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The Fed between doves and hawks

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- After several years of a close-to-zero federal funds rate in the US, the Fed has prepared markets for higher interest rates.
- These efforts were explained with positive expectations for output, inflation and the labor market in 2015-2016. The early optimism was dampened by the harsh reality of weak economic data in the first quarter of 2015. However, May data suggest the weakness may have been temporary.
- Doubts about the meaning of the data are mirrored in the split inside the Fed between “dovish” and “hawkish” views of FOMC members.
- The composition of the FOMC is clearly dovish at present. This points to rate increases later rather than sooner and could disappoint consensus expectations for a September hike.

Almost 8 years ago, as a reaction to the turbulences in the financial markets, the Fed was the first among the major central banks worldwide to cut its policy interest rate, the federal funds rate. It was also among the first to take unconventional policy measures, when the interest rates had fallen close to zero. Helped by this, the US economy was the first to embark on recovery. Now the Fed strives to be the first to return to a more normal monetary policy stance, away from an ultra-accommodative past.

For some time the Fed has signaled the possibility of higher interest rates. The hawkish bent of some of the FOMC members seemed to drive the strategy – despite a considerable slowdown of the US economy in the first quarter of 2015. At first, even more dovish members of its decision making body were predicting that factors responsible for the poor economic data of Q1 were of a temporary nature. This was an indication that rates could rise as early as in June 2015. But more skeptical voices from the FOMC could also be heard arguing for a postponement of the move to 2016. These different voices reflect the uncertainty about the economic outlook and the complexity of the Fed’s decision making process. At present, it seems that any prediction of the Fed’s future policy course is awaited with greater uncertainty than in the past.

The Fed for beginners

The Fed’s FOMC holds primary responsibility for monetary policy implementation. The regular meetings of the FOMC serve to discuss the different views of its members and to arrive at a consensus concerning the policy interest rate, the federal funds rate.[1] But within the FOMC the views are often divergent, with members at one side being dovish, neutral in the middle, and hawkish at the other side. Specifically, doves (or more dovish members) are cautious about the economy's development, they worry about jobs, and tend to prefer accommodative policies and low interest rates, as they now do.

On the other side, hawks worry more about inflation and advocate an earlier raise. Table 1 provides an overview of the personal composition of the FOMC and Reserve Bank Presidents, with a subjective assessment of members' attitude towards monetary policy stance.

Table 1. FOMC members and Reserve Bank Presidents with their views concerning the monetary policy stance.

	Fed member	Position	Views
FOMC members voting 2015	Janet Yellen	Chair, permanent	Dove
	William Dudley	New York, Vice Chair, permanent	Dove
	Lael Brainard	Governor, permanent	Dove
	Stanley Fischer	Governor, permanent	Dove
	Jerome Powell	Governor, permanent	Neutral
	Daniel Tarullo	Governor, permanent	Dove
	Charles Evans	Chicago	Dove
	Jeffrey Lacker	Richmond	Hawk
	Dennis Lockhart	Atlanta	Neutral
	John Williams	San Francisco	Neutral
Alternate FOMC members, voting 2016	James Bullard	St. Luis	Hawk
	Esther George	Kansas City	Hawk
	Loretta Mester	Cleveland	Hawk
	Eric Rosengren	Boston	Dove
	Christine Cumming*	First Vice President, New York	Dove
Nonvoting members	Richard Fisher	Dallas	Hawk
	Narayana Kocherlakota	Minneapolis	Dove
	Charles Plosser	Philadelphia	Hawk

Note: This table offers a summary view based on information coming from different sources, which sometimes assign a quantitative value to the degree of dovishness/hawkishness of the FOMC members (like the one by Joseph La Vorgna from the Deutsche Bank). Some differences exist in the precise assessment of the grades, but there is a general consensus on the relative positions of each member within the FOMC.

* The First Vice President is the alternate for the President.

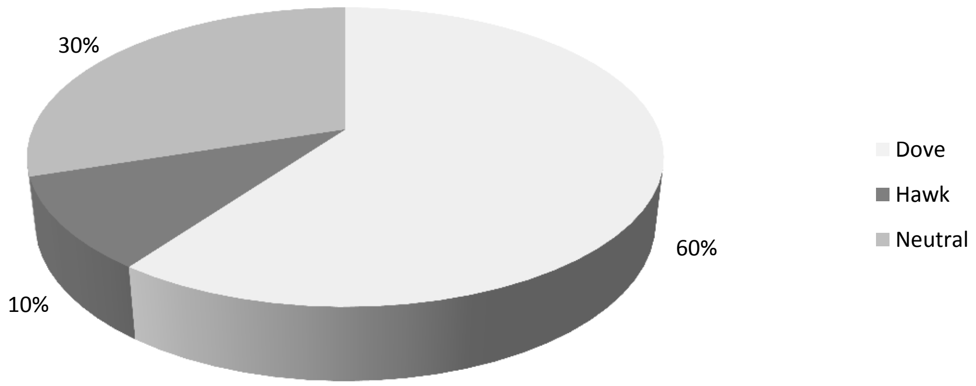
Source: Federal Reserves, Reuters, Deutsche Bank.

[1] This is the rate at which depository institutions lend reserve balances to other depository institutions overnight. Historically, the Federal Reserve has used open market operations (the purchase and sale of securities in the open market by the central bank) to adjust the supply of reserve balances so as to keep the federal funds rate around the target established by the FOMC.

The FOMC consists of twelve voting members: seven (permanent) members of the Board of Governors of the Federal Reserve System[2], the president of the New York Fed who also serves on a continuous basis, and four of the remaining eleven Fed presidents, who rotate each year at the first regularly scheduled meeting of the year.[3] In Table 1, the alternate FOMC members who will be voting in 2016 are listed in the middle horizontal bloc. Rotation foresees that the boards of directors of Reserve Banks elect one member in each of the following groups: 1) Boston, Philadelphia, and Richmond; 2) Cleveland and Chicago; 3) Atlanta, St. Louis, and Dallas; and 4) Minneapolis, Kansas City, and San Francisco. All nonvoting Reserve Bank presidents (alternate FOMC members and the remaining three Reserve Bank presidents) attend the meetings of the Committee, participate in the discussions, and contribute to the formulation of the Committee's assessment of the economic conditions and policy options.

In 2015, the FOMC became significantly more dovish, as the hawks Fisher und Plosser were replaced with the doves Evans, Lockhart and Williams. The actual composition of the voting members is clearly dominated by doves (Fig. 1). Although each change in the composition of the FOMC may affect the direction of the monetary policy decisions, there are always other factors leaving the final outcome difficult to predict.

Figure 1. Composition of 2015 FOMC voting members.



Source: Federal Reserves, Reuters, Deutsche Bank.

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[2] Since May 2014 there are two permanent positions within the Board of Governors that remain unfilled. As a rule of law, the members of the Board of Governors are appointed by the US President and confirmed by the Senate. At present, there is one pending nomination of former Bank of Hawaii chief executive Allan Landon expected to fill one of two empty positions on the Board. His policy views are not well known yet.

[3] Meetings have a confidential nature and are thus restricted to Committee members, nonmember Reserve Bank presidents (nonvoting members), staff officers, who prepare written reports on past and prospective economic and financial developments, the Manager of the System Open Market Account, and a small group of Board of Governors and Reserve Bank staff.

The Fed between doves, hawks and the US economy

On the dovish side, the chairwoman Yellen spoke on May 6 this year about the risk of a "sharp jump" in longer-term bond yields as a byproduct of higher short-term interest rates and warned that prolonged periods of extremely low interest rates and large-scale asset purchases could have adverse, long-term consequences "for the things we really care about – price stability, employment, sustainable growth". [4] On that occasion she abstained from giving any indication about the timing of the Fed's action, but clarified two weeks later that the US economy would be on a path that would allow raising rates (later) in 2015. Much more dovish were recent comments by Governor Tarullo, who on June 4 said that "in a broader sense, there are more questions at this point in 2015 than there were at this point in 2014", in line with Lael Brainard's and Charles Evans' statements – all voting members of the FOMC – calling for the postponement of any Fed action to 2016.[5]

On the other side, the only voting hawk this year, Jeffrey Lacker, recently dismissed the weak economic data as transitory and most probably due to bad weather, as well as transitory movements in oil prices and in the dollar. Against this background, on April 10 Lacker said that "a strong case can be made that the federal funds rate should be higher than it is now." According to Lacker's expectations, although "inflation is currently below the FOMC's goal of 2 percent [this is caused partly by transitory effects of lower energy and import prices and makes] it likely that inflation will move back toward 2 percent this year". He also expects an average GDP growth of 2-2.5 percent during 2015.[6]

Although the division between doves, hawks and neutral members is generally stable, swings of positions occasionally take place. This was the case with ex-voting FOMC member Kocherlakota, who had been previously quite hawkish, but became dovish during his FOMC membership in 2014. In his current view, the Fed "can only achieve its congressionally mandated price and employment goals by being extraordinarily patient in reducing the level of monetary accommodation." He also said that "it would be a mistake to raise the target range for the fed funds rate in 2015."

Finally, some of the FOMC members tend to stay away from the public announcement of their opinions, which complicates predicting their votes on the federal funds rate.

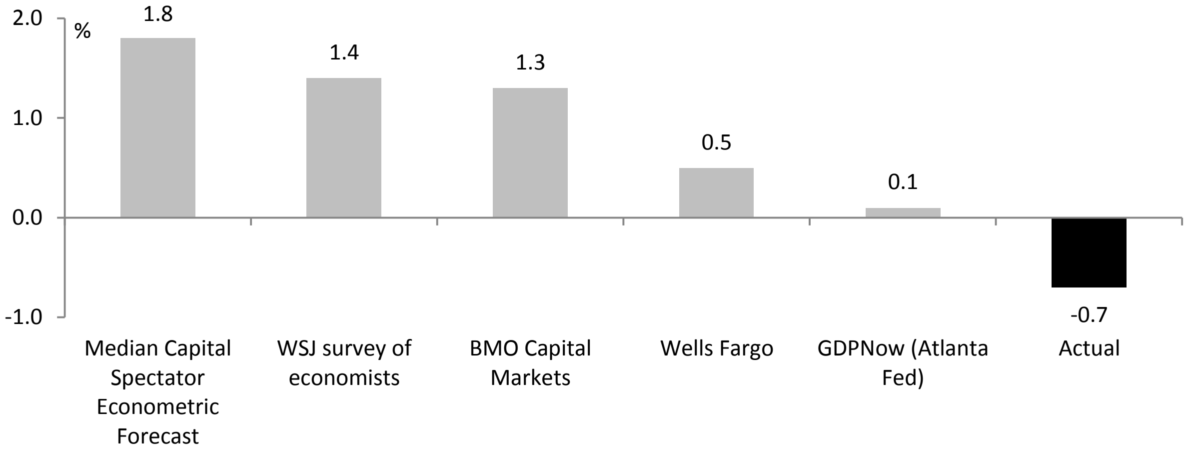
Uncertainty about the FOMC's reaction to data is increased by uncertainty about the economic outlook of the US and the world economy. The US economy has started 2015 on a poor footing. Weak Q1 data have been almost a rule recently, but this year's first-quarter weakness was disappointing even for the most pessimistic analysts (Fig. 2). Initially, it was uncertain how much of this weak GDP outcome would be due to temporary or anomalous factors like a port strike and the cold winter, or possibly due to technical issues of data construction.

[4] From the Speech titled "Finance and Society" at a conference sponsored by the Institute for New Economic Thinking, available at http://www.federalreserve.gov/newsevents/speech/yellen20150506a.htm.

[5] Back in March, Brainard was in favor of a 2015 rate hike and until recently she has not ruled out a move this year, but she recognized the risk of a "more significant drag on the economy" driven by weaker exports and sluggish manufacturing activity.

[6] See Lacker's Speech „Economic Outlook" at the Global Interdependence Center, available online at https://www.richmondfed.org/-/media/richmondfedorg/press_room/speeches/president_jeff_lacker/2015/pdf/lacker_speech_20150410.pdf.

Figure 2. Actual GDP growth and forecasts for the first quarter 2015.



Source: bea.gov, capitalspectator.com, wsj.com, wellsfargo.com, bmonesbittburns.com, frbatlanta.org.

Now, according to the latest official analysis, it is clear that one of the major reasons for the first-quarter slowdown was an unexpectedly weak trade balance, with the rise in imports much exceeding that of exports.

The IMF enters the stage but the Fed has not made up its mind yet

According to the International Monetary Fund "[although] the underpinnings for continued growth and job creation remain in place", it warned the Fed that too much vulnerability would undermine the recovery and a premature lift-off would be difficult to justify. At the beginning of June, both the IMF and the OECD revised down their 2015 growth estimates for the US economy. The OECD cut its October 2014 forecast from 3.1 percent to 2 percent.

The IMF revised its forecast from 3.1 percent to 2.5 percent. These forecasts seem to be rather optimistic, though. This is illustrated in a simple simulation in Table 2. If the Q2 growth forecast of 1.9 percent published on June 11 by the Atlanta Fed materializes, the US economy has to growth at an annual rate of 4.4 percent in the third and the fourth quarters in order to arrive at 2.5 percent GDP growth in the annual average.

Even if the current data on the labor market give some hope for the recovery, it is doubtful whether the momentum will be enough to achieve the growth forecast of the IMF. Also, the inflation rate continues to be below the Fed's target. In normal times, this would be a strong reason not to raise rates. But we are clearly not in normal times, as the public debate between the Fed's doves and hawks show.

Table 2. Actual and expected annualized growth rates of GDP in the US economy.

	Q1	Q2	Q3	Q4	Annual
2014	-2.1	4.6	5.0	2.2	2.4
2015	-0.7	1.9	4.4	4.4	2.5

Source: Atlanta Fed, US Bureau of Economic Analysis and own calculations.

Rates outlook

Although the eventual outcome of the voting depends on the highly uncertain future development of the US economy and the equally uncertain reaction of the FOMC members to these developments, the dovish composition of the FOMC points to rate increases later rather than sooner. However, in view of the likely continuation of a relatively weak recovery, the pace of rate increase will probably be slow. This should reassure bond markets and militate against sharper increases of rates at the longer end of the yield curve.

At the same time, the past and present massive interventions in global bond markets by all major central banks have sharply increased market participants' uncertainty about appropriate term premia. In this environment, overreaction to central bank policy changes and herding behavior of market participants will continue to destabilize markets. Continuously low interest rates by historical standards and increased volatility will continue to further reduce the attractiveness of fixed income as an asset class.

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