RESEARCH

Fed Watch

US

Houston, September 13, 2012
Economic Analysis

US

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FOMC Statement: September 12-13th

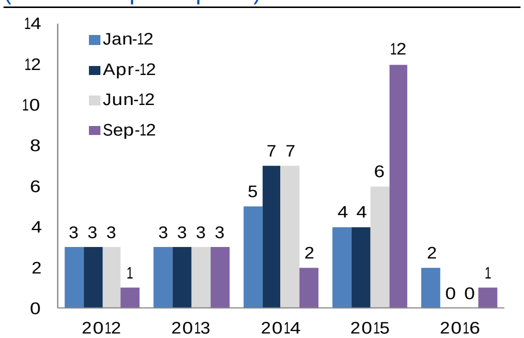
Fed Announces QE3 and Extends Policy Guidance

- Effective immediately, the FOMC agreed to purchase $40bn per month of MBS on an open-ended basis
- The Fed also extended its policy guidance through at least mid-2015 and will continue Operation Twist through the end of the year
- Committee members downgraded their outlook for 2012 but upgraded growth projections for 2013

Today's FOMC announcement mostly lived up to market expectations. Despite the fact that recent macroeconomic data were not a dead giveaway for QE3, the Fed decided to move forward with additional easing in order to stimulate the economy. As expected, this round of quantitative easing will be slightly different than the previous two rounds, with plans to purchase $40bn per month of mortgage-backed securities (MBS) on an open-ended basis (i.e. until we see substantial improvement in labor market conditions given that inflation is under control). The purchases will start tomorrow, totaling $23bn for the rest of September. According to the Open Market Trading Desk, agency MBS purchases associated with both principal reinvestments and additional asset purchases will most likely be focused in newly-issued agency MBS, but other purchases may be warranted under certain circumstances. Details regarding the exact amount of upcoming MBS purchases will be announced near the last business day of each month. Other upcoming purchases (i.e. those associated with reinvestments of principal payments on agency securities holdings) will be announced near the eighth business day of the month. The FOMC also decided to continue Operation Twist as scheduled through the end of the year. Ultimately, both policy accommodations will increase long-term securities holdings by about $85bn per month until the end of 2012. In addition, the FOMC announced an extension of their policy guidance. The committee expects that "exceptionally low levels for the federal funds rate are likely to be warranted at least through mid-2015" rather than late-2014 as announced in the previous meeting.

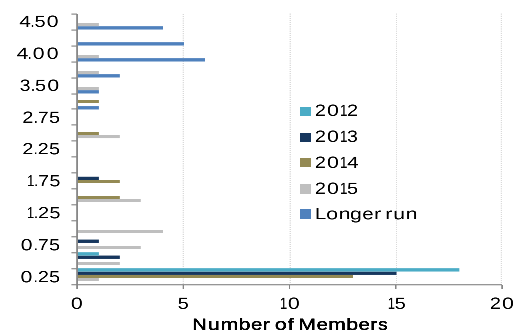
The FOMC also released today its Summary of Economic Projections. In general, committee members downgraded growth forecasts for 2012 but upgraded the outlook for 2013. Compared to our own baseline scenario, we continue to see a more optimistic outlook from the Fed.

Chart 1
Appropriate Timing of Policy Firming
(Number of participants)



Source: Federal Reserve & BBVA Research

Chart 2
Target Federal Funds Rate Forecast
(Year-end %)



Source: Federal Reserve & BBVA Research

On average, the Fed's projections suggest annual growth between 2.1% and 2.5% for 2013, higher than our expectations for a 1.8% annual rate. Bullish long-term projections remain unchanged from the previous release. In regards to the appropriate timing of policy firming, we see a dramatic shift from the June meeting in the number of participants expecting the first target rate hike in 2015.

Following the announcement, Fed Chairman Ben Bernanke participated in a press conference in order to clarify the FOMC's policy decisions. To start, Bernanke addressed a few common concerns with additional quantitative easing. First, he mentioned that MBS purchases are not comparable to government spending given that the Fed buys financial assets rather than goods and services. He stated that the Fed has been sending revenues from its MBS operations to the Treasury and is therefore helping the Treasury to lower the budget deficit. Another concern is that low interest rates are bad for savers, and while this is the case, Bernanke emphasized that the Fed's policy actions support mortgage and business loans that are imperative to economy activity and that in the end, Americans will be better off. Finally, Bernanke calmed worries that QE3 would boost inflation, noting that long-term expectations remain stable and that if inflation does rise above the target, the Fed will work to balance its policy to be consistent with the dual mandate. It is important to note that the inflation mandate refers to mid- and long-term rates, so short-term price increases that may occur would not necessarily have an immediate impact on policy.

Many questions from the audience related to the open-ended aspect of this third round of quantitative easing. The biggest concern with the announcement appears to be the lack of a policy reaction function to establish a clear goal for when the purchases will end. While the FOMC does not have a specific set of target numbers in mind, Bernanke emphasized the importance of reaching a point where the economy is growing fast enough to generate jobs at a sustainable pace. Stronger employment growth and a gradual decline in the unemployment rate are key issues that will determine when an exit strategy will be appropriate. As always, the Fed will "employ policy tools as appropriate" until we see desired improvements in the labor market. Other options include further balance sheet actions and/or restructuring of current policies as well as communication tools.

Bottom line: FOMC remains far from an exit strategy

Today's FOMC statement and Chairman's press conference highlighted the prolonged extent to which the Fed will continue with easy monetary policy. Ultimately, Bernanke made it clear the Fed's highly accommodative stance will be appropriate even as economic growth picks up. The FOMC is committed to promoting a stronger recovery and will be careful not to prematurely tighten monetary policy in order to give some time to the economy to show steady growth. Prior rounds of quantitative easing have been effective in helping economic growth, yet monetary policy cannot solve the problem on its own. As in previous communications, Bernanke highlighted the need to address the fiscal cliff while simultaneously focusing on long-term fiscal sustainability. Monetary policy "is not a panacea."

Table 1
Federal Reserve Forecast Comparison: September 13th FOMC Statement and Press Conference (Central Tendency)

Sept 2012 FOMC Projections						June 2012 FOMC Projections					
	2012	2013	2014	2015	Long-term		2012	2013	2014	2015	Long-term
GDP, 4Q yoy % change						GDP, 4Q yoy % change					
Low	1.7	2.5	3.0	3.0	2.3	Low	1.9	2.2	3.0	n/a	2.3
High	2.0	3.0	3.8	3.8	2.5	High	2.4	2.8	3.5		2.5
Unemployment rate, 4Q %						Unemployment rate, 4Q %					
Low	8.0	7.6	6.7	6.0	5.2	Low	8.0	7.5	7.0	n/a	5.2
High	8.2	7.9	7.3	6.8	6.0	High	8.2	8.0	7.7		6.0
Core PCE, 4Q yoy % change						Core PCE, 4Q yoy % change					
Low	1.7	1.7	1.8	1.9	---	Low	1.7	1.6	1.6	n/a	---
High	1.9	2.0	2.0	2.0	---	High	2.0	2.0	2.0		---

Source: Federal Reserve & BBVA Research