



Here's what the Fed just signaled about the rest of 2017

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The Federal Open Market Committee [delivered on its long-signaled quarter-point hike in the target range for the federal funds rate](#). Markets will now focus on the committee's next move. There are two questions to be answered. First, will there be another rate hike this year? Second, how will the anticipated shrinkage of the Fed's balance sheet proceed? Thus far, markets seem calm.

This was the fourth rate hike since December 2015. The FOMC has signaled one more rate hike this year, but markets give it only about a 50/50 probability. Certainly, inflation gives no reason for the Fed to move aggressively on rates. Inflation remains below 2 percent.

The [Federal Reserve](#) has persistently over-estimated the inflation threat and today's FOMC statement seems to recognize that. The yield curve has flattened despite the anticipated rate hike at this meeting. In short, financial markets are not signaling further Fed rate hikes. The Fed is inclined to adjust its actions to the market's expectations. That suggests there will be no further rate hikes this year.

The labor market is the central bank's other key concern. The May jobs report once again sent mixed signals. Job creation was weak at 138,000. Yet the unemployment rate declined to 4.3 percent, the lowest in 16 years. These are mixed signals that can, however, be reconciled. We are in a historically long, but subpar economic recovery. Slow job growth accompanies slow economic growth.

The historically low unemployment rate is the seeming anomaly. That figure is misleading on at least two counts. First, the decline in unemployment is a consequence of the length of the recovery rather than its strength. Second, the fall in the unemployment rate has been affected by the decline in the labor-force participation rate.

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The decline in the overall labor-force participation rate chiefly reflects a decline in the male labor-force participation rate, and a flattening in the rate for women. Observers have offered conflicting reasons for the worrisome decline in men working.

Focusing on the prime-aged workforce, 25-54 years, eliminates most of the demographic explanations. By this measure, nearly 7 million workers, mostly men, have dropped out of the work force in the last 50 years. They are removed from both the workforce measure and the measure of the unemployed. The measured unemployment rate falls, but in a misleading way. Now the low unemployment rate is not a sign of strength in the labor force, but of men no longer seeking employment.

There are policy reasons for this (e.g., Social Security Disability Insurance) and social forces, including a decline in the work ethic among white, blue collar men. The latter has been examined by Charles Murray in [Coming Apart: The State of White America, 1960-2010](#) and, more popularly, by J. D. Vance in *Hillbilly Elogy*. The bottom line is that, given economic entitlements and underlying social forces, we may be at the fullest employment possible.

Accordingly, there is a labor-market rationale for further rate hikes. The unemployment rate has become a misleading signal, however, and is neither a reliable target nor indicator of the stance of monetary policy. Further, the reasons for slow-output growth must be rethought. Slow growth in GDP reflects, at least in part, supply constraints in labor markets. There is nothing the central bank can do about that.

In my view, downsizing the Fed's balance sheet is where the important policy actions will now take place. While an unwinding could potentially lead to instability in financial markets, the action is long over-due. The Fed's outsized balance sheet, with a large amount of mortgage-backed securities, has put it in the credit-allocation business. It needs to get out of that business.

For the rest of 2017 we are looking at likely no further rate hikes and shift in the focus of monetary policy to the size of the Fed's balance sheet. The FOMC is signaling that the unwinding will proceed at a moderate pace. Monetary policy is once again entering uncharted waters.

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