SCB Economic Intelligence Center

Flash by EIC

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Fed hikes rate as expected, citing a strengthened economic outlook and 2 more hikes this year

Event

- Following the Federal Open Market Committee (FOMC) meeting on 20-21 March 2018, the FOMC voted in favor of raising its federal funds rate (Fed funds rate) by 25 bps, to a range between 1.50% and 1.75%. In addition, most of the FOMC members maintained calls for two more hikes this year. This will make the Fed funds rate 2.0-2.25% at the end of 2018.

Analysis

- **The Fed raised the Fed funds rate as anticipated, not a surprise to the market. This resulted in a mild response in the financial markets.** After the Fed's meeting on 21 March 2018, U.S. stocks fell slightly, with the Dow Jones Industrial Average closed 0.2% lower. Similarly, the S&P 500 index closed 0.2% lower. Meanwhile, the dollar index weakened 1.0%, while the 10-year U.S. treasury yield dropped slightly to 2.87%. This morning, the baht appreciated slightly by 0.2% from yesterday's close.

- **The FOMC keeps forecast for the total of three hikes in 2018.** Although some investors currently expect up to four rate hikes this year as the U.S. economy continues its upward trend supported by household consumption and private investment, the dot path projections (dot plot) still anticipate three hikes in 2018. However, the FOMC expects a steeper path of rate hikes, seeing 3 hikes in 2019 (from the previous forecast of 2.5 hikes), and also revises the long-term rate from 2020 onward up to 2.875% from 2.75%.

- **The Fed raised its economic growth forecasts,** expecting the GDP growth of 2.7% and 2.4% in 2018 and 2019, respectively. These were higher than its previous forecasts in December and mainly on the back of larger fiscal impulse both from the tax reform and increasing budget caps as imposed by the Bipartisan Budget Act 2018 that has recently been approved by the Congress in February. Moreover, the unemployment rate was also revised down from 3.9% to 3.8%. Nevertheless, inflation forecast remained largely unchanged, where inflation is expected to stay at 1.9% this year. The Fed also signaled regarding the return of inflation to the level near its target of 2% in coming months.

- **EIC also expects that the Fed will likely hike rate 3 times in 2018.**

Strengthening economic outlook will facilitate the tightening of monetary policy. Supporting factors include declining unemployment rate to its record low in 17 years, impact from fiscal stimulus measure in boosting growth, improved consumer confidence to its highest level since 2000, as well as inflation that will likely return to the target this year. Nevertheless, EIC views that the FOMC led by the new chairman, Jerome Powell, will raise its Fed funds rate 3 times this year in a careful and gradual manner, while an increase in inflation this year will not result in an overheating economy. The Fed's inflation projection also sees inflation rising to the level close to or even higher than its target of 2% (projections for 2019 and 2020 at 2.0% and 2.1% respectively). This is not a concern for the Fed and thus, the normalization path will likely continue as previously forecasted.

- **However, Fed sees some room for additional rate hike if inflation accelerates faster than projected.** EIC sees accelerating growth of the US economy this year, so inflation could accelerate at a faster-than-expected pace in the second quarter onward. This is because the Fed is achieving its dual mandate of inflation at 2% and full employment, while the dollar index continues to weaken. Also, there will be additional fiscal stimulus measures this year. Moreover, comparing dot plots of March 2017 with December 2017 reveals that more FOMC members adjusted their views to expecting 4 rate hikes this year, the number rising to 7 out of 15 from 4 out of 16 members. (figure 1)

Implication

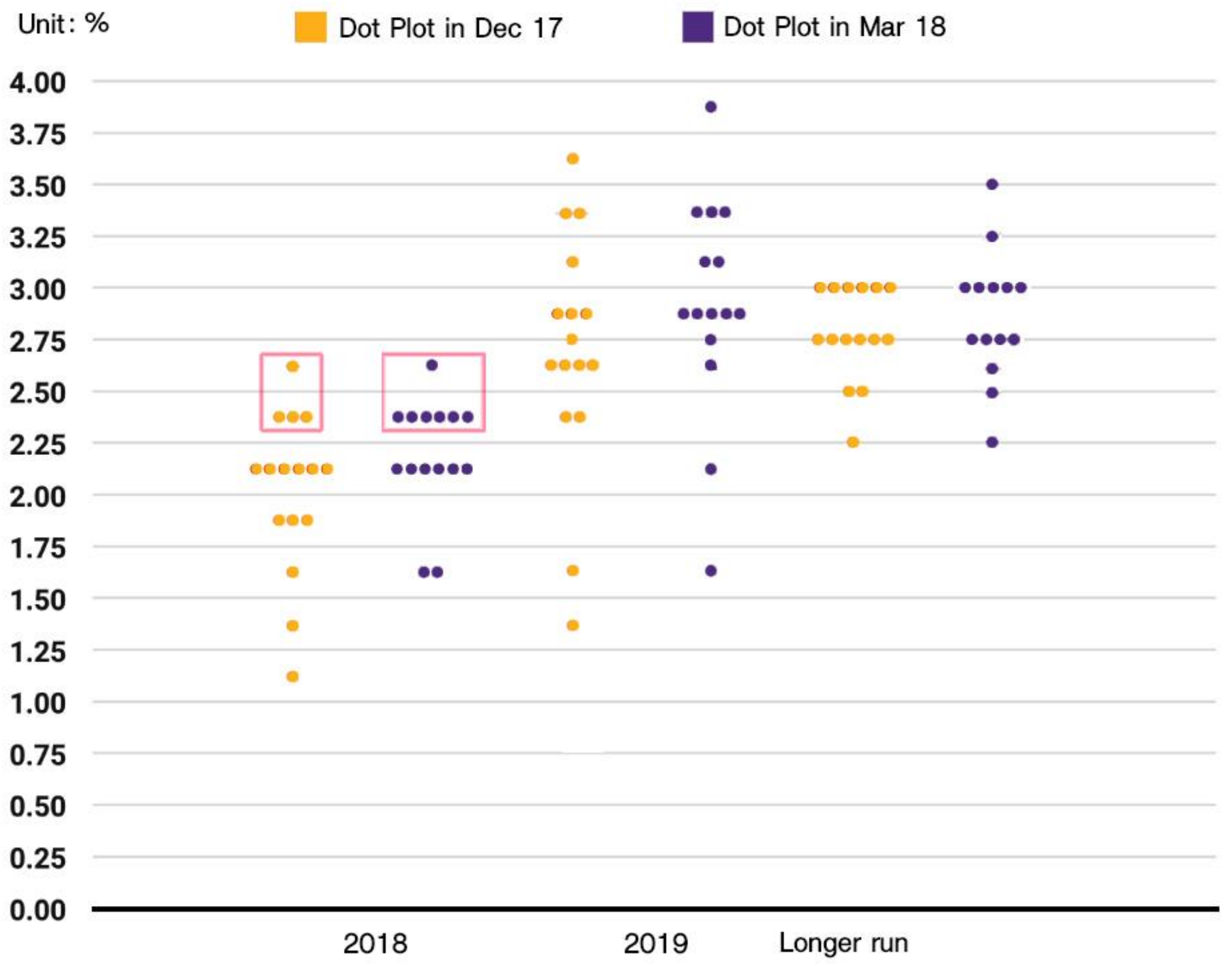
- **Thai exports could see benefits from stronger U.S. economy.** An upgrade on US growth forecasts for both 2018 and 2019 confirms a strengthening growth outlook and reflects growing demand from the U.S. this year. This will benefit Thai exports to the US despite trade protection measures. This is because such protection only applied to certain products, which might not significantly impact overall exports this year.

- **The US rate hike may not impact the baht significantly.** Although the Fed will likely raise its rate 2 more times this year, this may not have significant impact on the US dollar index as investors have already priced in rate hikes. Therefore, the baht may not be driven by the rate hike provided the Fed keep its forecast for 2018.

- **EIC expects the Bank of Thailand (BOT) to hold its policy rate at 1.50% in 2018.** Although the US rate is rising and the Thai economy has been improving at 3.9% in 2017, such growth is still concentrated in certain economic sectors that benefited from external demand including merchandise exports and tourism. On the contrary, recovery in domestic demand, particularly purchasing power of low-income households, is still weak, while inflation is likely to remain low. Moreover, the strong external positions and current account surplus will not cause significant volatility on capital movements. This justifies the

BOT's decision to maintain the policy rate at low level in order to accommodate further economic growth going forward.

Figure 1 The U.S. interest rate hike projections (dot plot) December 2017 compared with March 2018



Source: Federal Open Market Committee (FOMC)

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