Loose and Staying Loose

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The most important takeaway from today's Fed meeting is that policymakers don't expect to raise short-term interest rates until *at least* 2023.

The Federal Reserve's "dot plot" shows where policymakers think short-term interest rates will be at the end of this year, 2021, and 2022 and these show that no members of the rate setting committee – literally, none – think rates will go up this year or in 2021 and that only a small minority thinks they'll rise in 2022.

Moreover, the median estimate among policymakers is that the unemployment rate will finish 2022 at 5.5%. In the aftermath of the 2008-09 recession, the Fed didn't raise rates until December 2015, when the unemployment rate was 5.0%. As a result, we think it would be useful to follow the Fed's projections in the quarters ahead, using the 5.0 – 5.5% range as a proxy for when the Fed expects to start once again lifting short term rates. Notably, the Fed still projects that the average short-term interest rates target over the long run will be 2.5%, no different than it projected in December, before the Coronavirus Recession.

The Fed's economic projections show a deep recession followed by above-trend growth thereafter as the economy heals, with no permament damage to GDP. The longer run unemployment rate is still projected at 4.1%, no different than in December. Inflation, the Fed projects, will be very low this year and then move back toward, although remain below, its 2.0% target in 2021-2022.

The Fed statement itself, which was unanimous, made only two notable changes. First, it acknowledged an improvement in financial conditions. Second, it said it would keep buying Treasury securities and agency residential and commercial mortgage-backed securities at "at least" the current pace. So no slowdown in the expansion in the Fed's balance sheet.

Does this loose monetary policy mean higher inflation? Yes, but not right away. We think the immediate deflationary impulse from the sudden sharp recession and drop in commodity prices is likely over. General prices should start rising again soon. But the rise in inflation will depend on how quickly the economy recovers, how fast consumers and businesses back away from the demand to conserve cash, and how quickly the Fed recognizes these changes by altering the pace of asset purchases. In the past three months, because of this new QE, the M2 measure of money has grown 86% at an annualized rate. We know of no time in history when the money supply increased this rapidly. So, while we expect inflation to return slowly, the "potential" for relatively high inflation is greater than at any time since the 1970s. In other words, the jury is still out on how quickly inflation rises during the next couple of years.

Looking forward, expect more of the same in 2020: continued expansion of their balance sheet and short-term rates near zero.
