Central Banks

FOMC Meeting September 15-16th: Fed delivers on forward guidance, but defers on changes to QE

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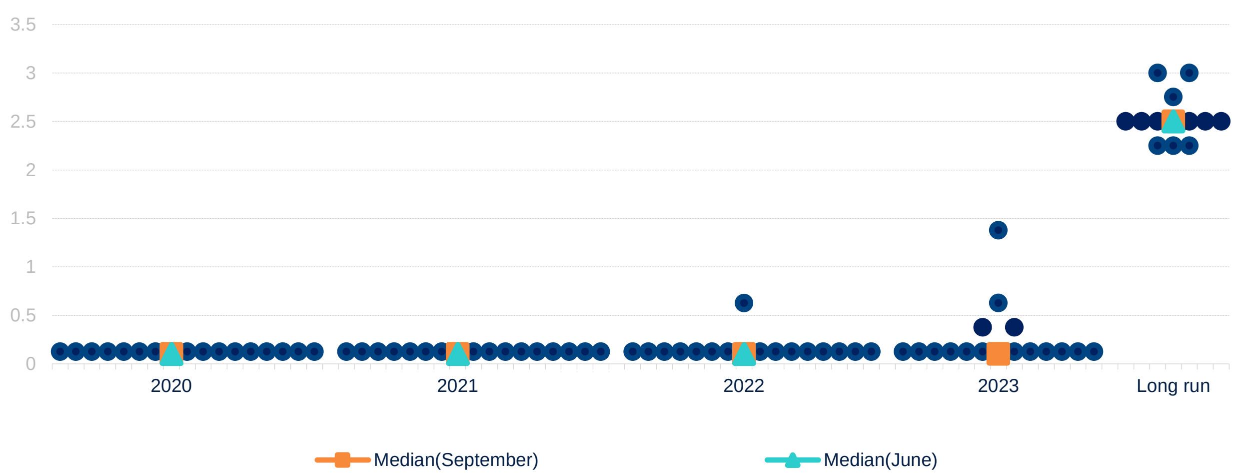
September 16, 2020

After announcing the changes to the Longer-Run Goals and Monetary Policy Strategy in the intermeeting period, the FOMC followed up with a very dovish statement at the September 15-16th meeting that included references to the committee's new goals on maximum employment and flexible average inflation targeting (FAIT).

The change in forward guidance from "weather recent events" and "is on track to achieve its maximum employment and price stability goals" to "maintain an accommodative stance of monetary policy until these outcomes are achieved" and "have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time" send two fundamental signals. First, rates will remain below neutral even after reaching the goals. Second, interest rates will remain at the zero lower bound indefinitely.

Nonetheless, the Fed also left the door open to adjust policy, probably in relation to financial stability risks: "The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals."

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



Source: BBVA Research & FRB

With respect to asset purchases, the statement signaled no meaningful change to guidance, stating that purchases would continue "at least at the current pace to sustain smooth market functioning and help foster accommodative financial conditions, thereby supporting the flow of credit to households and businesses." The statement also included an explicit expansion of scope of conditions the committee would monitor including "readings on public health, labor market conditions, inflation pressures and inflation expectations, and financial and international developments."

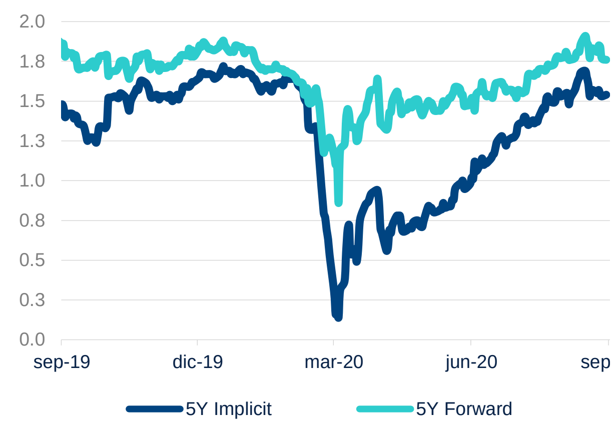
Unexpectedly the statement contained two dissents, one from Dallas Fed President Kaplan and one form Minneapolis Fed President Kashkari. Kaplan's dissent centered around the degree of dovishness in the new forward guidance, with Kaplan preferring to retain the previous guidance on weathering the current storm and "on track" to reaching maximum employment. Kashkari, who tends to fall into the more dovish group on the committee, preferred to maintain the current stance of monetary policy until "core inflation has reached 2 percent on a sustained basis." The balanced dissent suggests that while the consensus view aligned with the Longer-Run Goals and Policy Strategy, the degree to which committee members are willing to go on reaching the goals varies, particularly in relation to the period that rates will remain at the ZLB and the time it will take to bring them back to neutral. This in turn is most likely linked to different expectations on the time that it will take for inflation to return to 2% on a persistent basis.

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

	2020	2021	2022	2023	Long-run
Change in real GDP*	-3.7	4.0	3.0	2.5	1.9
Range	-5.5–1.0	0.0–5.5	2.0–4.5	2.0–4.0	1.6–2.2
Unemployment rate*	6.5–8.0	4.0–8.0	3.5–7.5	3.5–6.0	3.5–4.7
Range	7.0-14.0	4.5-12.0	4.0-8.0	3.5-4.7	3.5-4.7
PCE inflation*	1.0–1.5	1.3–2.4	1.5–2.2	1.7–2.1	2.0
Range	0.5-1.2	1.1-2.0	1.4-2.2	2.0	2.0
Core PCE inflation*	1.5	1.7	1.8	2.0	
Range	1.2–1.6	1.5–2.4	1.6–2.2	1.7–2.1	
Federal funds rate*	.1	.1	.1	.1	2.5
Range	0.1	0.1	0.1–0.6	0.1–1.4	2.0–3.0
***Median**					

* Median
Source: BBVA Research & FRB

Figure 3. **Inflation Expectation** (%)



* Median
Source: BBVA Research & FRB

Unlike the uncertain and pessimistic tone that the statement and Q&A signaled, the committee's outlook for the economy improved markedly from June. For example, Q4/Q4 GDP growth was revised up from -6.5% in June to -3.7%. Similarly, the unemployment rate is now expected to be 7.6%, up from a median estimate of 9.3%. Expectations for headline and core PCE inflation in the short-run also improved 40 and 50bp higher, respectively. That said, the forecasts for core and headline inflation remain at or below 2% throughout the forecast period, suggesting that the committee does not believe that it will achieve its FAIT target of 2% before 2023. As a result, nearly all the committee members expect interest rates will remain at the zero lower bound through 2023 with only one member projecting rate increases in 2022 and three members expecting rate increases in 2023.

Given that inflation is just back to 2% in 2023 in the SEP, achieving an average inflation target of 2% would require letting inflation run above 2% in 2024 and 2025 to make up for previous years while labor market conditions will not achieve “maximum” employment until well after the unemployment rate reaches its long-run equilibrium level. As such, assuming that the SEP projections continue after 2023 -last year shown in the SEP-, the earliest the Fed would raise rates would be 2024. However, if the economic outcome turns out to be less optimistic than the latest SEP, the Fed would raise rates in 2025.

During the press conference, Powell tried to explain the dichotomy between the Fed’s objective of inflation running above 2% and the fact that the median forecasts remain no higher than 2% throughout the forecast horizon. Although Powell acknowledged that the pace of recovery will slow and the uptick in inflation will take time, “inflation does move up over time”. The Chair also described the new guidance as “powerful” and remained optimistic in the ability of the Fed to reach its goal: “We think that effectively saying that policy will remain highly accommodative until the economy is very far along in its recovery should provide strong support for the economy and get us there sooner rather than later.” Powell also said that while he is not expecting a big reaction to the enhanced forward guidance, committing to keep the current policy stance “until the economy has moved very far toward our goals” will provide strong support to the economy.

Based on the latest statement and changes to the committee’s Longer-Run Goals and Monetary Policy Strategy, we have revised our forecast for the policy rates with the first rate increase occurring in 2025. This implies that long-term yields will remain well below historical averages for a prolonged period. Should economic conditions surprise on the upside, the policy rate increase may happen sooner, possibly in 2024. However, given the long-lasting effects from Covid-19, elevated policy uncertainty, and the expected moderate improvement in labor market conditions, inflation and inflation expectations that follow deep recessions, the risk of low policy rates for an even a longer period remain high.