Central Banks

FOMC Meeting July 28-29: Dovish tone signals more accommodation for an extended period

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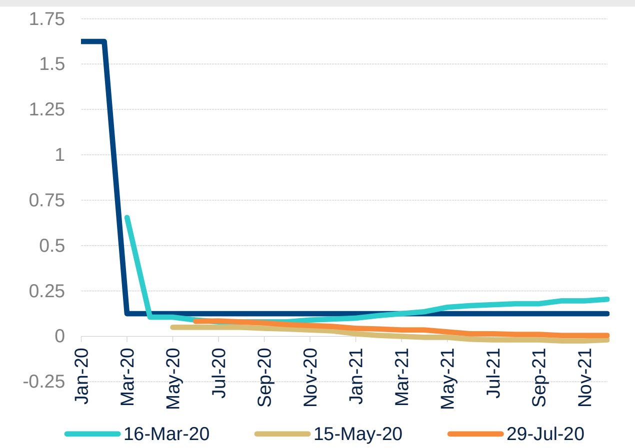
As expected, the Fed left interest rates unchanged and reaffirmed its commitment to, at a minimum, maintaining the current pace of asset purchases while also defending its expanded use of its lending powers until the economy is on the road to recovery. This week, the committee also announced that it would extend its lending programs, U.S. dollar swap lines and foreign and international monetary authorities (FIMA) Repo facilities until the end of the year.

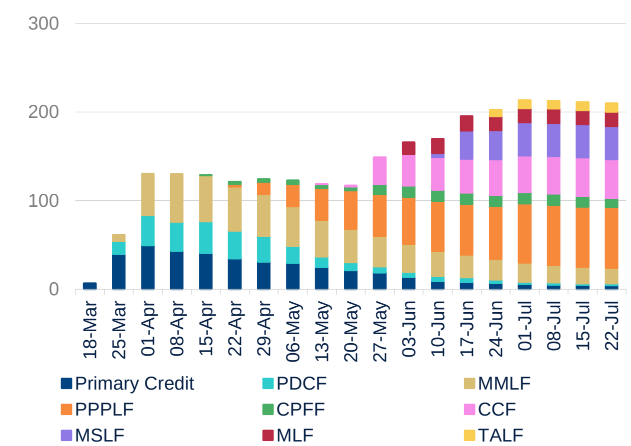
Ultimately, staying the course was justified by improvement in traditional measures of economic activity such as labor market reports, industry surveys and output, and consumer spending and confidence levels as well as financial conditions. That said, high frequency data and some more recent survey data suggests that the economic recovery has slowed with the rise in the number of Covid-19 cases and elevated level of uncertainty. Moreover, the impact of the pandemic-led recession has been heterogeneous, damaging lower-income households, minorities, women and younger individuals. In fact, in the Q&A, the Chairman cited research that suggested that for people making under $40K a year there was a 40% chance of losing their job in April and May. This prompted the inclusion of this phrase in the statement: “The path of the economy will depend significantly on the course of the virus.”

Figure 1. **FED FUNDS FUTURES & BBVA BASELINE** (%)



Source: BBVA Research & Bloomberg

Figure 2. **LOANS & NET PORTFOLIO HOLDINGS** (US$bn)



Source: BBVA Research & FRB

In the prepared post-meeting comments, the Chairman went further to say that with the rise in the number of Covid-19 cases “we have entered a new phase in containing the virus” and that the “path forward is extraordinarily uncertain and will depend in large part in keeping the virus in check.” He went on to say that, “social distancing measures and fast reopening of the economy actually go together and are not in competition with one another.” As such, it will take a long time for the economy to return to pre-crisis levels and that will not happen until people are confident that it is safe to engage in a broad range of activities, according to the Chairman.

Not surprisingly, Powell reaffirmed the decision to use all available tools and to further support the economy with more accommodation. Particularly since the Fed is more likely to be confronted with disinflationary pressures than with inflationary pressures amid elevated unemployment rates. In fact, the Chairman's response to a question on motivation for Large-Scale Asset Purchases (LSAP) signaled that the policy could move from a phase of mostly targeting financial conditions to one more consistent with the QE following the financial crisis, which had a more targeted “macro” focus. Notwithstanding the Fed’s commitment to use the full range of tools, Powell reiterated that, “fiscal policy is essential” and better suited to address issues the Fed cannot as well as supporting particular groups.

On the review of the Fed’s monetary policy framework, the Chairman teased an update, but rather than committing to any policy changes, he only shared that the committee would wrap up their deliberations in the near future.

Barring a major upside surprise in the short-term, higher uncertainty surrounding the economic outlook and the combination of low inflation and high unemployment suggests that the committee needs to build consensus if it is to make important adjustments in the next phase of monetary policy. For example, the Fed could announce the adoption of average inflation targeting, stronger forward guidance, open-ended asset purchases and yield curve targeting.

Today’s statement and most importantly, the press conference, sent a clear dovish message to assuage financial market concerns and reiterate that the Fed will keep interest rates at the zero lower bound for the foreseeable future and that it remains committed to do whatever it takes to support the economic recovery. Since this is likely to take a considerable amount of time, we maintain our expectation for the Fed funds to remain unchanged at least until 2023. In addition, we expect the balance sheet to continue expanding at a moderate pace for some time, supported by Treasury and MBS purchases and the credit and lending facilities.