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ECONOMIC REPORT

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MONETARY POLICY TO REMAIN EXTREMELY AGGRESSIVE, FOMC SAYS PATH OF ECONOMY DEPENDS ON VIRUS

SUMMARY

- The FOMC kept monetary policy unchanged in its July 29 policy statement. The committee promised to continue with its very aggressive efforts to support the nascent economic recovery.
- The FOMC acknowledged that the U.S. economy has improved in recent months. It also said that the outlook for the economy depends on the path of the coronavirus.
- Inflation will remain below the FOMC's 2 percent objective for some time to come, giving the central bank room to maintain expansionary monetary policy. PNC expects the fed funds rate to remain in its current near-zero range into 2024.
- PNC also expects the FOMC to announce forward guidance, and move to average inflation targeting, later this year.
- PNC expects real GDP to decline more than 30 percent in the second quarter of 2020 in the preliminary release.

On July 29 the Federal Open Market Committee restated its commitment to support the U.S. economy during the recovery from the recession precipitated by the coronavirus pandemic. In language unchanged from its previous policy statement, on June 10, the FOMC said that the "Federal Reserve is committed to using its full range of tools to support the U.S. economy in this challenging time, thereby promoting its maximum employment and price stability goals."

Specifically, the FOMC said that it would keep the fed funds rate in its current range of 0.00 to 0.25 percent, where it has been since two emergency rate cuts in March as the pandemic took hold in the U.S. and states began restrict economic activity. As it did in June, the FOMC said that it would keep the funds rate in this range "until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals." In his post-meeting press conference, Fed Chair Powell emphasized the need to maintain an aggressive monetary policy stance.

In its July 29 statement the FOMC also said that the central bank will continue to expand its balance sheet and purchase $80 billion per month of longer-term Treasury securities, as well as a combined $40 billion per month of Fannie Mae and Freddie Mac debt and residential and commercial mortgage-backed securities, to ensure that long-term interest rates remain low and that credit continues to flow to real estate markets ("quantitative easing"). With extraordinarily aggressive monetary policy, both short-term and long-term interest rates are near record lows (see Chart).

In the section on current conditions the July 29 statement said that "Following sharp declines, economic activity and employment have picked up somewhat in recent months but remain well below their levels at the beginning of the year." The statement also said that inflation is low because of weak demand and low oil prices. The statement acknowledged that financial conditions have improved in recent months, in part because of fiscal stimulus and previous Fed efforts to ensure continued flows of credit. The FOMC also added a sentence to its statement saying that "The path of the economy will depend significantly on the course of the virus." The statement was unanimous.

The July 29 FOMC statement did not indicate a change in monetary policy from the previous statement, in mid-June. The two major changes were an acknowledgement that economic activity has picked up after a steep contraction earlier this year, and a sentence saying that the outlook is highly dependent on the path of the virus, a point Powell also made at his press conference.

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At some point later this year the FOMC is likely to tie monetary policy more explicitly to economic outcomes, a policy tool known as forward guidance. The FOMC is likely to set targets for inflation and/or the unemployment rate before it would increase the federal funds rate. By committing to numerical targets, the FOMC can convince financial markets that short-term rates will remain low for an extended period of time; this helps keep long-term rates low as well, supporting economic growth. In addition, the FOMC could adopt yield curve control, where it sets a target for an intermediate-term interest rate (for example, the yield on a 3-year Treasury security); this also helps keep long-term rates low.

The FOMC is conducting a review of monetary policy that it will release later this year. This review is likely to call for inflation to average 2 percent (using the personal consumption expenditures price index) over the long run. Given that inflation was below 2 percent for most of the previous expansion, and has moved still lower over the past few months with the Viral Recession, average inflation targeting would call for inflation of above 2 percent for an extended period of time in the future. This change to average inflation targeting would support keeping monetary policy highly aggressive in the short and medium terms. PNC expects the fed funds rate to stay in its current near-zero range into 2024.

There was no mention in the statement of the potential for a negative fed funds rate, and FOMC participants across the monetary policy spectrum have expressed extreme reluctance to push the policy rate below zero.

The Bureau of Economic Analysis will release the preliminary report on GDP for the second quarter of 2020 on the morning of July 30. PNC expects a decline in real GDP of more than 30 percent at an annualized rate for the quarter, which would be by far the largest one-quarter of contraction in the history of the series, going back to 1947. Consumer spending, business fixed investment, investment in housing, and exports all plunged during the quarter as the coronavirus pandemic and state restrictions on movement led consumers to cut back on their spending, worksites to close, and business activity to plummet. Real GDP fell 5 percent annualized in the first quarter of the year as the pandemic took hold in March.

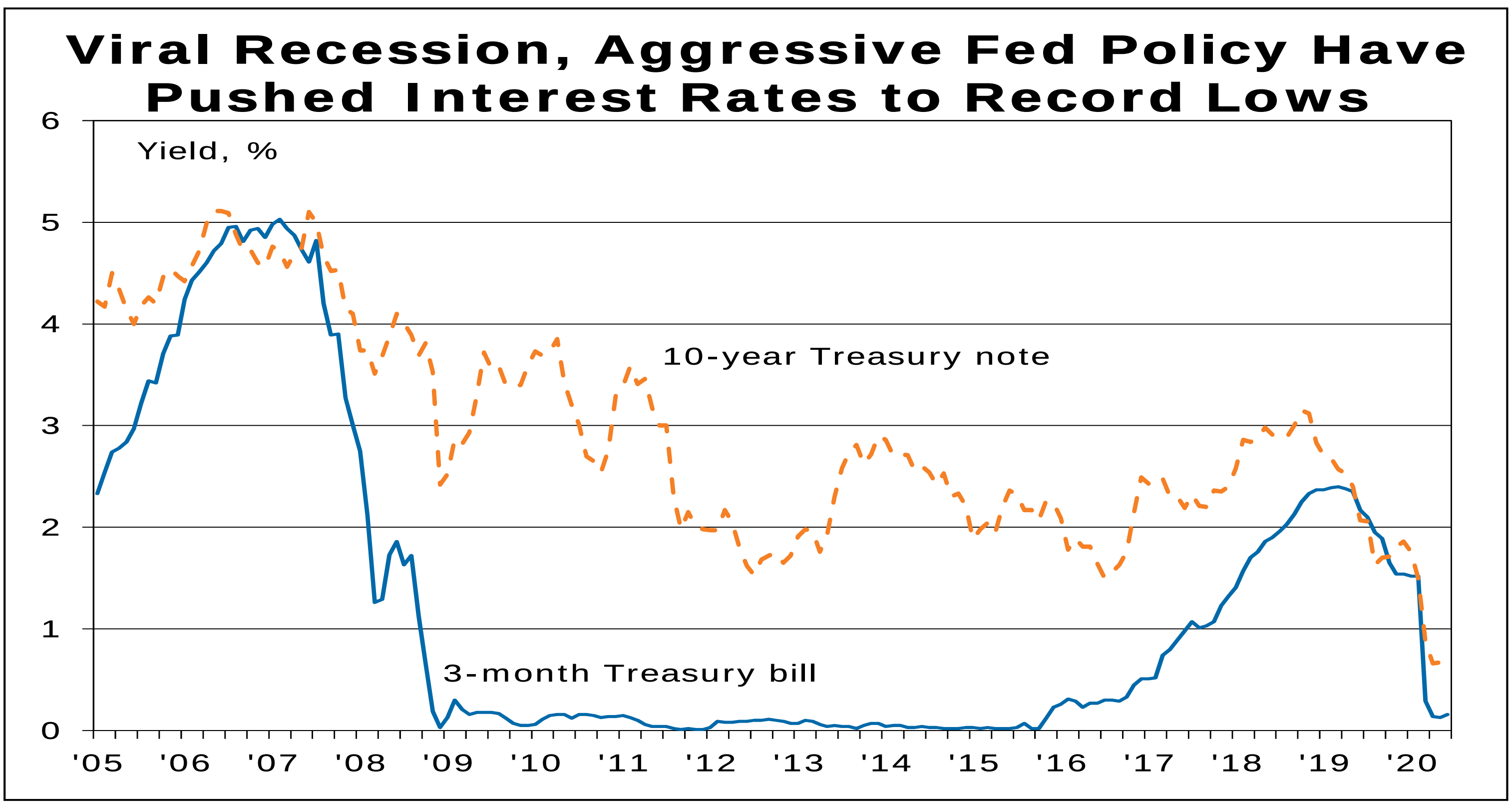

Chart source: Federal Reserve Board

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