ECONOMICS: US PERSPECTIVES

POLICY SHIFTS: FOMC RAISES RATES AND CONGRESS RAISES SPENDING

+ Joseph G. Carson, US Economist and Director—Global Economic Research, joe.carson@abglobal.com

A significant change in the stance of US monetary and fiscal policy is underway. The Federal Reserve raised the target on official rates by 25 basis points, and Congress lifted federal spending by hundreds of billions. While all of the attention has been on the first official rate hike in nine years, we think the change in the fiscal policy is more important, as it will directly lift economic growth over the next year and beyond.

Monetary Policy Uptick—Finally!

The Federal Open Market Committee (FOMC) voted unanimously to raise the target on the federal funds rate 25 basis points, lifting the range to 0.25%–0.50%. This modest change is the first rate hike in nine years and ends the extraordinary period of near-zero official interest rates that have been in place since the end of 2008.

According to Fed Chair Janet Yellen, the decision to raise the target range on official rates was based on considerable improvement in the labor markets, which in turn underpins the FOMC confidence that inflation would hit the committee's 2% objective over the medium term (roughly one to two years).

Updated economic projections by Fed policymakers suggest a rather benign outlook of real GDP growth running around 2% (or slightly higher) for the next three years; the jobless rate dipping below 5%, which is close to the full employment measure estimated by most FOMC members; and headline and core inflation gradually moving to the 2% target by the end of 2018.

Rate Hike Is a Vote of Confidence

Even with the benign growth and inflation outlook, the FOMC still expects to lift official rates approximately 100 basis points in each of the next three years. Policymakers justified the decision to raise rates and the future path of rate hikes based on expectations of continued gains in the economy, but they also assessed the situation from a risk-management standpoint. Indeed, at the press conference, Yellen stated that "we considered the risks to the outlook and worried about the fact that with interest rates at zero, we have less scope to respond to negative shocks than to positive shocks that would call for a tighter policy." And, "what we would like to avoid is a situation where we have waited so long that we are forced to tighten policy abruptly."

From our vantage point, the change in official rates is an endorsement by policymakers in the sustainability of the economic cycle and should boost consumer, business and investor confidence. Moreover, even with the small change in official rates, monetary policy remains overly accommodative. And we view this continuation as a positive factor for faster economic growth in 2016. If there is a risk to the benign outlook painted by the FOMC, it's that the economic growth environment becomes stronger sooner due to changes at the federal level.

Fiscal Policy—From Headwind to Tailwind

Congress is currently completing a broad year-end spending and tax package that fundamentally shifts the stance of fiscal policy. Based on press reports, Congress has agreed to add $66 billion to overall government spending, which is in addition to the incremental boosts to defense and transportation budgets that were passed a few weeks ago.

Congress also decided this week to permanently extend a number of tax credits for low-income individuals, small businesses, business investment and energy development, while also delaying prospective tax hikes for healthcare plans that would have been impacted by the Affordable Care Act. While the year-end pattern of extending expiring tax credits is a recurring theme, this is the first time in many years that Congress has decided to make permanent a large number of tax provisions that are scheduled to be renewed each year.

While the renewal of expiring tax provisions is a recurring issue, there is always a risk that Congress will decide to extend some and not extend others. That uncertainty no doubt weighs on decisions of individuals and businesses. The fact that these tax provisions have now become a permanent part of the federal tax law should, at the margin, boost confidence in consumers and businesses, since they will be able to plan beyond the next 12 months and not worry that an investment today will look less attractive from an after-tax sense in a year or more.

Up to now, fiscal policy has been a major headwind to the economic growth cycle, and the contraction in government spending has been one of the most unusual features of this cycle. For 2016, we project an acceleration of 200 to 300 basis points in the aggregate growth of nominal government spending—and that should add, point for point, to nominal GDP growth. This shift in fiscal policy is currently being overlooked by the financial markets and analysts. But we believe this will be a key aspect of a more positive and faster growth environment for next year. ■