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Fed Watch

US

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Economic Analysis

US

Hakan Danış
hakan.danis@bbvacompass.com

Jeffrey Owen Herzog
jeff.herzog@bbvacompass.com

Nathaniel Karp
nathaniel.karp@bbvacompass.com

FOMC Minutes: December 13

New Developments in Communication

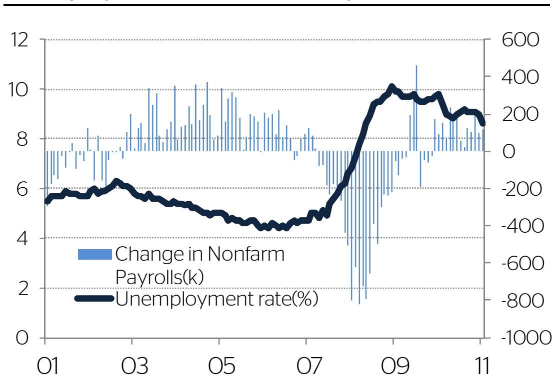
- **Fed to release forecasts of target rate, timing of first rate hike in January**
- **Economic outlook unchanged, FOMC views recovery as fragile**
- **Participants still working on how to transmit long-term policy goals**

Minutes reveal discussion of labor market indicators, communication policy

Today's release of the minutes revealed few changes in terms of the Federal Reserve's economic outlook, but suggested important changes to the Federal Reserve's communication of monetary policy. Turning to the economic outlook first, many of the persistent drags on the economic highlighted in previous statements and minutes remain in place. While indicators of economic activity over the past two months support moderate GDP growth, the fragility of the recovery remains an issue alongside potential shocks from a worsening European debt crisis. Federal Open Market Committee (FOMC) participants regard inflation as moderating and expect it to eventually converge to a rate at or below the Fed's mandate given persistent excess resource slack. Consumer spending arrived stronger than the FOMC's expectations, but they continue to express concerns that this trend might be unsustainable given that the growth in real disposable income is not consistent with strong growth of personal consumption expenditures. A number of different views prevail on the labor market, with the minutes highlighting different implications of the unemployment rate, gross labor flows in and out of unemployment, and the participation rate. The crux of the discussion hinges on whether or not structural unemployment has increased or if the decline in the labor force represents an erosion of potential GDP. In total, committee members noted that their overall economic assessment had not changed appreciably since the last meeting.

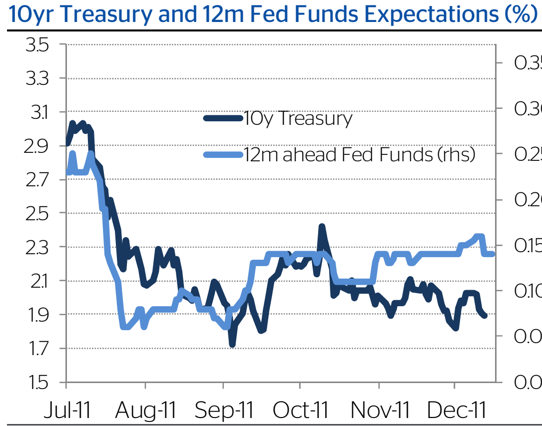
The second major development in the minutes relates to monetary policy communication. The FOMC agreed to release the future path of the Federal Funds Target Rate, a long-run level of the rate, and a timing of the first rate increase as part of January's forthcoming Summary of Economic Projections (SEP). We believe that it is important to separate the communications policy improvement from the decision to add or decrease monetary stimulus. The decision to include new

Chart 1
Unemployment and Nonfarm Payroll



Source: BBVA Research

Chart 2
10yr Treasury and 12m Fed Funds Expectations (%)



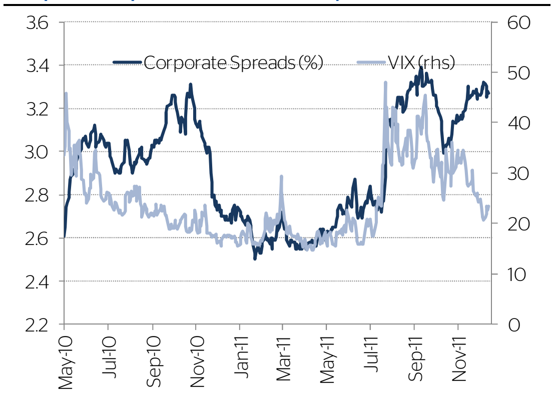
Source: BBVA Research

forecasts represents a costless improvement to monetary policy. The result may or may not be expectations of a later first rate hike, but the purpose of the policy is to provide more transparency to the financial markets of the FOMC's thinking and reduce uncertainty. A side effect of the decision will be to lower interest rate volatility or interest rate option volatility. The circumstances of this particular FOMC meeting are key: a number of FOMC members favor additional stimulus, but the rational for additional stimulus is not as solid as some would desire. This is because the Fed is still awaiting outcomes in Congress, in Europe and in the American consumer. Given this gap of time, it presents the FOMC an opportunity to develop its communications strategy. Internationally, central banks that follow an inflation targeting regime tend to public forecasts of their target interest rates. Although the Federal Reserve may never adopt a formal inflation targeting regime, it may wish to adopt some of the best tools to use in its own way.

Expectations for January

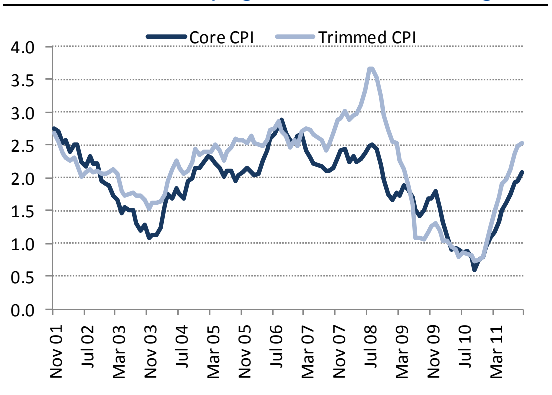
In the next meeting, we expect the FOMC to follow through on its comment in the minutes to release forecasts as part of the SEP. Given that we do not expect serious changes in economic activity during the intermeeting period, we do not believe the FOMC will alter their economic outlook. The Federal Reserve will remain focused on developments in Europe, which if poorly managed has the ability to trigger a risk scenario. The bands of the interest rate forecast and the timing of the first rate hike will represent the main focus of market watchers in the January meeting. As mentioned in the minutes, FOMC participants are still deciding on the best course of action for conveying their long-term monetary policy goals to the public. As such, we expect these to feature as questions to Chairman Bernanke during the press conference and also to feature in the minutes released in February.

Chart 3
Corporate Spreads and Volatility Index



Source: BBVA Research

Chart 4
Measures of Underlying Inflation (YoY % change)



Source: BBVA Research