United States

Ceasing purchases is the plan

■ **Activity rebounded since the middle of 2016, while the labour market is close to full employment. If inflation remains subdue, in all likelihood it will move closer to the Fed's target in the medium term.**

■ **The normalisation of the US monetary policy can go on. Its pace will depend on the fiscal outlook, but the path followed has been decided a long time ago.**

■ **The Fed will stop rolling over maturing debt in order to downsize its balance sheet, not only at first, as it intends to use net sells at last resort only.**

US growth seems to have hit a new stride in the second half of 2016. GDP growth rebounded to 3.5% in the third quarter after nine months of performing below potential: between end-2015 and the second quarter of 2016, growth was limited to an annualised quarterly rate of just 1%. Although preliminary estimates for the final 2016 quarter are not available yet, the Atlanta Fed's nowcasting model points to growth of 2.8%. At the same time, the main job market indicators are very upbeat: job creations are strong enough to absorb new entrants to the job market; the unemployment rate is as low as 4.8% and the hourly wage rate is accelerating. Inflation remains weak: in November, the personal consumption expenditures (PCE) price index was up 1.4% year-on-year, or 1.6% excluding energy and food prices. Yet at a time of robust growth and quasi full employment, inflation is bound to rise towards the Fed's medium-term target. In December, the FOMC, the Fed's monetary policy committee, unsurprisingly raised the Fed funds target rate by 25 basis points.

It's sad, so sad. It's a sad situation

Yet what caught our attention was not this decision – which would have been risky not to make seeing how convinced the financial markets were in its ineluctability – but Janet Yellen's speech afterwards. Admittedly, the press conference following the latest FOMC meeting was not very informative. Indeed, most of the questions pertained to fiscal policy, which the Fed is careful not to comment on in order to preserve its independence. Even so, Janet Yellen did end up saying that the Fed did not esteem that the time was very ripe for fiscal stimulus. If public spending were to be used as leverage, then it should focus on raising growth potential, notably through support for education. To sum up: as the output gap has been closed, a short-term stimulus would lead to overheating, and to foster better economic performances, it is first necessary to boost potential growth.

The closing of the output gap – the difference between observed and potential growth – is not as positive as it might seem. The gap was closed through the erosion of potential growth, and not through stronger-than-potential growth rate. This observation boils down to saying that the accumulated shortfall in production during and after the crisis will never be made up. There is little chance that those experiencing what Janet Yellen calls "shadow unemployment" will

■ **Air pocket passed**

Quarterly annualised growth rate, % ■ GDP, _ Final domestic demand

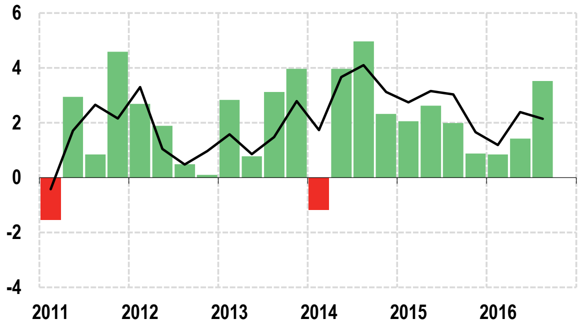

Chart 1 Source: US Bureau of Economic Analysis

return to full-time employment. Their only chance lies in a structurally more dynamic economy, which is not within the reach of monetary policy.

Moreover, if the Fed esteems that the output gap has closed at a potential growth rate of just below 2%, then we can conclude that it will take a restrictive bent whenever growth exceeds that rate, to keep inflation from accelerating and/or bubbles from forming. The reaction of the financial markets fits within this analysis: any fiscal stimulus will come at the cost of a more restrictive monetary policy.

How many key rate hikes in 2017?

For the moment, the Fed is being cautious. The rate projections of the various FOMC members have barely changed. Granted, the median is no more for two but for three rate increases in 2017. But Janet Yellen calls for caution, implying that the consensus[1] continues to be built around two rate increases… as projections currently stand. For the moment, with the exception of a few members, no one has integrated fiscal stimulus in their scenario. To do so, they would first have to wait for Congress to debate any draft bills. Only then could the Fed estimate their expected effects on the economy and adapt its policy accordingly. The Fed undoubtedly would adopt a more restrictive stance if it were to conclude that changes in household and corporate taxation and/or shifts in public spending were to accelerate growth. In this case, we can expect the Fed's wording to shift from the "normalisation" of monetary policy to "accommodation

[1] The FOMC is comprised of voting members (currently five governors, the president of the New York Fed and the presidents of 3 of the 11 other regional Feds, who rotate each year), and non-voting members (the remaining 8 presidents of the regional Feds). The projections published by the FOMC pool together the opinions of all voting and non-voting members, which means it does not necessarily reflect the sentiment of the voting members.

removal", and then more or less quickly thereafter to the need for "policy firming".

The Feds's balance sheet

This brings us to the question of the Fed's balance sheet, which has swollen under the various waves of quantitative easing (QE). The current policy of rolling over securities as they reach maturity does not change the size of its balance sheet. Very early on, the Fed provided the broad outlines of its QE exit strategy. In February 2010, in the final weeks of QE1, Ben Bernanke presented Congress with the successive steps for normalising monetary policy[2]. These steps were officialised at the FOMC meeting of June 2011 and then amended slightly a little over three years later[3].

The stated aim is to reach a "normal" balance sheet, in which securities (mainly Treasuries) are held in the amounts needed – no more and no less – to effectively conduct monetary policy. To reduce its balance sheet, the Fed will begin by halting the roll-over of securities as they reach maturity. Only Treasuries are likely to be sold off. Agency-issued mortgage backed securities (MBS) will be held until maturity. Selling securities appears to be an ultimate, hypothetical step, and as the Fed points out, the public would be informed far in advance of the details of any operations, including the date, duration and amount.

To sum up, we should not expect the Fed to begin liquidating its balance sheet this year. Security disposals seem to be a measure of last resort that would only be used if the economy were to overheat and/or the Fed were to esteem that bond yields are too low. In the short term, there is very little probability that these conditions will come together. The Fed could, however, totally or partially halt the rolling over of debt at maturity. This would be totally up to the Fed's discretion. The only firm indication is that such a move would not be made before the first key rate increases. Key rates were raised in December 2015 and again in December 2016, which means the door is open, but the Fed is by no means obliged to act. The Fed clearly stated that "the timing will depend on how economic and financial conditions and the economic outlook evolve".

Since the presidential elections, long-term rates have surged, even though this movement, which accompanied the dollar's appreciation, has since levelled off. Between 8 November and 16 January, the yield on 10-year Treasuries gained 72 basis points to 2.40%. It was accompanied by similar pressures on mortgage rates and by slightly less marked pressures on corporate bonds. A broad measure of the effective exchange rate shows that the dollar has appreciated by 4.7%. In conclusion, monetary and financial conditions have tightened and could strain the recovery. Under these conditions, it is hard to imagine that the Fed would add to these pressures. Unless, of course, fiscal policy effectively proves to be very expansionist. To evaluate this, we must first wait until Congress debates any draft proposals. It is hard to define a precise calendar. Yet we can refer to the timetable that was followed after George W. Bush took office in 2001: the piece of law was introduced in the House of Representatives in early May, definitely adopted by the Senate eight days later and signed into law in a month. The first rebates arrived in mail boxes in August. First, tax cuts resulted in a surge in the saving ratio. This was to be expected: either saved for good or eventually spent, tax rebates first appear as "savings" in the national accounts. Try and estimate the final effects of the 2001 tax cuts on the economy is simply impossible, though. On September 11th, 2001 America was attacked.

Fed balance sheet

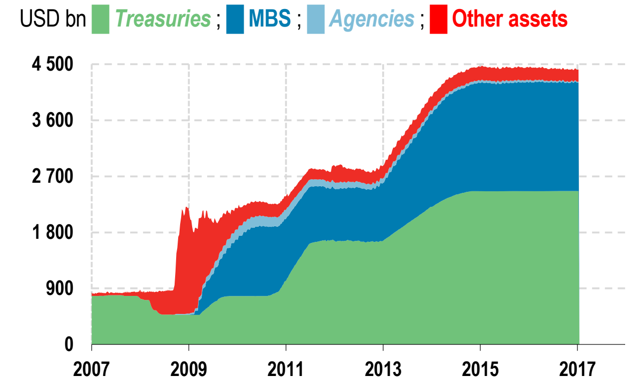

Chart 2 Source: US Federal Reserve

[2] "*Federal Reserve's exit strategy*", Ben S. Bernanke, Testimony before the Committee on Financial Services, U.S. House of Representatives, February 10, 2010.
[3] "*Policy Normalization Principles and Plans*", September 17, 2014.