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Five reasons the Fed to hike rates three times in 2018

Economist

Kathy Bostjancic
Head of US Investor Services
+646 503 3066

- **Having revised our Fed rate call for next year, we now expect three rate hikes of 25bp each in 2018 (up from two previously). The three hikes will follow an expected third rate increase for this year at the December FOMC meeting.**
- **We see five reasons for a moderately faster pace of policy tightening in 2018:**
  (i) Larger estimated fiscal stimulus will boost growth and inflation next year
  (ii) Most Fed officials have not previously factored stimulus into their forecasts
  (iii) A more hawkish shift in the FOMC's voting composition
  (iv) Core CPI has rebounded, led by a recovery in core services prices
  (v) More Fed emphasis on tightening resource utilization than inflation

We now expect the Fed to hike rates three times in 2018

Our revised forecast means the midpoint of the federal funds target range would rise from 1.38% at the end of 2017 to 2.13% by the end of 2018. Looking at timing, we expect there to be three rate hikes of 25bp each in Q1, Q2 and Q3 next year. Such a pace of tightening would still be gradual. Gradual progress in inflation towards 2% will allow three rate hikes in 2018, which is in line with the current median fed funds dot plot estimates and similar to the expected three rate hikes this year. However, we believe still moderate wage and inflation growth will restrain the Fed from being more aggressive.

We see five important reasons for a moderately faster pace of rate hikes in 2018:

Larger-than-expected fiscal stimulus boosts growth and to a lesser extent inflation

1. **Fiscal stimulus.** It is looking increasingly likely that Congress will pass a fiscal stimulus package along the lines of the Senate's $1.5 trillion Tax Cuts and Jobs Act. Our upcoming December baseline will therefore assume $1.5 trillion of tax cuts over the next decade, up from $500 billion previously. Based on this assumption, the economy is expected to advance 2.4% Q4/Q4 in 2018 with a 0.3ppt fiscal boost. Moreover, with the economy currently close to potential and the fiscal package expected to have limited supply-side benefits, expansionary fiscal policy will lead to modest inflationary pressures. We forecast PCE inflation to average 1.8% Q4/Q4 in 2018 (up from 1.7% in 2017), the unemployment rate to fall to 3.9% on average in Q4 2018 and core inflation to average 1.8% Q4/Q4, up from 1.5% in 2017. Compared with the FOMC's median forecasts released in September, our revised forecasts show GDP growth in 2017 and 2018 moderately higher, the unemployment rate slightly lower, and headline and core inflation in 2018 only slightly lower (see Table 1 on p3). This would be consistent with the FOMC's median fed funds dot plot estimates, which show three rate hikes in 2018.

Contact: Kathy Bostjancic | Kathybostjancic@oxfordeconomics.com

Factoring in fiscal stimulus into their forecasts will support Fed officials' view of three rate hikes next year

2. **Most FOMC officials have not previously** factored any stimulus into their individual forecasts. And those who have factored in stimulus have scaled back its size and timing. Factoring in the stimulus will not only support the FOMC's median dot plot estimates of three rate hikes in 2018, but could also result in four or more hikes (Chart 1).

Table 1

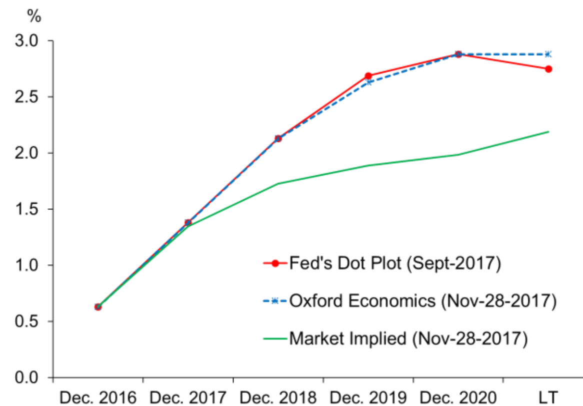
FOMC's median forecasts vs OE forecasts

Summary of Economics Projections	2017		2018		2019		2020		Long run	
%	FOMC	OE	FOMC	OE	FOMC	OE	FOMC	OE	FOMC	OE
GDP Q4/Q4										
Dec-17		2.6		2.4		1.7		1.5		1.5
Sep-17	*2.4*	*2.1*	*2.1*	*2.2*	*2*	*1.7*	*1.8*		*1.8*	*1.5*
Jun-17	*2.2*	*2.2*	*2.1*	*2.6*	*1.9*	*1.7*			*1.8*	*1.5*
Mar-17	*2.1*	*2.2*	*2.1*	*2.3*	*1.9*	*1.6*			*1.8*	*1.5*
Unemployment rate Q4										
Dec-17		4.1		3.9		4.0		4.1		4.2
Sep-17	*4.3*	*4.3*	*4.1*	*4.2*	*4.1*	*4.3*	*4.2*		*4.6*	*4.5*
Jun-17	*4.3*	*4.4*	*4.2*	*4.4*	*4.2*	*4.4*			*4.6*	*4.5*
Mar-17	*4.5*	*4.6*	*4.5*	*4.6*	*4.5*	*4.7*			*4.7*	*4.8*
PCE Inflation Q4/Q4										
Dec-17		1.7		1.8		1.8		2.0		2.0
Sep-17	*1.6*	*1.4*	*1.9*	*1.7*	*2.0*	*1.7*	*2.0*		*2.0*	*2.0*
Jun-17	*1.6*	*1.7*	*2.0*	*1.9*	*2.0*	*1.8*			*2.0*	*2.0*
Mar-17	*1.9*	*2.1*	*2.0*	*2.1*	*2.0*	*1.7*			*2.0*	*2.0*
Core PCE inflation Q4/Q4										
Dec-17		1.5		1.8		1.9		2.0		2.0
Sep-17	*1.5*	*1.5*	*1.9*	*1.8*	*2.0*	*1.7*	*2.0*			*2.0*
Jun-17	*1.7*	*1.6*	*2.0*	*1.9*	*2.0*	*1.8*				*2.0*
Mar-17	*1.9*	*1.9*	*2.0*	*2.0*	*2.0*	*1.7*				*2.0*

Source: Federal Reserve, Oxford Economics (OE)

Chart 1

US: Federal funds rate expectations



Source: CME/Federal Reserve/Oxford Economics

Our forecast for the path of the fed funds rate has now converged to the Fed's median dot plot estimates. However, Fed officials might revise up their dot plot estimates in December, given the increasing likelihood of fiscal stimulus that will boost economic growth.

FOMC voting composition to be more hawkish in 2018

3. The **changing composition of the** **voting members** **of the FOMC** in 2018 tilts the policy committee moderately more hawkish. Beyond a new Federal Reserve chair, there will be extensive changes taking place on the Board of Governors and among the regional Fed presidents. The rotation raises the possibility that the pace of hikes may be on the high end of what could be considered a gradual removal of policy accommodation. **The likely composition of voting regional Fed presidents in 2018 suggests that there will be two hawks, two moderates and one dove.** This is a shift from the three doves and two moderates that comprised the Federal Reserve District Bank voters in 2017.

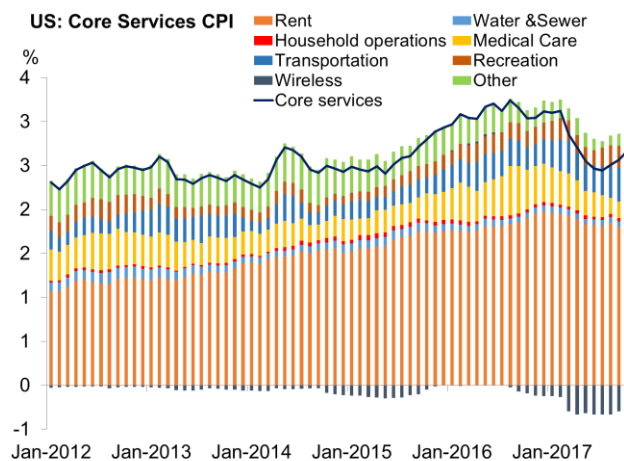
Contact: Kathy Bostjancic | Kathybostjancic@oxfordeconomics.com

President Donald Trump has the opportunity to dramatically reshape the Board of Governors. Out of the three current Governors (excluding Janet Yellen, whose resignation will take effect when Jerome Powell is sworn in as the new chair), only Brainard and Powell are Obama-era appointments. If Brainard leaves before the end of her term, it means that the entire seven-seat board could essentially be filled with the Trump Administration's nominees.

Core CPI readings have rebounded recently

4. **The Core CPI (excluding food and energy) reading has rebounded recently.** The year-on-year rate increased to 1.8% in October, breaking a string of five consecutive readings of 1.7%. The rise was led by a recovery in core service prices to a pace of 2.7% y/y, the fastest since April. The reacceleration in core service prices is significant because it was this category that drove the surprising deceleration in overall inflation this year. If the rebound continues, it supports the FOMC's forecast of 2% inflation in the medium term and emboldens it to hike three times next year.

Chart 2



Source : Oxford Economics/Haver Analytics

Core consumer service price gains are rebounding after a surprising slowdown earlier this year.

Fed officials place more emphasis on the output gap (or resource utilization gap) than the inflation gap

5. **Fed officials are placing more emphasis on the output gap (or resource utilization gap) than the inflation gap,** as per the Taylor Rule. As we have written previously, this suggests that if the labor and product markets continue to tighten it outweighs the fact that inflation may lag behind Fed forecasts and the 2% target. This, in turn, supports a moderately faster pace of rate hikes next year (Chart 3).

   There is little remaining slack in the labor market and while the product market still has excess capacity, it is gradually diminishing as a result of the rebound in global economic and manufacturing activity. A weighted average of our calculated labor and product market gaps produces an alternative, bottom-up output gap measure. Inputting the bottom-up output gap measure into a modified Taylor Rule, which places relatively more emphasis on deviations in output growth, shows the Fed continues to operate along a consistent monetary path as it removes accommodation at gradual pace.

   Former Fed chair Ben Bernanke has argued that the 0.5 coefficient on the output gap should be increased to 1.0 because, based on his experience, "the FOMC paid closer attention to variants of the Taylor Rule that include the higher output gap coefficient." He cited comments made by Chair Yellen and subsequent research into Taylor's original 1993 paper, summarized by Taylor himself in 1999,

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that support raising the weight placed on the output gap to 1.0. While the FOMC pursues policy that fulfils both of its dual mandates of full employment and low and stable inflation, this modified version of the Taylor Rule suggests the FOMC places more importance on promoting full employment and output on a relative basis. In exchange, it accepts moderately more volatility in inflation.

Modified Taylor Rule $r = r^* + inf + 1.0\,(\text{resource gap}) + 0.5\,(inf - 2)$

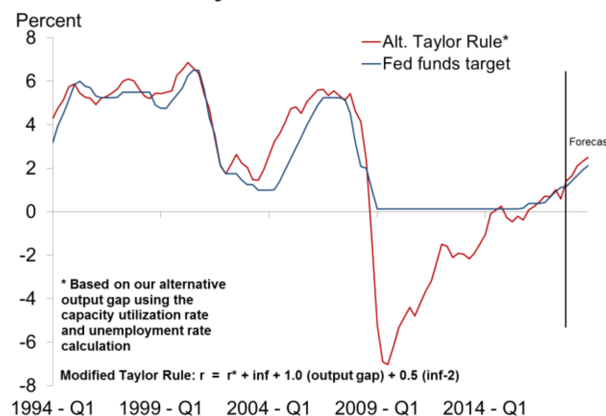
where r = nominal fed funds rate

r* = real long-term fed funds equilibrium rate

inf = core personal consumption expenditure (PCE) prices y/y%

resource gap = alternative output gap measure using the labor and product market gap calculation

Chart 3



Source : Oxford Economics/Haver Analytics

With Fed officials placing more emphasis on the output gap (or resource utilization gap), it supports three rate hikes next year, despite inflation lagging behind expectations.

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