CARE Ratings
Professional Risk Opinion

US Fed and Bank of England both hold policy rates

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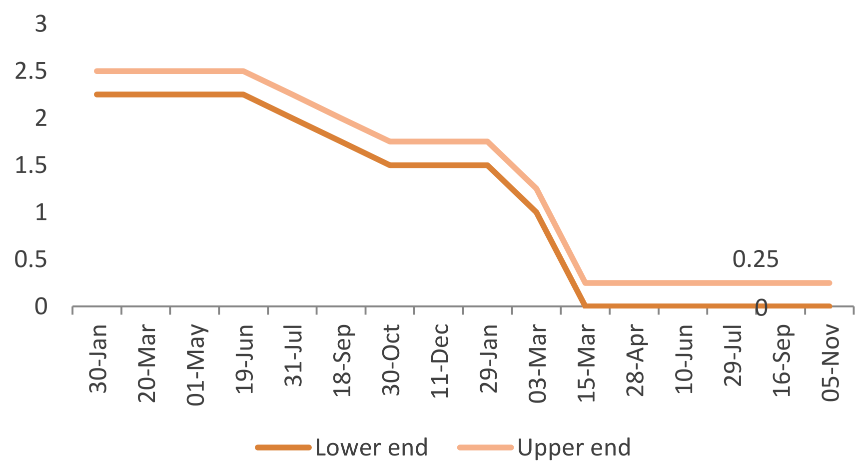
Two key central banks in the world i.e. the US Federal Reserve and the Bank of England have announced their monetary policy decisions. The MPC of both the central banks have unanimously decided to hold policy interest rates. While the US Federal Reserve plans to continue with its liquidity infusion program at the current pace, the Bank of England has announced additional liquidity infusion measures of £150 bn going ahead. Both the central banks believe that the outlook for both the economies is uncertain and the path of the economy will be contingent on the course of the virus. The reason for the uncertainty in the outlook is that in both the US and UK economy, a second wave of corona virus infections have partially stalled economic activities and have also led to the UK Parliament recently announcing a 1-month lockdown. The ongoing health crisis will continue to weigh on economic activities, employment and inflation in the near term and poses considerable risks to the economic outlook.

US Federal Reserve FOMC announcement

The Federal Reserve's Open Market Committee unanimously decided to maintain the federal fund rate at **0 – 0.25%** in its recently announced monetary policy. The Committee asserted that it will be appropriate to maintain the policy rates in this target range until labour market conditions are consistent with the assessment of maximum employment and inflation averages 2% over time. It also expects to maintain an ***accommodative stance*** until these outcomes are achieved.

This is the **fifth policy meeting when the Committee has decided to maintain status quo** after slashing the Federal fund rates from 1.5-1.75% to 0-0.25% in the month of March 2020 following the outbreak of the coronavirus pandemic.

Chart 1: Movement in federal fund rate (%)



Source: Federal Reserve

Assessment of the US economy:

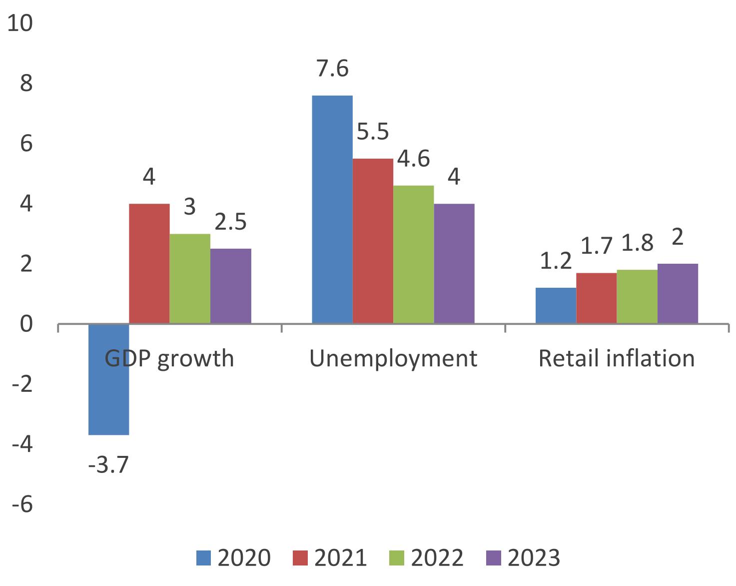
- Economic activities and employment continue to recover but remain well below the levels at the beginning of the year. The re-opening of the US economy led to rapid rebound in activities*. **The US economy contracted by (-)2.9% in Q3-2020, significantly narrower than the (-)9% negative growth recorded in Q2-2020***. However, in recent months, the pace of improvement has moderated on account of a sharp increase in the coronavirus cases in the US.
- The household spending on goods (including durable goods) has been robust but the spending on services continues to be bleak. Overall economic activity remains well below its level before the pandemic and the path ahead remains highly uncertain.
- The pace of improvement in the labor market has moderated to some extent and the unemployment rate at 7.9% is perceptibly low from the highs of 14.7% in April'20 but continues to remain at an elevated level.
- Inflation continues to remain benign owing to weaker demand and earlier fall in crude oil prices. Inflation stood at 1.4% in September 2020, marginally lower than the inflation target of 2%.

Liquidity measures to continue:

- The US Fed has been purchasing sizeable quantities of Treasury and agency mortgaged-backed securities, which are vital for credit flow in the economy.
- The US Fed is purchasing holdings of Treasury securities and agency mortgage backed securities at $120 bn per month - $80 bn per month of Treasury and $40 bn of mortgage backed securities.
- In addition, large-scale overnight and term repurchase agreement operations will also continue.

Outlook on the US economy: The outlook of the US economy presented in the previous US Federal Reserve's FOMC meeting still continues.

Chart 2: Economic projections of US Federal Reserve –(%)



Source: Federal Reserve

- The path of the economy is significantly contingent upon the course of the virus. The ongoing COVID-19 pandemic is expected to weigh heavily on the economic activity, employment and inflation in the near term and pose considerable challenges to the outlook in near term.
- The path forward will also depend on the fiscal support by the Government as well.
- GDP growth projections for the US economy have been sharply revised upwards from (-)6.5% to (-) 3.7% in 2020. The projections for 2021 and 2022 have been revised downwards to 4% and 3% respectively.
- Retail inflation projection is revised upwards to 1.2% in 2020 compared with 0.8% as per the June 2020 projections. Inflation is expected to gradually pick-up in 2021, 2022 and be at 2% in 2023.
- US unemployment rate is projected to improve to 7.6% in 2020 as against 9.6% in the June 2020 projections.

Bank of England's Monetary Policy Announcement

The Monetary Policy Committee (MPC) of the Bank of England unanimously voted to maintain the Bank Rate at 0.1% as England enters a fresh period of lockdown which is likely to adversely weigh on the country's economic recovery. Since the outbreak of the pandemic, the BOE has slashed the Bank rate twice from 0.75% in Jan-20 to 0.1% at present. The liquidity measures unanimously voted by the MPC include:

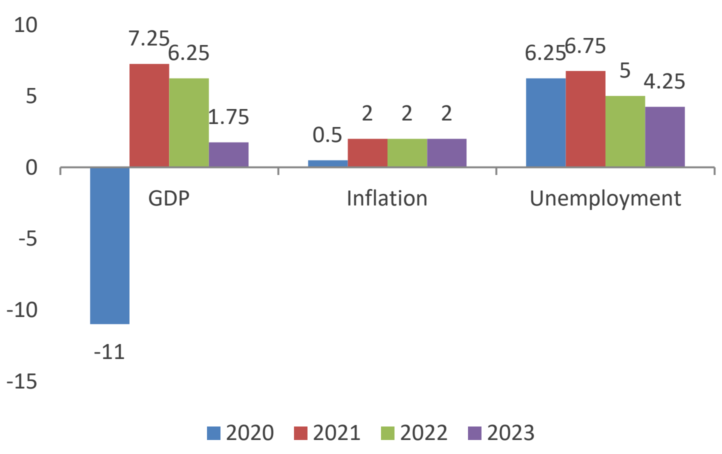
- Non-financial investment grade purchase of corporate bonds aggregating to £20 billion to be maintained
- To continue with the existing program of €100 billion of UK government bond purchase
- Additionally, purchase stock of UK government bond purchase aggregating £150 billion

Therefore, the total stock of government bond purchases will increase to £875 billion

The MPC will continue to monitor the situation closely. If the outlook for inflation weakens, the MPC stands ready to take whatever additional action is necessary. The MPC does not intend to tighten monetary policy at least until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably.

Assessment of the UK economy

Chart 3: Bank of England's projections



Source: BOE

- There has been a rapid rise in rates of COVID infection in the United Kingdom and the government has responded by increasing the severity of the restrictions.
- Consumer spending and investment intentions continue to remain weak and household spending is expected to pick-up in Q1-2021 as restrictions loosen.
- UK's GDP contraction is estimated at (-)21.5% in Q2-2020 compared with (-)2.1% in Q1-2020. UK GDP is expected to fall in Q4-2020 reflecting the impact of stricter measures.
- Inflation remains benign and significantly lower at 0.5% for September 2020, significantly lower than 2% inflation target. Low inflation reflects the direct and indirect impact of Covid on the economy including the temporary effect of lower energy prices, reduction in VAT and downward pressure of spare capacity.

Outlook of the UK economy:

- The outlook remains unusually uncertain and is contingent upon measures taken to protect public health, trading agreements between UK and EU and responses from households and businesses.

- GDP is projected to fall by (-)11% in 2020 as against the previous estimate of (-)9.5% and is expected to recover to 7.25% in 2021 and 6.25% in 2022.

Market Reactions

The **equity markets** (US Dow +1.95%, NASDAQ +2.6%, S&P +1.95%, FTSE 0.4%) have been ended in the positive territory but the impact of the central bank policies on the markets have been limited. Investor sentiments have primarily been driven by the prospective outcome of the US Presidential elections. However, the continuous liquidity infusion likely to be continued by the US Fed and the Bank of England is likely to have buoyed investor sentiments. **US treasury yields** closed marginally higher (10 year at 0.78%) while the **US dollar weakened** against major currencies on the back of improved risk sentiments. However, the resurgence of coronavirus infections in some regions of the global has pressured investor sentiments.