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Fed Watch

US

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Economic Analysis

US

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FOMC Minutes: June 21-22

No Longer a Theoretical Exercise

- **Uncertainty over the labor market creates imprecision over the NAIRU and is creating a quandary for the FOMC normalization policy**
- **Transitory influences on growth must dissipate before definitive decision**

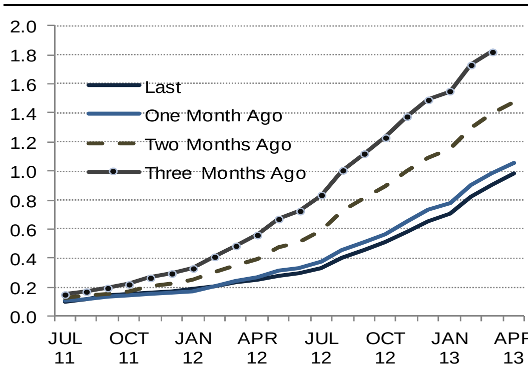
The Fed takes a line on agency securities sales, but not Treasury securities sales

Today's release of the minutes revealed a more formalized sequencing of the exit strategy or the normalization of the balance sheet and accommodative stance. The minutes underlined that this discussion of normalization is for "prudential planning" purposes only and should not be construed as an imminent sign of exit. As expected (see Chart 3), the sequencing is as follows: cease reinvestment, modify forward guidance, raise target rate (using the corridor system of interest on excess reserves, overnight rate), and later on conduct sales of agency securities from the System Open Market Account (SOMA) portfolio with ample preannouncement. In previous minutes, the Fed expressed a desire to return to an all-Treasuries SOMA and in the current minutes estimated a normalization schedule of two to three years, depending on economic conditions. This represents the first time the Fed has expressed a more clear timing for sales of agency securities. However, the question of sales of Treasury securities remains open.

The staff review of the economic situation unveiled a focus on two major issues: first, ongoing changes in both survey and market-based inflation expectations, and second, structural unemployment and wage pressures in a "softened" labor market. As already known, staff members expect moderate growth in the second half of the year buoyed by accommodative policy and increasing business confidence, but the minutes revealed for the first time that the staff believe that increases in credit availability will provide further impetus to growth. Our view is that this is the case in commercial and consumer lending, but not in real estate.

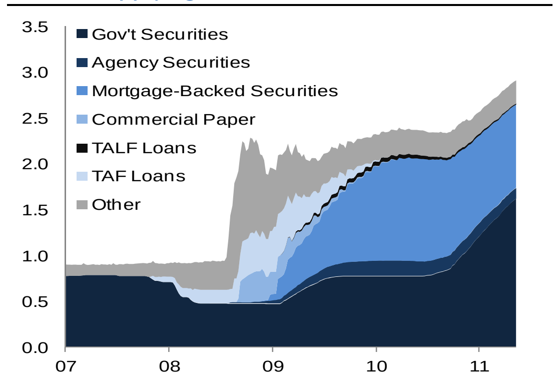
FOMC members' take on economic conditions mirror the staff's sentiment. FOMC members believe that the expansion will gain strength as temporary factors decline. Inflation will remain stable and transitory effects from an oil spike will dissipate. Recent growth is affected by a depressed housing

Chart 1
Fed Funds Futures Contracts (%)



Source: Haver Analytics & BBVA Research

Chart 2
Factors Supplying Reserve Funds ($tr)



Source: Haver Analytics & BBVA Research

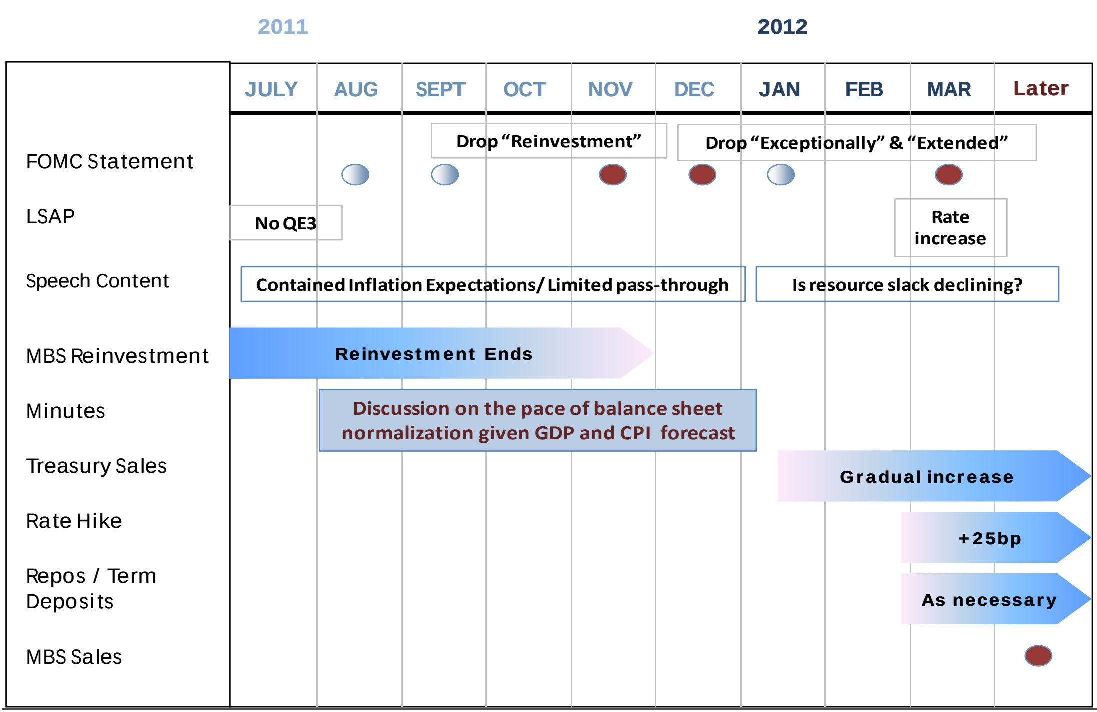
market, household deleveraging, sluggish income and consumption, fiscal austerity, and uncertainty over regulatory policy and the economic outlook. FOMC members believe risks are tilted to the downside and arises from the possibility of further housing market weakness, stronger fiscal austerity and new European sovereign debt calamities.

The most important part of the participants' discussion revolved around two different scenarios. In the first scenario, discussion implied that no action would be taken until transitory factors dissipated. In the first case of slow growth and a return of inflation to relatively low levels that increase the probability of deflation, some participants said this would trigger additional accommodation. However, other participants noted that slow growth and higher inflation implies greater structural unemployment, less resource slack, and temporarily lower potential output. This means the calculation of the non-accelerating inflation rate of unemployment (NAIRU) is higher and justifies withdrawal of monetary accommodation sooner than currently anticipated in financial markets.

Bottom line: a policy jammed by uncertainty

This discussion within the FOMC is extremely instructive of the blockage to clear action created by uncertainty. The current business environment suffers from uncertainty. Uncertainty over hiring in the labor market (and the degree of structural unemployment) leads to inefficiency in judging the level of the NAIRU. Imprecision in the NAIRU affects the decision to begin the normalization of the balance sheet and accommodative stance. Due to uncertainty over the sustainability of the recovery, the timing of policy action will depend on the evolution of data over the summer. We continue to expect a first rate hike in March 2012. The minutes are also consistent with our expected sequencing of policy (Chart 3), but we have pushed back the cessation of reinvestment to Nov-Dec. We expect that core inflation will continue edging up but will remain within the Fed's comfort zone. Our outlook also predicts a strengthening of growth in 2011H2, but at a very moderate pace.

Chart 3
Expected Sequencing of Federal Reserve Monetary Policy



Source: BBVA Research