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TD Economics

Data Release: Fed expresses optimism in outlook, but cloud of uncertainty around fiscal policy

- The minutes from the FOMC's December meeting showed a relatively balanced economic outlook, but one that expressed considerable uncertainty around future fiscal policy and its effect on an economy operating increasingly close to full employment.
- Most aspects of the FOMC's economic outlook remained unchanged, but for one notable development. The Committee expressed increased optimism surrounding the business sector outlook, with an increasing number of participants noting the potential for an uptick in business investment following several quarters of weakness.
- The amount of slack in the labor market remained a topic of hot debate among the meeting participants. The consensus is that the labor market continues to make progress, but there is more disagreement about how much further unemployment can continue to move lower without generating higher inflation.

Key Implications

- The job of conducting U.S. monetary policy has not become any easier over recent months. The minutes highlighted this, with much of the discussion focused on the heightened level of uncertainty surrounding the course of future fiscal policy and what this will mean for the economy.
- The debate about fiscal stimulus comes at a time when unemployment rate, which has fallen to 4.6% in November, increasingly points to an economy that is nearing full health. At the same time, inflation metrics, which remain well below 2.0%, suggest further scope for improvement. The takeaway from these minutes appears to be that as long as the outlook for inflation remains benign, the FOMC is willing to allow the unemployment rate to continue to "run hot." However, the moment it gets a whiff of higher inflation, it will not hesitate to push rates higher.
- The potential for fiscal stimulus further raises the stakes for the Fed. If the economy is indeed at full employment, any meaningful change in fiscal policy should be offset by a monetary response. If, on the other hand, there is more than a modicum of slack left in the labor market, it can afford to accommodate at least some of this stimulus.
- In our view there is still enough slack left in the labor market for the American economy to continue to generate above-trend economic growth over the next several quarters. Having said that, by the end of this year the economy should effectively begin to bump up against capacity constraints with any additional fiscal stimulus likely to be offset by a faster pace of rate hikes from the Federal Reserve.

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