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December FOMC Meeting: Surprising Timing To A Not So Surprising Move

- As expected, the FOMC announced it would purchase longer-term Treasury securities to fill in the void left by the end of Operation Twist.
- The FOMC also swapped its calendar-based forward guidance on the timing of a Fed funds rate hike for guidance based on economic markers – the unemployment rate and expected inflation. This had been expected, but not at today's meeting.

Clearly not pleased with the pace of the economic recovery, specifically with what remains a high degree of labor market slack, the FOMC announced it will become even more aggressive in its efforts to move things along. Thus, as was widely expected, the FOMC announced it will purchase $45 billion of longer-term Treasury securities on top of ongoing monthly purchases of $40 billion of agency mortgage-backed securities. To help improve clarity around policy, the FOMC also altered its guidance on the timing of an initial hike in the Fed funds rate, swapping a calendar based approach for one tied to specific economic markers – the unemployment rate and expected inflation. While the FOMC has been moving in this direction for some time, it was widely expected they would not implement this change until Q1 2013.

The purchases of longer-term Treasury securities are in essence taking the place of purchases of such securities now in place under Operation Twist, which expires at year-end. Note, however, the key difference between the two programs – purchases made during Operation Twist changed the composition, but not the size, of the Fed's balance sheet, as at present the Fed is selling shorter-term Treasuries to fund purchases of longer-term securities. The new program, "QE-4" if you like, will result in an expansion of the Fed's balance sheet in addition to the expansion due to purchases of mortgage-backed securities. Assuming total purchases (longer-term Treasuries plus mortgage-backed securities) persist at the same pace the Fed's balance sheet will be pushing $4 trillion by year-end 2013. The FOMC also noted they would maintain the existing policy of reinvesting principal payments from current holdings and will resume rolling over maturing Treasuries.

There were no material changes in the FOMC's assessment of overall economic conditions. Which of course is precisely the problem – the U.S. economy looks pretty much the same as has been the case over the course of the recovery. Specifically, there has been progress in paring down the high degree of labor market slack, but at a frustratingly slow pace that has yet to ignite meaningful pressure on wage and salary earnings despite a sizeable decline in the unemployment rate. With the FOMC, or at least the vast majority of voting members, not viewing inflation as a meaningful risk at present, the Committee opted to do still more to try and speed up the pace of the recovery.

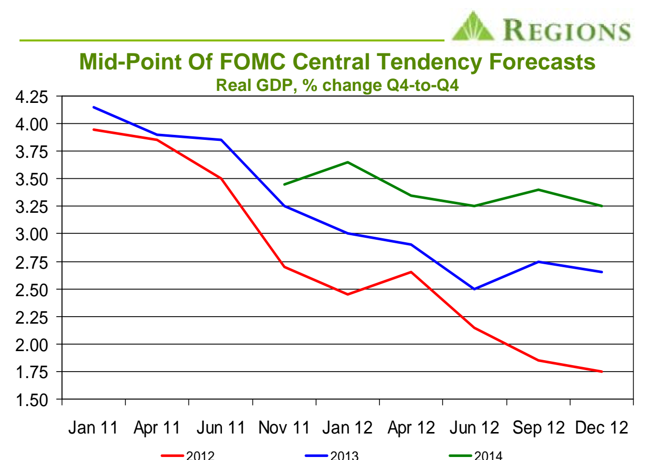
Whether further balance sheet expansion will actually accomplish that remains to be seen. The post-meeting statement points out that ongoing asset purchases "should maintain" downward pressure on longer-term interest rates and help support mortgage markets. We think it unlikely that this will have a meaningful impact on the rate of economic growth, but one can argue that the value of the change is that the FOMC's policy will guard against rising long-term rates choking off economic activity. As long as inflation expectations remain somewhat anchored, the odds of such a rise in long-term interest rates will remain low.

How long the Fed will continue these asset purchases, and at what pace, will be determined by an ongoing cost-benefit analysis, as Chairman Bernanke discussed at his press conference. This is a key point to make – while the FOMC offered quantitative guidance as to the timing of an initial hike in the Fed funds rate, the guidance on the asset purchases is more qualitative in nature. In short, the FOMC will assess, on an ongoing basis, the benefits of further asset purchases versus the potential costs, such as inflation expectations becoming unanchored.

The quantitative guidance on the timing of a funds rate hike is just that – guidance. Stating that the funds rate will not change for at least as long as the unemployment rate remains above 6.5 percent and expected inflation one to two years ahead remains no higher than 2.5 percent. Chairman Bernanke made it clear that this is a target and not a trigger, and that many other variables, including nonfarm employment, hours worked, and the labor force participation rate, will be considered in assessing the stance on the funds rate.

Still, in the end, today's action may not leave us in a different place than the calendar based guidance. The FOMC today released the latest round of central tendency forecasts. As shown below, growth expectations were downgraded slightly. The central tendency forecast for the unemployment rate, however, shows the FOMC as a whole does not expect to hit the 6.5 percent target until at least mid-2015 – stop us if you've heard that phrase before. There is, however, still value in the change – if the recovery picks up pace the financial markets will have more clarity as to the timing of a potential change in the funds rate.

In short, the change in the FOMC's forward guidance is not a change in policy, but rather represents an attempt to tie policy more closely to the evolution of the economic data. Clearly the FOMC will adjust policy according to the path of the economy, but they simply do not see such an adjustment to policy as being necessary for some time to come.



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