U.S.

Fed Watch

April 8, 2011

Orchestrating a Breakout

The Reversal of Extraordinary Monetary Policy

Economic Analysis

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- **Asset purchases will end as planned; cessation of principal reinvestment in Aug-Sept**
- **A first rate increase is expected in March with moderate risks of an earlier rate hike**
- **The pace of balance sheet normalization will depend on the GDP and inflation outlook**

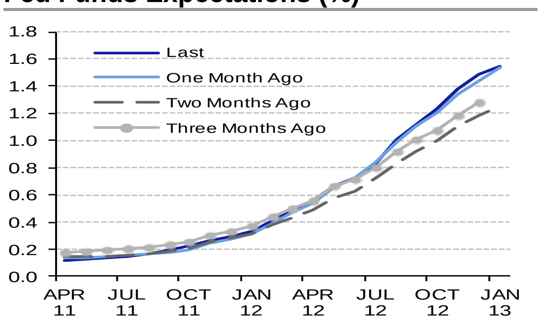
A Path for Federal Reserve Policy Given the BBVA Baseline Scenario

Looking back at the past few years of monetary policy, the Federal Reserve is on the verge of attempting a reversal of unorthodox interventions in the financial markets. Zero interest rate policy is rare and a successful exit from zero interest rate policy is even rarer. The experience of the Bank of Japan at the end of the 90's and early part of the last decade provide at best mixed results. As such, the Federal Reserve's task is to properly sequence the reversal of all these extraordinary measures. Our view of this sequencing is tied to a particular baseline forecast of GDP and inflation. Although many different indicators may ultimately influence policy – some are more salient than others given uncertainty stemming from extraordinary policy – we believe the key indicators are the GDP and inflation forecast. Our expected sequencing by the Fed is directly dependent on the following baseline scenario. Namely, in the medium-term, we anticipate a gradual increase in underlying inflation that – while higher than today – is still within the Fed's comfort zone and welcomed by the Fed to a certain extent. Implicitly, this suggests temporary oil price increases and a low pass-through effect of oil price increases to core inflation measures. We surmise that market-based measures of long-term inflation expectations will remain stable and that modest economic growth will continue through 2011, with a gradual improvement in labor markets. Credit growth will remain constrained due to a slowly healing banking sector through 2011. Lastly, we hypothesize that there will be no additional uncertainty shocks, including surprises in fiscal policy. With this story in mind, we map this expected GDP and inflation path to the Federal Reserve's sequencing.

Sequencing a Reversal of Extraordinary Monetary Policy

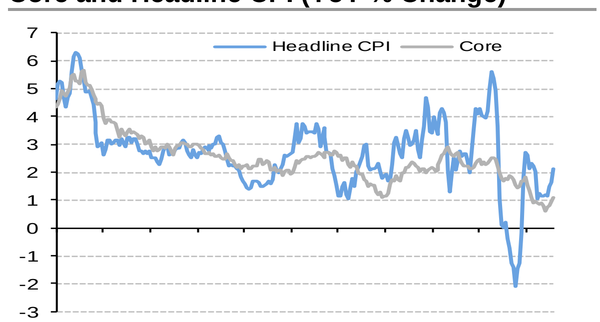
Each stage of the sequence will require communication from the Federal Reserve, which is now also newly-equipped with Chairman's press conferences starting April 27. Communication at each point will be crucial to ensuring clarity of objectives and implementation of monetary policy to the private sector. The very beginning of the process starts with the wrap-up of the large-scale asset

Graph 1
Fed Funds Expectations (%)



Source: BBVA Research & Bloomberg

Graph 2
Core and Headline CPI (YoY % Change)



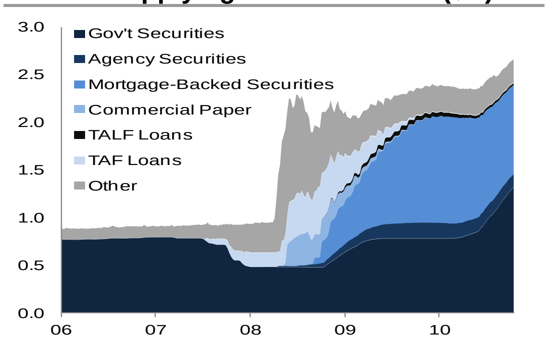
Source: BLS

purchase program (LSAP) of $600bn in treasury securities. We currently expect the Fed to finish LSAP as planned at the end of June 2011 given upward-trending inflation indicators, with no need for another round of purchases. For several months, members of the FOMC have discussed the end of LSAP and in April, the Fed will probably be more explicit about not needing to extend LSAP beyond the initial plan. Due to the depth and liquidity of the secondary treasury market, the Fed sees no reason to taper purchases as a means of avoiding market disruptions. This is in contrast to the previous purchases of mortgage-backed securities (MBS), where the Fed decided to taper purchases due to the shallowness of this market during the recovery.

Once the market fully absorbs this change, the second step is to halt the reinvestment of principal from maturing balance sheet MBS, likely to be announced either in August or September. Currently due to high prepayment rates, the Fed's holdings of MBS are declining by around $25bn a month. The prepayment rate will decline as mortgage interest rates rise, but we can conservatively estimate natural run-off of roughly $200bn per year in MBS. This represents a passive reduction of the balance sheet. In practice, more active measures may be needed depending on the pace of the economic recovery. At this point, the Fed will examine both the impact of the end of LSAP and the cessation of reinvestment. The impact on the 10 year treasury interest rate and the mortgage rate will depend on the willingness of private investors to purchase these securities. Considering that the government will still need to finance a large deficit, a solid economic recovery would probably also imply higher risk taking and thus, less demand for Treasuries. This would push up yields. However, if the risk appetite stays low, private purchases of Treasuries would partially replace those from the Fed and the increase in yield could be marginal. Considering that financial institutions have ample liquidity and would be willing to hold a high level of reserves relative to the pre-crisis period, demand for risk-free securities would likely be elevated thereby keeping upward pressures on yields contained. Given that the Fed wants to avoid swings in interest rates, we do not expect a major change at the end of LSAP. An additional rationale, although more theoretical, is the belief by some Federal Reserve staff that the stock of assets is more important than the flow of assets.

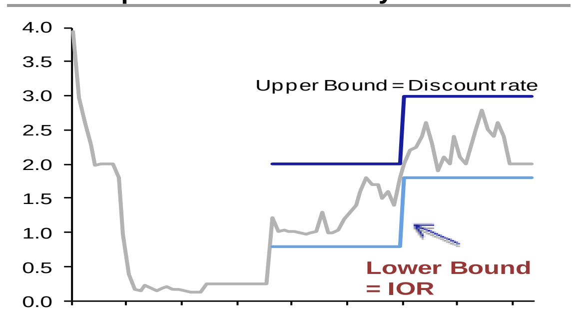
So far, the steps in the process have required the Fed to act passively. At this third stage of the process, more active measures are needed. Overall, we expect the Fed to distinguish between asset sales and the target interest rate. The former affects long-term interest rates, while the latter affects the short-term interest rate. The long-term rate is determined by fundamental factors, while the short-term rate reflects only monetary policy. In general, the Fed will wish to normalize the balance sheet while at the same time raising interest rates. The most crucial part of this process will be the "corridor system," whereby the interest rate on reserves and the discount rate represent the lower and upper bounds of the targeted Fed Funds rate, respectively. Given liquidity trap conditions, this is the only viable way to increase the Fed Funds rate away from zero. We now expect the first increase in the target Fed Funds rate to occur in March 2012, although there are moderate risks of an earlier hike. In order to prepare for the first use of the corridor system, the Fed will remove the reference to "exceptionally low levels for the federal funds rate for an extended period" two months prior to the March rate hike. This phrasing may be altered to something along the lines of "economic conditions still warrant low levels of the federal funds rate, which will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information."

Graph 3
Factors Supplying Reserve Funds ($tr)



Source: BBVA Research & Federal Reserve

Graph 4
An Example of the Corridor System



Source: BBVA Research

Sales of securities on the Fed's balance sheet may occur before, during or after the use of the corridor as market conditions allow. Since the exact anticipated market reaction is unknown, the precise management of the balance sheet must be closely tied to short-term conditions. After balance sheet normalization begins and the corridor system is utilized, the Fed's supporting tools are activated. Term deposits and reverse repurchase agreements allow the Fed to adjust the outflow of excess bank reserves. If these excess reserves move too quickly from the Fed's balance sheet to loans by depository institutions, then these supporting tools will provide a way for the Fed to slow this process.

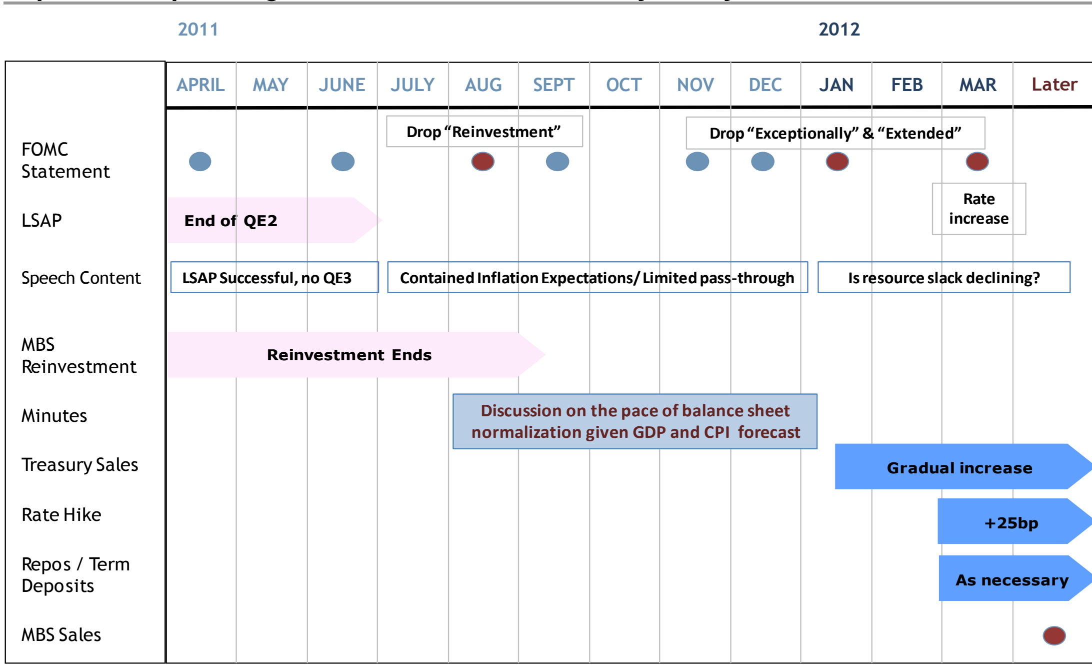
Lastly, as monetary policy reaches more standard conditions, the Fed will begin to sell its stock of MBS acquired during the financial crisis. This step could occur earlier if the Fed perceives a high demand for high yielding securities, which would allow it to reduce interest rate risk and potential capital losses.

Bottom line

We expect that the Federal Reserve will not increase its target rate throughout 2011. Recent speeches by Fed officials with a more hawkish bias are consistent with a communications strategy aimed at containing inflationary expectations and, at the same time, they reflect the difference of opinion among FOMC participants on the need to intensify the policy normalization debate inside the FOMC. The timing and the pace of the rate hikes will depend on macroeconomic conditions. In particular, policymakers will scrutinize the level of slack in the economy and potential structural unemployment, both of which are a result of the sharp downturn. We emphasize that the outlook for inflation will be particularly important to the Fed alongside these measures of resource and labor slack. Commensurate with our economic scenario, the Fed will begin rate hikes around March 2012. In an alternative scenario of ongoing price pressures and elevated contagion to core inflation and inflation expectations, the Fed would intensify its communication strategy to keep its credibility intact. However, hiking rates to keep inflation in check would present a dilemma for the Fed if upward inflation trends occur in tandem with slower economic growth. From this perspective, the Fed would hike rates at a faster pace but pause at a lower level than in the baseline scenario.

Graph 5

Expected Sequencing of Federal Reserve Monetary Policy



Source: BBVA Research

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