Economic Analysis

Ahead of the October 28th – 29th FOMC Meeting

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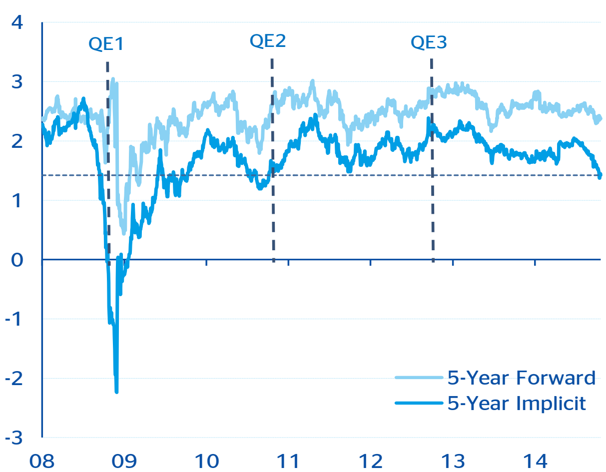
- **Fed is expected to stay on track ending QE3 in 4Q14**
- **Decline in inflation expectations poses concerns**

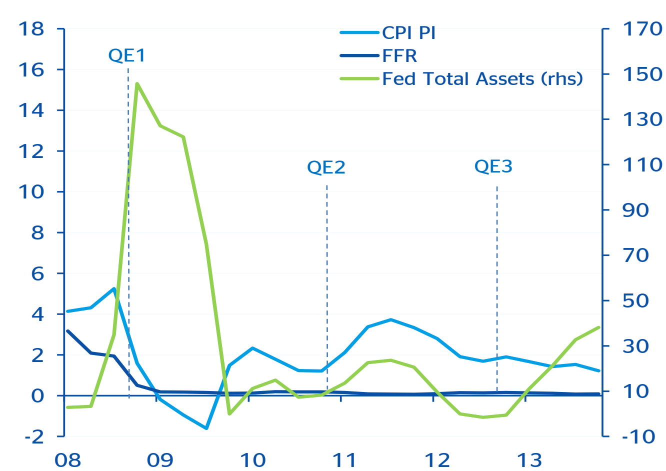
Headline and core consumer inflation at 1.7% in September should not prompt any significant policy changes by the FOMC at next week's meeting. Producer prices in September did not surprise either with a YoY increase of 1.7%. However, inflation expectations have been on the decline since August and reached their lowest level since October 2010. Low inflation expectations raised concerns amongst FOMC members with an immediate reaction by Bullard (FRB St. Louis, October 16th) stating that: "We [FOMC] could go on pause on the taper at this juncture and wait until we see how the data shakes out into December." The decline in the inflation expectations will undoubtedly take the center stage of FOMC discussions at the upcoming meeting. At the same time, the focus of the Committee's discussion is expected to progress beyond the timing to end QE3. Whether FOMC ends its $15bn large scale monthly asset purchases in October or December would likely be considered a minor concern, in comparison to modifications to forward guidance and crafting an effective communication strategy that will anchor expectations of the future path of the Federal Funds rate. In fact, extending large scale asset purchases has shown in the past to have limited to no impact on price levels when interest rates are at or near the zero lower bound. The following argument was also supported by Rosengren (FRB Boston, October 20th) stating that "We [FOMC] could stay at the zero lower bound for longer. We could decide to raise rates at a more gradual pace. It's not clear to me that continuing QE would necessarily be the best way to address concern." Additional views were offered by Williams (FRB San Francisco, October 20th) concluding that "We're [FOMC] on track to end our asset purchases and we're [FOMC] preparing for the time the economy can sustain an end to accommodation." Despite mixed communications from FOMC members, we maintain our expectations of QE3 ending in 4Q14 and the first rate hike in mid-2015.

Chart 1
Inflation Expectations (%)



Source: FRB & BBVA Research

Chart 2
Federal Funds Rate, Balance Sheet, and CPI Inflation (YoY, %)



Source: FRB, BEA & BBVA Research

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