# FOMC Preview

## Risk management approach favors more easing

**The FOMC meet 19 & 20 June to decide the near-term course of monetary policy. We stick to our recently expressed view that the chances of another easing move at this meeting are slightly better than 50% ("US Monetary Policy: Shifting Gears?" 7 June 2012). The key factor for this decision will be changes in the policymakers' forecasts for job growth in coming months. If a majority of the Committee feels that the employment outlook has taken a turn for the worse, then they may opt to step up the current degree of monetary accommodation, perhaps by extending Operation Twist.**

A number of Fed officials have recently made it clear that the outlook for job growth is the key determining factor for monetary policy in the near term. While inflation is always important, most Fed officials are fairly confident that the outlook for inflation is fairly benign. Unemployment at 8.2% and underutilized capacity in many industries suggest that there is little in the way of inflation pressure brewing in the economy. Recent declines in crude oil and gasoline prices should gradually feed through to the prices of other goods and services and bring down the core inflation rate. Surveys show that longer-run inflation expectations are stable, and both the five- and ten-year rate of inflation implied by Treasury inflation-adjusted securities have moved lower in recent months. And FOMC members themselves are forecasting a very stable outlook for inflation close to or just below 2.0% for the next few years.

JOB GAINS FALTERING

In contrast to the stability of inflation, data on employment gains have softened noticeably over the last few months. The average three-month gain in payroll employment dropped to 96,000 in May from 252,000 three months earlier. More importantly, the index of aggregate weekly hours worked, which combines the change in employment with the change in the average workweek, has fallen abruptly since February. There has also been a noticeable rise in weekly claims for unemployment insurance benefits since the end of March.

The slowdown in employment growth could be temporary. The country experienced a very warm winter, which may have pulled forward some hiring at the expense of the normal upturn in the spring. The run-up in gasoline prices from January through April may have dented business confidence and caused some firms to postpone new hiring for a while. Now that gas prices have fallen significantly since the April peak, hiring might pick up again.

ADDITIONAL DATA POINT TO SLOWDOWN

There are, however, other signs that economic activity has softened across the board. Retail sales have fallen in nominal terms for the past two months. Manufacturing output has been essentially flat since February. Surveys of manufacturing activity from a number of Federal Reserve Districts have moved lower over the last few months. Measures of consumer confidence have also turned down.

Whether the FOMC will ease monetary conditions further depends on what they think will happen next. In his April press conference, Fed Chairman Ben Bernanke said the decision to pursue additional monetary accommodation would depend on "whether or not unemployment is making sufficient progress towards the longer run, normal level." The latest data suggest

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that that is not the case. If a majority of FOMC members agree that the prospects for further declines in the unemployment rate have diminished, then they are likely to decide that more monetary ease is appropriate.

RISK MANGEMENT

The case for easing policy is reinforced by the FOMC's "risk management approach" to policy making. This usually involves two questions. First, if the FOMC chooses to ease policy when it is not really necessary, what is the likely cost of the mistake? Second, if the policymakers choose not to ease when they should be easing what will be the damage? The choice then rests on which mistake would be more costly.

Currently, most Fed officials believe that if they were to ease when in fact it was unnecessary, the penalty in terms of higher inflation somewhere down the road would probably be small. Before inflation rose to an uncomfortable level, the FOMC would probably be able to tighten policy sufficiently to damp down inflation expectations and cool off the growth of demand enough to contain inflation pressures.

On the other hand, if recessionary conditions are beginning to develop and the Fed ignores them, the cost of non-action could be quite high in terms of lost output and higher unemployment. Once a downward spiral in demand and employment gets underway, the Fed may find that its ability to offset an economic contraction is limited since the Fed funds rate is already close to zero and quantitative measures, such as balance sheet expansion, have only a limited impact on economic activity.

Though there is some ambiguity surrounding the trends in the latest economic data and some FOMC members may prefer a "wait-and-see" policy stance right now, risk management considerations tilt the balance in favor of providing more monetary accommodation in reaction to signs that employment growth is already faltering.

POLICY OPTIONS

There are a number of policy options available to the FOMC, but given the tenuous nature of the data pointing to a slowdown in economic activity, the Committee may opt for a modest easing step rather than adopt another large scale asset purchase program at this point (QE3). We discuss two possibilities below.

One modest step would be to adjust the forward guidance contained in the FOMC's policy statement by indicating a willingness to ease further in the near term if labor market conditions do not improve soon. In addition, in the summary of the policymakers' projections released after the policy meeting, the median assessment of the appropriate timing and pace of "policy firming" could shift out to a later date. This could create the impression of a stronger commitment to keep the fed funds rate close to zero "at least through late 2014."

A second option might be to extend Operation Twist beyond its scheduled 30 June termination for a short period, say three months. That would provide a modest degree of additional monetary accommodation and give the Committee more time to assess economic conditions before deciding if a larger quantitative easing program was truly necessary. Alternatively, Operation Twist could be scaled down in size and continued for a longer period, say six to nine months.

The FOMC members might be tempted to wait a few more weeks to see if the recent slowdown in job gains is temporary. But the policymakers will also feel pressure to do something now, to take out some "insurance" against a further deterioration in economic conditions. The pressure to act at this meeting will be strong since the meeting will be followed by the release of new economic projections from Committee members and by a press conference conducted by the Chairman, Ben Bernanke.

The press conference provides the opportunity to explain any policy changes (or non-changes) by the Committee. The next meeting, scheduled for 31 July and 1 August, will not be followed by a press conference, nor will there be a new set of economic projections.

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# Disclosure appendix

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