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Fed Watch

US

2 November 2011
Economic Analysis

US

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FOMC Statement: November 2

Discussion gravitating towards more stimulus

- **Bernanke sees no need for a nominal GDP target at present**
- **MBS purchases are a "viable option" and likely to act in 2012Q1**
- **Fed to provide new communication strategy in December**

FOMC members downgrade their growth forecast for 2012-2013

Today's press conference revealed more insight into monetary policy than today's statement. The statement today repeated many of the themes from the previous FOMC meeting, but with a dissent from one member urging more accommodation. While growth strengthened in the third quarter of the year, overall economic conditions remain insufficiently strong to appreciably reduce the unemployment rate. Growth remains limited by household deleveraging, global financial uncertainty, sluggish residential investment and tight credit conditions. The lack of new insight from the statement reflects the strong internal discussion occurring within the Fed regarding the need for additional stimulus. We believe the FOMC needed more time to consider the effects of potential new tools and the maturity lengthening program and thus used this meeting to build consensus for further action. The Federal Reserve's new projections suggest a downgraded outlook for the economy, which ties into the robust internal discussion occurring now. In particular, the FOMC lowered their estimate for 2012-2013 GDP growth and increased their projection for the 2012-2013 unemployment rates.

Today's press conference did provide clarity on a few issues. For example, the Chairman said that a nominal GDP target is not needed at the present time and that the current mandate-related targets are sufficient. Part of his comments may also reflect his long-held affinity for inflation targeting regimes. Bernanke also said that purchases of mortgage-backed securities (MBS) are a "viable option" for the Fed "if conditions warrant." Bernanke mentioned insufficient growth and falling inflation as two possible metrics for MBS purchases. The Chairman also said no decision on new communication methods had been made and the FOMC is still considering different options. One of the impediments to the effectiveness of monetary policy is the tightness of credit standards, according to Bernanke, which are breaking the transmission mechanism from policy to real estate. Additionally, the Chairman said it is too early to adequately gauge the performance of the maturity lengthening program.

Table 1
Federal Reserve Forecast Comparison, November 2 FOMC Statement and Press Conference

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

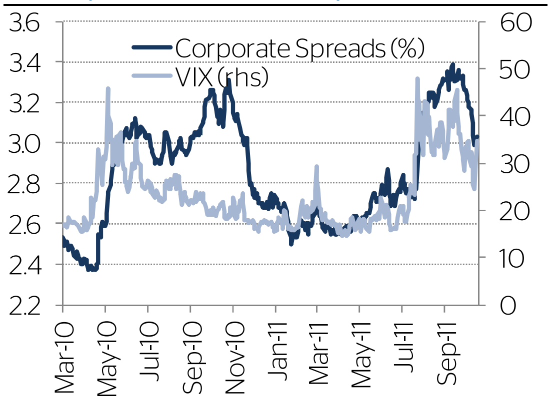
Nov 2011 FOMC Projections					
	2011	2012	2013	2014	Long-term
GDP, 4Q yoy % change					
High	1.8	3.5	4.0	4.5	3.0
Low	1.6	2.3	2.7	2.7	2.2
Unemployment rate, %					
High	9.1	8.9	8.4	8.0	6.0
Low	8.9	8.1	7.5	6.5	5.0
Core PCE, yoy % change					
High	2.0	2.1	2.1	2.2	---
Low	1.7	1.3	1.4	1.4	---

Source: Federal Reserve

Bottom line: Communicate in December, stimulate later

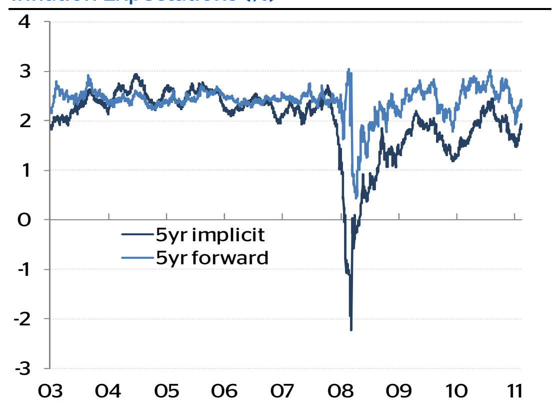
We believe that a strong probability of additional large-scale asset purchases of MBS exists, but the timing of this is not certain given potential dislocations arising from European negotiations and the US fiscal commission. Given the Chairman's press conference today, we regard the first step of the FOMC towards more stimulus will involve a new communication mechanism in December. Our impression of the press conference is that Bernanke appears to be more amenable to tying action to specific conditions rather than publishing the Fed's forecasts. This will provide the FOMC an incremental step before entering into another large scale asset program that will require more solid support of FOMC members. The December meeting has the potential for more drastic action only if financial conditions worsen considerably. Additionally, January's meeting will involve a change in committee membership and new members will lean more towards Bernanke's views. Therefore, we believe there is a high, but not certain, probability that a new round of MBS purchases will occur in January. Given the "attenuated" transmission mechanism and continuing high unemployment, the Fed will attempt again to push residential investment by engaging in large-scale asset purchases.

Chart 1
Volatility Index and BAA Bond Spread



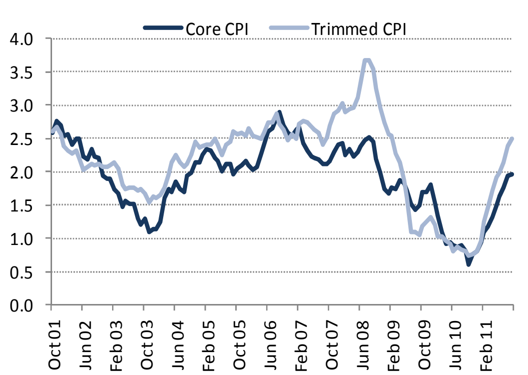
Source: BBVA Research and Haver

Chart 2
Inflation Expectations (%)



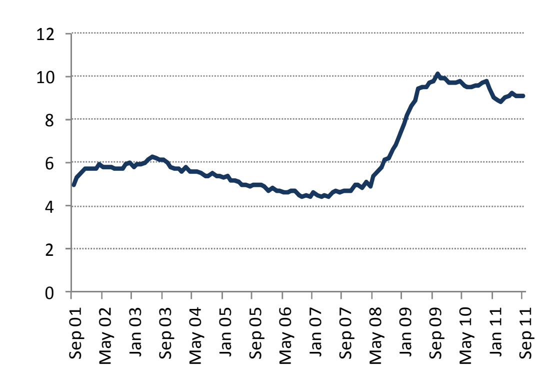
Source: BBVA Research and Haver

Chart 3
Underlying Measures of CPI Inflation



Source: BBVA Research and Haver

Chart 4
Unemployment Rate (%)



Source: BBVA Research and Haver

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