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Monthly condensed analyses of crucial real estate and economic issues offered by the UCLA Anderson Forecast and UCLA Ziman Center for Real Estate. Here, Stephen Oliner, resident scholar at the American Enterprise Institute and a senior fellow at the UCLA Ziman Center for Real Estate, considers when the Fed may increase the federal funds rate.

The First Fed Tightening Probably Will Not Be Soon

By Stephen Oliner, senior fellow, UCLA Ziman Center for Real Estate

As was widely expected, the Federal Open Market Committee (FOMC) recently announced the end of its current round of asset purchases, which began two years ago and left the Fed holding \$4 trillion in Treasuries and mortgage-backed securities. With this decision, the first item on the Fed's list of steps to normalize monetary policy has been crossed off. The next item on the list is the initial increase in the federal funds rate from its current level near zero.

Unless the economy performs better than expected or inflation heats up, the liftoff will not happen soon — I would bet on next September, though June is a possibility. This forecast reflects the simple fact that the economy is still a fair distance from full employment, despite the ongoing improvement in the labor market, and inflation remains persistently below the 2 percent target rate.

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The FOMC's only guidance on timing is that it expects to keep the funds rate near zero for a "considerable time" after its asset purchases end. This language was introduced in March and has been a constant feature of the FOMC statements since then.

But what does "considerable time" mean? During her press conference in March, Fed Chair Yellen offered that "it probably means something on the order of around six months...". That answer was roundly criticized for being too specific given the uncertainty about the economic outlook. Having been burned, Yellen gave a much fuzzier answer at her next press conference: "... there is no mechanical formula whatsoever for what a 'considerable time' means". Last month, Vice Chair Fischer was asked the same question in a panel discussion and responded that "considerable time" could mean anything from two months to a year. So we now know the phrase has essentially no content.

The financial market provides a forecast of the funds rate every day. For the past several weeks, including after Friday's employment report, the market judgment has been that a rate increase before next September is pretty unlikely. I think the market has it right.

Let's consider the Fed's options for the date of its first tightening. The FOMC has demonstrated that it makes significant policy changes only at meetings followed by a press conference — March, June, September, and December under the current schedule. Only the most hawkish members of the FOMC have been talking about next March as a realistic option. That leaves June as the earliest possible meeting with more than trivial odds.

The FOMC has stressed that its rate decisions will be data-driven. When the Committee meets next June, it will have data on the labor market and inflation through May. How will the data look at that point and how will they be interpreted?

In assessing the degree of slack in the labor market, the FOMC (and everyone else) is looking beyond the official unemployment rate because it fails to capture important aspects of underemployment in today's economy. Notably, the official rate does not count discouraged workers who have left the labor force but are still interested in working, nor does it count people who are working part-time but want a full-time job.

A broader measure of slack known as the U-6 rate captures both aspects of underemployment. In October, the U-6 rate stood at 11.5 percent, down from 13.7 percent a year earlier. If the average monthly decline over the past year — which has been substantial — were to continue, the U-6 rate would be 10.2 percent in May of next year. Despite the further decline, the projected May reading would be only a shade below the peak for the U-6 rate during the 2001 recession. That doesn't describe a labor market at close to full employment.

Inflation is currently running below the FOMC's 2 percent target and, in the near term, will be heading lower because of the plunge in oil prices and the stronger dollar, both of which reflect concern about weak economic performance abroad. The FOMC statement does not suggest much confidence that inflation will move back up to target. It merely says: "... the Committee judges that the likelihood of inflation running persistently below 2 percent has diminished somewhat since early this year." At that time, the Committee was very worried about low inflation. So now the Committee is only somewhat worried. For the FOMC to become confident by June that inflation is heading in the right direction, they'll need to see a sustained period of faster price increases that begins no more than three or four months from now. That's a high hurdle.

Unless the data send a clear signal that the FOMC is falling behind the curve, the Committee has a strong incentive to be patient given the asymmetry of the risks it faces. On the one hand, with the funds rate near zero and the Fed's balance sheet already enormous, a tightening that turns out to be premature leaves the Committee with limited and risky tools to spur growth. Conversely, if the FOMC ends up waiting too long, it can raise the funds rate more rapidly than is currently anticipated and, if need be, can sell assets. Although an abrupt policy tightening could be disruptive to the economy and financial markets, the Fed at least has the tools to do the job.

The Fed's decision to end the QE purchases was easy. The harder decision — when to raise the funds rate — lies ahead. Could the data provide a compelling case by June in favor of tightening given the risk of making a policy mistake that would be difficult to reverse? It's certainly possible, but a later date seems more likely.

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