JOINT ECONOMIC COMMITTEE
SENATOR DAN COATS, CHAIRMAN

March 2016 Federal Open Market Committee Announcement Review

The financial market volatility that followed the Fed's December rate hike led most market watchers to conclude that the projected four increases incorporated in the Fed's December "dot plots" would be delayed. After assessing the comparative strength of the U.S. economy and improved employment statistics, most Fed-watching economists expect no rate rise before June. Yesterday's FOMC press release announced no increase in interest rates; the accompanying "dot plot" projections echoed market expectations, anticipating just two Fed rate increases this year. As FOMC members revised their GDP forecasts slightly lower, this implies that they determined more easing was justified, despite falling unemployment:

March Projection	2016	2017	2018	Previous Dec. Projection	2015	2016	2017	2018
Change in Real GDP	2.2%	2.1%	2.0%	Change in Real GDP	2.1%	2.4%	2.2%	2.0%
Unemployment Rate	4.7%	4.6%	4.5%	Unemployment Rate	5.0%	4.7%	4.7%	4.7%
PCE Inflation	1.2%	1.9%	2.0%	PCE Inflation	0.4%	1.6%	1.9%	2.0%
Core PCE Inflation	1.6%	1.8%	2.0%	Core PCE Inflation	1.3%	1.6%	1.9%	2.0%
Fed Funds Rate	0.9%	1.9%	3.0%	Fed Funds Rate	0.4%	1.4%	2.4%	3.3%

Note: Median projection; Source: Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents

One FOMC member, Kansas City Fed Governor Esther George, dissented, advocating faster rate increases.

Context

The U.S. recovery continues, slow and steady.

- Projections for 3%+ real GDP growth seem to have disappeared with the last recession. The Atlanta Fed currently estimates real GDP growth for the first quarter to be 2.2%, just below the 2.4% rate for 2015. The Organization for Economic Cooperation and Development (OECD) recently lowered its estimate for U.S. growth in 2016 to just 2.0% -- which appears robust when compared to 1.4% in the EU and 0.8% in Japan. Wells Fargo also estimates sub-par real GDP growth of 1.9% in 2016.

- The strong dollar is weighing down exports, harming the manufacturing and agricultural sectors. Higher Fed rates would keep the dollar value high, especially while Japan and the EU try negative interest rates.
- The unemployment rate is down to pre-recession levels, at 4.9% in February. However, Goldman Sachs expects no rebound for the labor force participation rate, which, at 62.9%, stands 2.8 percentage points below the recovery start. The "inclusive" unemployment rate stands at 9.7%, measuring the unemployed, discouraged job-hunters, and part-timers seeking full-time work. In addition, part-time workers as a share of total employed remain more than 1.5 percentage points above pre-recession levels.
- The average 2% real GDP growth rate has yet to show up in equivalently higher wages. Real hourly compensation achieved small gains over the last year. In 81% of U.S. counties, median household income peaked 15 years ago.
- Inflation has not reached the FOMC's 2% target rate, but core inflation (excluding food and energy) just saw a year-over-year 2.3% rise – the largest inflation increase in almost five years. The Fed will be monitoring both actual and expected inflation, but its inflation expectations remain low.

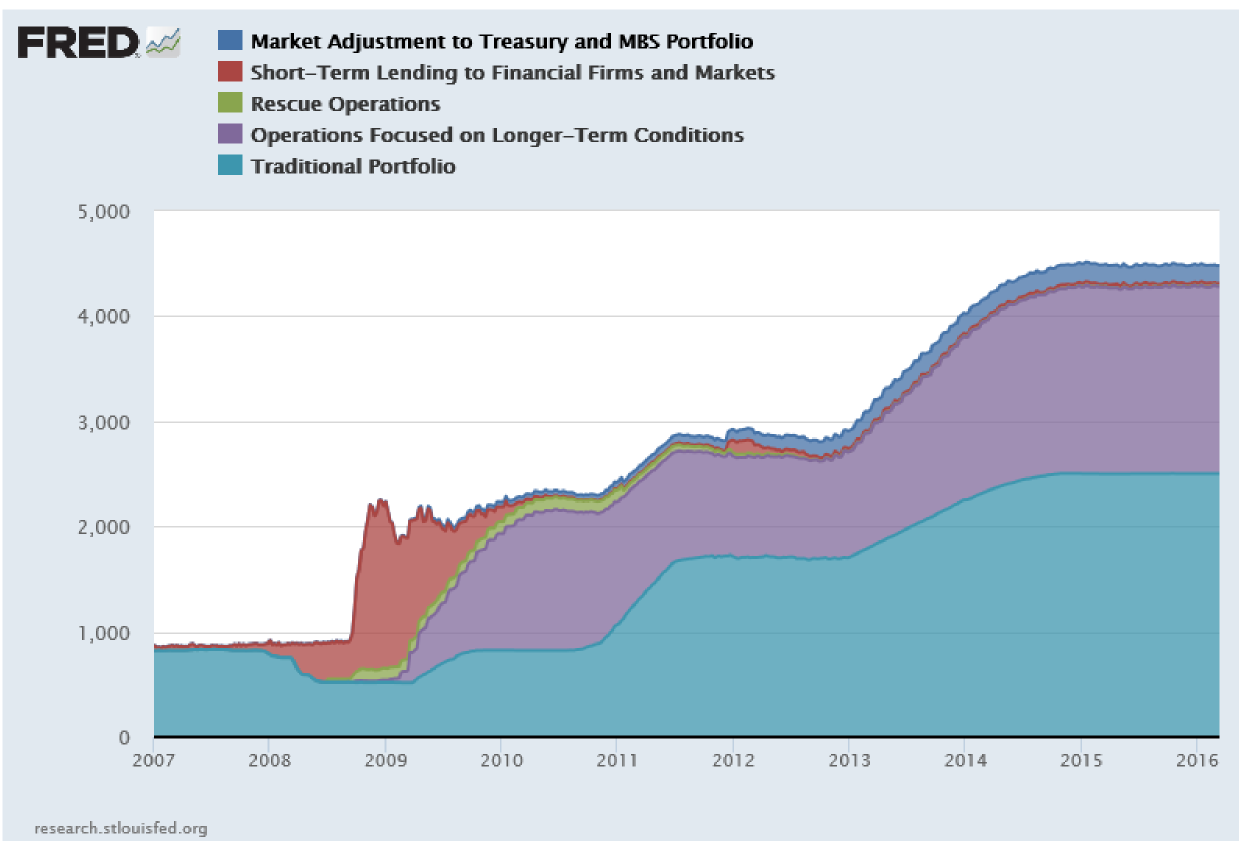
EU Impact?

While the Fed embarks on a schedule of interest rate increases, the European Central Bank is following in the steps of the Bank of Japan, implementing a Negative Interest Rate Program (NIRP). Other central banks are undertaking a high-risk zero interest rate experiment to encourage bank lending that provides economic stimulus in countries that have little or no growth and face risk of deflation. The Fed notes that it will continue to monitor the global situation.

The Bigger Picture

The stock market volatility seen since the Fed's December interest rate hike has been particularly hard on retirees, who had moved investments from bonds and savings accounts to stocks because low interest rates could not provide adequate income. They have seen stocks lose 20%, then climb back to December levels; however, these value swings do not suit investors counting on income to pay retirement bills. Some advisors argue that the Fed's low interest policy is making long-term changes to retirement planning.

There is still plenty of speculation as to how the Fed plans to deleverage the assets it has accrued over the course of the recession and into the recovery. As of March 10, the Federal Reserve balance sheet reported total assets of $4.5 trillion, showing no material decrease.



Asset reduction may be a long time away. Today's press release affirmed that there would be no reduction in portfolio assets until interest rate normalization is "well under way"; since their own projections see only gradual increases this year, the underlying message is that the portfolio is not shrinking.

Debt Impact

Significantly, a rise in rates brings with it higher service payments on the gross federal debt, which currently tops $19 trillion. In the latest *Budget and Economic Outlook: 2016 to 2026* (p. 178), the Congressional Budget Office (CBO) expects net interest payments on government debt to double their share of the federal budget, rising from 1.4% of GDP in 2016 to 3.0% in 2026. In fact, over the decade these interest payments are expected to grow to be the third largest spending program, exceeding spending on national defense. Over the same time period, publicly-held debt is projected to climb by 70%, rising to 86% of GDP by 2026.

Alternatively, as CBO noted in its January report, if interest rates on all types of Treasury securities were one percentage point higher each year through 2026 than projected, and all other economic conditions remain equal, the projected increment of deficit increase over the decade would amount to $16 billion in 2016, $269 billion in 2026, and total more than $1.6 trillion over ten years:

Federal Debt Interest Costs	2016	2017	2021	2026	2017-2021	2017-2026
Higher deficit if rates rise 1 percentage point above projections per year (billions of dollars)	16	45	143	269	470	1,622