BBVA Research

U.S.

Fed Watch

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Economic Analysis

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FOMC Statement: January 25-26

No sign of early termination of LSAP

- **Household expenditure growth picks up, but remains constrained**
- **Commodity prices have increased, but inflation expectations remain stable**
- **No dissenting opinion due to change in FOMC membership**

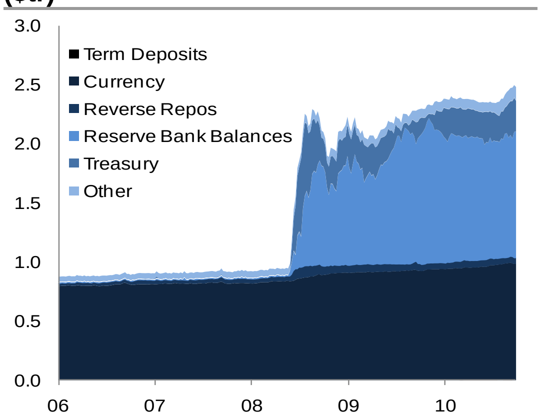
LSAP program moves forward as expected

The Federal Open Market Committee (FOMC) released a statement today indicating no major changes to the current monetary policy stance, which is pursuing a combination of extremely low interest rates and large-scale asset purchases (LSAPs) to combat below-mandate inflation and employment. Of the few material changes to the statement, FOMC members upgraded their characterization of household spending for the second statement in a row. FOMC members now see the pace of personal consumption growth as picking up compared to December. However, personal consumption remains constrained by tight credit conditions, low housing wealth and high unemployment. The statement noted that while commodity prices have increased, indicators of inflation expectations remain stable and measures of core inflation continue to trend downward. Additionally, with the inclusion of new FOMC members, the statement does not have any dissenting opinions for the first time in many months.

Given this discussion above and the “disappointingly” slow progress towards achieving its dual mandate, the FOMC decided to continue with its November decision to purchase $600bn in Treasury securities by the end of 2011Q2. This program is in addition to its existing earlier decision to reinvest the principal from retiring mortgage-backed securities (MBS) held on the Federal Reserve’s balance sheet. Naturally, the FOMC will also continue to hold the Fed Funds rate at 0 to .25 percent. In our previous Scorecard for Week 9 of LSAP, we highlighted that financial stability and macroeconomic indicators are improving. However, with limited gains in nonfarm payroll levels, labor market conditions remain weak. Overall, today’s statement by the Federal Reserve is consistent with our expectations for a low Fed Funds rate for an extended period of time.

Chart 1

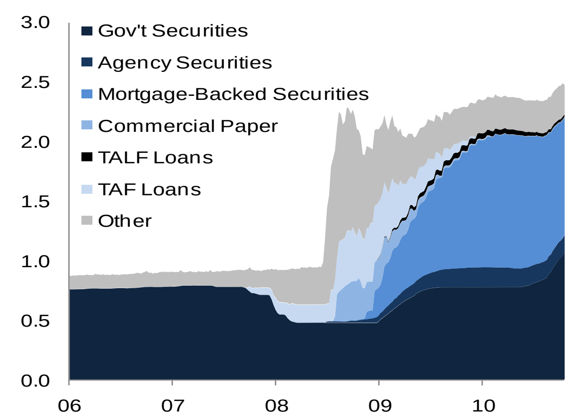
Factors Absorbing Reserve Funds ($tr)



Source: BBVA Research and Bloomberg

Chart 2

Factors Supplying Reserve Funds ($tr)



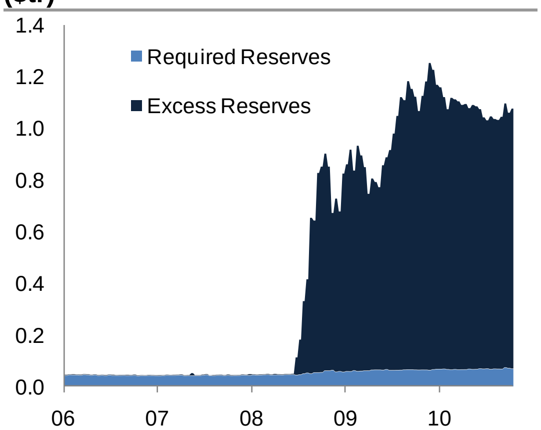
Source: BBVA Research and Federal Reserve

How will the Fed communicate an end to LSAP?

As mentioned above, we expect the Federal Reserve to complete the LSAP program during May 2011 as planned. Current trends in economic data do not warrant an additional dosage of securities purchases, but as always this decision will be conditional on unfolding data. At the same time, it is clear that the Federal Reserve must begin building a communications strategy for the end of LSAP. The Fed does have the enviable position that, so far, LSAP is progressing as planned. Although unlikely, if conditions worsened as a result of LSAP, the communications strategy would be far more difficult. Aside from this consideration, the end of LSAP must be framed within the Fed's monetary policy aspirations for the remainder of the year, necessitating a focused effort to prepare markets in anticipation of the end.

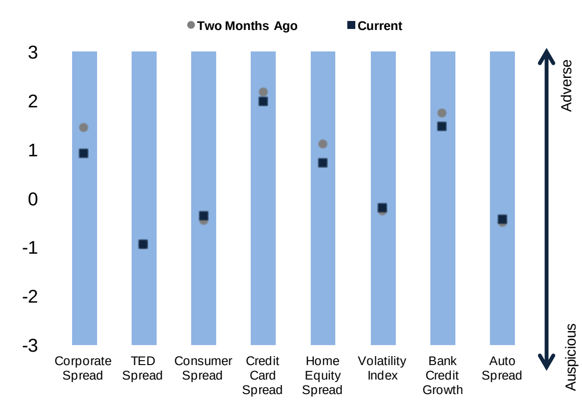
We anticipate that the Fed will justify the end of LSAP during the April meeting by discussing the positive impact of LSAP on the economy. This would be articulated through commentary addressing two major themes: (1) LSAP's ameliorating effect on macroeconomic and financial indicators and (2) inflation expectations' stabilizing trend and declines in some measures of deflation probability. Specifically regarding inflation expectations, the Fed will argue that inflation numbers are strongly-lagged data and that inflation expectations are more contemporaneous with policy instruments like asset purchases. Another portion of the Fed's commentary will address improvements in risk appetite by highlighting declines in the corporate spread, flows to higher-risk equity classes, and stabilizing interbank lending spreads. However, unemployment remains a thorn in the Fed's side in that substantial slack in the economy remains in place. The flip-side of the unemployment situation, something we surmise that the Fed will emphasize, is that while the unemployment situation is undesirable, it is not so bad as to justify further stimulus. Secondarily, an oft-cited worry surrounding LSAP is the generation of credit or asset bubbles. At the present time, credit growth remains subdued and loan standards remain tight. Domestic asset indicators, such as stock market indices, have increased, but not yet to the point of unambiguously-triggering bubble concerns.

Chart 3
Reserves at the Federal Reserve ($tr)



Source: BBVA Research and Bloomberg

Chart 4
Financial Indicators (Deviations from Mean)



Source: BBVA Research and Federal Reserve

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