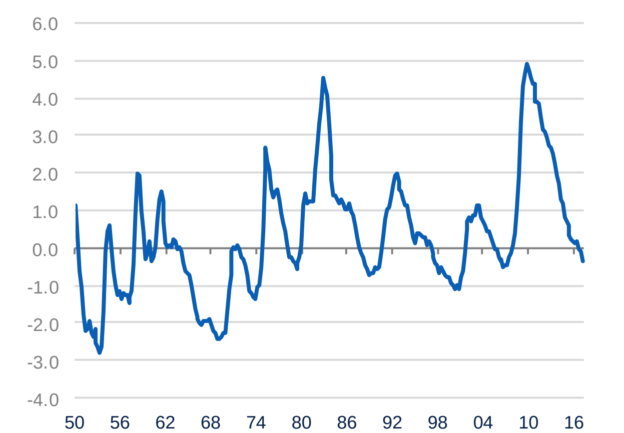
6. Monetary policy normalization

After jumpstarting market expectations, which had been on life support after a prolonged pause in interest rate increases in 2016, the Fed seemed to set a course for predictable path of rate increases and the balance sheet normalization in the first quarter. With respect to the balance, the Fed has effectively communicated its strategy of foreseeable and passive balance sheet withdrawal coalescing market expectations around a September start date. The gradually increasing caps also allows for near perfect foresight over the first two years and minimal market disruption, as projected runoff will exceed the initial caps during the first five quarters of the process.

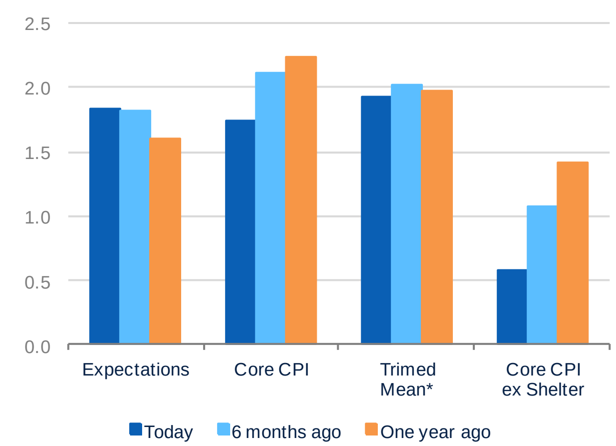
For rates, the Committee's confidence in reaching their inflation target has diminished, as recent inflationary trends have bifurcated members into two schools of thought. One, in which the established relationships between labor market tightness and wages holds and current labor market conditions necessarily and sufficiently push wages and inflation up in the medium term. Two, a world where the structural headwinds in the labor market, low productivity growth, skills deficits and weak investment weaken the links between wages, inflation and labor market implying an ever widening inflation gap.

Figure 6.1 Unemployment rate gap (%)



Source BBVA Research, CBO & BLS

Figure 6.2 Inflation, year-over-year (%)



Source BBVA Research, FRB, Cleveland Fed & Haver Analytics

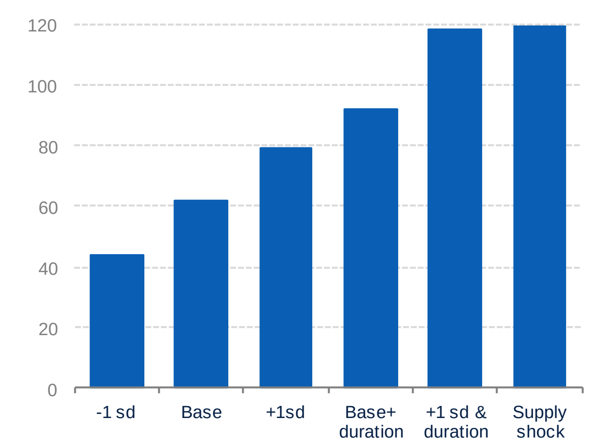
In the first case, the policy response remains in place, with ongoing interest rate increases at a pace determined by how fast or slow the dual mandate is met. A quick rebound in inflation would allow the Fed to lift rates faster but if inflation remains low for longer, interest rates increases will have to be delayed. The Fed leadership seems to be in this camp. In the second scenario, interest rates will be put on the side burner and the Fed will have to go back to the drawing board to rethink its overall policy strategy. This could mean lowering the inflation target level or something more aggressive such as switching the Fed's strategy from inflation targeting to price-level targeting.

With respect to balance sheet normalization, the supplement and highlights from June's minutes have solidified the Fed's plans to use a system of gradually increasing caps over a 12-month period, likely beginning at the end of this year. The caps initial values will be set at $6 billion for Treasury securities and $4 billion for agency and mortgage-backed securities (MBS). Every three months, the caps increase by $6 billion and $4 billion, respectively, until they reach $30 billion and $20 billion. With this, the Fed can ensure a predictable and passive exit. This would imply reducing the balance sheet by around $300bn in the first 12 months and $2 trillion over four years. In order to balance currency in circulation and Federal Reserve assets, we expect Treasury purchases to resume when the balance sheet is close to $2.5Tr— around 2021.

As a result, the balance sheet composition will be primarily of shorter-term Treasury Bills and Notes, in line with the historic portfolio composition. Although the Fed expects reserves balances to be “appreciably” lower than current levels but higher than pre-crisis, the FOMC was not ready to commit to any particular target. Ultimately, the FOMC will allow reserves to adjust to a level that allows the Fed funds to become once again the primary monetary policy tool.

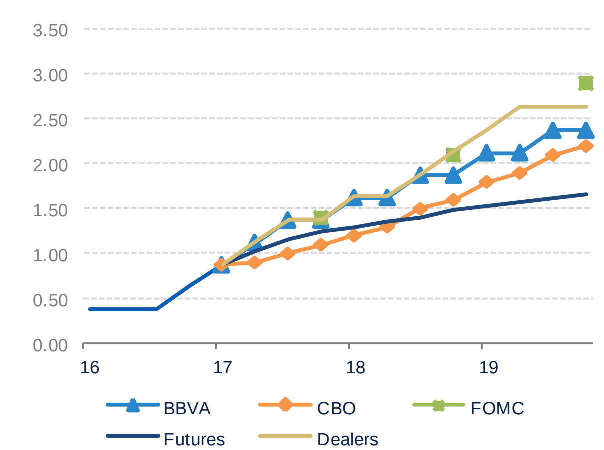
By way of signaling and portfolio rebalancing, we anticipate that the balance sheet normalization strategy should push the term premium and long-term rates up. Ultimately, although the timing and magnitude of the impact will be determined by the market for Treasuries and MBS, a clear communication strategy and a predictable and passive implementation reduce the risks of large swings in yields. Regulatory changes to money market funds and stricter capital requirements from commercial banks lower the probability of an immediate misalignment, as their need for safe-assets has increased. Similarly, while a sharp contraction in foreign U.S. Treasuries holdings is possible, recent indicators suggests that there has not been a fundamental shift following the FOMC’s announcement of Balance Sheet Normalization. For many central banks around the world, holding Treasuries is not dependent on their price or yields but on their intrinsic value as safe assets and the benefits to foreign exchange rate management. As a result, long-term rates should increase moderately. Our models suggest that the cumulative impact could be between 40 and 120bp in response to impact from portfolio rebalancing channel; with respect to the signal, investor were unmoved by the announcement of Balance Sheet Normalization. Nonetheless, some market participants, particularly nonfinancial private and foreign buyers could move in the same direction if a one-sided market is perceived as a “sure bet” much as was the case when the Fed implemented QE.

Figure 6.3 Impact of balance sheet normalization on 10-year Treasury (%)



Source: BBVA Research

Figure 6.4 Fed funds rate (%)



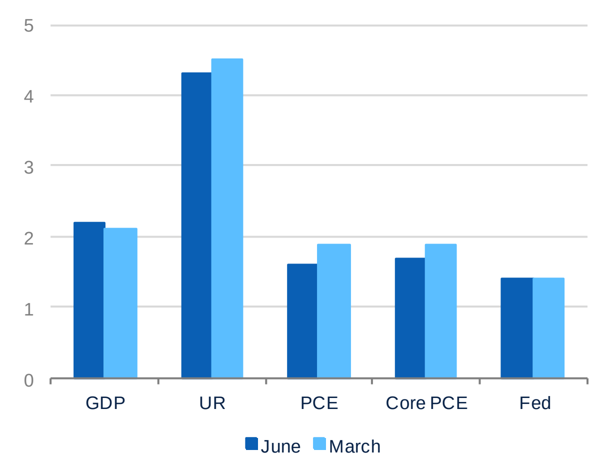
Source BBVA Research, CBO, FRB & Bloomberg

Going forward, officials will have to focus on their communication strategy in order to realign market expectations with their outlook, as Fed Fund Futures imply only 2 rate increases between now and the end of 2019. This means first lifting expectations of the December rate increase, which has an implied probability of less than 50% to achieve a smooth increase to 1.25-1.50% and then realigning markets with the committee's long-term projections, which remain closer to 3.0%— seven additional rate hikes by 2019.

This can be done through Fed communication and in the upcoming meetings, as was the case leading up to the March increase. Particularly if we consider that real GDP growth will be higher in 2H17 than the first half, labor markets will continue to converge with full employment, and global risks abate. However, this will only happen if downward price pressures actually fade away, and inflation expectations realign with the Fed's 2% target over the medium term. Past experiences suggest that inflation begins to edge up well after significant declines in the unemployment rates have taken place. Therefore, besides one-off price declines, the key uncertainty is if labor markets have tighten sufficiently or not.

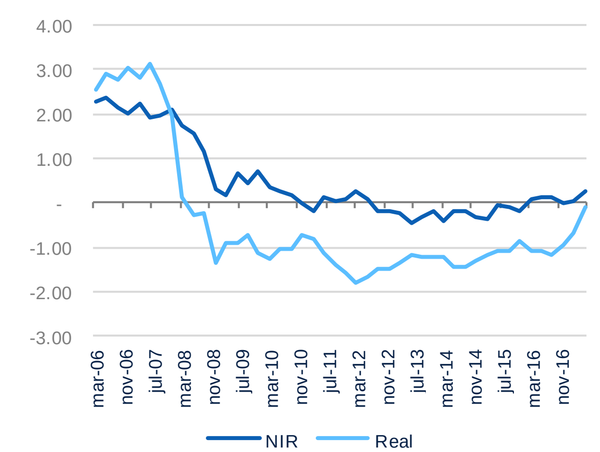
The FOMC seems convinced that the course of monetary policy normalization is appropriate in this environment. With the economy at or near full employment, benchmark interest rates need to move away from the zero-lower bound, so that the FOMC has space to respond to the next cycle. A noticeable downshift in the median of the dot plot or a wider distribution in September's Summary of Economic Projections (SEP) would confirm a shallower path. This is consistent with our baseline for two additional rate increases in 2018 and 2019. However, failing to realize the implied path in the survey of economic projections for several years also puts the FOMC's credibility at risk, which markets currently discount as having a low likelihood of occurring. Moreover, the task of convincing investors to have faith in the Phillips curve will be challenging, particularly since it's unclear how much of the flattening is cyclical or structural.

Figure 6.5 FOMC forecasts (%)



Source BBVA Research & FRB

Figure 6.6 Natural interest rates & inflation-adjusted target Fed funds rate (%)



Source BBVA Research, Laubach & Williams, FRB

The Fed also has to balance expectations of unobserved factors such as R* or the natural real interest rate. With estimates of the natural real interest rate at around 0% and with core PCE inflation at 1.8% in 2Q17, it would take only a couple of rate increase the bring monetary policy back to neutral levels. However, if the natural real interest rate begins to edge higher to around 1% as a result of stronger productivity growth and higher potential output, and inflation returns to the target of 2%, a neutral monetary policy would imply that fed funds fed would need to increase to 3%. That said, the evolving outlook on neutral interest rates and uncertainty over the outlook for inflation could leave members feeling confident that rates are not overly accommodative with 2-4 additional rate increases.

Meanwhile, financial conditions have eased over the year despite monetary accommodation being removed, suggesting that higher interest rates might be needed to prevent the likelihood of an asset price misalignment and contain the risks of the bubble bursting if one actually exists. Officials also have to contemplate the potential effects of fiscal stimulus and financial deregulation, which increase the potential of significantly undershooting their unemployment target and stoking inflationary pressure.

Early confidence in the new administration's ability to implement a moderately expansionary fiscal agenda has given way to a more measured view. In fact, there are signs that the White House is beginning to back away from its aggressive proposals to lower the corporate tax rate to 15% while also significantly reducing individual rates. Member, also, have to discount a lower probability of this happening given the lack of agreement within the GOP. In spite of the obstacles still faced by Congress and the White House, failing to prepare the economy for a fiscal shock could risk derailing the current course of policy normalization.

While the Fed has little to say when it comes to fiscal policy the fact remains that low interest rates has muted all discussions on the high levels of public debt and the burden to finance it. If interest rates edge up, the debate could return to the forefront of the political agenda and policymakers will have more pressures to deal with these issues.

With Yellen likely to step down or be replaced at the end of her tenure in January, three seats open and Stanley Fischer's term ending in June, consideration of the board composition and leadership in the near future will also factor into the decision making process. It is unclear how President Trump will balance the desires of some members within the GOP that advocate for a rules-based monetary policy with his own aspirations to grow the economy, which will benefit from lower interest. However, where Trump's objectives align most with the GOP is on deregulation, suggesting appointees will have an inclination towards reduced oversight and fewer capital requirements. Yellen has said that with the macroprudential tools the Fed has in place today and with enhanced capital buffers in the financial sector it was unlikely that we would see another financial crisis in her lifetime. Regardless, there is no doubt the risk posed by a potential dismantling the safeguards put in place after the financial crisis would be unpalatable for the current committee, jeopardizing their legacy that will boil down to the success of the normalization strategy and long-term stability of the financial sector.

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This report has been produced by the U.S. Unit

Chief U.S. Economist

Nathaniel Karp
nathaniel.karp@bbva.com
+1 713 881 0663

Filip Blazheski
filip.blazheski@bbva.com

Shushanik Papanyan
shushanik.papanyan@bbva.com

Kan Chen
kan.chen@bbva.com

Boyd Nash-Stacey
boyd.stacey@bbva.com

Marcial Nava
marcial.nava@bbva.com

CONTACT DETAILS:
BBVA Research USA
2200 Post Oak Blvd.
Houston, TX 77025
United States.

Email: bbvaresearch_usa@bbva.com
www.bbvaresearch.com
www.bbvacompass.com/compass/research/
twitter.com/BBVAResearchUSA
bbvaresearchusa.podbean.com

BBVA Research

Group Chief Economist

Jorge Sicilia Serrano

United States of America
Nathaniel Karp
Nathaniel.Karp@bbva.com

Spain & Portugal
Miguel Cardoso
miguel.cardoso@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Turkey, China & Geopolitics
Álvaro Ortiz
alvaro.ortiz@bbva.com

Turkey
Álvaro Ortiz
alvaro.ortiz@bbva.com

China
Le Xia
le.xia@bbva.com

South America
Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Julio Pineda
juliocesar.pineda@bbva.com

Macroeconomic Analysis
Rafael Doménech
r.domenech@bbva.com

Global Macroeconomic Scenarios
Miguel Jiménez
mjimenezg@bbva.com

Global Financial Markets
Sonsoles Castillo
s.castillo@bbva.com

Global Modelling & Long Term Analysis
Julián Cubero
juan.cubero@bbva.com

Innovation & Processes
Oscar de las Peñas
oscar.delaspenas@bbva.com

Financial Systems & Regulation
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Countries Coordination
Olga Cerqueira
olga.gouveia@bbva.com

Digital Regulation
Álvaro Martín
alvaro.martin@bbva.com

Regulation
María Abascal
maria.abascal@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com