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Fed Watch

US

30 August 2011
Economic Analysis

US

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FOMC Minutes: August 30

Bias towards action growing

- **FOMC reduces its outlook for growth**
- **Many participants view downside risks to growth as having increased**
- **Forward guidance usage represents a measured response to deterioration**

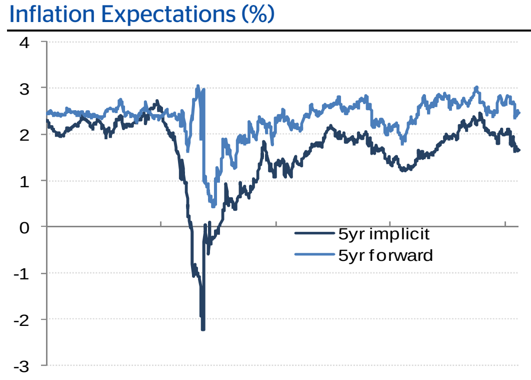
September's meeting to focus on selection and effectiveness of policy tools

The release of the FOMC minutes today described a deteriorating recovery in the US that has increased already high forecast uncertainty. The Federal Reserve notably lowered their forecasts for the US and the staff review of the economic situation painted a morose picture of current conditions. Many FOMC participants view downside risks to growth as having increased since the last meeting. In particular, the state of the economy leaves it vulnerable to shocks, which may arise from European sovereign debt issues, unfolding US fiscal austerity, and household financial conditions. Inflation forecasts over the medium term are for subdued growth after temporary price shocks dissipate. High resource slack will contain any inflation fears for a considerable time. The FOMC discussed possible tools for implementing more accommodation at this stage in the business cycle: lowering the interest on excess reserves, lengthening the average maturity of the System Open Market Account, use of more forward guidance, and possibly tying decisions to a numerical inflation or unemployment rate. Some FOMC members believe that monetary policy may be ineffective in combating the long-term rigidities that are currently holding back a robust recovery. The minutes, therefore, show a Fed more willing to ease, but with some internal convincing required. However, even the dissenters do not paint a rosy picture of the economy: they are dissenting because they envisage problems that cannot be remedied by monetary policy. The easing camp sees conditions as deteriorating. So no matter how you slice it, the outlook is dire, but the monetary policy role is different. The tools to be used so far are not a surprise and we do not think the Fed is sure which one will pack the best value for money just yet. Given the easing camp felt that the use of forward guidance was a measured step towards more aggressive easing, we can expect more accommodative measures if economic conditions deteriorate further.

Chart 1
Volatility Index

Source: BBVA Research and Bloomberg

Chart 2
Inflation Expectations (%)



Source: BBVA Research and Haver