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Fed Watch

US

Houston, February 21, 2013
Economic Analysis

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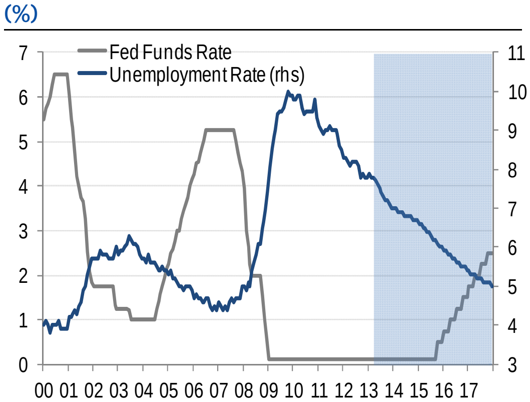
FOMC Minutes: January 29-30th

Details Reveal Intense Discussion on Monetary Policy Tools

- **Participants agree that economic activity "paused" in recent months and purposely left out mention of fiscal issues in the FOMC statement**
- **No mention of an expected deadline to QE3, but the cost-benefit analysis has become dominant in discussion**
- **FOMC members continue to emphasize that the economic-based thresholds for policy guidance are not triggers for immediate action**

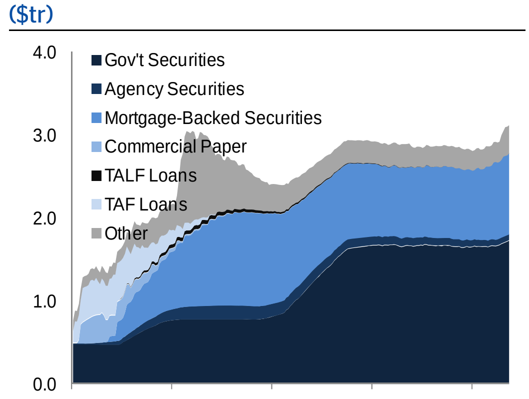
The January 2013 FOMC meeting was ripe with discussion on improvements in economic activity and the implications for maintaining a highly accommodative stance of monetary policy. Committee members took time to explore the latest economic and financial market trends, with the minutes reflecting a more optimistic sentiment than the statement released a few weeks ago. While both revealed that FOMC participants saw a "pause in overall output growth in recent months," the meeting minutes emphasized little to modest improvement from the December outlook and a reduction in downside risks, both domestically and from abroad. Labor market discussions were also a bit more in-depth than in previous meetings, noting that despite gradual improvements, the recovery is "far from complete". Structural unemployment concerns are making their way back into conversation, with some FOMC members noting a shift in the relationship between job openings and the unemployment rate (i.e. the Beveridge Curve) and several hinting at permanent damage if we continue to see high long-term unemployment. As has been the case, inflationary risks were a minor concern. Committee members also touched upon slower growth of potential output and the difficulties of making monetary policy decisions based on this uncertain and unobservable factor. The meeting statement lacked any details on how the committee interpreted the fiscal deal on January 1st, yet the minutes were more revealing: while the partial fiscal resolution helped to reduce some uncertainty heading into 2013, the near-term view regarding automatic spending cuts is that they could still cause significant drag on growth for the year. Interestingly, according to the meeting minutes, committee members agreed to withhold any mention of fiscal-related issues in the initial January statement.

Chart 1
Fed Funds and Unemployment Rate (%)



Source: FRB, Bureau of Labor Statistics, & BBVA Research

Chart 2
Factors Supplying Reserve Funds ($tr)



Source: Federal Reserve & BBVA Research

The statement in January also ignored the hotly debated topic regarding the end of QE3 that grabbed market attention back in December. However, the meeting minutes were somewhat of a disappointment and did not specifically mention a possible slowing or stopping of asset purchases in 2013. Instead, much of the meeting was dedicated to a cost-benefit analysis of additional asset purchases. The FOMC agreed to continue its current pace of $85bn per month in asset purchases, yet the outlook was a bit more ambiguous than in December's meeting. Participants agreed on the benefits for QE3 and viewed them as effective in reaching the housing market, consumer durables, and auto purchases, as well as improving labor conditions. At the same time, FOMC members diverged in the assessment of the potential risks that could arise from the current pace of asset purchases. The main concerns expressed by the participants were related to the possible complications during eventual withdrawal of policy accommodation, potential negative effects on financial markets, as well as a chance that a very large portfolio of long-duration assets would, under certain circumstances, expose the Federal Reserve to significant capital losses when these holdings were unwound. The following discussion resulted in the Committee asking its staff to prepare additional analysis assessing the costs and benefits of asset purchases for future FOMC meetings.

The conversation about the potential of increasing risks associated with the current pace of QE3 carries on outside of the Board of Governors. James Bullard, President of Federal Reserve Bank of St. Louis and voting member on the FOMC, noted in a speech on February 14 that "The size of the balance sheet could inhibit the Committee's ability to exit appropriately from the current very expansive monetary policy." Sandra Pianalto, President of Federal Reserve Bank of Cleveland, added: "we should be sure that when the time comes, we can exit without adversely impacting markets," highlighting that decreasing the current pace of asset purchases and keeping a smaller balance sheet can help to avoid credit risk, interest rate risk, adverse market functioning risk, and the inflation risk.

The meeting minutes also highlighted the sensitivity of current monetary policy to the well-tailored 'forward guidance' tool. The old calendar date unintentionally communicated a 'pessimistic signal' regarding future economic growth, while the current thresholds dependent on economic conditions is at risk of being misunderstood as an immediate trigger for FOMC action. The members discussed on how to improve the unambiguousness regarding the future course of policy guidance. The list of suggestions emphasized the fact that the Committee is ready to vary the pace of asset purchases, which could mean making incremental changes from meeting to meeting in response to the latest economic news. Other suggestions included the need to communicate a consensus expectation to the public for the path of the federal funds rate after a threshold is reached, as well as the possibility of providing monetary accommodation by holding securities for longer than underlined in the exit principles. Charles Plosser, President of Federal Reserve Bank of Philadelphia, noted in his speech on February 12th that "the public must understand how the central bank intends to conduct policy in the future and also that this conduct differs from the typical way policy is set."

As expected, Esther George, President of the Federal Reserve Bank of Kansas City, was the lone dissenter against this action, suggesting that the risks of current accommodative action overweighed the benefits. While Ms. George agrees that supportive monetary policy is needed, she believes that unintended side effects of current policy pose increased risks to financial stability and could cause an increase in inflation expectations.

Bottom line: Less Clarity on QE3 Exit but Fed Remains Watchful of Incoming Economic Data

January's meeting minutes revealed less clarity on the near-term future of monetary policy accommodation, but our expectations remain unchanged. We continue to expect that the current pace of purchases will proceed until mid-2013, with a slower pace ongoing until the end of the year as the economy slowly improves and the risks from the increasing balance sheet and aggressive asset purchases elevate. FOMC meeting conversation will continue to focus on how to provide highly accommodative monetary policy while at the same time reducing the possibility of an adverse impact when the time comes to decrease the balance sheet.