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ECONOMICS

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US – No change to Fed funds target rate of 0–0.25% & QE stance

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US

No change to Fed funds target rate of 0–0.25% & QE stance

As expected, the Fed unanimously decided to leave the its target rate unchanged at 0–0.25% with no change to its quantitative easing (QE) stance. During the meeting, the Fed also announced an extension of the dollar repo and swap lines through to 31 March, a sign that it is looking to ensure that market functioning continues without stress.

A major statement change is that the Fed added a clear warning that "the path of the economy will depend significantly on the course of the virus". It appears to be providing a dose of realism as opposed to what seems to be in the equity market where there is more optimism that recovery is kicking in.

While financial markets continue to price in the possibility of negative interest rates, the Fed officials have downplayed this. An option that continues to be discussed as a potential future policy tool is yield curve control – using QE to target specific yields to prevent borrowing costs rising too far too quickly. But with the US 10Y Treasury yielding less than 60 basis points and the 30Y a mere 1.25%, there is no pressing need to do anything. If yields start to rise on economic optimism and the perception that inflation is rising, the Fed is unlikely to stand meaningfully in the way.

- The Fed unanimously decided to leave the Fed funds target rate unchanged at 0–0.25% with no change to its QE stance, which is well within expectations. This resulted in the purchase of Treasury and mortgage-backed security purchases to slow sharply since the peak of the crisis in March. During the meeting, the Fed also announced an extension of the dollar repo and swap lines through to 31 March, a sign that it is looking to ensure that market functioning continues without stress.

- In the Fed's statement, it reiterated the tone that it remains committed to keep the Fed funds rate at the 0–0.25% level "until it is confident that the economy has weathered recent events and is on track to achieve our maximum-employment and price-stability goals".

- A major statement change is that at the beginning of the second paragraph, it added a clear warning that "the path of the economy will depend significantly on the course of the virus". It appears to be providing a dose of realism as opposed to what seems to be in the equity market where there is more optimism that recovery is kicking in.

- Looking at the Fed's dot diagram from June, it showed just two FOMC members expecting the Fed to announce any increase in the policy rate before the end of 2022. Besides, there is hardly much need for the Fed to be more specific with its policy guidance at this stage.

- In the press conference, Fed Chair Jay Powell expressed the same view as at last month's testimony to Congress that "until the public is confident that the disease is contained, a full recovery is unlikely".

- Powell emphasised on how "critical" fiscal support has been to the recovery so far in a plea for an agreement between the Republicans and Democrats on another fiscal package. And so, the interest rates are not going anywhere for a long period and the bond markets and dollar are reflecting this.

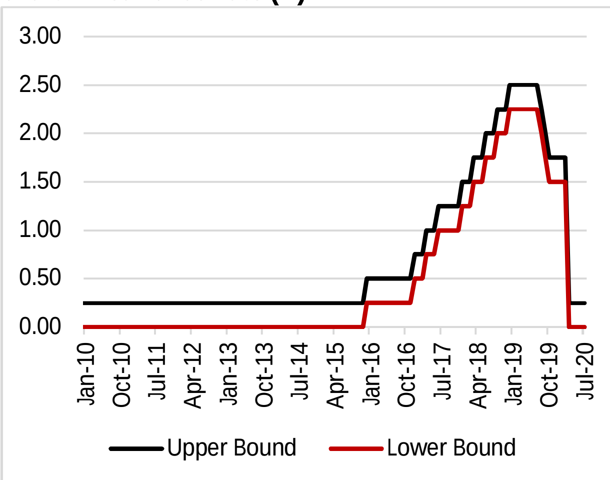
- The Fed also cited that markets should prepare for a potential change in strategy "in the near future" in relation to the way it looks at the goal of price stability and full employment. The Fed's long-run policy setting framework will be announced in September. It seems to be moving towards a policy of targeting 2% inflation by tolerating stretches of above 2% inflation to make up for long periods of sub-target inflation. This would mean looser monetary policy for longer periods and supports the message from the dot diagram that a rate hike remains at least another two and a half years away.

Additional policy options downplayed for now

- Financial markets continue to price in the possibility of negative interest rates. But the officials have downplayed this. The Fed again hinted it is not an attractive option, citing little evidence to show it has boosted inflation in the Eurozone or Japan. It felt that such as a move "could have more significant adverse effects on market functioning and financial stability here than abroad". It also acts as a disincentive for businesses to maintain cash buffers to deal with future financial stress.

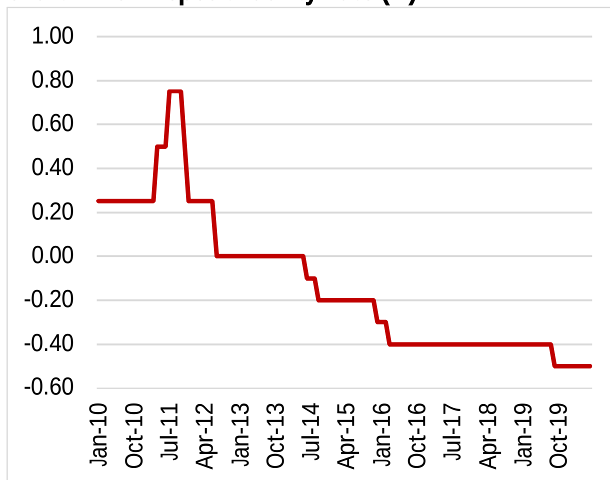
- Another option that continues to be discussed as a potential future policy tool is yield curve control – using QE to target specific yields to prevent borrowing costs rising too far too quickly. However, with the US 10Y Treasury yielding less than 60 basis points and the 30Y a mere 1.25%, there is no pressing need to do anything. If yields start to rise on economic optimism and the perception that inflation is rising, the Fed is unlikely to stand meaningfully in the way. However, if it is more a fear of a demand/supply mismatch, as Treasury issuance rises to fund a fiscal deficit that we think could hit 20%–25% of GDP this year, then it will be far more willing to prevent rising borrowing costs from threatening the recovery.

Chart 1: Fed Funds Rate (%)



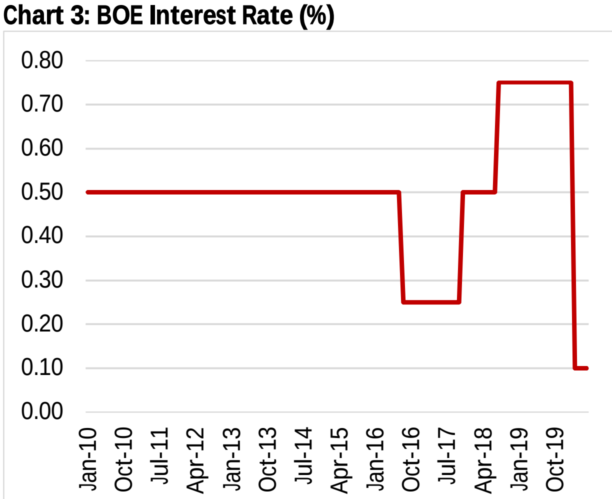
Source: CEIC/AmBank Research

Chart 2: ECB Deposit Facility Rate (%)



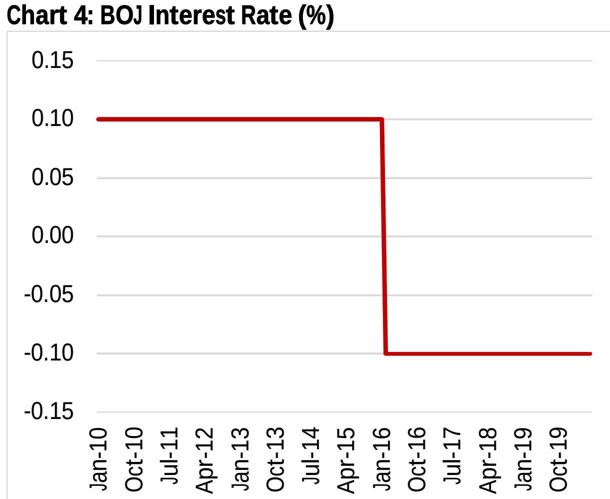
Source: CEIC/AmBank Research

Chart 3: BOE Interest Rate (%)



Source: CEIC/AmBank Research

Chart 4: BOJ Interest Rate (%)



Source: CEIC/AmBank Research

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