Central Banks / Global Economy

Fed: double somersault with a twist

Expansión (Spain)

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As expected, on March 20 the Federal Reserve (Fed) decided to leave the federal funds rate unchanged. Despite this, the Fed also indicated that, if economic conditions evolve in line with their forecasts, they would not change the rate for the rest of the year. This shows a dramatic turnaround compared to six months ago, when the Fed anticipated an increase of 75 basis points (bps) in the interest rate in 2019. This U-turn largely reflects greater uncertainty about expected economic performance and the inability to achieve the inflation target in a sustained manner.

On the one hand, although the unemployment rate is below the long-term equilibrium level and recent data on consumption, investment and the labor market remain positive, the pace of economic expansion has slowed significantly. In fact, between September 2018 and March 2019, the Fed revised its GDP growth expectations for 2019 downwards from 2.5% to 2.1%. In addition, risks associated with greater global economic weakness, tensions over Brexit and the uncertainty surrounding trade negotiations have increased considerably.

On the other hand, despite the high level of monetary accommodation and one of the longest economic expansions in history, inflation has remained persistently below the Fed's target. Just a few weeks ago, implied inflation expectations fell to their lowest level in almost three years. Moreover, core inflation has averaged 1.6% over nine years and has only exceeded the 2% target in six of the last 108 months.

As such, the next rate move will take some time and could go in either direction. This uncertainty should not come as a surprise. For example, in September 2015, under Janet Yellen's mandate, the Fed anticipated an increase of 100 bps in 2016. However, faced with greater global uncertainty and weaker economic conditions, the Fed increased the rate by just 25 bps. This helped keep the economic expansion afloat -although GDP growth fell from 2.9% in 2015 to 1.6% in 2016-, while core inflation increased from 1.3% in September 2015 to 1.9% in December 2016.

The current conditions are undoubtedly different to those in 2016. The expansion is more mature, business-sector debt is at a historical high and risk appetite in the non-banking financial sector does not appear to be sustainable. In addition, real-estate investment is continuing to decline, in line with a slowdown in exports. As a result, the likelihood of an economic recession has increased significantly in recent quarters. Nevertheless, economic fundamentals remain strong. Low unemployment, robust growth of household income and the strong consumer confidence are supporting personal consumption. Furthermore, private investment in equipment and intellectual property continues to grow, while federal spending will expand at its fastest rate in ten years.

In this climate, the Fed will keep monetary policy on a prolonged pause to counteract potential risks and create conditions to achieve higher inflation. This "wait and see" strategy implies that, faced with greater economic weakness and the materialization of downside risks, the Fed would lower interest rates. In contrast, in the event of a sustained expansion with lower downside risks and higher inflation, it would increase interest rates. For the time being, the markets are betting on the former scenario.

Therefore, the Fed's two major challenges in the short term are to avoid market pessimism turning into self-fulfilling expectations and to adjust its monetary policy strategy, with the aim of strengthening its credibility with regard to target inflation. The latter could generate more space to respond in case the business cycle edges down, which is currently limited by low interest rates and subdued inflation expectations.

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