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# Fed Watch
US

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Economic Analysis

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## Scenarios for the Federal Reserve
### A Review of FOMC Options for Action

- **Downside scenarios outnumber upside scenarios**
- **Handicapping the chance of a successful fiscal deal a major quandary**
- **Our baseline scenario is for a first rate hike in October 2014**

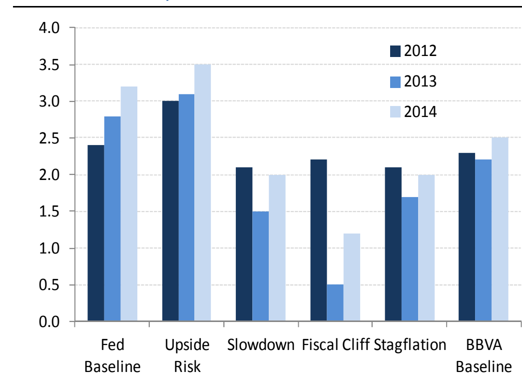
### Framing the Drivers of Present Monetary Policy Strategy

The minutes of the FOMC meetings often remark that the economic outlook contains an unusually high amount of uncertainty. The month-to-month data time and again fails to reveal a clear direction for the economy's evolution. For example, the most recent GDP release indicated strong consumption, but a large part of this may be related to pent-up demand purchases for automobiles. Employment indicators have improved over the past several months, but it is unclear if this is the result of demographic, seasonal or structural factors. When enough data arrives to reveal a clear strategy, the implications for monetary policy can be starkly different. For example, if potential growth is permanently lower and structural unemployment is higher, the Federal Reserve will need an early start in countering inflation and reigning in its highly accommodative stance. If the data reveal slow growth and deflationary pressures, then the Federal Reserve will need to redouble its efforts at stimulus. However, there is a gradient across these outcomes that results in several scenarios for the Federal Reserve. Specifying these different scenarios and mapping them to Federal Reserve actions is therefore helpful in guiding our expectations for the future. We outline some of these scenarios below.

### Federal Reserve Baseline

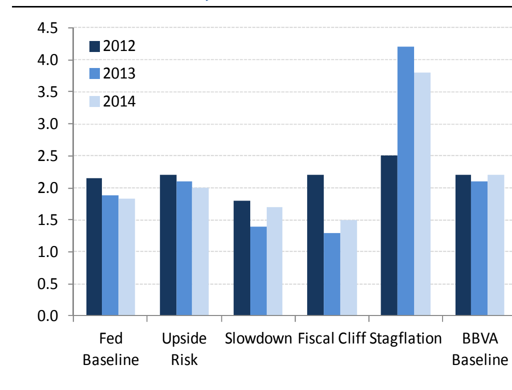
According to FOMC statements and speeches by Regional Federal Reserve Presidents, the central bank is expecting a temporary increase to inflation from oil prices. Inflation will subsequently run at or below the Fed's long-run inflation target. The Federal Reserve continues to see considerable excess resource slack and low rates of resource utilization in the data. The FOMC expects growth to be moderate over the course of the year and then to "pick up gradually." This gradual pickup in growth will also coincide with a gradual reduction in the unemployment rate. Recent speeches by Williams, Lockhart and other members of the Federal Reserve suggest the centrist consensus of the

Chart 1
**GDP Scenarios, Annual Rate**




Source: BBVA Research

Chart 2
**Inflation Scenarios, Annual Rate**




Source: BBVA Research

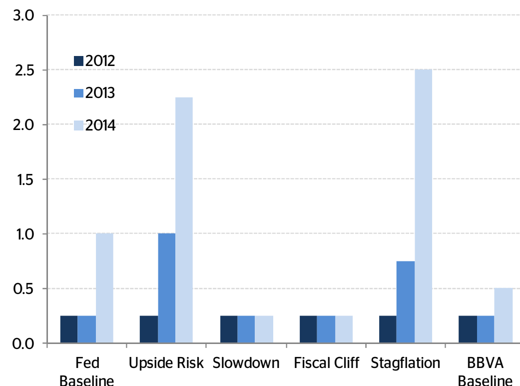
Fed is in control. This is a view that the economy still requires considerable accommodation via low rates, but taking further risks with balance sheet is not currently warranted. All indications so far from the Federal Reserve suggest the FOMC will end Operation Twist as scheduled at the end of June. Previous Fed communications imply they believe that the stock of purchases is more important than the flow of purchases. Therefore, ending Operation Twist would have a very limited effect on the yield curve. After the end of Twist the FOMC will take time to evaluate this theory's fidelity. However, this will depend on how the markets perceive the end of Operation Twist: either the Bernanke put has ended for good or the Fed's accommodative policies will continue in the near future.

One wrinkle in the Federal Reserve's baseline scenario, as is probably the case for most forecasters, is the exact probability of a failed fiscal deal. At the present time, the event of a fiscal disaster is still not large enough to merit placement in a baseline scenario, but it is a clear risk scenario. The Federal Reserve may have better political contacts than other forecasters, but the central bank will have to amend its baseline forecast as the probability of a fiscal disaster rises or falls over the next several months. This means that the best practice for the immediate months is for the Fed to communicate its concerns. Only when a spoiled fiscal deal reaches a higher probability will the Fed downgrade its baseline growth forecast accordingly.

## Upside

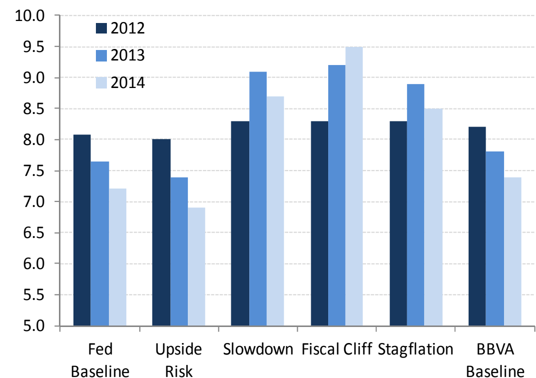
Economic projections suggest that downside risks to growth clearly outweigh the upside. However, even an upside risk scenario would result in a cautious and gradual policy response from the Fed. Consider a scenario with real GDP growth near 3% and inflation at or slightly above the 2% target, or a situation where European sovereign debt issues are neatly resolved or Congress creates a fiscal grand bargain. Given the lagged data releases and annual revisions to growth, the Fed would be unlikely to raise rates any sooner than late 2013. To counteract any criticisms of delayed action in a growing economy, the Fed would be more inclined to enhance their communication strategy and make gradual changes to the forecast tables released to the public. In addition, it would be necessary for the Fed to carefully manage the outflow of reserves to maintain control over inflation via term deposits or reverse repurchase agreements. In this scenario, the Fed's balance sheet will receive much higher scrutiny of its size and composition than what typically occurs today. Previous Federal Reserve speeches and minutes suggest that the FOMC would not move to sell securities from its portfolio until it begins to raise interest rates. Actions in this vein might be to tie the pace of asset sales to the pace of interest rate increases. Additionally, the Federal Reserve could attempt as an intermediate step to create an "Operation Untwist," or a shortening of the average maturity of its securities holdings. This maturity shortening could occur before any interest rate increases and would work in tandem to changes in the communications strategy.

Chart 3
**Fed Funds Rate Scenarios, In % (EOP)**




Source: BBVA Research

Chart 4
**Unemployment Rate Scenarios, In %**




Source: BBVA Research

## Slowdown

One of the clearest scenarios for discerning Federal Reserve action is the case where growth slows and deflation risk rises notably. If GDP growth were to slow below 2.0% per year and PCE inflation falls below 1.5%, the Fed would find itself again combating a deflationary spiral with additional quantitative easing. If this also coincides with increased financial instability, the job of the Fed is magnified due to its role as a liquidity provider of last resort. Federal Reserve action in this scenario is to preempt an even stronger slowing of the economy to the point where it reaches a full-blown recession. If quantitative easing is not successful in preventing a slowdown from turning into a recession, the Fed may have to turn to more experimental methods of quantitative easing to combat deflation, much like the case of Japan in the 1990s. In Japan's case, the central bank purchased assets that included corporate bonds, exchange-traded funds, and real estate investment trusts, in addition to government bonds. The reason for turning to more experimental methods is that the longer deflation persists, the greater need for innovative methods for reducing term and risk premia.

## Fiscal Cliff

Recently, the Fed has become more vocal regarding the uncertain fiscal outlook, stressing the need for reforms as we approach the 2013 target for automatic clauses in the Budget Control Act. Congress is sitting on the imperative decision of how to handle the $7 trillion worth of tax revenues and spending cuts that will be triggered by year end. Similar to the debt ceiling debacle back in the summer of 2011, the debate in Congress will certainly cause higher financial market stress as the year progresses without some sort of an agreement. Inaction would trigger automatic spending cuts and ultimately knock into growth prospects for 2013. Depending on whether PCE inflation is above or below the 2% target, the Fed could implement either sterilized or unsterilized quantitative easing to provide stimulus and combat the slowing economy. While there are some options on the table, Bernanke has clearly acknowledged the fact that "if no action were to be taken, the size of the fiscal cliff is such that there's no chance that the Federal Reserve could or would have any ability whatsoever to offset that effect on the economy." Unlike a slowdown scenario, the fiscal cliff scenario entails more fine-tuned monetary policy decisions because of the highly unstable fiscal component of GDP. While in the slowdown scenario, fiscal conditions are constant or following trend, the fiscal cliff imparts a serious deviation from trend, both in terms of the data and in terms of politics. As opposed to free reign in the slowdown scenario, in the fiscal cliff scenario the Fed will need to weigh the benefits of policy actions to offset fiscal cuts. The Fed will need to consider its role in enabling bad behavior from Congress via stemming the effect of cuts, but at the same time considering its independence from politics.

## Stagflation

A trickier scenario for the Federal Reserve is stagflation. Very strong stagflation is an unlikely occurrence. During the 1970s, the United States experienced an episode of stagflation that arose, according to a speech by Bernanke in 2003, as a result of a spotty Fed track record in fighting inflation, political pressures, and overly optimistic assessments of the economy's growth potential, amongst other reasons. This period also coincided with a structural shift in global oil markets, which further contributed to unhinged inflation expectations. One of the most important factors in Bernanke's estimation is the credibility of the Federal Reserve in combating inflation. In the historical experience of other countries, strict labor market laws may also contribute to a stagflation event, but this is unlikely to be the case given the flexibility of US labor markets. In historical experiences of stagflation, the best remedies are institutional fixes to labor markets and credible, independent central banks. Since this second institutional structure is in place, most of the pressure to act is via legislative means until inflation pressures rise to an uncomfortable level. At this point, the Fed would have to consider strongly hiking rates to reestablish low inflation expectations.

A more reasonable risk scenario reminiscent of stagflation would occur if GDP were to grow at a 1.7% to 2.0% annual rate and PCE inflation were to rise above a 2.5% annual rate. In this situation, the Federal Reserve could only act to provide more accommodation if it proves that the rise in inflation is temporary or the result of one-off factors. A more likely scenario would be for the Federal Reserve to turn to sterilized bond purchases in order to provide stimulus. This policy tool would at least have the perception of less of a link to inflation growth than outright asset purchases. Nevertheless, this

stagflation scenario would be rife with political problems for the Federal Reserve's communications strategy. It would most likely be difficult for the FOMC to convey their policy aims to the public in this scenario. This would be further complicated by the fact that a mix of slow growth and higher inflation would spark a more populist political environment that would work against the Federal Reserve. In the end, the Federal Reserve will place inflation expectations above all other considerations.

## Bottom line: BBVA Baseline Scenario

Our primary scenario – and what we regard as the most probable outcome – is for continued moderate growth over the next two years due to significant headwinds: household deleveraging, persistent weakness of the housing sector, fiscal drag and Europe's recession. We expect that Congress will reach some sort of agreement on fiscal policy so that austerity measures would be smaller than the situation where Congress does nothing. Even in this scenario, the fiscal drag would be sufficient enough to slow down the US economy in 2013. Our expectation for GDP growth is lower than the central tendency of the Federal Reserve, thus our outlook foresees more of a probability of additional quantitative easing than probably currently considered by the FOMC. We expect the Fed Funds rate to remain low until a first rate hike in October 2014. The evolution of core inflation will be around 2.0% for the next two years as a result of continued high excess resource slack.

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