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Fed Watch

US

22 June 2011

Economic Analysis

US

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FOMC Statement: June 22

Sleeping with one eye open

- **FOMC lowers growth estimates, still expects transitory inflation increase**
- **Bernanke said more data is needed to assess recent weak indicators**
- **FOMC will wait for definitive proof that recovery is sustainable before exit**

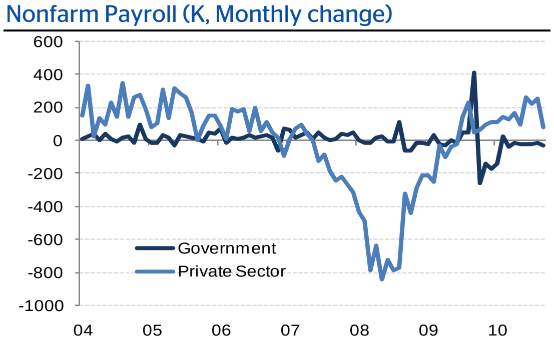
Today's statement implies no major changes to current policy stance

The Federal Reserve today released a statement describing the economy as displaying moderate growth, but at a pace somewhat more slowly than previously expected by the Federal Reserve. The contents of the statement imply that the Fed believes that the recent weakness in economic indicators will be transitory and is the result of dampened consumption from a spike in oil prices and dampened business activity from a natural disaster in Japan. While business investment expanded, residential investment remains depressed. Turning to inflation, the FOMC continues to assert that the recent uptick in inflation is the result of transitory commodity price increases and will converge to a level more comfortable with FOMC members.

Bernanke said that part of the recent slowdown is a result of the aforementioned transitory factors, but the other part of this recent slowdown is attributable to long-term factors that are more persistent than previously expected. These long-term factors – the aftereffects of a banking crisis, household deleveraging and depressed household investment – will continue to drag on growth. Another source of downward pressure on growth will arise from "fiscal drag" as a result of possible future austerity programs by the government. On this point, the Chairman stressed that fiscal reforms should take a long-term perspective rather than a short-term perspective. Overall, Bernanke still sees considerable resource slack within the economy. While reluctant to offer exact times and procedures, the Chairman did elaborate on some features of the normalization of the Fed's balance sheet and accommodation stance. Bernanke said that a little more time would be useful for policy decisions at the present time. In case of clear sustained weakness in the economy, the Fed may employ additional tools such as: more asset purchases (although structured in different ways), reduce the interest on excess reserves, offer guidance on the size of the balance sheet, and offer a date for the removal of "extended period" language. The Chairman note that these tools are untested and arrive with particular costs. Longer-term, Bernanke remains a fan of an explicit inflation target for the Federal Reserve, although adopting one will require preparing Congress and the public that this is not an abandonment of the Fed's dual mandate of price stability and full employment.

Chart 1

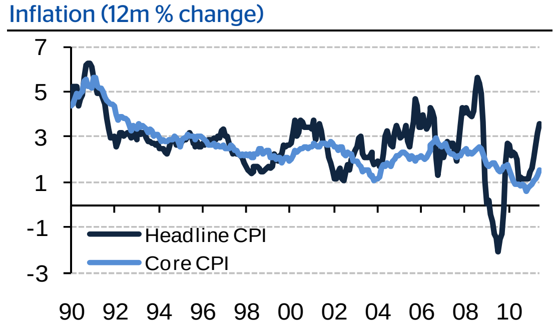
Nonfarm Payroll (K, Monthly change)



Source: Bloomberg & BBVA Research

Chart 2

Inflation (12m % change)

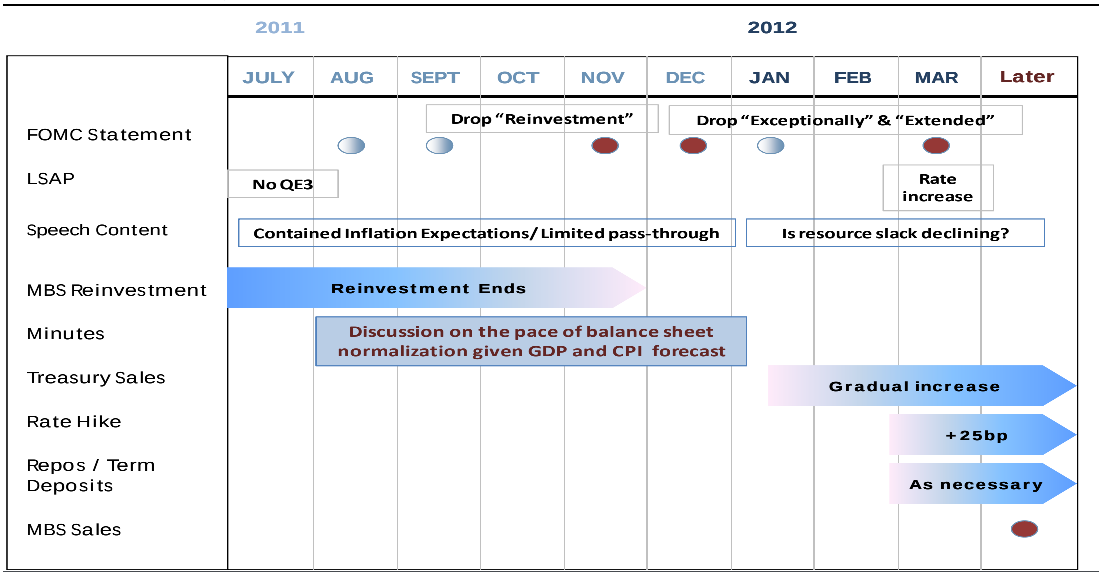


Source: Bloomberg & BBVA Research

Bottom line: uncertainty over sustainability continues to weigh on policy action

We believe that Bernanke's press conference comments and the FOMC statement confirm the narrative of our baseline scenario: moderate economic growth, a transitory shock to inflation from oil prices, no rate hike in 2011 and no additional large-scale asset purchases. As we previously surmised, the current weakness in recent economic data will be transitory and followed by moderate growth in 2011H2. We have consistently argued that there are long-term structural issues providing a block to achieving high growth rates, for example, household deleveraging, structural unemployment, and weakness in residential investment. Looking ahead, today's statement and comments suggest that the Fed needs more data to prove whether or not this is a temporary or significant and permanent slowdown in the economy. As a result, we have shifted the cessation of reinvestment of principal to November, but the rest of our sequencing remains the same and we still expect a first rate hike in March 2012. We currently foresee risks tilted to the downside, suggesting a postponement to the first rate hike if the economy slows considerably. Deflation risk appears to have dissipated from the FOMC's dialogue, but FOMC members will continue to monitor inflationary expectations moving forward.

Table 1
Expected Sequencing of Federal Reserve Monetary Policy



Source: BBVA Research

Table 2
Federal Reserve Forecast Comparison, April 27 FOMC Statement and Press Conference

	April 2011 FOMC Projections				June 2011 FOMC Projections			
	2011	2012	2013	Long-term	2011	2012	2013	Long-term
	GDP, 4Q yoy % change				GDP, 4Q yoy % change			
High	3.7	4.4	5.0	3.0	3.0	4.0	4.5	3.0
Low	2.9	2.9	3.0	2.4	2.5	2.2	3.0	2.4
	Unemployment rate, %				Unemployment rate, %			
High	8.9	8.4	8.4	6.0	9.1	8.7	8.3	6.0
Low	8.1	7.1	6.0	5.0	8.4	7.5	6.5	5.0
	Core PCE, yoy % change				Core PCE, yoy % change			
High	2.0	2.0	2.0	---	2.3	2.5	2.5	---
Low	1.1	1.1	1.2	---	1.5	1.2	1.3	---

Source: Federal Reserve