U.S.

Fed Watch

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Economic Analysis

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FOMC Minutes: October 12

FOMC Still Concerned About Pace of Recovery

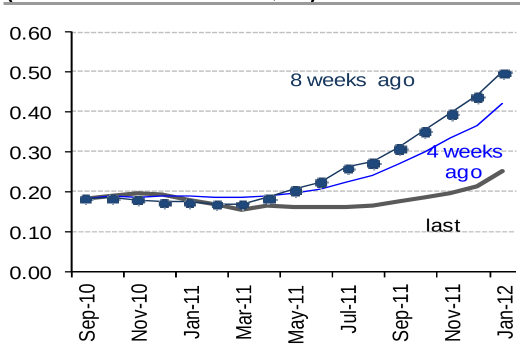
- **Staff economists lower their economic outlook for 2010**
- **Participants discuss other strategies; Second round of easing highly likely in Nov.**

Minutes of the last FOMC meeting reveal that Federal Reserve **staff have lowered their economic outlook** for 2010, but still continue to expect moderate growth in 2011 and a light acceleration of growth in 2012. In the near term, the FOMC staff economists were surprised by weaker than expected aggregate demand and the outlook for foreign economic activity is slightly weaker. Bridging the short term and long term, the staff economists expect elevated resource slack by the end of 2012, although **increases in real GDP are also expected to slowly reduce the output gap**. The staff economic analysis views a small probability of deflation.

This probability level of deflation and the zero bound on interest rates raised an interesting policy point in the section on participants' views of the current economic situation. Some participants argued that a **decline in inflation expectations at the zero bound is essentially a tightening** of monetary policy. In such an environment, an increase in inflation expectations stimulates the economy through a lowering of real interest rates and thereby pushes aggregate demand.

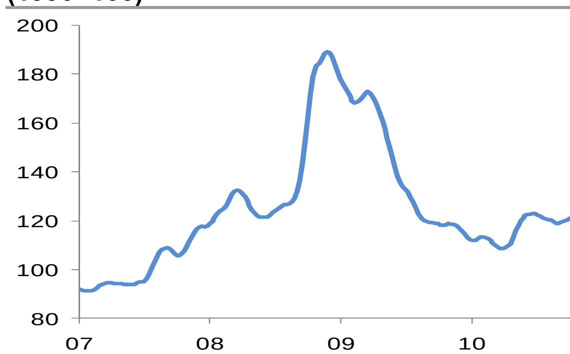
On the subject of inflation expectations, participants also **discussed other monetary policy strategies for expectations management**, such as (1) explicit inflation rate targets (2) price level targets and (3) nominal GDP targets. Although it is unclear if these strategies will be used, mentioning them in the minutes allows the Fed to communicate that it still has options beyond asset purchases. This communication imperative is necessary because participants' comments suggest that if inflation or unemployment continues below the Fed's mandate, the use of a second round of quantitative easing is likely to occur. During the period of the meeting, considerable uncertainty over the direction of the economy gave weight to some participants' inclination to "accumulate further information" before enacting a second wave of large-scale asset purchases. With these minutes and recent public speeches by FOMC members, it is **highly likely that the Fed will start a second round of quantitative easing** in its November meeting.

Chart 1
Fed Funds Expectations (Future Contract End, %)



Source: Bloomberg & BBVA Research

Chart 2
BBVA Risk Aversion Index (1990=100)



Source: BBVA Research

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