ISSN: 1791-35 35

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GLOBAL ECONOMIC & MARKET OUTLOOK

August 28, 2014

Eurobank

FOCUS NOTES

US Fed: Faster convergence toward the Fed's mandate could prompt earlier tightening

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- According to the July FOMC minutes, cumulative progress in labor market conditions over the past year has been faster than previously expected, with the labor market now closer to what might be viewed as normal in the longer run.
- The hotly debated issue is the degree of slack that remains in the US labor market, with some FOMC members emphasizing on broader labor market indicators that suggest a significant underutilization of labor resources.
- Given the positive assessment of the US labor market, the committee revised down its unemployment rate forecasts and reduced its estimate of the US output gap, sending a slightly hawkish signal.
- Fed is expected to keep fed funds rate as a primary instrument of monetary policy, with the interest rate paid on excess reserves setting the upper band of the target range and the fixed-rate reverse repo setting the bottom of the target range.
- Should economic and labor market conditions continue to outperform Fed's expectations, the Committee could move to an earlier monetary policy tightening. This is in line with our view that the first rate hike will come in mid-2015, with a risk that faster convergence than expected could lead to an earlier start of rates hikes during Q1 2015.

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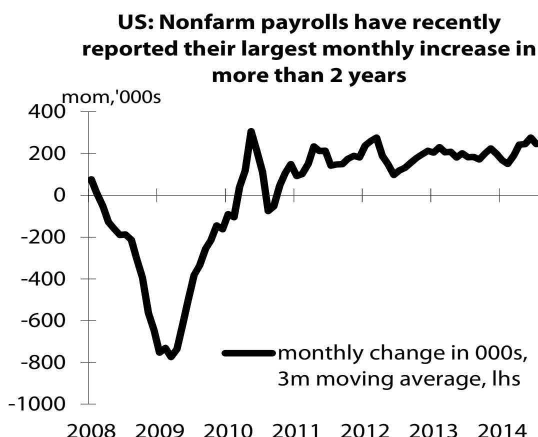
Progress in labor market faster than expected, but the degree of slack is still elevated

The Fed continued to normalize its monetary policy at its July 29-30 FOMC meeting, given the recent improvement in labor market conditions. The Committee agreed to reduce its monthly asset purchases by another $10bn (from $35bn previously to $25bbn, i.e $10bn in MBSs and $15 in Treasury securities) beginning in August. As is often the case, the minutes of the July FOMC meeting revealed a more hawkish tone compared to the statement, highlighting that the cumulative progress in labor market conditions over the past year has been faster than previously expected. Total nonfarm payrolls increased strongly in June, with the three-month moving average gain surging to roughly 300k, the largest increase in more than two years (Figure 1). Participants generally agreed that the labor market is now closer to what might be viewed as normal in the longer run. Given the positive assessment of the US labor market, the committee revised down its unemployment rate forecasts. Nevertheless, the committee continues to disagree about the degree of slack that remains in the US labor market. While a few FOMC members believe that the U3 unemployment rate[1] is a reliable measure for the general state of the labor market, others believe that the decline in the unemployment rate does not reflect the actual improvement in labor markets, but it rather overstates the improvement. The latter shifted focus to the high level of long-term unemployed (Figure 2) and part-time employees for economic reasons (Figure 3), i.e. broader labor market indicators that point to a significant underutilization of labor resources.

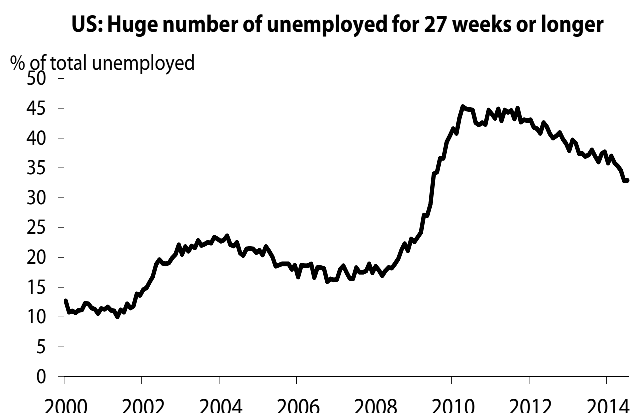
[1] U3: Official unemployment rate from the International Labour Organization (ILO) definition occurs when people are without jobs and they have actively looked for work within the past four weeks.

Figure 1



Source: Bureau of Labor Statistics (BLS)

Figure 2

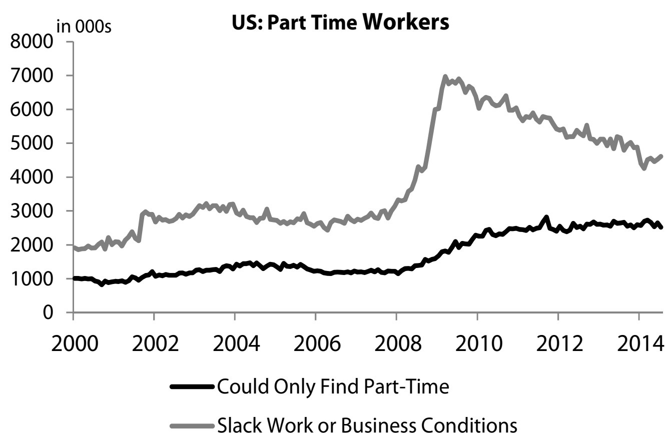


Source: Bureau of Labor Statistics (BLS)

Lower output gap sends a rather hawkish signal

Disappointing GDP growth in the first half of the year is expected to be followed by a rebound in the second half, given the waning fiscal drag, easier credit standards, a pickup in consumer and business optimism and a rebound in foreign economic activity. The slowdown of economic activity in the first half of the year, in combination with the outperformance of the US labor market, led the Fed to give a rather hawkish signal by reducing its estimate for the size of the output gap, as it actually lowered its potential output growth by more than it lowered its GDP growth forecast in the following quarters. On the inflation front, the committee revised modestly higher its near-term outlook for inflation, with stable longer-term inflation expectations. In line with the June projection, inflation is projected to remain below the Fed's longer-run goal of 2.0% for several years.

Figure 3



Source: Bureau of Labor Statistics (BLS)

Fed's exit strategy

Both June and July FOMC minutes revealed extensive discussions by Fed officials of aspects of the exit strategy. Most Committee members prefer to keep the fed funds rate as a primary instrument of monetary policy stance in order to keep the frame of the financial industry and not to reshape it in ways that would be difficult to anticipate, providing a target range at least at the early stages of the normalization process. Hence, the current target range of 0-0.25 basis points for the federal funds rate will be continued, with the first rate hike moving to a target range of 0.25-0.50 basis points.

Furthermore, most FOMC participants believe that the interest rate paid on excess reserves (IOER) should play a key role in the Fed's exit strategy, setting the upper band of target range. The Federal Reserve started to pay interest on reserve balances held by depository institutions in October 2008, and this interest rate has been equal to 0.25 basis points since then. Theoretically, the actual federal funds rate should never trade below the interest rate paid on excess reserves, as holders of reserve balances should always prefer holding their reserves at the Fed so as to receive 0.25% than lending them to another institution for less than 0.25%. However, in practice the actual federal funds rate has been slightly below 0.25% since December 2008, partly because some non-banks (i.e. Government-Sponsored Enterprises-GSEs) who do not get interest from the Fed are willing to lend below the floor [2].

[2] See Labonte M., (2014), Federal Reserve: Unconventional Monetary Policy Options, Congressional Research Service, February 6.

In addition, the fixed-rate reverse repo (RRP) could also have a supporting role in Fed's exit process. A reverse repurchase agreement is a security's purchase with an agreement to resell it at a higher price at a specific future date. The transaction is economically equivalent to a loan made to the Federal Reserve by a financial institution on a collateralized basis. Chair Yellen referred to the RRP facility as a "back-up tool" in her semi-annual monetary policy testimony before the Senate. Most FOMC participants agreed that the bottom of the target range for the fed funds rate could be the overnight fixed-rate RRP facility. The Fed currently pays a counterparty 5 basis points to borrow cash overnight, with a security actually serving as collateral, and this is actually the floor on repo rates. Indeed, if repo rates decline below the Fed's rate on reverse repo facility, a primary lender could theoretically borrow in repo and place the money at the Fed facility, earning a zero risk profit. This arbitrary process tends to push reverse repo rates closer to the fed floor. The reverse repo facility would probably have a temporary role until Fed's balance sheet and excess reserves decline to a level whereby the Committee can control the fed funds rate without the use of overnight RRP facility as a floor for its rate guidance. Maintaining a relatively wide spread between IOER and the RRP facility rates near or above the current level of 20bp might be appropriate. Otherwise, there is a risk that in times of financial stress, the facility's counterparties could shift investments toward the facility instead of financial and nonfinancial corporations, increasing the Fed's role in financial intermediation and possibly causing funding disruptions. Some participants expressed their view that the overnight RRP rate should be set lower than the floor of the target range so as to further deter dealers from using the facility. Nevertheless, many FOMC members highlighted that such a move could cause insufficient control over the level of money market rates, causing confusion about the likely path of fed funds rates or uncertainty about the Fed's ability to implement monetary policy in an effective way.

In terms of the ordering of Fed's exit strategy, most FOMC participants are in favor of removing the reinvestment of maturing Treasury securities and MBS after the first rate hike, using a rather smooth process for Fed's balance sheet decline. For example, the Fed could reinvest some maturing securities in cases of large maturities, so as not to generate disruptions to the US financial market. New York Fed President Dudley, San Francisco Fed President Williams and Boston President Rosengren have expressed publicly their view for a later end to reinvestment a few months ago, and this view has found widespread support among FOMC participants.

Conclusion

All in all, FOMC participants consider the data up to date as confirming their expectations for continued moderate economic growth. Economic conditions seem to converge to the Fed's dual mandate of employment and inflation, with the unemployment rate having declined to 6.2% and inflation moving back to the Fed's 2.0% objective. Should economic acceleration and labor market improvement continue to outperform Fed's expectations, then according to the latest FOMC minutes the Fed could move to an earlier tightening of its monetary policy. This is in line with our view that the asset purchase program will conclude in October 2014 and the first rate hike will come at the end of the second quarter of 2015, with a risk of an earlier start of rates hikes during the first quarter of the following year.

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