Central Banks

Ahead of the December 16th – 17th FOMC Meeting

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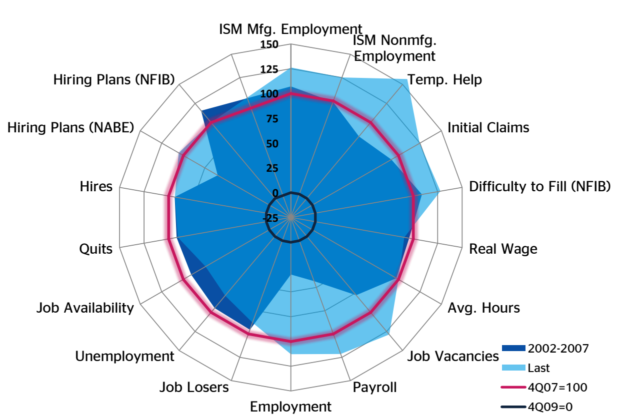
At the Crossroads of Soft Inflation Expectations and a Strengthened Labor Market

- **Sustainable labor market gains and stronger fundamentals behind GDP growth tipoff a hawkish FOMC stance**
- **Softening inflation expectations reinforce the dovish FOMC members' push for explicit 2 percent "symmetric" inflation target**
- **Downward pressure from energy prices on inflation expectations will leave the Fed cautious not to signal unintended tightening of financial conditions**

Judged solely by advancements in the labor market and upbeat growth expectations for 4Q14, the Fed should not place its policy normalization action-plan on pause and should proceed with the introduction of new language to its forward guidance to clarify the 2015 trajectory of the federal funds rate. What could keep the Fed cautious is a softening in inflation expectations. In summary, FOMC members are faced with a quandary of a five month decline in inflation expectations that is occurring at the same time that the economy is seeing sustained job growth. Payroll growth averaged at 260K per month for the last 8 months, and the number of unemployed per job opening dropped below 2, while the 5-year implicit inflation expectations fell to the lowest level since September 2010, which was before QE2 was implemented.

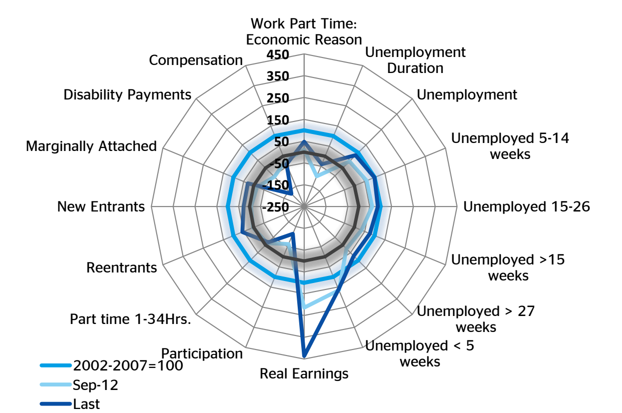
The most likely outcome of December meeting is removing calendar-date associated languages, such as "considerable time" and to re-emphasize the data-dependency of policy normalization decisions. However, the FOMC's October minutes hinted at caution toward potential changes in future meeting statements. Therefore, no changes in the December statement's forward guidance should indicate difficulty in reconciling the views of the dovish members with those of the hawks. Thus, a unanimous vote for December policy action is unlikely.

Chart 1
Labor Market Outlook (%)



Source: BLS, DoL, NABE, NFIB, ISM & BBVA Research

Chart 2
Labor Market Utilization (%)



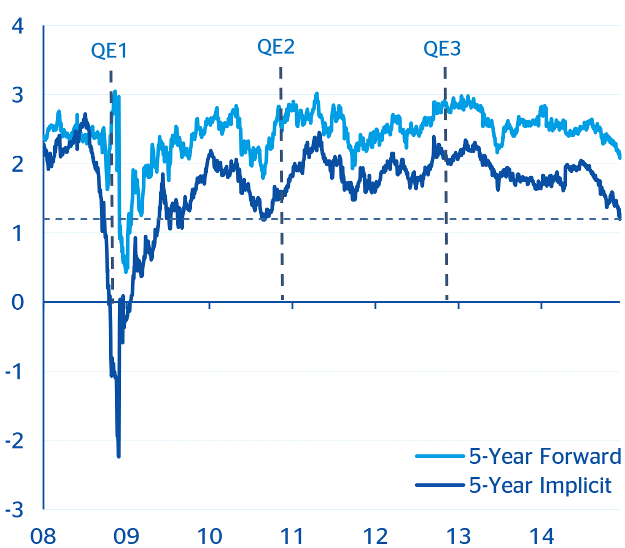
Source: BLS, DoL, NABE, NFIB, ISM & BBVA Research

The hawkish Committee members are given favorable economic conditions to advance their agenda and eliminate language in the statement indicating that the near zero target range for the policy rate would likely be maintained for a "considerable time" after the end of the QE3. The multidimensional labor market indicators highlight that the headwinds to the labor outlook are steadily abating. Many labor market statistics have surpassed both the pre-recession peak and the sustainable levels seen in the five-year period prior to the great recession. At the same time, a group of labor market utilization indicators have also approached the sustainable levels seen in the five-year period prior to the recession. The positive economic outlook has been further reinforced by the November industrial production index release, which increased by 1.3% MoM, exceeding consensus expectations to mark the highest increase since May 2010. However, the hawkish FOMC members would like to see more changes than elimination of the “considerable time” language from the forward guidance. Several of them favor FOMC commitment to monetary-rule-like policy language to communicate the post-liftoff path of the federal funds rate.

> **Plosser** (2015 Voting Member, FRB Philadelphia, December 3, 2014): *“We must avoid such date-based forward guidance, whether it uses specific calendar dates or more vague references alluding to a "considerable period" of time. As policymakers, we do not know what the future holds, so forward guidance in this form cannot be very credible.”*

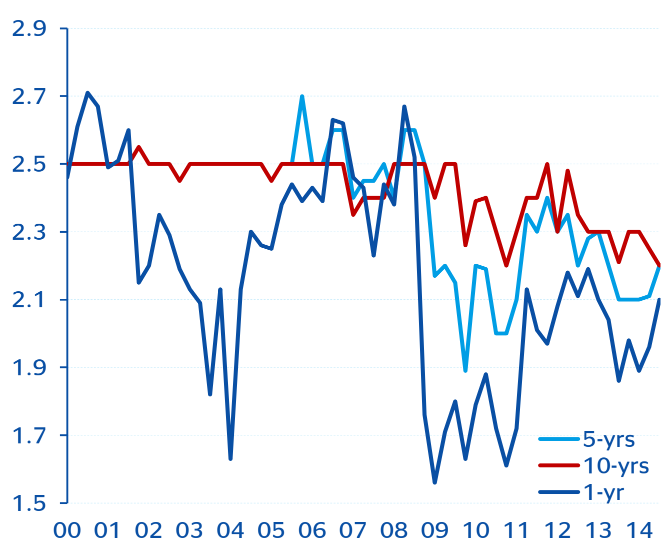
The Committee members with a strong dovish stance will advocate against removal of the "considerable time" phrase in fear of signaling a “significant shift in the stance of policy.” There will be well founded concern with regard to falling inflation expectations and the strong downward pressure on inflation from falling crude oil prices. Along with the recent decline in crude oil prices, the December Summary of Economic Projections will likely cause FOMC members to adjust downward their short-term to medium-term inflation projections. Consequently, doves will most likely also advocate for additional language in the forward guidance that would strengthen the FOMC’s commitment to the 2 percent inflation objective. However, such FOMC commitment would implicitly delay the timing of the first rate hike from the current mid-2015 consensus date.

Chart 3
Market Inflation Expectations (%)



Source: FRB & BBVA Research

Chart 4
Survey Inflation Expectations (%)



Source: FRB & BBVA Research

> **Evans** (2016 Voting Member, FRB Chicago, December 3, 2014): *"I think appropriate monetary policy would keep the funds rate where it is until the first quarter of 2016. "Considerable time" seems to describe that perfectly fine. I don't feel it's important to change the public's thinking on that, so I don't see a need."*
>
> **Kocherlakota** (2015 Voting Member, FRB Minneapolis, December 1, 2014): *"The adoption of this explicit 2 percent target means that the American public need guess no longer about the Federal Reserve's inflation intentions – either on the upside or on the downside: 2 percent is our goal."*

Despite the visible divergence on the introduction of new language to the forward guidance, FOMC members will most likely continue to view falling energy prices as temporary. Thus, the FOMC will view the favorable consumer and economy wide growth environment coupled with only short-term transitory downward pressure on headline inflation as a positive scenario. Furthermore, despite continuous downward pressure on inflation, the monetary policy stance of several prominent FOMC members has not changed since the pre-September meeting, and they have shifted their attention beyond the timing of the federal funds rate liftoff.

> **Fischer** (Permanent Voting Member, Vice Chairman, December 1, 2014): *"If unemployment continues to decline, if the labor market continues to strengthen and if we see some signs of inflation beginning to increase, then the natural thing is to get the interest rate up. We call it normalization. And it's important to recognize that we've almost got to thinking that the zero is a natural place for interest rate but it's far from it. And furthermore I think is that the first step is very important but there is a process that is set off when the process starts. Interest rates are going to go up and they are going to keep going up for some time. We need to start thinking about what is going to happen in the year and years to come as we go back to a normal situation."*
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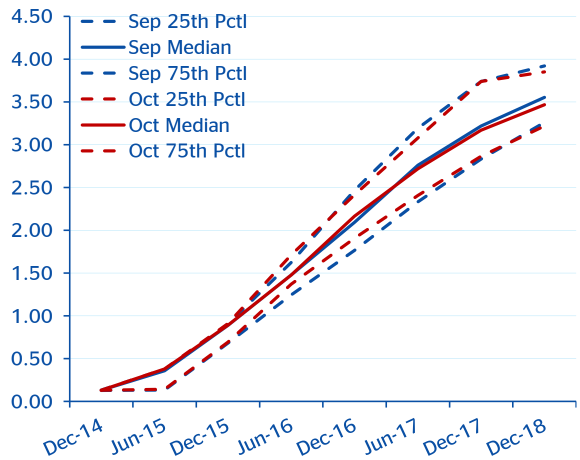
> **Dudley** (Permanent Voting Member, FRB New York, December 1, 2014): *"Market expectations that lift-off will occur around mid-2015 seem reasonable to me. Although that could change depending on how the economy evolves, my views on "when" do not differ appreciably from the most recent primary dealer and buy-side surveys undertaken by the New York Fed prior to the October FOMC meeting."*
>
> *"After lift-off looks sustainable and the federal funds rate is somewhat above the zero lower bound, the Committee will cease to reinvest those funds generated by maturing Treasury securities and prepayments of agency MBS securities."*

Bottom Line

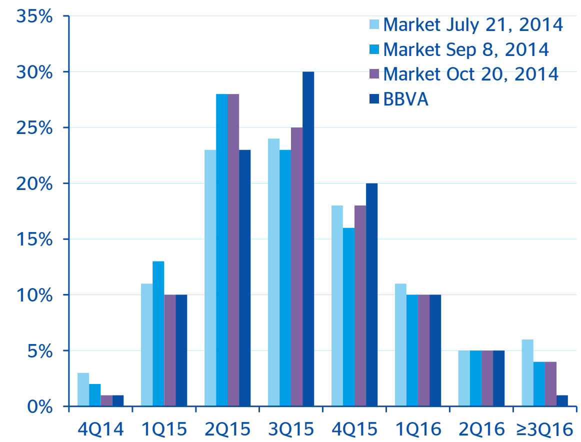
Discussion at the December 16th-17th FOMC meeting will focus on the challenges of transparent and clear communication of the timing and the path of the federal funds rate. Most FOMC members will likely support removing calendar-date associated language, such as "considerable time." At the same time, no changes in the forward guidance would indicate difficulty in reaching consensus. Despite the sustained job gains, labor resource slack remains elevated and the uncertainty around energy price declines will continue to put downward pressure on inflation. Thus, the Fed will remain cautious not to signal unintended tightening of financial conditions. The Committee will also publish a Summary of Economic Projections and Chair Yellen will hold a press-conference providing additional insights on how FOMC members have adjusted their medium-term inflation and policy rate projections to the recent decline in crude oil prices. We expect that the Fed will continue to adjust policy plans dependent on incoming data, with the first rate hike to occur in mid-2015.

Chart 5
Fed funds survey expectations (%)



Source: FRBNY & BBVA Research

Chart 6
Fed funds probability of first rate increase (%)



Source: FRBNY & BBVA Research

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