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Fed Watch

US

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Economic Analysis

US
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Ahead of April 30-May 1, FOMC Meeting

FOMC Voting Members Address the Extent of QE3 and the Exit

- **Projections are similar on the pace of asset purchases but diverge on the future of the balance sheet and how to exit**
- **Discussion of inflation vs. unemployment targeting and the sustainability of labor market improvements**

Within the last week, 8 of the 12 FOMC voting members made public appearances to discuss monetary policy and to offer an evaluation of financial stability and the economic outlook. These appearances come ahead of the FOMC 2-day meeting starting on April 30th.

QE3: The expectation is that the upcoming meeting is not likely to bring any big policy surprises. There will likely be no change in the pace or composition of asset purchases. Backed by the slowdown in March payroll growth, the dovish members of the committee - Dudley and Evans - emphasized that the labor market improvement seen in the previous 4 months is not sustainable and should be characterized as "moderate" rather than "substantial." The majority of the voting members consider the current highly accommodative monetary policy stance to be appropriate, stressing that the benefits - such as the quickening pace of interest rate sensitive spending on consumer durable goods, housing, and capital goods - continue to outweigh the risks to financial stability posed by the policy.

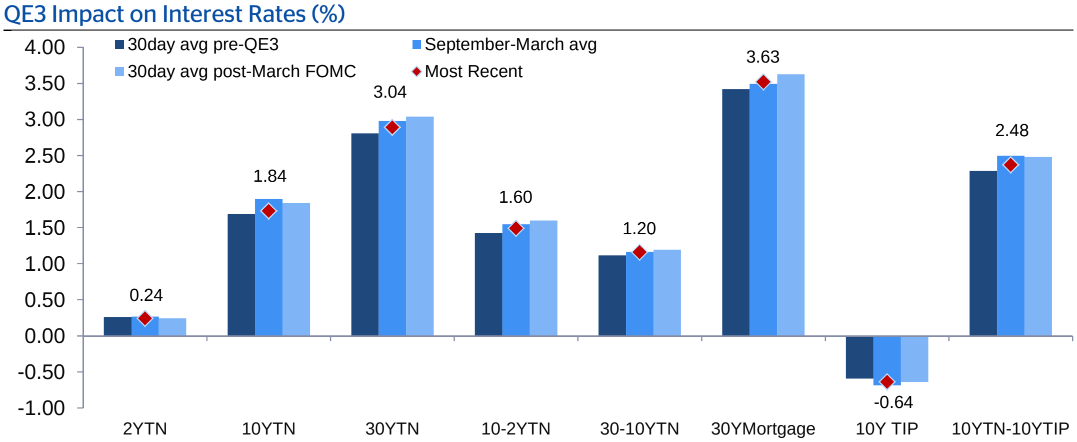
Yellen (April 16, 2013): *"I don't see pervasive evidence of rapid credit growth, a marked buildup in leverage, or significant asset bubbles that would threaten financial stability."*

Dudley (April 16, 2013): *"(The FOMC) will continue purchasing assets until it sees substantial improvement in the outlook for the labor market, conditional on ongoing assessment of benefits and costs."*

Duke (April 16, 2013): *"Keeping interest rates low has helped keep many borrowers from missing loan payments."*

Ruskin (April 18, 2013): *"...accommodative monetary policy that lifts economic activity more generally is expected to increase the odds of good outcomes for American families."*

Chart 1
QE3 Impact on Interest Rates (%)



Source: Federal Reserve & BBVA Research

We maintain our projection that the current pace of purchases will continue through mid-2013, will begin tapering off in 3Q13, and will come to an end by January 2014. No change in the composition of current asset purchase program is expected. Our current projections are re-enforced, as Dudley suggests a period of 3 to 6 months of no policy change to clear the effect of fiscal policy that in his view had a sharp shift from mild restraint in 2012 to much greater restraint in 2013. Furthermore, Evans repeated his opinion that there should be payroll growth of at least 200,000 per month for several months coupled with above-trend real gross domestic product growth before considering any change to the current policy. He assigned a "high probability" to the FOMC keeping the same pace of purchases through the Fall and beginning to exit by the end of 2013. Dudley and Evans join Bernanke, Yellen, and the remaining dovish members of the FOMC in the view that cyclical factors are the reason behind the weakness in labor market conditions. Our forecast of unemployment rate corresponds closely to the Federal Reserve's upper bound forecast for unemployment, suggesting that the 2Q13 cyclical unemployment, measured as the difference between the unemployment rate and the non-accelerating inflation rate of unemployment (NAIRU), is at 1.03%. NAIRU for 2Q13 is estimated at 6.6% and the 2013 average is estimated at 6.5%, which is in line with the Fed's current policy thresholds of what would constitute healthy economic activity.

George, who was the only dissenting vote at the first two 2013 FOMC meetings, continued to urge that prolonged use of "emergency" policies, such as near zero interest rates and large scale asset purchases, carries significant risks: "I am concerned that monetary policy at its current settings is overly accommodative relative to the long and variable lags with which it operates. Central banks must focus on achieving sustainable growth in the long run and be patient in pursuing its longer-run goals." This makes us to believe that she will continue to be the single vote against the FOMC actions in the meetings ahead.

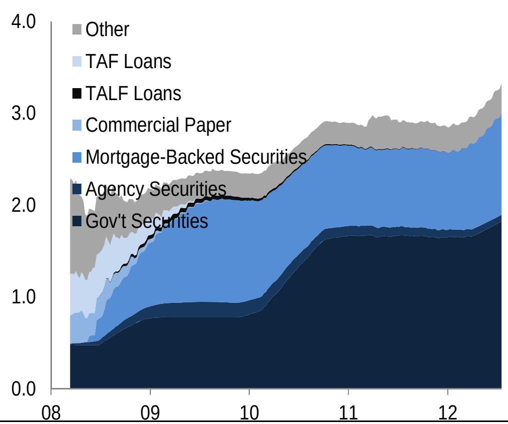
Exit: The Federal Reserve balance sheet includes $3.2 trillion of assets and, with the current pace of purchases of $85bln per month, should reach $3.54 trillion by the end of July. We project that by January 2014, balance sheet assets should hover close to $4 trillion. The question on the public's mind as well as that of some Fed officials is whether the Fed is prepared for the exit, when the time approaches for to exit from its accommodative policy. The framework for the exit strategy was crafted during the June 2011 FOMC meeting when the balance sheet was at $2.85 trillion. Plosser, an alternate voting FOMC member in 2013, and a voting FOMC member in 2014, was actively involved in the June 2011 exit outline and called for necessary changes to the exit strategy that will need to be agreed on.

Plosser: *"A lot has changed with respect to the economy and monetary policy over the last two years. So it is entirely appropriate to reconsider the Fed's exit strategy."*

Opinions regarding the exit diverge along 2 possible paths: The first exit scenario, strongly backed by Plosser, is similar to the outline of June 2011: normalization of balance sheet within 2-3 years, with the sale of mortgage back securities (MBS) complete within 3-5 years, a return to the federal fund rate as the primary policy instrument, and a return to the pre-crises portfolio of predominantly short-term Treasuries. The risks to the implementation of the following exit scenario include capital losses due to the sale of long-term assets in an environment of increasing interest rates, as well as disruption of the MBS market if the pace of MBS sales is moderate enough. The second option for exit, first mentioned during Bernanke's congressional testimony and later echoed in several FOMC voting members speeches (Ruskin, Bullard, and Evans), is simply to hold the long term assets to maturity. This second scenario implies that the interest rate on reserves will be the policy rate, thus the size of the Federal Reserves' balance sheet would be irrelevant and could expand to be large without affecting the implementation of monetary policy. The outcome will be the loss of remittances, as the Fed will pay a higher interest rate on reserves than it will receive on the securities held. However, the risk of market distortion will be avoided.

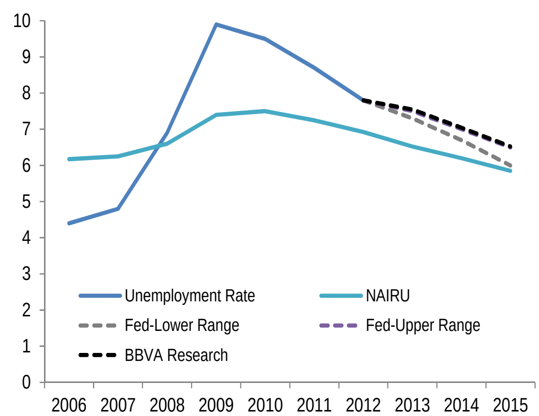
Unemployment vs. Inflation targeting - the dual mandate: In the face of accommodative monetary policies around the world and likely triggered by Japan's decision on monetary easing, Yellen and Rosengren underscored the advantages of the Federal Reserve's dual mandate and flexible inflation targeting policy in contrast to exclusively inflation targeting, noting that it helps in achieving clarity, transparency of communication with the public and with maintaining the central bank's credibility. The transparency and communication with the public, formally called 'forward guidance,' has become the pivotal tool of monetary policy for an FOMC constrained with a zero lower bound. At the same time, Bullard addressed a more significant issue for the current Federal Reserve policy: the post-crisis suggestions that the FOMC should "put more weight" on unemployment in its decision-making process. Citing academic research, Bullard emphasized that 'price stability' should remain the main focus for the central banks, arguing that "attempts to address the various labor market inefficiencies solely with monetary policy do not work very well," and that "monetary policy alone cannot effectively address multiple labor market inefficiencies." Is he possibly a calling for a responsible fiscal policy?

Chart 2
Factors Supplying Reserve Funds ($tr)



Source: Federal Reserve & BBVA Research

Chart 3
Unemployment Rate (4Q %)



Source: Federal Reserve & BBVA Research

Bottom line: No changes to the QE3 are expected from upcoming April 30-May 1 FOMC meeting

There will likely be no change in the pace or composition of asset purchases. We maintain our projection that the current pace of purchases will continue through mid-2013, will begin tapering off in 3Q13, and will come to an end by January 2014. Opinions regarding the exit diverge along 2 possible paths. Fiscal policy poses lingers restraining on the economic growth and improvement in labor market, while monetary policy alone cannon address all the inefficiencies of present labor market. Committee members are watchful of substantial improvements in the labor market outlook and are prepared to dial down the pace of QE3 if they detect any evidence of improved economic momentum or overheating of credit markets. However the FOMC is also ready to dial up the pace of QE3 if the negative impact of fiscal policy turns out to be stronger than expected.

Citations

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