RESEARCH

Fed Watch

US

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Economic Analysis

US

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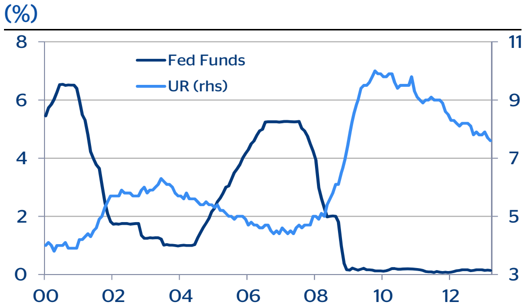
FOMC Minutes: March 19th-20th

Discussion Intensifies on Risks and Extent of QE3

- **Review of the U.S. economy is optimistic. Could the recent slowdown in job growth alter the FOMC's optimistic outlook?**
- **FOMC acknowledged that fiscal policy was "exerting significant near-term restraint on the economy."**
- **FOMC minutes reinforce BBVA projections of reduction in the pace of asset purchases in 2H13.**
- **Members' discussion of possible change to the composition of QE3 as Fed weighs efficacy of long-run Treasuries vs. MBS.**

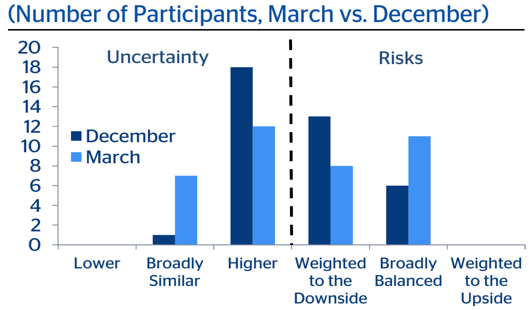
The latest FOMC meeting minutes (leaked early) provided further details on a slightly more optimistic economic review as well as future plans for the current asset purchase program. Looking first at the Summary of Economic Projections, the FOMC acknowledged positive changes in employment, manufacturing, consumer and business spending, and the housing sector; however, it is important to note that this discussion occurred before the release of the weak employment report for March. Participants agree that while unemployment remains elevated it will continue to decline gradually, though the recent progress towards the Committee's objective of 6.5% is not yet viewed as sustainable due to the possible structural changes in the labor force dynamics. Despite the decrease in real federal, state, and local government purchases, the Fed expects to see a moderate growth rate in the first quarter after the pause in 4Q12. Participants acknowledged lowering growth expectation for 2013 due to fiscal policy "exerting significant near-term restraint on the economy." Fiscal policy restraint is expected to dissipate by 2014, and the FOMC expects gradual acceleration of growth in 2014 and 2015. Nevertheless, the levels of uncertainty and risk regarding the participants' projections of GDP growth and unemployment remain high. The FOMC minutes noted discussion on improved sentiment in the U.S. financial markets due to favorable economic data and successful monetary policy communication. Highlighting significant positive factors in the financial situation, the minutes stressed improvement in the commercial real estate sector, as commercial debt in 4Q12 increased for the first time since 2009. At the same time concerns are elevated regarding weaker-than-expected economic data from the Euro area, United Kingdom, and Canada, adding to the already existing political uncertainty in Europe. In order to curb significant market reactions, the FOMC continues to monitor conditions closely and conduct surveys, watchful for signs of risks to financial stability due to this prolonged low interest rate environment.

Chart 1
Fed Funds & Unemployment Rate (%)



Source: FRB & BBVA Research

Chart 2
Uncertainty and Risks to GDP Growth (Number of Participants, March vs. December)



Source: Federal Reserve & BBVA Research

As expected, a significant portion of the FOMC meeting minutes were devoted to the intense discussion on the efficacy and costs of large scale asset purchases. The common view among participants is that the macroeconomic benefits of the current program continue to outweigh the likely costs and risks of those purchases. In general, committee members agree that the risks include those posed to the functioning of particular financial markets (such as MBS), the smooth withdrawal of accommodations when timing is appropriate, the possible rapid rise of long-term interest rates in the future, and the Federal Reserve's future net income and decline in remittances to the Treasury. This time around, Committee members also compared the costs and benefits of long term Treasuries vs. MBS, pointing to different possible scenarios of tapering the purchases with weighting one type of asset of the other. Still, there appears to be deeper divergence in the various FOMC opinions on weighting the efficacy and costs. Only a few suggest that the Fed should start tapering the asset purchase program immediately; most of the participants communicated that considering current labor market improvements and the growing risks arising from QE3, a slowdown in purchases should be appropriate around mid-2013. With what we know now about the deceleration in employment growth in March, payrolls will likely have to jump back up to the 200K level for more than three consecutive months for most FOMC members to feel comfortable slowing down purchases (as long as the benefits continue to outweigh the costs).

It is important to note that the Fed's MBS holdings increasingly become larger in relation to the overall supply of outstanding MBS. The minutes revealed the participants' exit-related concerns regarding the sales strategy of MBS during the normalization of the balance sheet in addition to strategies on how to avoid market disruptions. They have surely emphasized transparency throughout this process, and possible alterations to the exit strategy outlined in the June 2011 FOMC minutes include holding MBS to maturity or very slow sales as part of the exit plan, to mitigate the risks to financial stability and lower the decline of remittances to Treasury during the exit.

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

Despite fiscal restraints, March's meeting minutes reveal a mostly positive economic outlook, reinforcing our expectations regarding the path of monetary policy. We continue to expect that the current pace of purchases will proceed until mid-2013, assuming that the latest deceleration in payroll growth is only temporary and that the committee continues to see benefits to the asset purchase program. Once they adjust QE3, we will likely see a slower pace ongoing until the end of 2013 and into 2014 as the economy continues to gradually improve and the risks from the increasing balance sheet and aggressive asset purchases elevate.