BBVA Research

Creating Opportunities

Central Banks

FOMC Meeting: December 10th-11th

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As we expected, the Fed lefts its benchmark interest rate unchanged at 1.5-1.75% and made only minor adjustments to the October statement. The change was the slight tweak in forward guidance to reflect previous communication that in order to alter the level of accommodation the committee would need to see a “material” changes in their outlook. With respect to material changes, the committee included “global developments and muted inflation pressures”, as areas where the committee would be closely monitoring as it contemplates further adjustments in the Fed Funds rate. Unlike the past meeting, which had the inflation and financial vulnerability hawks dissenting, there was unanimous support for today’s statement.

In terms of the dot plot, while some members still envisage hikes in 2020, the number of members expecting increases next year declined significantly from nine in September to four. Moreover, the four members still expecting rate increases next year only anticipate one 25bp increase whereas in September, seven members believed rates would be above 2.0% by yearend. With no material change in the committee’s outlook on inflation and given the consensus that tradeoffs between high resource utilization and inflation are low, it is not surprising that the pause has gained traction.

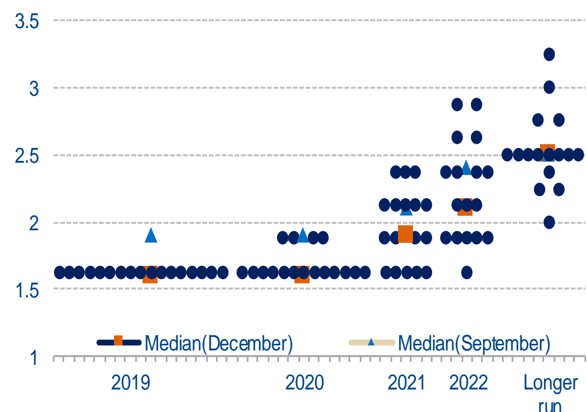
That being said, it was hard to reconcile the modest upward drift in inflation in 2020 and 2021 in the Summary of Economic Projections with the broad consensus among FOMC members that rates would move up in 2021. With the Fed trying to gain credibility on its inflation target and its commitment to a symmetric objective, raising rates after only reaching its target for a short period would be troublesome. In such a scenario, the committee could risk repeating the misstep in 4Q18 that has led to a persistent downward drift in inflation expectations despite firming inflation data.

Chart 1. **December FOMC Median Projections,** (%)

FOMC Median Estimates	2019	2020	2021	2022	Long-run
Change in real GDP	2.2	2.0	1.9	1.8	1.9
September projection	2.2	2.0	1.9	1.8	1.9
Unemployment rate	3.6	3.5	3.6	3.7	4.1
September projection	3.7	3.7	3.8	3.9	4.2
PCE inflation	1.5	1.9	2.0	2.0	2.0
September projection	1.5	1.9	2.0	2.0	2.0
Core PCE inflation	1.6	1.9	2.0	2.0	
September projection	1.8	1.9	2.0	2.0	
Federal funds rate	1.6	1.6	1.9	2.1	2.5
September projection	1.9	1.9	2.1	2.4	2.5

Source: BBVA Research & Bloomberg

Chart 2. **FOMC Dot Plot,** (end of year %)



Source: BBVA Research & Bloomberg

In the press conference, Powell faced a number of questions surrounding this inconsistency and his commitment to a structural change in the committee's approach to inflation. From an empirical perspective, he agreed that the relationship between labor market slack and inflation has diminished and that remaining accommodative in such a scenario could provide additional benefits to "workers on the margin" of the labor force, particularly low income communities. When pushed on systematizing this approach, the chairman suggested that adding such a component to the framework was unlikely, but that the Fed Listen Events helped reinforce the idea that estimates of the natural rate of unemployment may be too high since contacts within low-to-moderate income communities continue to highlight that utilization may be lower than it is believed to be. In this context, the Chairman said that he would prefer to err on the side of accommodation and that he would personally need to see inflation that is "persistent and significant" before he would alter his view on the appropriate level of accommodation.

On the Repo market and threats of a yearend liquidity squeeze, the committee remains committed to doing whatever it takes to relieve any market pressures that could spill over into the Fed funds market or threaten financial stability. In fact, the Chairman in the press conference said that yearend liquidity squeezes are common, implying the Fed is prepared for a potential event.

That being said, outside of the ad hoc approach of term and overnight temporary open market operations and modest increases in the level of reserves, there did not appear to be a comprehensive strategy that would eliminate the need for temporary operations. When asked about the BIS report findings that the September volatility was not a one-off event, his comments seemed to suggest his preference was for altering regulatory and supervisory guidance as opposed to more structural and untested approaches such as a standing Repo facility.

Bottom Line

With a handful of positive trade developments, signs of a bottoming out of the industrial slowdown in advanced economies, solid domestic conditions supporting consumption and low yet stable inflation we expect the Fed will continue to pause for the foreseeable future, waiting for a "material" change in their outlook. While it is hard to draw parallels between the 90s "mid-cycle" adjustment and recent adjustment by the Fed given the different macroeconomic backdrops, from a risk perspective they have had similar outcomes with nontrivial decreases in the model-based estimates of U.S. recession risk. A risk balance potentially tilting to the upside, our baseline view of a soft-landing for the U.S. economy and muted inflationary pressures are consistent with a pause throughout 2020. However, Powell's choice to stand by his decision to raise rates throughout 2018 in the spirit of returning interest rates to near neutral levels suggests that if given the opportunity with a more favorable inflation outlook and more upbeat global outlook he could pivot to supporting rate hikes as opposed to further cuts.

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