U.S.

Fed Watch

July 22, 2010

Economic Analysis

Kristin Lomicka
kristin.lomicka@bbvacompass.com

Semi-Annual Monetary Policy Report

Moderate growth, but risks are weighted to the downside

- **Heightened uncertainty in the economic outlook due to the global financial situation**
- **Inflation forecast remains low and positive, with risks balanced**
- **Economic outlook supports low rates for a prolonged period**

Moderate growth, a gradual decline in the unemployment rate and subdued inflation

Bernanke's remarks in his Semi-Annual Monetary Policy Report before Congress echoed soundings from the most recent FOMC minutes and speeches. The main message is that the Fed expects moderate economic growth to continue, but downside risks are elevated. In fact, Bernanke stated that, "most [FOMC] participants viewed uncertainty about the outlook for growth and unemployment as greater than normal." Furthermore, Bernanke explained that the slight downward revision to the FOMC's growth forecast in June was due to slower than expected progress in reducing unemployment and lower than expected inflation. Additionally, concerns about the EU's sovereign debt problems have weighed on financial markets. As a result, the markets have become less supportive of economic growth.

Unemployment remains a primary concern and could be a drag on consumer spending in the second half of the year. Additionally, the Fed is concerned about the tight credit markets still facing small businesses. These companies have historically been a source of employment and economic growth during periods of recovery. In order to promote more credit flow to this sector, the Fed has been working closely with both banks and small businesses to determine challenges and opportunities.

Regarding inflation, Bernanke stated that FOMC participants expect core inflation to average 1% in 2010 and to remain low in 2011 and 2012 with risks balanced. He did not mention the concerns that some members had regarding the likelihood of deflation as indicated in the latest minutes.

Bernanke also reiterated the approach to reducing the Fed's balance sheet. The Fed's securities portfolio has risen from $800 billion to $2 trillion and the composition has shifted from consisting of 100% Treasuries to almost two-thirds of agency-related securities. Furthermore, the average maturity of the Treasury portfolio has nearly doubled. In order to return to a more normal size and composition, the Fed is considering: 1) changing the reinvestment policy to reinvest proceeds of maturing Treasuries in shorter-term issues and 2) sell some holdings of agency debt and MBS. Additionally, the primary tools for removing monetary policy accommodation and draining excess reserves will be: 1) interest rate paid on reserves 2) reverse repos and 3) term deposits.

Lastly, Bernanke praised the financial system reform bill, saying that it "represents significant progress toward reducing the likelihood of future financial crises and strengthening the capacity of financial regulators to respond to risks that may emerge."

We continue to expect interest rates to remain low for a prolonged period of time

Bernanke's testimony did not raise any new issues, but highlighted the elevation of risks to the economic scenario. Unemployment remains an important concern because it is improving slower than expected and the situation in Europe has added greater uncertainty to the outlook. These developments, coupled with subdued inflation, support our expectation of low interest rates for a prolonged period and increase the risk that the first rate hike will occur later, rather than sooner, than expected.

BBVA Research

Chief Economist for US and Mexico
Jorge Sicilia
J.Sicilia@bbva.bancomer.com

Chief Economist for US
Nathaniel Karp
Nathaniel.karp@bbvacompass.com

Ignacio San Martin
Ignacio.SanMartin@bbvacompass.com

Jeffrey Owen Herzog
Jeff.Herzog@bbvacompass.com

Marcial Nava
Marcial.Nava@bbvacompass.com

Hakan Danış
Hakan.Danis@bbvacompass.com

Jason Frederick
Jason.Frederick@bbvacompass.com

Kristin Lomicka
Kristin.Lomicka@bbvacompass.com

Contact details

BBVA Research
5 Riverway Drive
Houston, Texas 77056

ResearchUSA@bbvacompass.com

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