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CENTRAL BANKS

Fed Puts Interest-Rate Hikes in Play

June increase on table, but Yellen's words and shifting forecasts show central bank's caution

By JON HILSENRATH

Updated March 18, 2015 6:52 p.m. ET

The Federal Reserve opened a door to raising short-term interest rates by midyear, but signaled it's in no hurry to walk through it.

The Fed, in a statement Wednesday after its two-day meeting, dropped an assurance that it would remain "patient" before acting on rates. In the odd parlance of central bankers, the shift meant the Fed would consider raising short-term rates at its June 16-17 meeting.

Because the unemployment rate has fallen to 5.5%, many Fed officials believe the economy is getting closer to a point where it can manage without the fuel provided by historically low borrowing costs. That has them looking toward gradually nudging interest rates higher.

Yet comments by Fed Chairwoman Janet Yellen after the meeting and new central bank forecasts suggested the Fed intends to proceed cautiously. It isn't yet set on raising rates in June, and once it starts it now sees a smaller succession of increases in coming years than it did just three months ago. That is in part due to low inflation.

"Just because we removed the word patient from the statement doesn't mean we are going to be impatient," Ms. Yellen said in a postmeeting press conference.

Investors had expected the Fed to signal a possible June increase. But they were surprised about the cautious longer-term stance on rates and took that as reason to buy stocks and bonds, while selling U.S. dollars.

The Dow Jones Industrial Average surged 227.11 points, or 1.27%, to 18076.19 after being down more than 100 points before the Fed's statement. It finished the day a little more than a percent from a record close. Yields on 10-year Treasury notes fell to 1.945%.

"Risky assets do well on a day like today," said Eric Stein, co-director of the $12 billion global income group at asset manager Eaton Vance. "Before this, I thought June was the most likely [time for a rate increase]. Now, I'd say move that to September."

The Fed has a meeting in April before the June gathering, but said in its statement it wouldn't move at that meeting.

When officials follow through with an initial rate increase depends now on their interpretation of an evolving economic outlook. The central bank said it would raise rates when it is "reasonably confident" that stubbornly low inflation is on track to return to its 2% target and as long as the job market keeps improving.

But the

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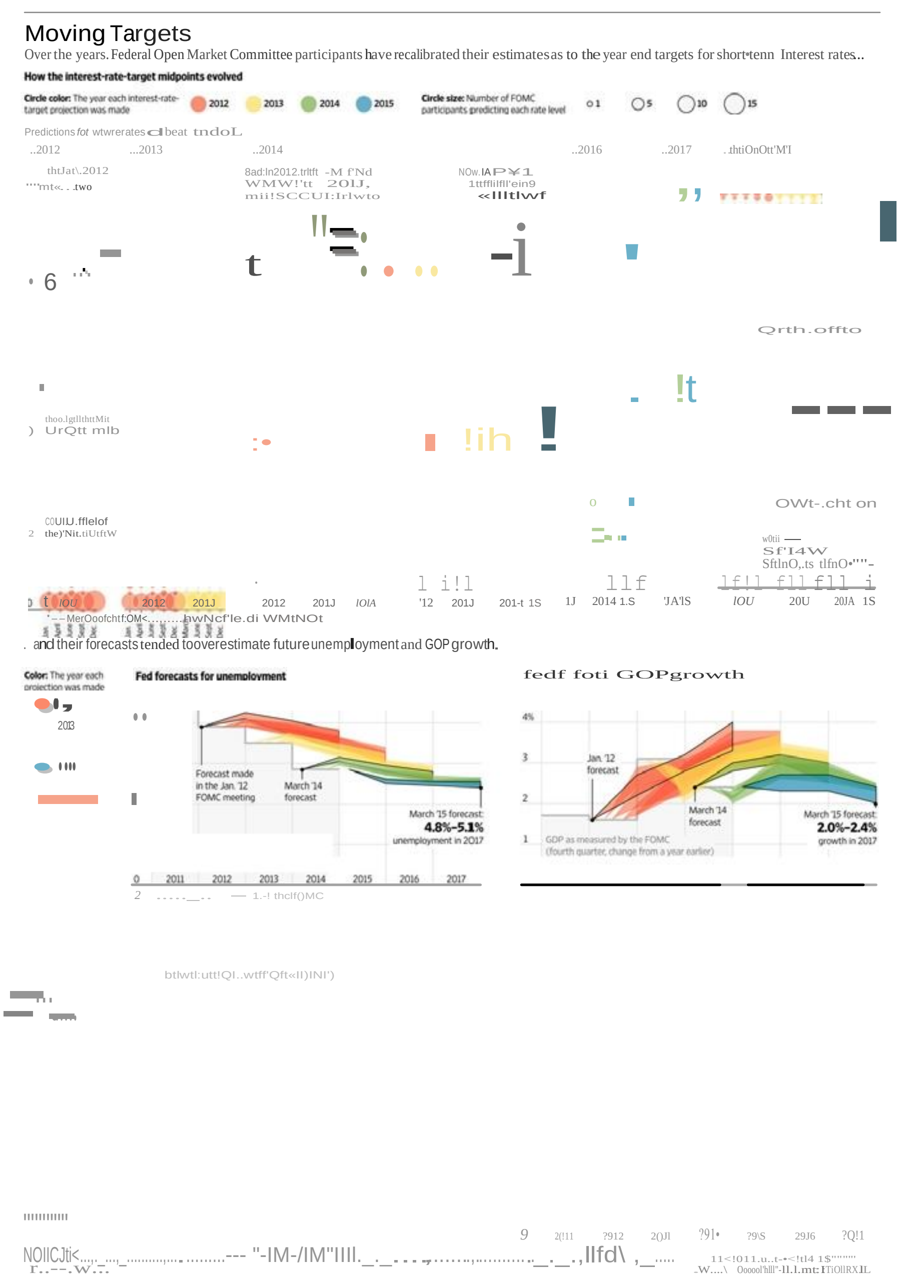
central bank faces several conundrums-and investors new uncertainties-about unfolding economic developments.

The jobless rate keeps falling faster than Fed officials project, a sign of a return to economic vitality that has given some officials confidence it is time to start increasing the cost of credit.

Inflation, on the other hand, has run below the Fed's target for 33 straight months, a sign of global weakness and other economic headwinds that could give officials pause in coming months.

Asked at the press conference what would make her and Fed officials confident inflation will rise toward the target, Ms. Yellen said, ((I don't have a mechanical answer for you."

New strains on growth and inflation have emerged in recent months.



A stronger dollar has put downward pressure on U.S. exports-a development the Fed acknowledged in its statement. The strong currency and low oil prices

also are weighing down in

inflation. Officials see these developments as temporary; still they admit to some angst.

to serve as a notable drag this

"I certainly expect net exports year on the outlook," Ms.

Yellen said.

While the Fed is looking at raising rates, central banks around the world are moving in the opposite direction. Just hours before Fed officials finished their meeting, for example, Sweden's Riksbank cut its benchmark lending rate to minus 0.25%, meaning banks had to pay to leave deposits with it.

Actions like that are adding to upward pressure on the dollar.

The Fed's own updated economic forecasts and its assessment of the economic landscape suggested officials are struggling to reconcile this complex backdrop.

Officials revised down their projections of economic growth in the coming years, thanks in part to the hit to exports.

In 2015, for example, they said they expected economic output to expand by between 2.3% and 2.7%, a downgrade from their December estimate of 2.6% to 3.0%. Forecasts for 2016 and 2017 were also shaded down, part of a long-running series of growth-estimate downgrades the Fed has confronted in recent years.

"Economic growth has moderated somewhat," the central bank said in its statement. That was a downgrade from January when the Fed described the pace of activity as solid. Bad weather might have restrained growth in the first quarter. But the longer-run downgrades of their estimates suggest officials see other headwinds holding the economy back in the months ahead.

At one point during the press conference, Ms. Yellen played down the discouraging undercurrent in the revised forecast. "It is important to recognize that this is not a weak forecast," she said. 'We continue to project above-trend growth. We continue to project improvement in the labor market."

The Fed also shaved its estimates of inflation. In 2015 the Fed projects inflation of 0.6% to 0.8%. Officials don't see it getting near its 2% target until 2017, a potentially important clue on the timing of rate increases.

Yellen's Official Calendar

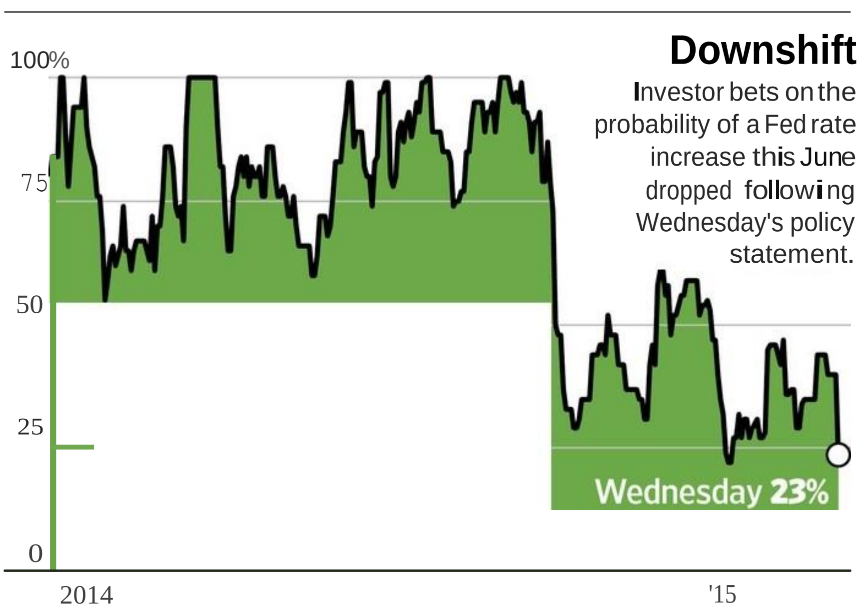
While growth and inflation look soft, the Fed sees the job market continuing to register gains. The jobless rate is projected to reach 5% by year-end and then possibly drop slightly below it in 2016 and 2017.

Importantly, however, the Fed also revised down its estimate of how low the jobless rate can fall before it starts creating inflationary pressure. In December, officials estimated this long-run rate was between 5.2% and 5.5%. Now they say it is 5% to 5.2%. That shift means officials believe they can wait longer before they start to raise rates.

Fifteen of 17 Fed officials said they still expected to start moving their benchmark short-term rate, the federal-funds rate, up from near zero this year, but they substantially revised down their estimates of how high they would go.Most officials saw the fed funds rate target reaching 0.625% by year-end.That was a half percentage point lower than they forecast in December.They also reduced their average estimates for rates at the end of2016 and 2017 to1.875% and 3.125% respectively.

Asked to explain the downward move, Ms.Yellen said she and her colleagues saw more slack in the economy than they had a few months ago.

The downward revisions go some distance to resolve a disconnect that has existed between the Fed and investors for several months.Futures markets indicated that investors expected lower rates in the years ahead than the Fed's earlier forecasts projected.The revisions narrowed the gap.



Source:Citigroup Global Markets THE WALL STREET JOURNAL.

The vote on the statement was unanimous with no dissents.

The Fed cut its benchmark rate to near zero in December 2008 in response to the financial crisis,and has held it there since to give a boost to the economy through the recession and uneven recovery.

Raising the benchmark rate could influence many other household and business borrowing costs, such as rates on mortgages,auto loans and corporate debt.

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