Economic Research Department

BBVA

U.S.

Fed Watch

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FOMC Minutes August 11-12, 2009

- **Economic recovery is expected in 2H09, but challenges remain**
- **Downside risks to inflation persist**
- **Target rate will remain at 0%-0.25% for a prolonged period**

The FOMC expressed more confidence in its outlook that economic growth would take hold in the second half of 2009, although it believes that risks remain. Furthermore, members agreed that the pace of recovery would pick-up in 2010, but they expressed uncertainty about the strength of the rebound, citing consumer spending and credit conditions as particular concerns.

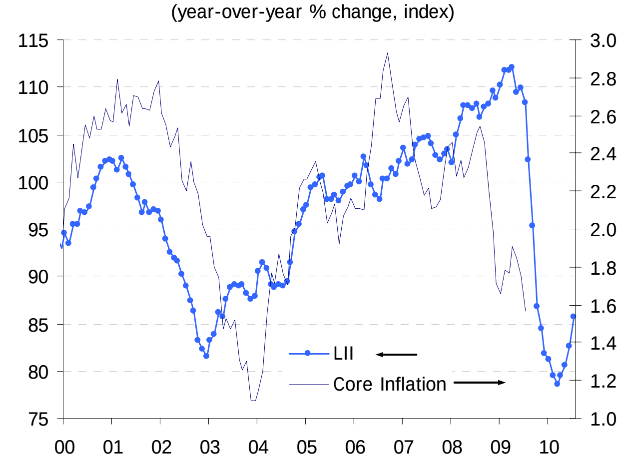
Both the staff and participants maintained their baseline scenarios of modest recovery in 2H09 given recent improvements in economic data. While consumer spending has shown signs of stabilization, it continues to be plagued by the weak labor market, tight credit conditions, high household debt and sluggish income growth. Furthermore, labor markets will face challenges to recovery as many businesses have suggested that they will be slow to hire once conditions perk up. Moreover, residential housing markets have stabilized further, but high inventory levels of existing homes are inhibiting construction. On the other hand, commercial real estate is suffering from deteriorating fundamentals and could pose risks to small and medium size banks. As a positive note, members noted that the faster than expected economic improvement abroad could lead to an expansion of U.S. exports.

On the inflation front, participants became concerned that *"substantial slack in resource utilization would lead to subdued and potentially declining wage and price inflation over the next few years."* This view, along with the outlook of a modest recovery, justified members' expectations that the Fed funds rate will remain at 0%-0.25% for a prolonged period of time. Lastly, the committee decided to maintain current monetary policy and asset purchase levels, but it extended the remainder of its Treasury security purchases through October in order to avoid disruption in the market as the program fazes out.

Bottom-line: The focus of the FOMC's discussion has shifted to recovery as the committee improved its economic outlook, but questions about the risks and pace of growth remain. Although members' views on economic challenges were consistent with the previous meeting, they now see exports as aiding rather than inhibiting recovery. Moreover, the minutes indicated that downside risks to inflation have become a greater concern as the committee put a more of an emphasis on the effects of economic slack and sluggish wage growth. Given the meeting's proceedings, we maintain our view that the Fed funds rate will remain low for an extended period of time.

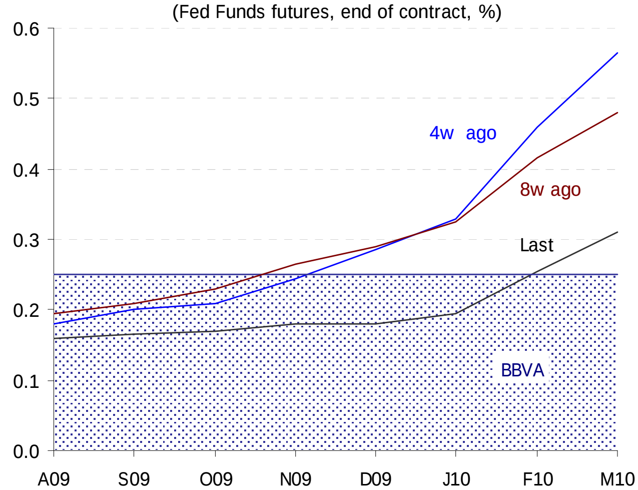
Fed Funds: 0% to 0.25%
Next Meeting: September 22-23
Minutes Release: October 14

Core Inflation & BBVA Leading Inflation Index
(year-over-year % change, index)



Source: BLS & BBVA ERD

Fed Funds Expectations
(Fed Funds futures, end of contract, %)



Source: Bloomberg