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New Fed key rate projections surprising

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At its latest meeting the Federal Reserve's Open Market Committee met market expectations with regard to the further correction of its asset purchasing program and the tweaking of its forward guidance for key rates. By contrast, the key rate projections are likely to have come as a surprise. All told, however, everything still points to a gradual normalization of monetary policy.

With regard to correcting its asset purchasing program, the Federal Open Market Committee (FOMC) remained on course. The monthly volume of government bond und mortgage-backed securities purchases was reduced by a further USD 10bn to USD 55bn a month. With a reduction on a similar scale at each of the remaining FOMC meetings up to October, the program would expire completely in November. Given the solid labor market data in February and comments by a string of Fed representatives in recent weeks, the decision to reduce asset purchases further came as little surprise.

As expected, the Fed also further tweaked its forward guidance. The forward guidance to date based on threshold values is being abandoned completely in favor of a qualitative guidance based on a broad spectrum of indicators (labor market, inflation/inflation expectations and financial trends). Based on the assessment of these factors, the FOMC continues to assume that the current level of interest rates will remain appropriate for some while after the completion of the asset purchasing program, especially if forecast inflation remains below the target rate of 2% and longer-term inflation expectations remain firmly anchored.

However, the new projections by the participants at the FOMC meeting regarding the interest rate level at the end of a given year do signal more strikingly than the assessments made in December 2013 initial key rate corrections next year. Accordingly, the key rate level could be raised to 1% by the end of 2015 and rise to 2.25% by the end of 2016. That is 0.25 and 0.5 percentage points more, respectively, than in December 2013. To date market expectations had been geared to a first rate hike in the second half of 2015. The expected timing for an initial rate move, particularly given a positive data flow, could now shift forward, bringing it into line with our assessment (first half-year).

Basically, however, the message remains that monetary policy is set to return to normal in the years ahead. The Fed underscores this with the first explicit hint in the statement accompanying the monetary policy decisions that the economic backdrop could warrant a key rate level below what is deemed (in the long-term) the neutral level of 4%, even if the unemployment rate and inflation fall in line with the targets. As the updated macroeceonomic projections also show, the latter would broadly be the case in late 2016. The statements by Fed president Yellen – like corresponding utterances by her predecessor Bernanke last year – can be interpreted as suggesting that the Fed is assuming a depressed level of the equilibrium real interest rate, at least for a while, that is compatible with economic growth in line with potential and a stable inflation rate.

These assessments are, as always, subject to the disclaimer provided below.

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

NO DUTY TO UPDATE