Central Banks

FOMC loads and aims, but refrains from pulling the trigger

Nathaniel Karp / Boyd Nash-Stacey

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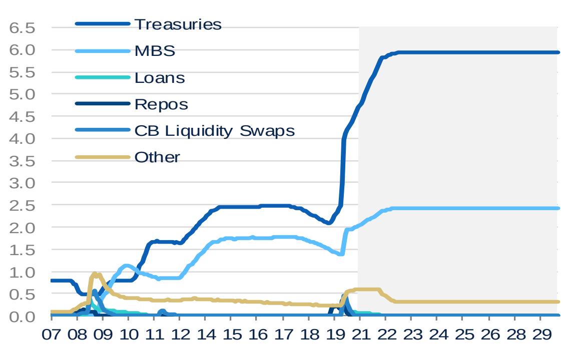
As we expected, after the December meeting, the FOMC left interest rates unchanged and enhanced their forward guidance on asset purchases. The Fed committed to at least $80Bn in Treasury purchases and $40Bn in mortgage-backed security (MBS) purchases "until substantial further progress has been made toward the Committee's maximum employment and price stability goals." This implies that purchases will continue for a prolonged period. The Fed will also consider additional asset purchases of Treasuries, CMBS and MBS, as well as repo operations and dollar roll and coupon swap transactions to guarantee the smooth functioning of financial markets. However, the net pace of purchases of $80Bn in Treasuries is consistent with the $83bn during the past three months. Moreover, the Fed refrained from making any commitment to duration and maturity. As such, today's move represents only a modest shift in guidance and will not significantly alter the level and depth of financial accommodation being provided by the Fed.

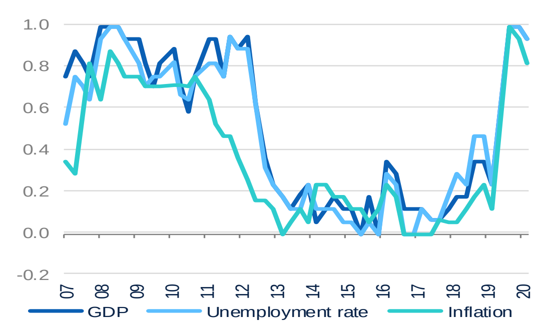
At the press conference, the Chairman signaled that the balance sheet tool would be endogenized within the Fed's reaction function. Specifically, he said "Enhanced balance sheet guidance will ensure that the stance of monetary policy remains highly accommodative…our guidance is outcome-based and is tied to progress toward reaching our employment and inflation goals." Keeping some dry powder in the face of elevated uncertainty and risks is prudent, especially considering that despite some signs of optimism on the vaccine the "timing, production, and distribution of vaccines, as well as their efficacy across different groups" remains unclear. Further action on the balance sheets could include shifting the portfolio's composition or extending its assets' weighted average maturity. We continue to believe that these tools would be the preferred option over yield curve targeting and negative interest rates, given that they remain unpopular among the committee members, market participants and policymakers.

Figure 1. **FED BALANCE SHEET ($USTN)**



Source: BBVA Research & FRB

Figure 2. **SEP UNCERTAINTY DIFFUSION INDEX (0=BROADLY SIMILAR)**



Source: BBVA Research & FRB

The new insight in the Summary of Economic Projections (SEP) into the committee's biases on uncertainty and risks to the outlook were absent in the forecasts, which were little changed and in some cases, slightly more optimistic than the September figures. The projections for core PCE only increased from 1.7 to 1.8%, while GDP growth in 2021 increased 20bp to 4.2% Q4/Q4. Meanwhile, projections for the unemployment rate showed a 0.5 and 0.4pp improvement for 2021 and 2022, respectively. According to the median estimates, only by 2023 does inflation return to 2% and the unemployment rate dips below 4%. These upgrades come even though only one member thinks that uncertainty is broadly similar and that 35% of the committee believe risks to GDP growth are skewed to the downside. There was no change to the expected path of the policy rate, with rate increases on hold at least through 2023. According to the statement, although "[e]conomic activity and employment have continued to recover," they remain well below their pre-pandemic levels and the health crisis "will continue to weigh on economic activity, employment, and inflation in the near term, and poses considerable risks to the economic outlook over the medium term."

Like many of his foreign counterparts, Powell took the opportunity to make the plea for additional governmental support, even considering the massive fiscal support provided earlier in the year. On the Exchange Stabilization Fund (ESF), the Chairman said, "[a]lthough funds from the CARES Act will not be available to support new loans or new purchases of assets after December 31, the Treasury could authorize support for emerging lending facilities if needed through the ESF." The gentle nudge for the incoming administration will likely be received well by former Chair Yellen, who will be the first female U.S. Treasury secretary. However, signs of an emerging policy cliff and their implications likely imply more immediate needs for direct fiscal support, particularly considering the sharp pullback in some sectors. In Powell's words, "[t]he current economic downturn is the most severe of our lifetimes it will take a while to get back to the levels of economic activity and employment that prevailed at the beginning of the year and it may take continued support from both monetary and fiscal policy to achieve that." Simply put, Congress's proposed measures are needed to stem the bleeding but fall short of the necessary stimulus to put the economy back on solid footing.

Today's Fed communication and actions confirm our view that a full recovery will take time to materialize despite the improvement in economic activity. Thus, we continue to expect rates to remain at the effective lower bound (ELB) for some time. With risks to the outlook elevated, the committee has successfully loaded the balance sheet for future deployment. That said, today's announcements fell short of expectations as financial accommodation was unchanged, suggesting that fiscal policy will have to do more of the heavy lifting until the new administration is sworn in. Otherwise, the economy risks backsliding at a time when the light is emerging from the end of the tunnel.