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Fed Watch

US

Houston, August 1, 2012
Economic Analysis

US

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FOMC Statement: July 31 – August 1

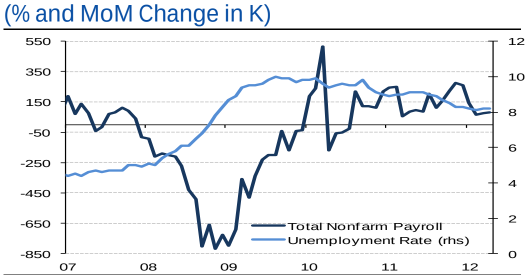
QE3 Debate Carries on Among FOMC Members

- Statement reflects more negative view on recent economic activity
- Weak 2Q12 GDP growth not enough to spark immediate reaction from Fed
- The lack of fiscal progress in Congress will likely push the Fed toward QE3

No Changes to Monetary Policy, but Probability Increases throughout 2H12

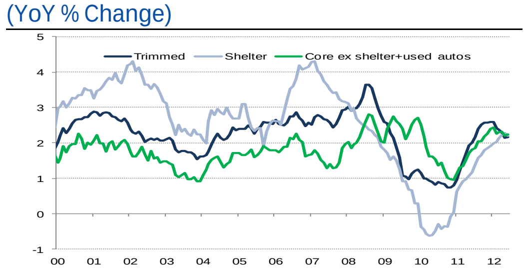
The FOMC statement issued today did not feature any additional monetary policy announcements but instead highlighted a weaker economic outlook, as recent data have shown. Throughout the intermeeting period, economic data have deteriorated but not quite enough to convince all committee members that further action is necessary. The fact that there were no significant changes to the meeting statement and the lack of policy action highlight the intense debate within the FOMC, and more time is needed for a majority agreement. The statement indicates that the Fed's economic outlook has deteriorated given the weak 2Q12 GDP growth rate, elevated unemployment rate, low payroll estimates, slowing manufacturing activity, and deteriorating conditions in global economies. Inflationary concerns are minimal, although rising food prices could continue to put upward pressure on the headline figure. As we have discussed before, July's nonfarm payroll number to be released this Friday will provide a clearer picture of labor market trends. While we were able to partially blame the weak 2Q12 employment growth on seasonality issues, the job report in July will be more reflective of the latest economic activity. Our monthly activity index points to weak economic growth in the coming months, which increases the probability for additional monetary easing. The Fed is also waiting for Congress to address the looming fiscal cliff, and we foresee that QE3 will become more and more attractive as time passes by without any fiscal progress. Overall, we believe that the Fed is seriously considering further action but needs to see more data with additional time to discuss. The addition of July's employment data, which will be released this Friday, and the upcoming Jackson Hole meeting will provide a chance for the Fed to better discuss further policy action. We expect that the Fed will take action in September or the following meeting if economic conditions deteriorate further, with the most likely scenario additional quantitative easing. The Fed will probably implement its options one at a time, rather than in combination. Other options on the table are less likely at this point, such as a change in the Fed's monetary policy guidance or a reduction in the interest rate on reserves. Changing the policy guidance would be a poor substitute for additional monetary stimulus and would have minimal impact on economic activity.

Chart 1
Unemployment Rate and Nonfarm Payrolls
(% and MoM Change in K)



Source: Federal Reserve & BBVA Research

Chart 2
Underlying Measures of CPI Inflation
(YoY % Change)



Source: Federal Reserve & BBVA Research