BBVA Research

U.S.

Fed Watch

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FOMC sees private demand growth outside of stimulus

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- **Recent data reflects moderate economic recovery and strengthening labor markets**
- **Primary challenges lie in personal consumption and residential real estate**
- **Official interest rates remain unchanged at 0%-0.25%**

FOMC members agreed that the economy is strengthening and the labor market is starting to improve in line with their expectation of moderate growth. In fact, at this meeting, participants submitted projections for economic growth. The average of the central tendency moved up to 3.5% in 2010 from 2.5%, indicating that members are feeling more confident about the strength of the recovery. On this point, members' concerns about a stimulus driven recovery are easing as, "growth in real GDP appeared to reflect a strengthening of private final demand and not just fiscal stimulus and a slower pace of inventory decumulation."

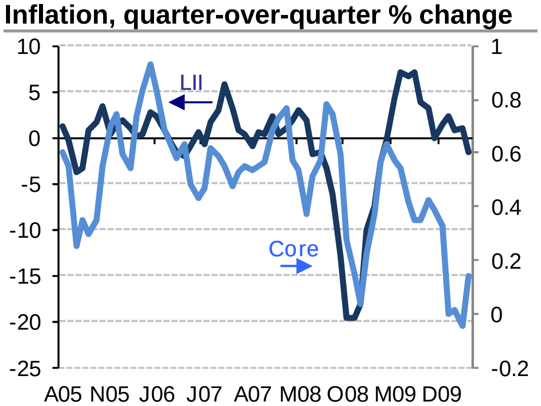
Participants agreed that one of the most positive developments was an improvement in the labor market and they expect the progress to continue, which could lead to further gains in spending by boosting consumer and business confidence. Nonetheless, concerns remain about the high unemployment rate, the loss of skills due to long-term unemployment and uncertainty about the economic outlook that remains in the business community (according to business contacts).

Another positive development was business investment, which members expect to be supported by improved conditions in financial markets. The credit markets have opened up as a source of financing for large firms. Nevertheless, small firms continue to face challenges obtaining bank loans. FOMC members view this as an obstacle to the economy because small companies have been drivers of job growth during previous recoveries.

Despite the improvement in the outlook, committee participants emphasized that downside risks remained. Consumer spending has been strong in recent months, but it could be supported by pent-up demands and other temporary factors, which raises the question of if it will be a significant driver of economic growth going forward. Moreover, members remained concerned that home sales and housing starts have stabilized at low levels, and that more foreclosures could raise inventory levels further and put downward pressure on home prices.

Graph 1

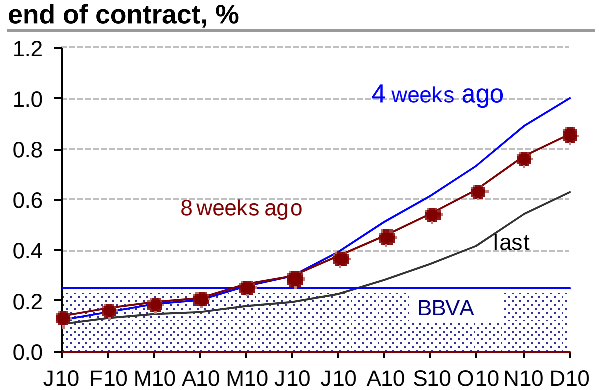
BBVA US Leading Inflation Index & Core Inflation, quarter-over-quarter % change



Source: BLS and BBVA Research

Graph 2

Fed Funds Expectations, Fed funds futures, end of contract, %



Source:: Bloomberg & BBVA Research

The debate on inflation continued. While members agreed that “overall and core inflation would remain subdued through 2012,” there was discussion about the current trends and direction of the risks. One member expressed concern that the shelter component could be the sole piece weighing down core inflation, but other members countered by pointing out that a moderation in price changes was actually widespread across many categories. In regards to near-term risks, some participants saw downside risks due to elevated levels of economic slack and the possibility that inflation expectations could begin to decline. On the other hand, others saw upside risks because the expansion of global economic activity could raise commodity and energy prices. Furthermore, some participants were concerned that market concerns about the Fed’s balance sheet could lead to an increase in long-term inflation expectations.

Given the outlook for the economy and inflation, the FOMC decided to maintain the target rate at 0%-0.25% with the language that, “economic conditions… were likely to warrant exceptionally low levels of the federal funds rate for an extended period. While the committee did not make any changes to monetary policy, members agreed that clear communication, transparency and responsiveness to economic changes are imperative for a successful policy.

Members discussed strategies for asset sales in order to return the balance sheet to more normal conditions. Participants expressed a range of views on some of the details. Most participants favored deferring asset sales for some time. A majority preferred beginning some time after the first hike in Fed funds while others suggested announcing a general schedule without linking the date of the sales and changes in interest rates. A few were inclined to start sales relatively soon.

Interest rates will remain low for an extended period of time

Participants agreed allowing all maturing agency debt and all prepayments of agency MBS to be redeemed without replacement while rolling over all maturing Treasury securities. Members will give further consideration to their longer-run strategy at a later date. The Fed’s outlook is improving in line with recent economic data. Nonetheless, the most imperative issue for the Fed will be the sustainability of the economic recovery as that will determine the timing and pace of the Fed’s exit strategy. In addition, recent events in Europe which prompted the Fed on May 9th to reestablish temporary U.S. dollar liquidity swap facilities with central banks around the world, increase uncertainty on the economic outlook. Given the degree of slack that remains in the economy and our outlook of subdued inflation, we continue to maintain our expectation that the target federal funds rate will remain low for an extended period of time.

Table 1

FOMC Member Forecasts

	Central Tendency			Range		
Variable	**2010**	**2011**	**2012**	**2010**	**2011**	**2012**
Change in real GDP	3.2 to 3.7	3.4 to 4.5	3.5 to 4.5	2.7 tp 4.0	3.0 to 4.6	2.8 to 5.0
January projection	2.8 to 3.5	3.4 to 4.5	3.5 to 4.5	2.7 to 4.0	2.7 to 4.7	3.0 to 5.0
Unemployment rate	9.1 to 9.5	8.1 to 8.5	6.6 to 7.5	8.6 to 9.7	7.2 to 8.7	6.4 to 7.7
January projection	9.5 to 9.7	8.2 to 8.5	6.6 to 7.5	8.6 to 10.0	7.2 to 8.8	6.1 to 7.6
PCE inflation	1.2 to 1.5	1.1 to 1.9	1.2 to 2.0	1.1 to 2.0	0.9 to 2.4	0.7 to 2.2
January projection	1.4 to 1.7	1.1 to 2.0	1.3 to 2.0	1.2 to 2.0	1.0 to 2.4	0.8 to 2.0
Core PCE inflation	0.9 to 1.2	1.0 to 1.5	1.2 to 1.6	0.7 to 1.6	0.6 to 2.4	0.6 to 2.2
January projection	1.1 to 1.7	1.0 to 1.9	1.2 to 1.9	1.0 to 2.0	0.9 to 2.4	0.8 to2.0

Note: Projections of change in real gross domestic product (GDP) and in inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated.
The central tendency excludes the three highest and three lowest projections for each variable in each year.
Source: Federal Reserve