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Fed Watch

US

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Economic Analysis

US
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FOMC Minutes Preview: January 24-25

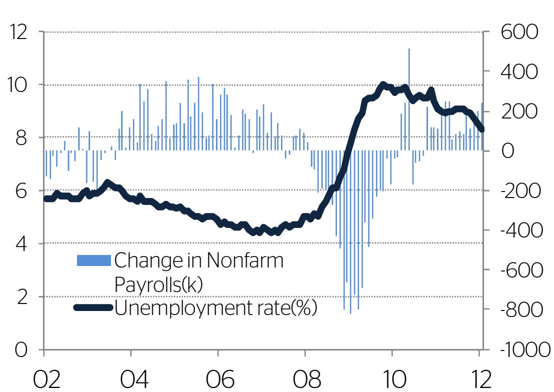
New era of communication, but continued doubts of the sustainability of the recovery

- **Effectiveness and design of communications, credibility of new forecasts**
- **Contrasting opinions of remaining resource slack and its effect on inflation**
- **Growing discord over the accurate description of the output gap**

What to Expect from the Federal Reserve this Week

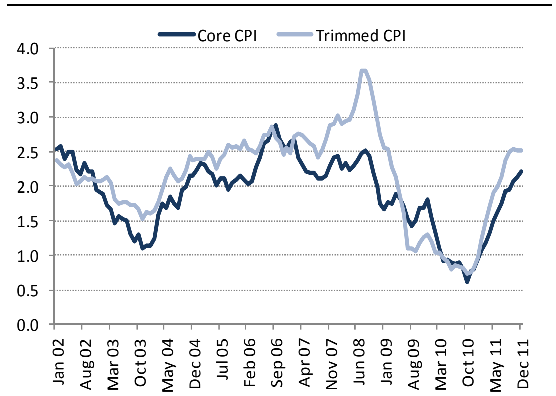
We regard discussions of excess labor market slack, the effective calculation of the output gap, measures to alleviate damage in residential investment and communication methodology as key points in the forthcoming FOMC minutes. The centerpiece of the minutes will be the FOMC's qualitative expectations of the size of the balance sheet. The Chairman already emphasized during the last press conference that, according to prior FOMC minutes, the Federal Reserve will only begin asset sales after normalization of the policy stance begins via target interest rate changes. As such, it will be important to note if any discussion of the composition of the balance sheet occurs. The most likely scenario is a lack of consensus on the discussion of the balance sheet and on the composition of the balance sheet. In reference to a risk scenario, the minutes' discussion of the balance sheet should reflect some members' uncertainty over the effectiveness of further asset purchases. However, the Fed's frequent public comments about the need to mend the link between monetary policy and damaged residential investment imply that potential future asset purchases will certainly target mortgage securities. The other significant communication policy discussion will revolve around the credibility of the FOMC and the recently-released expectations for the level of the target Fed Funds rate. Interest rates are inherently volatile and thus the released expectations are more a picture of the FOMC's accommodative stance rather than an actual forecast. As time progresses and new information is received, it will be possible to see how far Fed Funds futures are diverging from the FOMC's expectations. This credibility indicator will probably weigh on future FOMC meetings.

Chart 1
Unemployment Rate and Nonfarm Payroll Change



Source: BBVA Research

Chart 2
Trend Measures of Inflation



Source: BBVA Research

Inflation still represents a major quandary for the Fed, even if expectations are currently for inflation to remain at or below the new inflation target of 2.0% YoY. For example, if actual inflation is higher than expected over the next several months and no commodity price shocks occur, this result could reasonably be considered evidence of less resource slack in the economy. The reasons for less resource slack are numerous, but they mostly revolve around the effects of a wealth shock, potential growth calculations, the natural rate of unemployment, and population demographics, to name just a few. If less resource slack exists than currently estimated, this means that the Fed must fight inflation sooner than expected. The high rate of unemployment may not be mostly cyclical in this scenario and therefore the Fed would have to turn its attention to inflation. In effect, the Fed looses the war against fighting high unemployment, but continues to control inflation effectively.

This scenario, however, is not the base case in the Fed's mind. The majority of the FOMC expects inflation to remain low due to excess resource slack. As Bernanke commented in his speech on 7 February, he remains unconvinced of recent labor market indicators. Although labor conditions have improved over the past twelve months, the labor market cannot be considered as functioning normally. This is evidenced in high duration of unemployment, high levels of people involuntarily working part-time, and still-loose measures of labor market tightness. Given this scenario, the Fed has wide remit to continue its attempts to crack the response of housing investment and job openings to monetary policy. The potential further slowing of emerging markets and a disorderly resolution to Europe's fiscal woes further adds to the justification for the Fed's highly accommodative stance. Market-based measures of inflation expectations also indicate that inflationary expectations are not overwhelming. Nominal average hourly earnings of production and supervisory employees have trended in accordance with this view. Overall, we expect continued discussion of the many conflicting indicators of excess resource slack and their implications for inflation in the minutes.

Another major quandary for the Fed is the calculation of the output gap. Recently, James Bullard, a nonvoting President, stated his position that the gap between the level of GDP growth today and its prior peak is an unachievable benchmark. On the FOMC, the question is most likely the precise measurement of the output gap, which is sensitive to assumptions about demographics and the endogenous response of capital deepening to technological change. In short, if productivity does not grow as quickly as in recent memory, potential growth could be lower. Additionally, the response of hours worked to a sudden drop in financial wealth may be more persistent than currently anticipated by the Fed, which may translate into a smaller output gap. Overall, the uncertainty over this model hangs over the Federal Reserve and we expect further discussion of it in the minutes.

Bottom line: The Fed is looking for a beyond all reasonable doubt conviction

As mentioned above, the short-term market impact of the minutes will reflect the details of the qualitative description of the size of the balance sheet over time. Looking to the long-run, we regard the FOMC's caution in reading recent strong economic indicators as warranted given high duration of unemployment and expected future fiscal drag, just to name two factors mitigating stronger economic growth. The largest factor inhibiting stronger growth in the FOMC's mind is the lack of a definable bottom in the US housing market and the unhinged relationship between residential investment and monetary policy. The economy also remains vulnerable to external shocks, much like the shocks of 2011H1. Until a clear read on the economy is achieved the FOMC will continue to push interest rate expectations far into the future and moments of strong data will lure some to bet in the opposite direction.