BBVA | RESEARCH

Fed Watch

US

23 January 2012
Economic Analysis

US

Hakan Danış
hakan.danis@bbvacompass.com

Jeffrey Owen Herzog
jeff.herzog@bbvacompass.com

Nathaniel Karp
nathaniel.karp@bbvacompass.com

FOMC Meeting Preview: January 24-25

Many incomplete tasks to reactualize in 2012

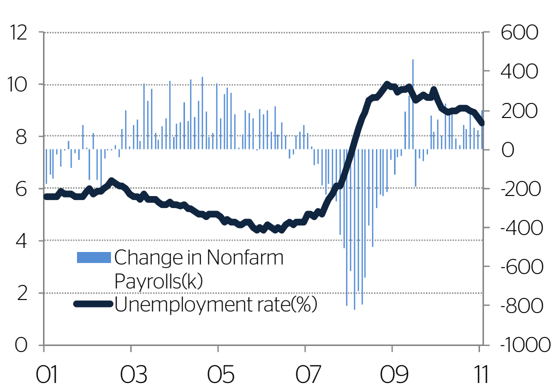
- **Recurrent attempts to fix the link between monetary policy and housing**
- **Conflicting employment, inflation indicators bow to change of members**
- **A more nuanced communications policy to further nudge expectations**

What to Expect from the Federal Reserve this Week

The forthcoming meeting of the Federal Reserve is a staging ground for policy initiatives that will last through 2012 and into 2013. In the coming months, the Federal Reserve must tackle anew a number of incomplete tasks from last year. Potential external shocks loom, the economic recovery is not yet certain, the linkage between monetary policy and housing is damaged, and quandaries remain in labor and inflation indicators. These themes will guide the Fed's thinking whilst the FOMC test-drives a new communications policy designed to deliver more nuanced instrument usage.

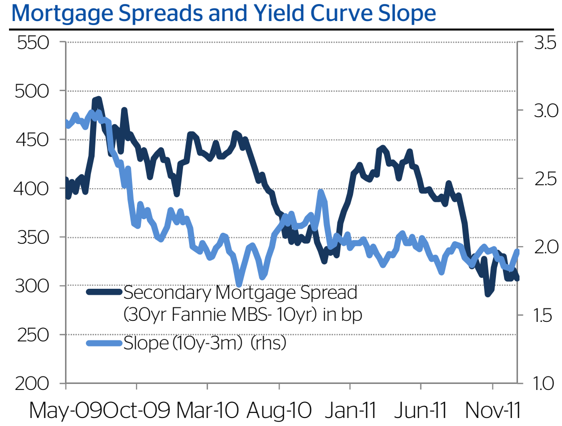
The attenuated link between the housing market and the target Fed Funds rate is emerging as a serious concern of the Fed given the central bank's recurrent comments on potential fixes for real estate. This is most clearly seen in the recent White Paper to the US Congress from the Federal Reserve. Away from the zero bound and outside of extreme oversupply of homes, the Federal Reserve's lowering of rates typically spurs investment in housing, which contributes to the early stage of an economic upturn. However, it is not simply the removal of oversupply that concerns the Fed. These concerns extend to changes in consumer behavior, reductions in household formation, and the lack of effectiveness of refinancing incentives. This fascination with rejoining the linkage between monetary policy and the housing market is the primary motivation for a second round of quantitative easing in some FOMC members' minds. The means of cauterizing the wound are not necessarily clear, however, as we believe further asset purchases will have limited effects, in contrast to the months around Lehman where such purchases clearly worked. The central bank cannot embark on a scheme of asset purchases without a clearly defined business cycle objective. In the case of 2009, avoiding financial turmoil could be identified in the asset spreads ameliorated through targeted purchases. In the case of late 2010, avoiding deflation could be identified through market and survey-based measures of inflation expectations.

Chart 1
Unemployment Rate and Nonfarm Payroll Change



Source: BBVA Research

Chart 2
Mortgage Spreads and Yield Curve Slope



Source: BBVA Research

However, today's economic conditions often imply conflicting signals to the Fed. These conflicting indicators often tend to spark significant conceptual differences between FOMC members. While the unemployment rate dropped, the duration of unemployment remains high and the change in the unemployment rate has been associated with a decline in the labor force participation rate. The evolution of inflation going forward likely reflects the waning commodities price spike of last year, but a few FOMC members suggest its future evolution will be dictated by the effect of lower potential growth and therefore less resource slack than currently envisaged. This represents an upside risk to inflation and a counterargument to another round of quantitative easing. Furthermore, it is unclear to what extent recent strength in economic growth is the result of greater internal momentum or the result of one-off effects. However, the level of divide on these conceptual issues will shift as a result of new FOMC members. Three hawkish members (Fisher, Kocherlakota, Plosser) and one dovish member (Evans) are being replaced by two dovish members (Williams and Pianalto) and a centrist (Lockhart).

Layered on top of the conflicting economic indicators, the attenuated monetary policy transmission mechanism, and the changing of the guard is the new thrust towards greater transparency and communication. Over the past 20 years, a number of important applied economics advancements have been made within the profession. Although the idea that expectations guide future inflation remains a cornerstone of analysis, the generation of trimmed-mean, median and sticky CPI indices have further developed the means of the central bank to look through headline inflation and towards so-called core price movements. Given the many counterfacutals in current economic indicators, the Federal Reserve needs more nuanced communication to guide the market's expectation of the policy rate. The gradual transition to a flexible inflation targeting regime is one means of doing so, but the best methods of communication remain to be determined by the FOMC. One wrinkle is already emerging from the fact that the Fed will publish FOMC members' expectations for the Fed funds rate, but these numbers will represent what members believe the future rate should be to achieve the dual mandate rather than where they actually think the Fed funds rate will rest in the future.

Bottom line: Miles to walk before they sleep

Overall, we are not yet convinced that the recent strong data suggests a self-sustaining recovery. We also believe the FOMC views the data in this manner. Added to this issue is the potential tail risk event emerging from a disorderly resolution to Europe's sovereign debt issues. We believe that the amount of excess housing inventory and the change in consumer attitudes towards residential investment has damaged the monetary policy transmission mechanism. We also surmise that any additional asset purchases, given the Fed's obsession with housing, will be targeted towards this aim, but will exhibit diminishing returns. The Fed will only commence renewed asset purchases in the event of a material slowdown in US economic growth or the clear emergence of a risk scenario. We regard the communications initiative and a general movement towards inflation targeting as an improvement to the conduct of monetary policy, but there will be a learning period for both the Fed and the markets as they grope towards a mutual understanding. Over the medium term, the Federal Reserve still has much work to complete, since the US recovery remains fragile, the link between policy and housing is damaged, and the balance sheet is stuffed with prior policy actions. The Fed's job remains incomplete.