U.S. Fed Flash

Ahead of December 17th – 18th FOMC Meeting: Cautious or Bold?

- **Labor market outlook and budget deal increase the Fed's probability of taper**
- **Objective for the meeting: disentangle expectations of tapering from policy tightening**

The upcoming FOMC meeting on December 17th – 18th will have to address the ongoing improvements in the labor market highlighted by the sudden drop in the unemployment rate to 7% and by strong payroll figures. At the same time, inflation continues to run low and is a front FOMC concern. While the taper remains "on the table" for the December meeting, the Fed will also evaluate the financial market conditions, and the interest rates sensitive sectors.

The labor market outlook alone increased the Fed's probability to announce the beginning of the taper. Furthermore, the bipartisan budget deal that will fund the government for FY2014 and FY2015 will remove the Fed's concern over political uncertainty and the fiscal drag. The readiness to taper was confirmed by Bullard, FRB St. Louis, who concluded the Fedspeak before the blackout period: "A small taper might recognize labor market improvement while still providing the Committee the opportunity to carefully monitor inflation during the first half of 2014. Should inflation not return toward target, the Committee could pause tapering at subsequent meetings." Nevertheless, if cautious, the Fed would likely remain concerned about low inflation, the potential of tightening financial conditions, and the sustainability of labor market outlook, and consequently postpone the decision to 1Q14.

Most importantly, the FOMC main objective for the meeting will be how to disentangle successfully the market's expectations on tapering from the expected path of the policy rate. Breaking the link between the taper talk and the forward guidance is on the front of the Fed's agenda. Taper or not, the Fed will likely introduce a modification or addition to the forward guidance. The choices laid out by the FOMC are introduction of an inflation floor of 1.5% or reduction of the threshold of the unemployment rate. The likelihood of the second option is small and could risk the Fed's credibility.

Table 1
Taper-Matrix: FOMC Set Goals, Economic Outlook Before QE3 Start , December 2013 and March 2014

	FedSpeak	Ahead of FOMC Meetings		
Economic Indicators	Goal	Sep-12 QE3 Start	Dec-13	Mar-14
Unemployment rate	7%	8.1%	7.0%	6.9% to 7.2%
3M MA Change in Nonfarm Payroll	190K	122K to 135K	193K	185K to 200K
Number of Unemployed per Job Opening	2	3.35	2.87	2.47 to 2.51
PCE Inflation (YoY)	2%	1.58%	0.74%	1.2% to 1.4%
Financial Conditions index*	(-)	-0.78	-0.94	-0.75
BBVA Policy Uncertainty Index**	(-)	1.73	-1.1	-1.86

*(+)=tightening
**(+)=high uncertainty

Source: BLS, BEA, FRB Chicago & BBVA Research

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