ECONOMIC UPDATE

REGIONS

December 18, 2013

December FOMC Meeting: Tapering, But With A Dovish Touch

- The FOMC announced as of January 2014 the pace of monthly asset purchases will be reduced to $75 billion per month.
- The FOMC's offered enhanced forward guidance that puts an initial hike in the Fed funds rate further into the future than previously implied.

The relevant question in the wake of the December FOMC meeting is whether or not monetary policy is really any less accommodative now than it was prior to the meeting. True, the FOMC did vote to reduce, as of January 2014, the pace of the Fed's monthly asset purchases to $75 billion per month from the current pace of $85 billion. At the same time, however, the Committee issued enhanced forward guidance that pushes an initial hike in the Fed funds rate further out into the future than previously implied. Given the widely held view, both within and outside of the Fed, that forward guidance is, at least at this point in time, a more effective policy tool than balance sheet expansion, we would argue the stance of monetary policy can be seen as more, not less, accommodative post-meeting than pre-meeting. It is also worth putting the decision to taper in proper context – instead of this being a first step in the Fed moving towards a "normal" balance sheet, it is merely the Fed slowing, modestly, the rate at which it continues to move further away from a normal balance sheet.

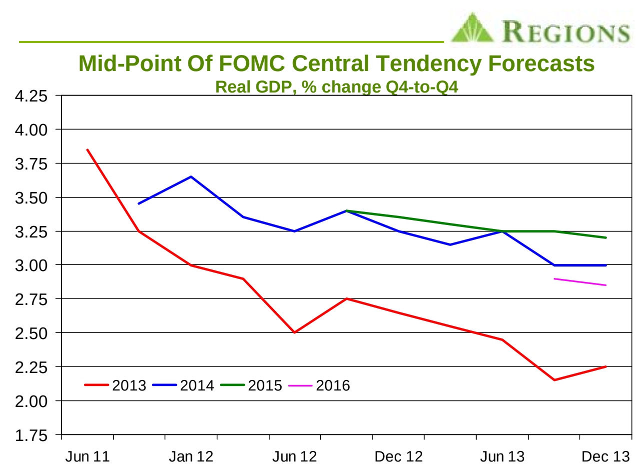
The Committee's assessment of current economic conditions was little changed, with the pace of economic growth described as "moderate" and the unemployment rate described as remaining "elevated" despite having declined. The statement notes what remains a low rate of inflation but repeats the by now familiar statement that longer-term inflation expectations remain stable.

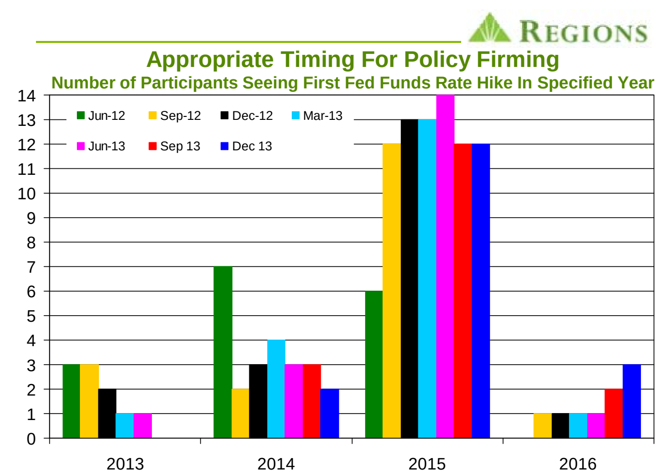
The Committee released the latest round of central tendency forecasts for economic growth, unemployment, and inflation. The central tendency forecast for real GDP growth, on a Q4/Q4 basis, in 2013 is now modestly higher than was the case in the September forecast, with no change to the forecast for 2014 and miniscule (five basis point) cuts in the outlook for both 2015 and 2016. Forecasts for the unemployment rate have been revised lower for all years. What is of more interest, however, is the extent to which the outlook for inflation has been pared down despite the expected paths of economic growth and the unemployment rate. The mid-point of the central tendency forecast for the headline PCE deflator remains below 2.0 percent through 2016, with the outlook for the core PCE deflator even lower.

The decision to pare down the rate of asset purchases – which will consist of $40 billion of U.S. Treasury securities and $35 billion of mortgage-backed securities – was based on the belief that improvement in economic growth and labor market conditions can be sustained. Again, though, it is worth repeating that the Fed's balance sheet will still be expanding – in the Committee's own words, the Fed's holdings of longer-term securities are "sizeable and still expanding." At his post-meeting press conference Chairman Bernanke noted his expectation of "further measured steps" towards the ultimate end of the asset purchases but also noted there is no predefined timetable and that from here out tapering will proceed at a deliberate and data dependent pace.

The decision to begin tapering notwithstanding, the bigger story from the December FOMC meeting is the enhanced forward guidance on the path of the Fed funds rate. Though many analysts, us included, expected the FOMC to lower the 6.5 percent unemployment rate threshold in conjunction with the beginning of tapering, the Committee did not opt to do so. Instead, the FOMC stated "it likely will be appropriate to maintain the current target range for the federal funds rate **well past the time that the unemployment rate declines below 6.5 percent**, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal" (our emphasis). Along these lines, while 12 of the 17 meeting participants still put the timing of the initial hike in the funds rate at some point in 2015, the median expectation for the funds rate at year-end 2015 is now 0.75 percent, down from 1.00 percent in September, while three participants put the first hike in the funds rate at some point in 2016, up from two in September.

In short, today's actions amount to tapering, but with a dovish touch, with the bottom line that policy will remain highly accommodative for longer than many thought would be the case before the meeting.





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