Few policy changes expected at this week's FOMC meeting

By: Eric Stein, CFA | July 28, 2020

Boston - Don't expect much by way of policy changes at the Federal Reserve's next Federal Open Market Committee (FOMC) meeting starting on July 28. It is more likely that substantive changes will occur at the September meeting when there will be a new statement of economic projections and a likely revision to the Fed's so-called dot plot, which reflects the interest rate forecasts of the central bank's policymakers. Now that we have press conferences at every meeting, there will quite likely be some hints of what to expect this fall from Chair Jerome Powell.

I expect this week's Fed meeting to reveal a continuance of the central bank's transitioning from a focus on market functioning and financial market stability to more traditional monetary policy. The markets have certainly recovered from the initial panic that occurred back in March, and today there are certain markets that could be viewed as somewhat frothy. As a result, the Fed is moving toward a focus on medium-term monetary policy to address what it needs to do to support economic growth, specifically to get inflation up to its target and unemployment back down from the current rate in the double digits.

This transition began at the June 9 FOMC meeting, during which Chair Powell alluded to the prospects of the Fed enacting yield curve control or interest rate caps for the first time since the 1940s to curb rising Treasury security rates and yields, while keeping borrowing costs low for businesses and consumers. In the minutes of its June meeting, the Fed seemed to play down the prospects of yield curve control, although they're studying what Australia is doing with front-end yield curve control, and considering various forms of forward guidance and more open-ended quantitative easing (QE). I think they'll head in that direction and will likely come out with policy changes at the September meeting.

The general consensus at the Fed is that it still has to do more to support the US economy. The central bank does not want to raise rates too early. I think the Fed learned a lesson that it was arguably too tight back in late 2018/early 2019, when it was forced to cut rates and it began to expand the balance sheet. It was probably about right from a monetary policy perspective. But when we headed into the coronavirus, the economic shock required the Fed to immediately recalibrate monetary policy.

Since the last FOMC meeting, Dallas Fed President Robert S. Kaplan gave a speech about the market recovery and suggested the Fed may wind down some of the programs it enacted to help the economy through the worst of the economic damage. That idea was quickly shot down by Lael Brainard, who along with Richard Clarida, is one of the intellectual policy architects on the Board of Governors. The consensus of the committee that there is more risk in *not doing enough* as opposed to a risk in *doing too much*, particularly when the Fed couldn't get inflation up to the 2% core PCE target[1] even before the coronavirus pandemic. Now, with unemployment in the double digits, I think the Fed will certainly err on the side of overshooting inflation and being more aggressive on a monetary front, with much less worry about whether financial markets are somewhat frothy.

Bottom line: I expect the Fed will hint at its new focus on more "traditional" monetary policy designed to invigorate growth amid a weak economic environment at this week's meeting. It is likely to formalize that policy transition at the upcoming September meeting.

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[1] Personal Consumption Expenditures (PCE) Price Index is the primary inflation index used by the US Federal Reserve when making monetary policy decisions.

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