Two Fed officials warn investors should take gradual rate-hike pledge with grain of salt

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Two Federal Reserve officials on Thursday said the pledge to hike interest rates at a gradual pace has important caveats amd is not a blanket promise.

With a rate hike in December now seen as very likely, the focus is shifting towards the pace of hikes, economists said.

In a rare joint press conference following speeches at the Cato Institute, St. Louis Fed President James Bullard and Richmond Fed President Jeffrey Lacker said the gradual pace was just a forecast.

“There is a chance, and I think people need to be aware of it, that our current anticipation about being able to sort-of go gradually is just an expectation, and we might have to change our mind about that,” Lacker said.

Bullard said the pace will depend on the state of the economy and shouldn’t be seen as a steady path higher.

Bullard said he thinks growth will be strong, and the unemployment rate should come way down into the 4% range. The unemployment rate was 5% in October.

“If that kind of forecast did develop, then I think it would be incumbent on the committee to react to that and react more aggressively,” he said.

In each of its policy statements this year, the Fed has said it “currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run."

Fed Chairwoman Janet Yellen has stressed the notion of a shallow path of rate hikes, saying the timing of the first move is not as important as the entire path of policy over time.

"And the committee's expectation is that will be a very gradual path," Yellen said in testimony to the House Financial Services panel earlier this month.

New York Fed President William Dudley, a key Yellen ally, said Thursday that he expects the pace of tightening to be "quite gradual."

Bullard said the gradual phrasing is designed to make clear to market participants that the Fed will not repeat the rate tightening cycles of 1994 or 2004-2006.

But, in the end, Bullard said the Fed won't have credibility on what is gradual until it makes the second move.

The Fed's current guidance is that rates will hit 1% by the end of 2016 while the market pricing remains at 50 basis points.

Both Lacker and Bullard said their dots are above the Fed's median forecast and are pressing for a rate hike at the Fed's next policy meeting in December.

Lacker said the "news" in the Fed December statement will be "the language looking forward and how we expect policy to unfold."

So that language is going to get a lot of attention from Fed officials going into the meeting, he said.

Lacker said there is a chance the Fed is lagging behind the battle against higher inflation. That is why Lacker has pressed the Fed to hike in September and October.