Central Banks

FOMC Meeting June 9-10: No end in sight for accommodative stance

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The June 9-10 FOMC meeting statement provided a very dovish perspective on the economy. First, although the Fed acknowledged that financial conditions have improved in response to the measures taken so far to mitigate the disruption, it reinforced the severe damage from Covid-19 to both economic activity and the labor market. In fact, the statement excluded any reference to May's employment report, which surprised to the upside. This implies elevated uncertainty on the pace of recovery of the labor market despite the upbeat official release, given data collection issues that if corrected, would show a higher unemployment rate (UR). In fact, the Fed expects the UR to average 9.3% in 4Q20, just 2pp below the latest datapoint. While this implies a gain of around 6.5M jobs by the end of the year, it would still leave the number of unemployed twice as high at the level in February.

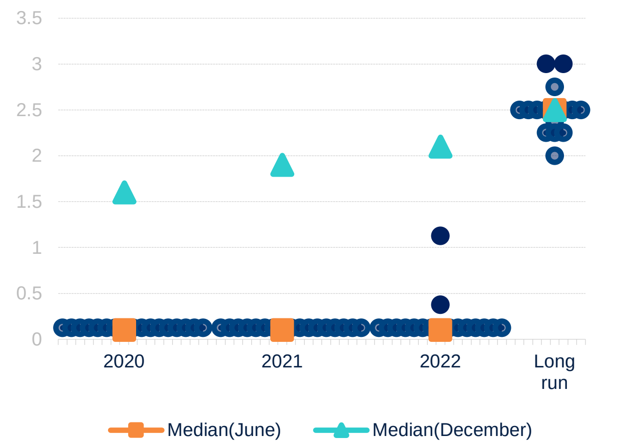
Second, the statement maintained the perspective that the pandemic will weigh heavily on economic performance in the short-term and exert downside risks in the medium term. This signals that members expect a recovery more aligned with a U- or L-shape rather than a V-shape one. However, there remains a wide-range of views regarding the pace of the recovery with some members expecting double-digit declines in 2020 and even negative growth next year, while others see a more moderate contraction this year and a strong recovery in 2021.

Third, the Fed committed to maintain its Large Scale Asset Purchases at least at the current pace. This implies around $80bn in Treasury purchases and $40bn in MBS purchases per month. On the one hand, this enables the Fed to maintain a significant level of support to market functioning. On the other hand, it allows the Fed to make changes should conditions divert significantly in the following months. This is particularly important given the uncertainty regarding potential additional waves and the effectiveness of the reopenings.

Last but not least, the Fed reiterated that it is "committed to using its full range of tools to support the U.S. economy in this challenging time". Our view remains that the Fed is willing to do -almost- whatever it takes to mitigate downside risks. This implies rolling out all the emergency programs and making tweaks to increase their effectiveness. In addition, the Fed has to deal with rising long-term yields, which are reflecting lower risk aversion and improved economic expectations. While we expect the Fed to resort to its communication strategy and forward guidance to avoid higher borrowing costs constraining the recovery, we cannot completely rule out yield curve control. In fact, at the meeting the FOMC members received a briefing on historical experience on yield curve control and the discussions will continue.

While the actions taken up to this point reflected a clear downward bias, the committee's members' forecasts for 2020 were bleak with forecasts ranging from -10.0% to -4.2% in 2020 with a median of -6.5%. Powell said: "This is the biggest economic shock in the U.S. and in the world really, in living memory, we went from the lowest level of unemployment in 50 years to the highest level in close to 90 years and we did it in 2 months, extraordinary… "

Figure 1. **FOMC Dot Plot** (%)



Source: BBVA Research & FRB

Figure 2. **FOMC Summary of Economic Projections** (SEP, %)

	2020	2021	2022	Long-run
Change in real GDP*	-6.5	5.0	3.5	1.8
Range	-10.0--4.2	-1.0-7.0	2.0-6.0	1.6-2.2
Unemployment rate*	9.3	6.5	5.5	4.1
Range	7.0-14.0	4.5-12.0	4.0-8.0	3.5-4.7
PCE inflation*	0.8	1.6	1.7	2.0
Range	0.5-1.2	1.1-2.0	1.4-2.2	2.0
Core PCE inflation*	1.0	1.5	1.7	
Range	0.7-1.3	1.2-2.0	1.2-2.2	
Federal funds rate*	0.1	0.1	0.1	2.5
Range	1.6-1.9	1.6-2.4	1.6-2.9	2.0-3.3

* Median
Source: BBVA Research & FRB

For inflation, in 2020, committee member's expectations for a deterioration in prices were rather subdued with forecasts for core PCE ranging from 0.5%-1.2%, but going forward members expected a slow convergence with the 2% target, although not until at least 2022. The snail-pace of inflation convergence amid solid growth and lower unemployment in coming years reflects that the Fed anticipates the flat Phillips curve environment to persist.

In addition, even in the most optimistic projections the UR does not return to the pre-pandemic rate of 3.5% before 2022, a scenario that Powell in the Q&A suggested was a comfortable level when considering how muted inflationary pressures that prevailed during that period. Powell also expressed significant concerns on long-term damages to the labor market considering the massive displacement of workers and the long period it could take to rehire them. As a result, the Fed expects to keep interest rates on hold at least though 2022. In fact, Powel said that "we are not thinking about raising rates, we are not even thinking about thinking about raising rates".

Powell's comments at the press conference and Q&A were consistent with the tone of the statement and economic projections. On the labor market, Powell reiterated that: "[Inflation is] very likely to remain low for some time below our target, so really it's about getting the labor market back and getting it in shape, that has been our major focus". The chairman highlighted the likelihood that misclassification of workers by the BLS was leading to an underreporting of the UR and that the most recent jobs report was consistent with a highly uncertain outlook and not a improving labor market.

With such high levels of uncertainty, as we expected, the Chairman noted that there was significant discussion on additional tools available to the committee: more explicit forward guidance, additional asset purchases and targeting interest rates.

In addition to the discussion on the use of traditional monetary policy tools, the chairman reaffirmed the Fed's commitment to "forcefully, proactively and aggressively" use section 13(3) powers. "Preserving the flow of credit is thus essential for mitigating the damage to the economy and setting the stage for the recovery." That being said, in an effort to assuage concerns about the increasing scope of the lending facilities, the Chairman committed to eventually putting the "tools back in the toolbox."

After today's communication, it is clear that the Fed remains committed to do as much as possible to support the economic recovery. While the Fed seems comfortable with the measures taken thus far to restore financial market functioning, the committee remains proactive in its assessment of its tool kit. Nonetheless, the Fed is deeply concerned about the severity of job losses and potential long-term damages to the labor market. In an environment of prolonged low inflation, this implies keeping interest rates at the zero lower bound and maintaining steady asset purchases for several years, while continuing the emergency lending facilities.