RESEARCH

Fed Watch

US

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Economic Analysis

US
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Expectations for U.S. Monetary Policy

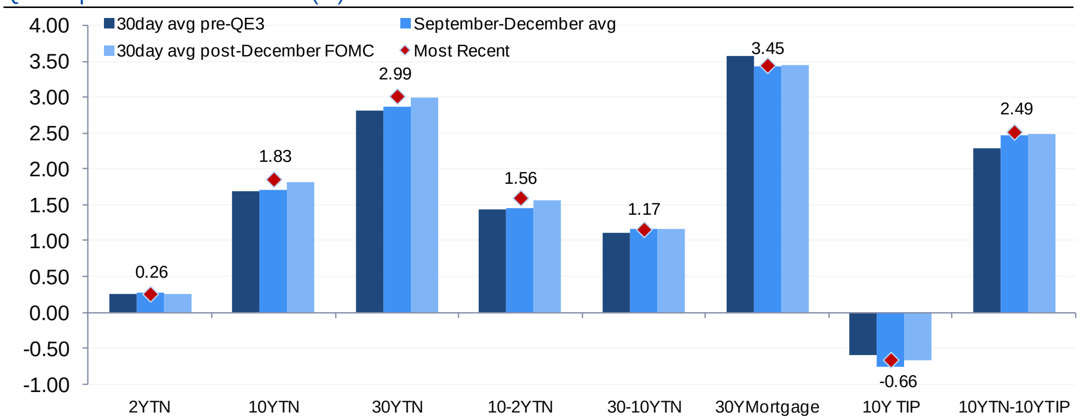
A Review of the FOMC and Plans for an Exit Strategy

- FOMC slightly more dovish in 2013 and watchful in 2014
- Slowing or stopping asset purchases likely by end of year
- Full speed ahead with an exit strategy in 2H14 or later

Monetary policy has seen its fair share of unconventional changes throughout the past year, and 2013 could prove to be another turning point for the Federal Reserve's strategy. With the recovery moving much slower than expected and political brinkmanship brewing, the Fed has had to accommodate in an unprecedented manner. After announcing a third round of quantitative easing in September and additional Treasury purchases to start 2013, the focus has started to shift to the future challenges of an exit strategy in the near to mid-term. The latest FOMC meeting minutes from December (see our Fedwatch) and recent Fedspeak in January have highlighted the general consensus among committee members regarding the change in policy guidance targets and an expected end to QE3 by the end of the year, at the latest. Most FOMC participants and Fed Bank Presidents agreed that replacing the calendar-date forward guidance with the quantitative thresholds of 6.5% unemployment and 2.5% of projected inflation rate between one and two years ahead re-emphasizes the Fed's dual mandate and spreads an optimistic signal regarding both the future state of the economy and the ongoing stability of inflation.

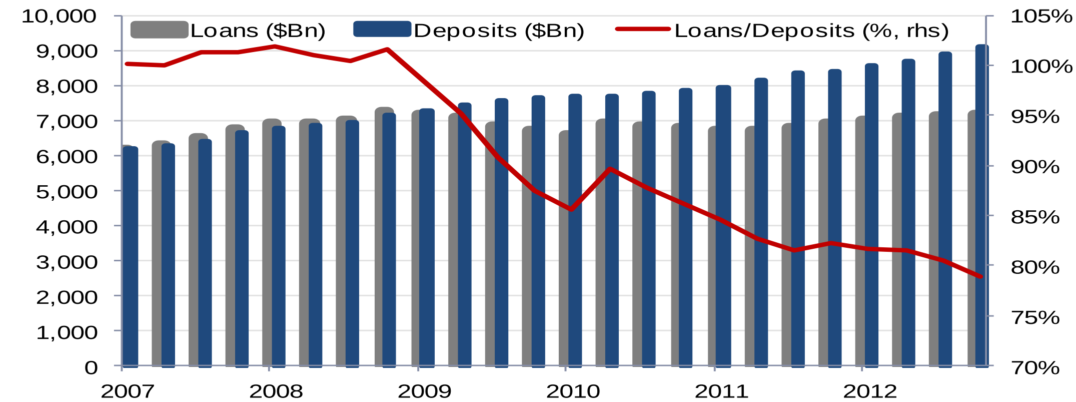
In general, the outlook for the FOMC remains dovish for 2013. The balance sheet movement to longer duration assets, including the ongoing purchases of mortgage-backed securities (MBS), is expected to continue through 2013, aiming to further reduce the difference between short-term and long-term rates, as well as reduce the spread between primary and secondary mortgage rates. According to the December 2012 FOMC meeting minutes, most members consider slowing or stopping this accommodation sometime during the second half of the year. On the other hand, FOMC projections suggest that the policy guidance threshold for the unemployment rate may not be reached until mid-2015. Therefore, the pace of the quantitative expansion will depend on the 2013 FOMC members' re-assessments of both the efficacy and the cost of those actions, while simultaneously monitoring economic data that may hint at a sooner-than-expected increase in the fed funds rate. So far, the impact of QE3 has been minimal compared to the previous rounds.

Chart 1
QE3 Impact on Interest Rates (%)



Source: Federal Reserve & BBVA Research

Chart 2
QE Impact on Loans and Deposits at U.S. Commercial Banks



Source: Federal Reserve & BBVA Research

Changes within the FOMC

As we look at the possible developments in the Fed's outlook and monetary policy strategy for the coming years, it is important to note the underlying changes within the FOMC. The following outlines the changes within the committee and introduces the viewpoints of incoming members for 2013.

Federal Reserve Bank Presidents: The annual rotation between regional Federal Reserve Bank presidents brings adjustments together with possible change of opinions among all members of the FOMC. The four president seats are filled by one from each of the following groups: Federal Reserve Banks of Boston, Philadelphia, and Richmond; Cleveland and Chicago; Atlanta, St. Louis, and Dallas; and Minneapolis, Kansas City, and San Francisco. The Federal Reserve Bank of New York has a permanent seat in the FOMC.

New York: William C. Dudley (dove) was appointed to the position of President of Federal Reserve Bank of New York after his predecessor Timothy Geithner was confirmed for the US Secretary of Treasury. He prefers more aggressive policy than the current actions of the FOMC, arguing that such a strategy could be more effective.

Boston: Eric S. Rosengren (dove) is a proponent of the highly accommodative monetary actions. He has argued that "continued monetary accommodation is absolutely appropriate and indeed needed" given that the new thresholds for policy guidance have not been reached. His speech highlights that the interest-rate sensitive sectors, such as real residential investment and consumer durable purchases together with the new car purchases, are the most improved and have growth rates that surpass the average real GDP growth rate of the past year. In 2010 he consistently voted with the majority on most FOMC actions.

Chicago: Charles L. Evans (dove) is a long time advocate of the current accommodative FOMC policy of open-ended asset purchases and tying policy guidance to economic conditions rather than the previously stated calendar-date target. In particular, his latest speech argued that current policy should remain accommodative even after the recovery strengthens. His economic forecasts are at the pessimistic end of the FOMC range, projecting real GDP growth of 2.3% and an unemployment rate of 7.6%, along with 2.1% CPI inflation. In 2011 he consistently voted with the majority on most FOMC actions.

St. Louis: James Bullard (center) comes into the FOMC with a very positive outlook on the US economy. His forecasts suggest 3.2% real GDP for 2013 and 2014 and an unemployment rate closer to 7%, with the PCE inflation rate remaining near the FOMC's target at 2%. While he previously expressed unease regarding QE3, his January speech indicates that he is in favor of the new data driven policy, including the revised policy rate guidance targeting the unemployment rate. He also stressed that "the FOMC cannot pretend to target medium- or long-term unemployment;" in order to avoid these thresholds being viewed as immediate triggers for action, Bullard suggests the committee needs to emphasize that it considers many more variables when assessing the state of the U.S. economy. In 2010 he consistently voted with the majority on most FOMC actions.

Kansas City: Esther L. George (hawk) has no previous history on voting within the FOMC since she took office on October 1, 2011 as President of the Kansas City Federal Reserve Bank. She is expected to continue the hawkish pattern of her predecessor Thomas M. Hoenig. In her recent speech she expressed concerns about the long period of low interest rates, stating that it creates financial distortions and false measures of risk. She also argued that such a strategy can create a dent in the Federal Reserve's credibility because longer-term inflation expectations could rise above the FOMC's 2% target. These are the same concerns raised by Mr. Hoenig during the 2010 FOMC meetings, when he consistently voted against FOMC actions.

Chart 3
FOMC Seats: Federal Reserve Bank Presidents

Dovish 1	2	Center 3	4	Hawkish 5

2012		2013	
New York	William C. Dudley	New York	William C. Dudley
Richmond	Jeffrey M. Lacker	Boston	Eric S. Rosengren
Cleaveland	Sandra Pianalto	Chicago	Charles L. Evans
Atlanta	Dennis P. Lockhart	St. Louis	James Bullard
San Francisco	John C. Williams	Kansas City	Esther L. George

2014		2015	
New York	William C. Dudley	New York	William C. Dudley
Philadelphia	Charles I. Plosser	Richmond	Jeffrey M. Lacker
Cleveland	Sandra Pianalto	Chicago	Charles L. Evans
Dallas	Richard W. Fisher	Atlanta	Dennis P. Lockhart
Minneapolis	Narayana Kocherlakota	San Francisco	John C. Williams

Source: Federal Reserve & BBVA Research

Board of Governors: No changes in the Board of Governors are expected in 2013 and 2014. Overall, the Board of Governors remains dovish with only one conservative member: Jerome H. Powell. Mr. Powell served as an Assistant Secretary and as Undersecretary of the Treasury under President George H.W. Bush, with responsibility for policy on financial institutions, the Treasury debt market, and related areas. He was nominated to the board by President Obama together with the Harvard economics professor Jeremy C. Stein to fill two vacant unexpired seats on the Board. During the 2012 FOMC meetings, the Governors voted unanimously for the FOMC actions.

Chart 4
Federal Reserve Board of Governors

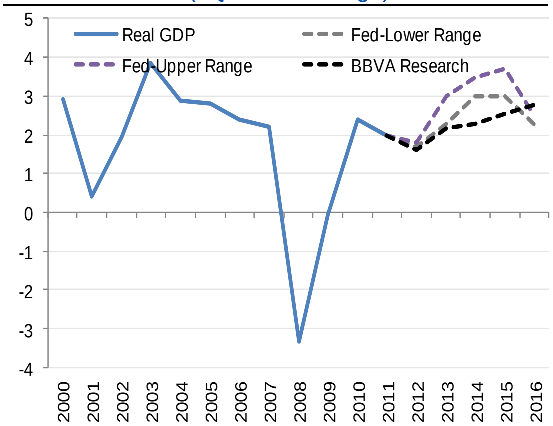
Chairman	Ben S. Bernanke	▪ Appointed by President Bush. ▪ Took office on February 1, 2006. ▪ Re-appointed by President Obama for the second term; start date February 1, 2010. ▪ The second term as Chairman ends January 31, 2014. ▪ The term as a Board member ends January 31, 2020.
Vice Chair	Janet L. Yellen	▪ Appointed by President Obama. ▪ Took office on October 4, 2010. ▪ Vice Chair term ends October 4, 2014. ▪ Term as a member of the Board that will expire January 31, 2024.
Governor	Elizabeth A. Duke	▪ Appointed by President Bush to fill an unexpired term. ▪ Took office on August 5, 2008. ▪ Term ends on January 31, 2012. ▪ Possibly reappointed to a full 14 year term.
Governor	Daniel K. Tarullo	▪ Appointed by President Obama to fill an unexpired term. ▪ Took office on January 28, 2009. ▪ Term ends on January 31, 2022.
Governor	Sarah Bloom Raskin	▪ Appointed by President Obama to fill an unexpired term. ▪ Took office on October 4, 2010. ▪ Term ends on January 31, 2016.
Governor	Jeremy C. Stein	▪ Appointed by President Obama to fill an unexpired term. ▪ Took office on May 30, 2012. ▪ Term ends on January 31, 2018.
Governor	Jerome H. Powell	▪ Appointed by President Obama to fill an unexpired term. ▪ Took office to fill an unexpired term on May 25, 2012. ▪ Term ends on January 31, 2014.

Source: Federal Reserve & BBVA Research

While 2013 could be a pivotal year for the FOMC, the risks for an exit strategy continue to increase with ongoing balance sheet expansion. Attention towards a more effective exit strategy will continue into 2014, with the FOMC shifting to a more hawkish position. For instance, incoming FOMC rotational members for 2014, including Charles Plosser (Philadelphia), Richard Fisher (Dallas), and Narayan Kocherlakota (Minneapolis), will take a more hawkish stance within the FOMC. In 2011, when the unemployment rate was hovering between 9.1% and 8.9% January to October, these three did not support the FOMC action on additional policy accommodation and the extension of maturity program.

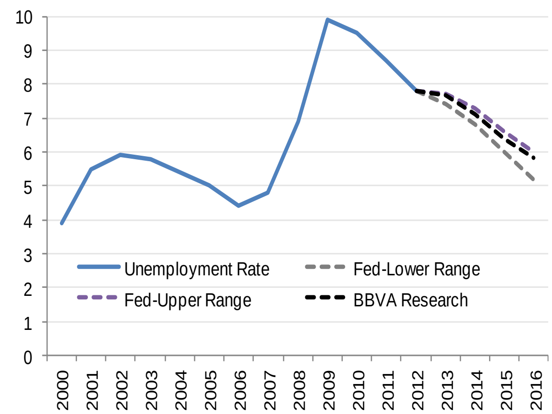
In the best case scenario, where the unemployment rate declines at a faster-than-expected pace in 2013, it is possible that the FOMC in 2014 will begin to reinvest proceeds of maturing securities into short to medium maturity Treasuries and make a preparation move towards implementing the exit strategy. As outlined in the June 2011 meeting minutes, the normalization of the size of balance sheet is expected to take place over a period of 2 to 3 years while the necessary sales of securities are expected to take place over a period of 3 to 5 years. However, the process of stopping all or some reinvestment of the proceeds of maturing securities will not likely be on the table before 2015. Dennis Lockhart recently noted that tools for an exit have been tested but that when the time comes, "it will be uncharted territory."

Chart 5
Real GDP Growth (4Q YoY % Change)



Source: Federal Reserve & BBVA Research

Chart 6
Unemployment Rate (4Q %)



Source: Federal Reserve & BBVA Research

Bottom line: FOMC Exit Strategy on the Horizon, Pending Improvements Outside of their Control

Changes within the FOMC could be significant in addressing the Fed's exit strategy in the years to come. Backing down from asset purchases would seem to be the first step, given that the latest inflation and unemployment rate targets suggest a post-2013 outlook for the first target rate hike. Still, committee members will closely monitor economic data for signs of a stronger recovery. Most importantly, the Fed faces the same fiscal uncertainties as businesses and consumers when it comes to the budget and debt ceiling negotiations in Washington. Without some additional compromise in Congress, the Fed has few tools left at its disposal that could offset major impacts to economic growth. As Ben Bernanke has mentioned all along, "monetary policy is not a panacea." For now, accommodative monetary policy is expected to continue to offset this fiscal uncertainty.