Fed Raises Inflation and GDP Forecasts

Central Bank Sees Rate Increases Coming Earlier Than Planned, but Powell Urges Caution

Federal Reserve Chairman Jerome Powell talked down the certainty around the revised forecasts. (Getty Images)

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June 16, 2021 | 3:49 P.M.

The Federal Reserve's Open Market Committee kept its policy rates unchanged at its June meeting that concluded Wednesday but upgraded its economic projections to signal coming interest rate hikes earlier than it previously planned.

In spite of this change in projections, Chairman Jerome Powell talked down the certainty around these revised forecasts in his remarks, noting “it would be premature to declare victory over the pandemic” and that “forecasters have a lot to be humble about.”

The moved-up tightening schedule caused an initial sell-off in stock and bond markets, with some losses recovered by day's end as Powell clarified the changes. Even with the upgraded projections, the Fed’s policy remains accommodative and supportive of commercial real estate, with the committee signaling it may keep a close eye on the sectors uniquely damaged by the pandemic to ensure a recovery.

The median member stance is now an expectation of two 25-basis-point increases to the federal funds rate by the end of 2023, where previously no hikes were anticipated. The more hawkish policy is the result of the Fed’s stronger inflation expectations and slightly better unemployment rate forecasts for the 2021-22 period, with better GDP growth anticipated in 2021 and 2023.

Any increases in the Fed’s policy rate probably won't happen until 2023, according to the Fed’s Summary of Economic Projections, though the hawkish wing of the committee signaled a desire for one or two hikes in 2022.

The improved sentiment came with the removal of language stating “the COVID-19 pandemic is causing tremendous human and economic hardship across the United States and around the world” from its prior statement in April, and noting the impact from COVID-19 vaccinations in improving the public health landscape.

Powell warned against overreacting to the changes during his press conference following the statement, noting the projections “are not a forecast or a plan” and should be taken with “a big grain of salt.”

The other way the Fed has been providing accommodation is through its balance sheet, consistently increasing its holdings of Treasury securities by at least $80 billion per month and of agency mortgage-backed securities by at least $40 billion per month through the pandemic. Powell indicated at the press conference that the Fed has begun discussing tapering those purchases, another sign of confidence in the economy to sustain itself with less stimulus going forward, though the process itself is still “a ways off," he said.

Inflation has come in above expectations in recent months and the Fed now expects a 3% rise in core PCE inflation in the fourth quarter of 2021 compared to the fourth quarter of 2020. The Fed expects this rate to slow to 2.1% in 2022 and 2023, roughly in line with its longer-run inflation goal of 2%.

The core PCE, or personal consumption expenditures index, rose 1.6% from the fourth quarter of 2019 to the fourth quarter of 2020. Such a miss below the Fed’s target warrants a period of “catch-up” above target, according to the Fed’s new policy framework released in August 2020. Powell talked down concerns around labor tightness leading to runaway inflation, noting “we’re seeing wage increases, but not anything that is troubling."

The Fed upgraded its unemployment rate forecast only slightly, expecting 4.5% unemployment by year-end 2021, unchanged from prior projections, while dropping its year-end 2022 forecast from 3.9% to 3.8% and keeping its year-end 2023 forecast unchanged at 3.5%. Powell also talked down these expectations in the press conference, noting “we are far from maximum employment.”

The Fed now expects real gross domestic product to increase 7% in the fourth quarter of 2021 compared to previous expectations of 6.5% on the back of COVID-19 vaccinations, with Powell again noting the tenuousness of such forecasts in his comments to the press.