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Viewpoint | US

Chair Yellen bit hawkish, but rate hikes to be gradual

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- **Chair Yellen's semi-annual monetary policy testimony was mildly hawkish, but still points to gradual rate hikes this year. We maintain our call that the Fed tightens in June, but see rising risk they could tighten as early as May. Yellen reiterated "waiting too long to remove accommodation would be unwise, potentially requiring the FOMC to eventually raise rates rapidly."**

- **With regard to the Fed's balance sheet, Chair Yellen confirmed the FOMC's intent to "passively and predictably" shrink the balance sheet by allowing securities to roll-off as they mature. She ruled out an outright selling of Treasury or mortgage-backed securities.**

Chair Yellen was mildly hawkish, but rate hike still likely to be gradual

Chair Yellen's semi-annual monetary policy testimony to the Senate Committee on Banking was mildly hawkish, but still consistent with gradual rate hikes this year. We maintain our call that the Fed waits to raise interest rates until June, but acknowledge the rising risk policymakers might raise rates at the May meeting. Yellen reiterated "waiting too long to remove accommodation would be unwise, potentially requiring the FOMC to eventually raise rates rapidly", providing a hawkish tone to her testimony.

In her "prepared remarks" for the semi-annual monetary policy testimony, Chair Yellen painted a picture of sustained moderate growth for the US economy, a robust labor market, and a pace of inflation that is returning back towards the Fed's 2% objective.

The outlook for the economy was upbeat, but risks and great uncertainty surround the outlook

She also assessed some of the risks facing that relatively rosy backdrop. There are still significant unknowns about what might happen with fiscal, trade and immigration policy, and concerns about another round of significant appreciation in the US dollar. Yellen noted, "As always, considerable uncertainty attends the economic outlook. Among the sources of uncertainty are possible changes in US fiscal and other policies, the future path of productivity growth, and developments abroad." Despite heightened expectations that the economic policies that President Trump and the Republican-led Congress might enact will boost economic growth, the lingering uncertainty over the course of policy in the meantime could hamper business investment and economic activity.

Lack of clarity on prospective economic policy changes creates a cloud of uncertainty for policymakers

In the Q&A, she was asked how policymakers are factoring in the impact of prospective economic policy changes on the economic and interest rate outlook. Chair Yellen replied that while some FOMC members incorporated some degree of fiscal stimulus in their macro and interest rate forecasts, the lack of clarity on the size, composition and timing prevents the FOMC from clearly factoring changes into its outlook. She said the FOMC will need to wait to "gain greater clarity" on policy changes. She also noted though that economic policy changes are among many factors that could affect monetary policy. On an optimistic note she said that some economic policies could lift the supply-side potential of the economy.

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That said, she warned again that the fiscal deficit and debt trajectory is not sustainable over the long-run and could end up eroding the productive capacity of the US economy.

Yellen said the FOMC intends to eventually shrink the balance sheet in a "passive and predictable" manner

With regard to questions about the balance sheet, Chair Yellen reaffirmed that the FOMC intends to "passively and predictably" shrink its balance sheet over coming years to a size that is "substantially" smaller. She reiterated that the FOMC intends to return the composition of the balance sheet back to primarily Treasury securities, but ruled out outright sales of mortgage-backed securities. As for the timing, she underscored the FOMC would want to make sure that rate normalization is well underway and that FOMC members will be talking about the logistics surrounding the reduction of the balance sheet over the coming months.

We forecast the FOMC starts to shrink the balance sheet in 2018, but Yellen's cautious comments suggest it could come a bit later

As we previously wrote, we forecast that with the fed funds rate above the 1% rate level in 2018 the FOMC will likely start to reduce the size of its balance sheet by tapering the reinvestments of maturing Treasury securities by 50%, so that it allows $213 billion of the $426 billion of maturing Treasury securities to roll-off its balance sheet. However, Yellen also commented that the FOMC intends to the maximum extent possible to rely on changes in short-term rates to implement monetary policy rather than to "use fluctuations in the balance sheet as an active tool of monetary policy management." This comment and her cautious view that the FOMC wants to have strong confidence that the rate normalization is well underway suggests the FOMC might be slower to start reducing the balance sheet than we currently estimate.

Yellen intends to remain Chair until her term is up in February 2018

Among other key topics, Chair Yellen reaffirmed her intent to remain Chair of the FOMC through the end of her term in February 2018. When asked about whether the FOMC should adopt mechanical rules to determine the course of monetary policy, she opined that a rule such as the Taylor Rule would call for a 3.5% - 4% fed funds target rate. That is of course much higher than what the FOMC has currently set short-term interest rates and she asserted such higher rates would have greatly slowed economic growth.

Not surprisingly, given the political backdrop and the fact that Federal Reserve Governor Tarullo, the *defacto* Vice Chair of Supervision, recently announced his resignation from the Board of Governors, Chair Yellen was asked how the Fed would interact in the future with a new appointee to the Vice Chair of Supervision. Her answers were straight forward and in line with what the Frank-Dodd law dictates. As we wrote yesterday, we see two large implications of Tarullo's departure from the Board. First, President Trump can fill the Vice Chair for Supervision with a proponent of his deregulation agenda for banks. Second, Trump can now fill three out of the seven FOMC Board of Governor seats

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