Creating Opportunities

Central Banks

FOMC holds the line despite more upbeat outlook

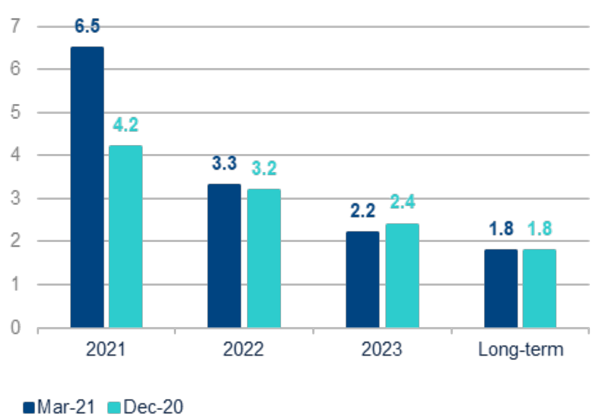
Nathaniel Karp / Marcial Nava
March 17, 2021

As we expected, the Federal Reserve (Fed) made upward revisions to their GDP and inflation outlook and lowered its estimates of the unemployment rate, but kept its projections of the policy rate at the zero lower bound at least until 2023.

On the one hand, this acknowledges the positive short-term effects from massive fiscal support since December, accelerating vaccinations trends and easing of restrictions across the country. However, on the other hand, it shows the desire of the committee to realign market expectations, which are discounting rate increases in 2022, with the Fed's outlook that rates will remain at the zero lower bound at least until 2023, despite improved economic outcomes. That is, the Fed wants to reassure markets that it is not ready to raise interest rates anytime soon or even start considering this possibility.

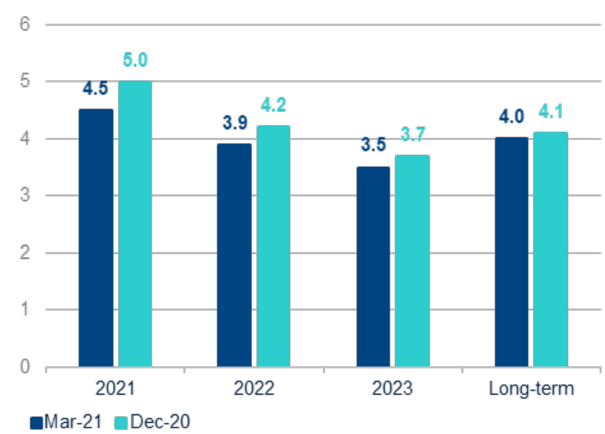
Regarding economic activity, the Fed acknowledged that the economy is recovering, but stressed that bringing the labor market back to pre-pandemic levels will take some time. The median of GDP projections for 2021 was revised up markedly from 4.2% to 6.5%. However, for 2022 and 2023, the outlook remained roughly the same. Meanwhile, the median projection for the unemployment rate edged down significantly as the Fed expects it to dip below 4% by the end of 2022, and to reach 3.5% by the end of 2023. This reflects the Fed's positive view on fiscal support as a way to avoid the long-term scarring effects from the pandemic on labor markets. Despite these revisions, the Fed highlighted that "... the sectors most adversely affected by the pandemic remain weak" and that "The ongoing public health crisis continues to weigh on economic activity, employment, and inflation, and poses considerable risks to the economic outlook."

Figure 1. **SUMMARY OF ECONOMIC PROJECTIONS: CHANGE IN REAL GDP** (MEDIAN, %, 4Q/4Q)



Source: BBVA Research and Federal Reserve

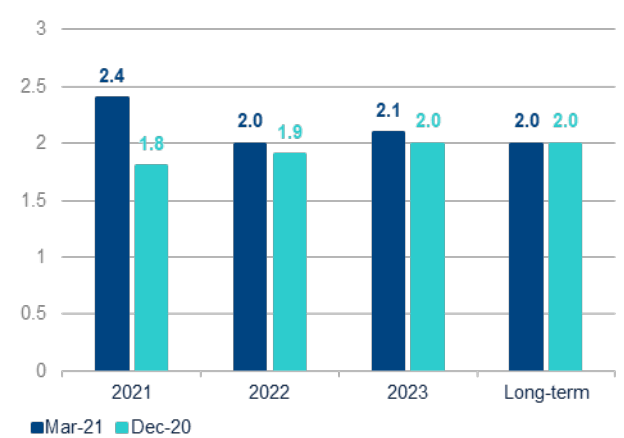
Figure 2. **SUMMARY OF ECONOMIC PROJECTIONS: UNEMPLOYMENT RATE** (MEDIAN, %, 4Q)



Source: BBVA Research and Federal Reserve

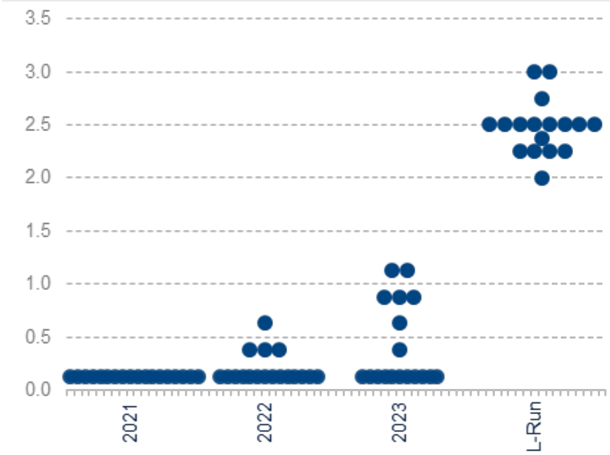
On price stability, the Fed stressed that “Inflation continues to run below 2 percent” but revised its 2021 outlook for headline PCE to 2.4% from 1.8%. However, for 2022 and 2023, the revision was just 0.1pp each year. This is consistent with our view that although inflation will edge higher, current inflationary pressures will prove transitory and core PCE will converge with the Fed’s 2% objective despite a stronger economic recovery and massive fiscal support. In fact, Powell stated that *"we could also see upward pressure on prices if spending rebounds quickly as the economy continues to reopen...However, these one-time increases in prices are likely to have only transient effects on inflation.”*

Figure 3. **SUMMARY OF ECONOMIC PROJECTIONS: PCE INFLATION** (MEDIAN, %, 4Q/4Q)



Source: BBVA Research and Federal Reserve

Figure 4. **SUMMARY OF ECONOMIC PROJECTIONS: MIDPOINT OF TARGET RANGE**



Source: BBVA Research and Federal Reserve

Regarding policy rates, the Fed’s median projection for Fed funds remained unchanged at 0.1% at least until 2023. Nonetheless, the number of participants expecting liftoff in 2022 increased from one in December to four in March. For 2023, seven members expect higher rates compared to five in December. This implies that although the likelihood of the Fed raising rates in 2022 or 2023 has increased, it remains low as the vast majority of participants would like to see significant further improvement in labor market conditions before considering rate increases. This would imply lower unemployment rates for minorities and low-income earners, higher participation rates (particularly for women), higher employment to population ratios, lower part-time employment for economic reasons, lower voluntary separations, and higher compensation measures.

Given the recent spike in long-term yields, some market participants were expecting the Fed to announce changes to its balance sheet and asset purchase program. However, the Fed reaffirmed that purchases of Treasuries and MBS will continue at a pace of $80bn and $40bn per month, respectively. Moreover, both the statement and Powell’s press conference stressed that financial conditions remain accommodative and continue supporting the economy. This suggests that the Fed is not concerned about the recent increase in long-term interest yields as this is primarily a reflection of higher inflation expectations and a rebound in the term premium.

Bottom line

As we expected, the Summary of Economic Projections revealed faster growth and lower unemployment on the back of recent fiscal policy actions, positive vaccination trends and the reopening of the economy. In addition, although PCE inflation projections were revised up, most of the upward pressures will be transitory. Moreover, the Fed kept its interest rate outlook unchanged. Therefore, the Fed will continue signaling that interest rates will remain low to avoid making the mistake of moving too soon (as it did after the Great Recession), given that *"The economy is a long way from our employment and inflation goals, and it is likely to take some time for substantial further progress to be achieved."* However, the Fed is likely to mark up its projections in future meetings as incoming economic data continues to show stronger economic performance and Congress moves forward with an infrastructure package. As a result, we expect more members to support tapering in 2022 and shift towards an interest rate hike in 2023.