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TD Economics

Data Release: Federal Reserve raises policy rate for the first time in nearly a decade

- They did it. As near-universally expected, the Federal Open Market Committee (FOMC) announced an increase in the federal funds target rate of 0.25 percentage points to a range of 0.25% to 0.50%. The upper range of this target will be hinged to the interest rate on excess reserves, while the bottom end of the range should be supported by the reverse repurchase facility, by which the Fed will borrow money from financial markets.

- The Committee maintained its policy of reinvesting assets and noted that "it anticipates doing so until normalization of the level of the federal funds rate is well under way." By our estimation this will be a minimum of six months.

- The statement's discussion of the economic outlook was noticeably more upbeat than the previous one in October, with greater confidence in the labor market recovery and a risk assesment that has moved to "balanced" from "near balanced."

- The summary of economic projections (SEP) released with the statement were relatively unchanged. The median projection for real GDP growth in 2016 edged up to 2.4% (from 2.3%), but remained unchanged for 2017 and 2018. The median unemployment rate projection edged down to 4.7% for 2016 through 2018 (from 4.8% previously). Inflation projections were modestly lower for 2016 (1.6% from 1.7%), but unchanged otherwise.

- The median "dot" projection of FOMC members for the end of 2016 was unchanged at 1.375%, suggesting fed members anticipate about four rate hikes over the course of the year. The median projection for 2017 fell 25 basis points, (to 2.375% from 2.625%), implying four rate hikes, relative to previously telegraphed five rate hikes.

Key Implications

- The important part of this statement was not the rise in interest rates, which came as a surprise to no one, but the message it gave to financial participants on the path of future rate hikes. On this front, the Fed reaffirmed that the pace of rate hikes would be slow relative to history, and the length of the cycle, by extension, would be longer.

- The Fed's expectations for rate hikes next year are set alongside a relatively cautious and entirely achievable economic outlook. Even with ongoing drag from the external sector, the fundamentals for domestic demand have improved over the last year on robust job growth, rising wages and continued low energy prices. This was recognized in the generally upbeat tone of the economic outlook in the statement. It could well be that after years in which the Fed has moved closer to the market, the market may finally have to move closer to the Fed.

- The biggest question mark is the outlook for inflation. The Fed is relatively cautious. As long as energy prices stabilize and the labor market continues to generate jobs at double the trend pace, inflation is likely to move toward the Fed's target, allowing policy rates to move up.

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