recent months, and business fixed investment has continued to expand</td>
<td>Hawkish</td>
</tr>
<tr>
<td><strong>Inflation</strong></td>
<td>Inflation measured on a 12-month basis recently has been running close to the Committee’s 2 percent longer-run objective, excluding energy and food, consumer prices declined in March and, inflation continued to run somewhat below 2 percent. Market-based measures of inflation compensation remain low; survey-based measures of long-term inflation expectations are little changed, on balance.</td>
<td>On a 12-month basis, inflation has declined recently and, like the measure excluding food and energy prices, is running somewhat below 2 percent. Market-based measures of inflation compensation remain low; survey-based measures of long-term inflation expectations are little changed, on balance.</td>
<td>Neutral to dovish</td>
</tr>
<tr>
<td><strong>Risk to the outlook</strong></td>
<td>The slow(down) in growth during the first quarter as likely to be transitory and continues to expect that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace, labor market conditions will strengthen somewhat further, and inflation will stabilize around 2 percent over the medium term. Near-term risks to the economic outlook appear roughly balanced. The Committee continues to closely monitor inflation indicators and global economic and financial developments.</td>
<td>With gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace, and labor market conditions will strengthen somewhat further. Inflation on a 12-month basis is expected to remain somewhat below 2 percent in the near term but to stabilize around the Committee’s 2 percent objective over the medium term. Near term risks to the economic outlook appear roughly balanced, but the Committee is monitoring inflation developments closely.</td>
<td>Neutral</td>
</tr>
<tr>
<td><strong>On Fed funds rate</strong></td>
<td>In view of realized and expected labor market conditions and inflation, the Committee decided to maintain the target range for the federal funds rate at 3/4 to 1 percent. The stance of monetary policy remains accommodative, thereby supporting some further strengthening in labor market conditions and a sustained return to 2 percent inflation.</td>
<td>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 to 1-1/4 percent. The stance of monetary policy remains accommodative, thereby supporting some further strengthening in labor market conditions and a sustained return to 2 percent inflation.</td>
<td>Hawkish</td>
</tr>
<tr>
<td><strong>Voting</strong></td>
<td>Voting for the FOMC monetary policy action were: Janet L. Yellen, Chair; William C. Dudley, Vice Chairman; Lael Brainard; Charles L. Evans; Stanley Fischer; Patrick Harker; Robert S. Kaplan; Neel Kashkari; and Jerome H. Powell</td>
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<td>—</td>
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*Highlighted portions represent additions to the statement*
B. Basic definitions

**Fed funds rate**

- The interest rate at which banks and other depository institutions trade balances (held at the Federal Reserve) with each other, usually on an overnight basis.
- The Fed fund rate target range reflects the band that the Federal Reserve intends to move the federal funds rate into. This Fed funds target range currently stands at 0.75%-1.00%.
- The weighted average rate for all of these types of transactions is called the effective Federal funds rate.

C. Details of Normalisation tools being used by the Fed

**Interest on excess reserves (IOER)**

- Prior to the financial crisis, reserve balances at the Federal Reserve did not earn interest. However, legislation passed in 2006 and 2008 authorized the Federal Reserve to pay interest on reserves held by depository institutions, starting in October 2008.
- FOMC participants voted, in this meeting, to raise the interest rate paid on required and excess reserve balances (IOER) to 1.00% (prior: 0.75%).

**Overnight Reverse Repurchase Agreement Facility (ON RRP)**

- IOER is not available to many large and active money market investors, such as money market funds (MMFs), other cash-management vehicles, nonfinancial corporations, and government-sponsored enterprises (GSEs).
- In some respects, an ON RRP facility would operate similar to the way the Federal Reserve's payment of interest on excess reserves works for depository institutions. In general, any counterparty that is eligible to participate in the ON RRP facility should be unwilling to invest funds overnight with another counterparty at a rate below the ON RRP rate.
- The Board of Governors, in today's policy decision, authorised the use of overnight reverse repurchase facility (ON RRP) and set the offering rate at 0.75% (prior: 0.5%).

**Discount rate**

- The discount rate is the interest rate charged to commercial banks and other depository institutions on loans they receive from their regional Federal Reserve Bank's lending facility—the discount window. The Federal Reserve Banks offer three discount window programs to depository institutions: primary credit, secondary credit, and seasonal credit, each with its own interest rate.
- Under the primary credit program, loans are extended for a very short term (usually overnight) to depository institutions in generally sound financial condition. Depository institutions that are not eligible for primary credit may apply for secondary credit to meet short-term liquidity needs or to resolve severe financial difficulties. Seasonal credit is extended to relatively small depository institutions that have recurring intra-year fluctuations in funding needs, such as banks in agricultural or seasonal resort communities.
D. Comparison of ‘dot-plots’ on Fed funds rate projections

**Note:** In the panel above, each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant’s judgment of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run.
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