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Fed Watch

US

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Economic Analysis

US
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FOMC Minutes: September 17th – 18th

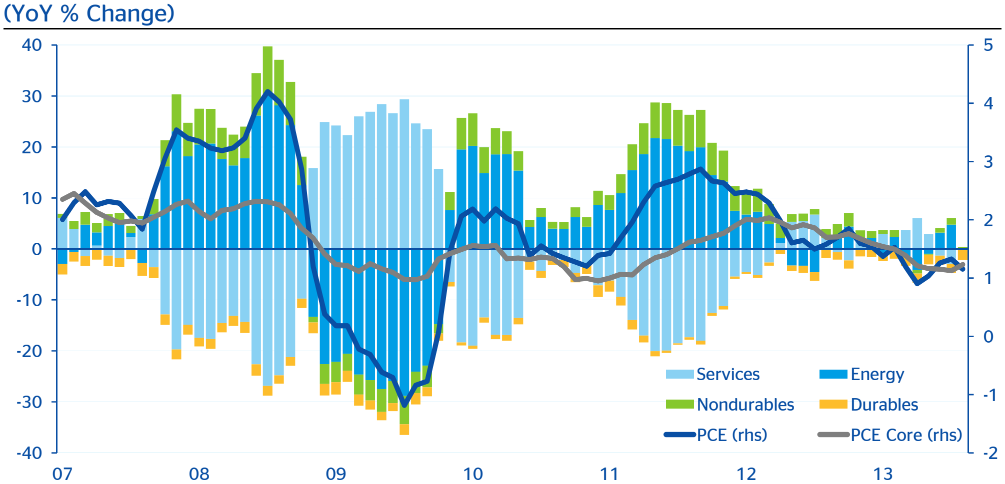
Foreseen Government Shutdown Put September Tapering on Hold

- **Committee decision of not trimming $85bn pace of asset purchases in September was a close call**
- **Improvement in economic activity and labor market was viewed suitable for a slight taper but judged to be not sustainable due to increased downside risks**
- **FOMC debated the details on whether Treasuries or Mortgage-Backed Securities pace should be scaled down**
- **Enhancing the effectiveness of forward guidance on federal funds rate was at the center of FOMC discussion**
- **Vice Chair Yellen's nomination to succeed Chairman Bernanke will provide continuity to the monetary policy going forward**

The FOMC minutes from the September 17th-18th meeting convey that the decision not to proceed with "taper" plan at the September meeting was a close call. Overall the Committee members viewed the cumulative progress of economic conditions and in the labor market satisfactory. However, a number of them were concerned with "heightened uncertainty about the course of federal fiscal policy over coming months" foreseeing the government shutdown and the risk of economic strains around the debt ceiling debate. Those fiscal policy concerns elevated downside risks to the FOMC economic outlook and led them to question the sustainability of progress.

Voting for the decision to maintain the $85bn pace of asset purchases, a number of Committee members stressed the "contingent and data-dependent nature" of the purchase program evaluating the economic data as mixed mainly due to sill low inflation rate. The minutes read: "risk-management considerations called for a cautious approach." At the same time for several FOMC members the decision to trim or maintain the pace of $85bn was a close call.

Chart 1
PCE Chain Price Index (YoY % Change)



Source: BEA & BBVA Research

The participants in favor to moderate the current pace of purchases viewed the cumulative economic progress satisfactory and "data broadly consistent" with the outlook presented by Committee in June, when the plan to taper was first communicated to public. The proponents to scale-down QE3 rightfully raised concerns that the delay will misalign monetary policy and financial markets expectations, posing risk to future credibility and the effectiveness of FOMC communications. It was stated that postponing the announcement to scale-down "could potentially undermine the credibility or predictability of monetary policy." The Fed's communication has been under attack in FRB President speeches and by the financial media since the September statement.

Committee members also deliberated how to proceed with the adjustment to the pace of asset purchases when the timing to scale-down is appropriate. Few participants expressed that the Mortgage-Backed Securities pace of purchases should remain unchanged to provide further support to the housing market. Nevertheless, the idea of "including both types of securities in any reduction" was also plausible. To reduce uncertainty with regard to the FOMC scale-down path, one Committee participant, likely Governor Stein (September 26, 2013 speech), suggested to link asset purchases reduction "to numerical values for the unemployment rate."

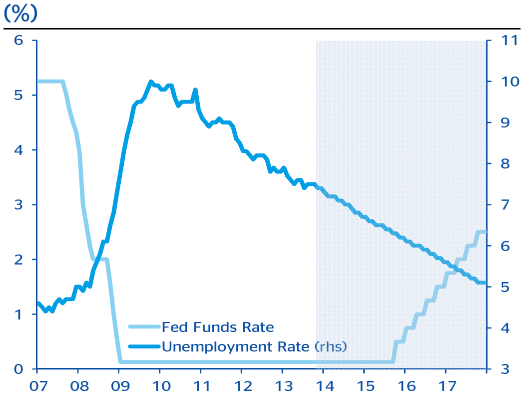
FOMC postponing the decision to reduce the asset purchases was also driven by June events when market interpreted possible decrease in asset purchases as a signal about the federal fund rate. These led to tighter financial market conditions. Committee participants felt that they needed time to strengthen communication on the forward guidance and reinforce the distinction between two policies – Large Scale Asset Purchases and federal funds target rate. Committee members stressed that the federal funds target rate will stay below the rate yielded by Taylor's Rule for considerable time.

Together with FOMC minutes release, Vice Chair Yellen was officially nominated by President Obama to succeed Chairman Bernanke whose term expires in January 2014. The nomination of Yellen removed uncertainty related to the Fed leadership transition and increased FOMC credibly on forward guidance. Today's nomination reassures the continuity of the monetary policy course set by the current Committee.

Bottom Line: FOMC Awaits Fiscal Policy Uncertainty to Dissolve to Taper

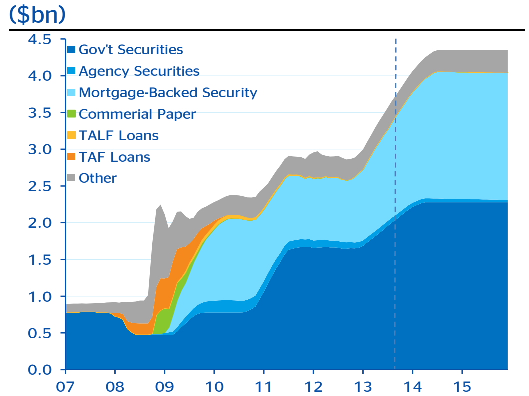
Postponing a QE3 scale-down announcement was a close call mostly driven by potential risk to further financial market tightening as well as increased downside risks elevated by fiscal policy uncertainty. Conditional on greater fiscal policy clarity, the FOMC could announce its plan to scale down QE3 in December. However, if the government shutdown and the debt ceiling debate linger the FOMC would likely delay tapering until 2014.

Chart 2
Fed Funds & Unemployment Rate (%)



Source: FRB & BBVA Research

Chart 3
Federal Reserve Balance Sheet ($bn)



Source: Federal Reserve & BBVA Research