BBVA Research

U.S.

Fed Watch

June 23, 2010

Economics Analysis

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FOMC Statement: June 22-23

The economy is improving, but at a slow pace

- **FOMC maintains fed funds rate at 0%-0.25%**
- **The European debt crisis has weighed on the financial markets**
- **Inflation does not pose any near-term risks for monetary policy**

Economic conditions continue to warrant *"exceptionally low rates for an extended period"*

The FOMC believes that the economic recovery is on track for a moderate recovery in line with expectations, but today's statement highlighted some of the risks to economic growth. Foremost, the statement addressed the effects of the European debt crisis on the financial markets by stating, "*[f]inancial conditions have become less supportive of economic growth on balance, largely reflecting developments abroad."* While the impact from abroad is evident in the markets, Bernanke expects the economic impact to be only modest, according to his most recent testimony on June 9.

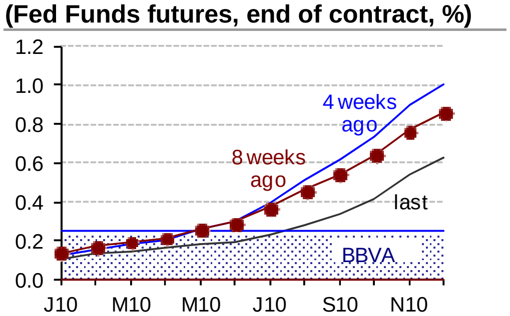
Furthermore, residential construction has become more of an uncertainty. Whereas the previous statement described housing starts as having "edged up," June's release eliminated that language. This change could imply that they Fed has some concerns regarding the recovery in residential construction. On the upside, the committee cited improvements in both consumer and business demand. Household spending was described as "increasing," compared to "beginning to improve" in the previous report, while business spending on equipment and software was described as having "risen significantly," as it was in the April statement. Lastly, while the improvement in the labor market is positive, it was described as gradual, which could limit the pace of recovery.

The Fed does not expect inflation to be a problem in the near-term. The committee continues to believe that inflationary pressures remain at bay and added the language, "prices of energy and other commodities have declined somewhat in recent months, and underlying inflation has trended lower." This statement is in line with our observation that core inflation has come in below consensus expectations since the beginning of the year due to declining prices of shelter prices and other goods due to meager demand.

Given this outlook, the FOMC maintained the fed funds rate at 0%-0.25% as well as the "extended period" language. The statement did not announce the use of any new policy tools, but reiterated that the Fed will employ its policy tools in accordance with economic and financial developments.

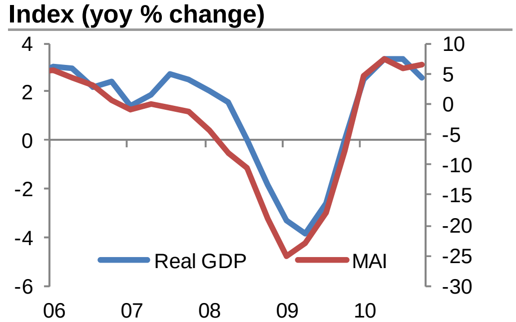
This month's statement is in line with recent economic data and speeches from FOMC members. While the release highlighted breakthroughs in the recovery, it also emphasized that risks remain. Recent economic developments are in line with the assumptions in our baseline scenario. As a result, we maintain our expectation that rates will remain low for an extended period of time.

Chart 1
Fed Funds Expectations (Fed Funds futures, end of contract, %)



Source: BEA and BBVA Research

Chart 2
Real GDP vs BBVA US Monthly Activity Index (yoy % change)



Source: BEA and BBVA Research

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