Central Banks

FOMC Statement: December 16th – 17th

Shushanik Papanyan / Kim Fraser Chase / Nathaniel Karp

Members' Stance on Policy Normalization Unchanged Despite Low Inflation

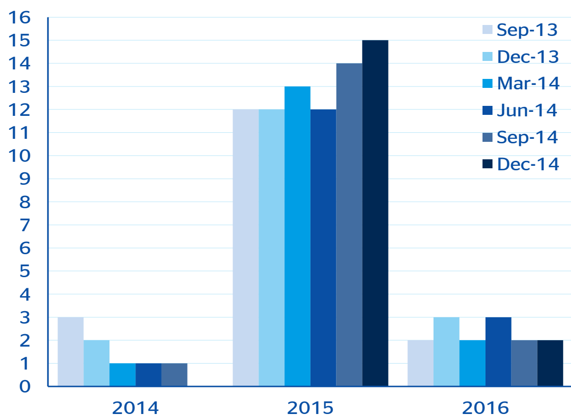
- **FOMC replaced "considerable time" language with "patient" while Yellen stated that normalization is unlikely to begin "for at least the next couple of meetings"**
- **Yellen clarified that direct pickup in headline inflation is not expected as part of the data-dependent environment of the lift-off**
- **Federal funds rate projections tighten in 2015 but disperse in 2016 and 2017 as members views diverge on the speed of the policy rate increase**
- **Changes to the forward guidance language left both doves and hawks unhappy with three members to dissent**

The FOMC made an effort to move away from a calendar-date communication strategy, replacing "considerable time" language with "patient" in the forward guidance language. However, the attempt to back off from a calendar-date commitment was faded with the decision to re-emphasize that the December meeting guidance is "consistent with its previous statement." Yellen's press conference statement elaborated further on the specific time commitments - stating that policy normalization would be unlikely to begin "for at least the next couple of meetings." Moreover, while the Committee removed the "considerable time" language, the press conference statement stressed that it was not to signal "a change in policy," but rather to detach from an awkward communication of the timing of liftoff "with reference to an event that is receding into the past," such as the end of QE3.

In line with previous statements, the FOMC made sure to keep data-dependency in the center of the policy normalization decision-wheel, and the press conference offered specifics on the economic conditions that "would make liftoff appropriate." The Committee specified that a pickup in headline inflation is not expected as part of the data-dependent environment of the lift-off, as long as the FOMC members project the gap between the inflation and the 2% goal to gradually close, with inflation expectations to move back to the 2% objective and core inflation to run near current levels. Overall, as expected, the changes in the forward guidance language reflected the ongoing difficulty in reconciling the views of the dovish members with those of the hawks (see Fed Watch Preview), resulting in the most number of dissents since August 2011 (with the exact same dissenters of Plosser, Fisher, and Kocherlakota).

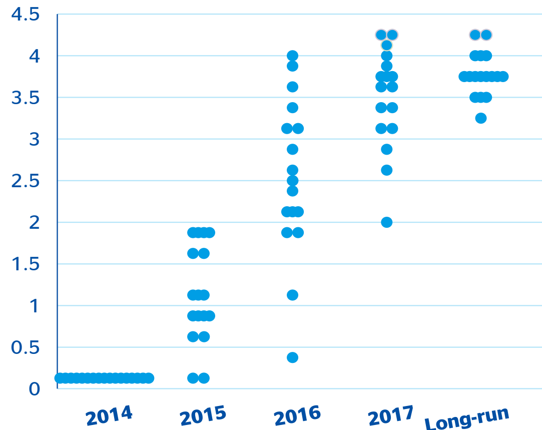
Other differences between the October and December statements include more optimistic language on labor market underutilization and the acknowledgement that inflation has run lower than their objective "partly reflecting declines in energy prices." Still, the FOMC maintains the viewpoint that energy price declines will soon fade and that inflation will move toward their 2% target "as the labor market improves further and the transitory effects of lower energy prices and other factors dissipate."

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

Three FOMC members voted against the action. Kocherlakota (FRB Minneapolis) was the only consistent dissenter, arguing the potential for “downside risk to the credibility of the 2 percent inflation target” given that prices and expectations remain low. Richard Fisher (FRB Dallas) and Charles Plosser (FRB Philadelphia) also dissented – the former arguing that the latest data have shifted forward the appropriate timing for the first rate hike, and the latter finding it unnecessary to point out the consistency of the revised forward guidance language to previous statements. Plosser also disagreed with the need to “stress the importance of the passage of time as a key element of its forward guidance.”

When it comes to the Summary of Economic Projections, the latest data influenced a mostly positive shift in expectations. Fifteen of the 17 FOMC members see 2015 as an appropriate year for the first increase in the federal funds rate. Clearly, FOMC members are in agreement regarding the timing of the liftoff and the projections for the long-run federal funds rate; however, there was higher dispersion in comparison to the September forecasts with regard to the steepness of the policy rate increase for the 2016 and 2017 federal funds rate forecasts.

The central tendency for real GDP growth was revised up for 2014 and unchanged for 2015, while unemployment rate forecasts were revised down for 2014 through 2016. The biggest adjustments were to the PCE inflation projections, with the central tendency down significantly for 2014 and 2015. Consistent with the inflation language in the statement, FOMC members did not adjust their PCE inflation forecasts for 2016, holding the assumption that prices will reach the target by that point. Long-run expectations remain unchanged from September’s release.

Bottom Line

Ultimately, members’ views on the appropriate timing of policy normalization have held steady since 2H14, despite the changes to headline inflation and unemployment projections. The December FOMC statement did not stray far from our expectations, presenting a slight change to the forward guidance language and hinting at modest adjustments to the economic outlook. As expected, the FOMC removed the “considerable time”

language related to the timing of the federal funds rate and instead specified that "the Committee judges that it can be patient in beginning to normalize the stance of monetary policy." However, the statement did point out that this new language is "consistent with its previous statement", giving the Committee the opportunity to ease into this adjustment in an attempt to curb any market misinterpretations or overreactions. The FOMC also readdressed the reinvestment strategy and the fact that the balance sheet will not decline even when interest rates start to increase, helping to maintain accommodative financial conditions. Our expectations remain unchanged, with the first rate hike projected for mid-2015 and the start of balance sheet normalization sometime in 2016.

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

	December 2014 FOMC Projections					September 2014 FOMC Projections				
	2014	2015	2016	2017	Longer run	2014	2015	2016	2017	Longer run
GDP, 4Q yoy % change										
Low	2.3	2.6	2.5	2.3	2.0	2.0	2.6	2.6	2.3	2.0
High	2.4	3.0	3.0	2.5	2.3	2.2	3.0	2.9	2.5	2.3
Unemployment rate, 4Q %										
Low	5.8	5.2	5.0	4.9	5.2	5.9	5.4	5.1	4.9	5.2
High		5.3	5.2	5.3	5.5	6.0	5.6	5.4	5.3	5.5
Core PCE, 4Q yoy % change										
Low	1.5	1.5	1.7	1.8		1.5	1.6	1.8	1.9	
High	1.6	1.8	2.0	2.0		1.6	1.9	2.0	2.0	

Source: Federal Reserve & BBVA Research

DISCLAIMER
This document was prepared by Banco Bilbao Vizcaya Argentaria's (BBVA) BBVA Research U.S. on behalf of itself and its affiliated companies (each BBVA Group Company) for distribution in the United States and the rest of the world and is provided for information purposes only. Within the US, BBVA operates primarily through its subsidiary Compass Bank. The information, opinions, estimates and forecasts contained herein refer to the specific date and are subject to changes without notice due to market fluctuations. The information, opinions, estimates and forecasts contained in this document have been gathered or obtained from public sources, believed to be correct by the Company concerning their accuracy, completeness, and/or correctness. This document is not an offer to sell or a solicitation to acquire or dispose of an interest in securities.