Central Banks

FOMC Statement: June 17th – 18th

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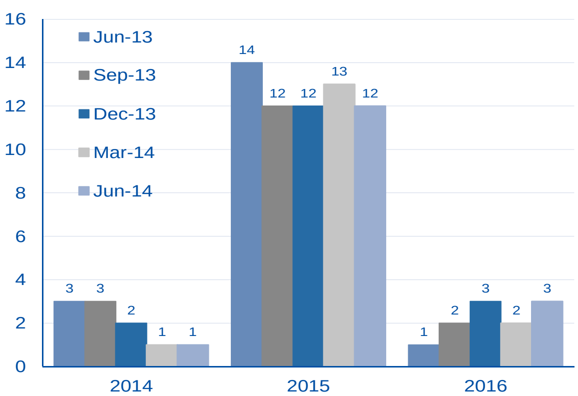
Setting the Stage for Pivotal Changes to Post-Recession Monetary Policy

- **Another $10bn reduction in asset purchases, on track for QE3 to conclude in 4Q14**
- **Updated economic projections reflect downward bias on short-term growth**
- **Discussions continue on the exit strategy but the Committee has yet to reach a consensus**

The FOMC Statement for the June meeting came as little surprise, with another $10bn reduction in asset purchases and consistent reports on gradual improvements in economic data. Continuing with the “measured steps” outlined in December, the FOMC announced that it would reduce its monthly asset purchases to $35bn ($15bn in mortgage-backed securities and $20bn in longer-term Treasuries) while continuing its reinvestment policy. The ongoing third round of quantitative easing is slowly coming to an end, and with only four scheduled meetings left in 2014, the chances are low that the Fed will move away from the $10bn per month reduction pace. Therefore, we continue to expect an end to QE3 in 4Q14 so long as economic data (mostly employment and inflation) do not deteriorate.

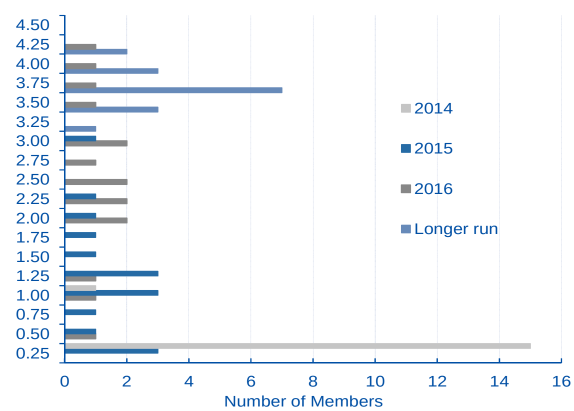
The Committee’s economic outlook will continue to play an important role in the Fed’s decisions throughout the coming year. FOMC members agree that economic data continues to improve gradually, mostly in line with expectations. June’s statement did not stray from the sentiments expressed in April, with household spending and business fixed investment listed as positives and housing activity moving along at a slower pace. Similarly, the statement also noted that fiscal policy remains as a constraint on economic growth, but that the impacts are dwindling. When it comes to labor market indicators, June’s statement was slightly more positive, leaving out the message of “mixed but on balance” progress and pointing directly toward “further improvement.”

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

The updated Summary of Economic Projections mostly reflected adjustments for actual data rather than any significant change in the Committee's outlook. First, there were notable changes in short-term growth projections, with the range of real GDP forecasts for 2014 dropping from 2.8-3.0% to 2.1-2.3%. Clearly, this is a reflection of the minor contraction in 1Q14, as the forecasts for 2015 and beyond remain unchanged. At the same time, the central tendency of FOMC projections for the unemployment rate dropped from 6.1-6.3% to 6.0-6.1%, in line with the faster-than-expected declines throughout the past few months. Central tendencies for the 2015 and 2016 unemployment projections were lowered as well, by 0.2% and 0.1%, respectively. Projections for PCE inflation were adjusted slightly but expectations remain for below-target inflation throughout the next few years. It is also important to note that these projections reflect influences from a few new committee members – Stanley Fischer, Vice Chair, Loretta Mester, Cleveland Fed President, and Lael Brainard as a member of the Board of Governors – who have the potential to sway the more dovish tone among the committee, particularly throughout the next year which could be defined by significant changes to the Fed's monetary policy stance.

The discussion on the Fed's exit strategy (last week's Fedwatch) was reserved for Yellen's press conference. Chair Yellen acknowledged the difficulty in determining the appropriate method for moving toward policy normalization. At the same time, Yellen reaffirmed that the broad principles of the June 2011 Exit Strategy (such as normalizing the size and composition of the balance sheet to Treasury security holdings) only remain true for the long-run. She also confirmed Fed's commitment to Bernanke's statement that they would withhold sales of MBS and keep it these assets to maturity. Most importantly, Yellen noted that while discussions continue, the Committee has not yet reached a conclusion regarding the reinvestment and exit strategy details: "Committee is working through many issues related to normalization and will continue discussions with expectations of providing additional details later this year." Finally, she emphasized the fact that the Fed's discussions and transparency are not intended to signal any immediate change but simply reflect the Committee's intention to communicate clearly to the public as their plans become more plausible.

Table 1
Federal Reserve Forecast Comparison: June vs. March FOMC Statement and Press Conference (Central Tendency)

	June 2014 FOMC Projections				March 2014 FOMC Projections			
	2014	2015	2016	Longer run	2014	2015	2016	Longer run
GDP, 4Q yoy % change								
Low	2.1	3.0	2.5	2.1	2.8	3.0	2.5	2.2
High	2.3	3.2	3.0	2.3	3.0	3.2	3.0	2.3
Unemployment rate, 4Q %								
Low	6.0	5.4	5.1	5.2	6.1	5.6	5.2	5.2
High	6.1	5.7	5.5	5.5	6.3	5.9	5.6	5.6
Core PCE, 4Q yoy % change								
Low	1.5	1.6	1.7		1.4	1.7	1.8	
High	1.6	2.0	2.0		1.6	2.0	2.0	

Source: Federal Reserve & BBVA Research

Bottom Line: Expectations Building as the Fed Approaches Significant Change

The next twelve months will be significant for the FOMC. First, the end of quantitative easing is in sight, with measured steps of $10bn reductions expected to continue until the last announcement in 4Q14. Second, the Fed has managed to anchor expectations for the first fed funds rate hike to occur in mid-2015 –consistent with our baseline scenario. Finally, the FOMC will have to overcome internal differences of opinion in order to convey a clear roadmap for balance sheet normalization. This may not be an easy process given the lack of experience with these policy tools and the divergence on opinions regarding the damage on long-term growth caused by the financial crisis.