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Data Insights: FOMC Minutes

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August minutes: key signaling language

The staff provided a briefing that summarized its analysis of the extent to which some of the Committee's monetary policy tools could provide adequate policy accommodation if, in future economic downturns, the policy rate were again to become constrained by the effective lower bound (ELB). The staff examined simulations from the staff's FRB/US model and various other economic models to assess the likelihood of the policy rate returning to the ELB and to evaluate how much additional policy accommodation could be delivered by the current toolkit. This toolkit included threshold-based forward-guidance policies, in which the Committee communicates that the federal funds rate will remain at the ELB until either inflation or the unemployment rate reaches a certain threshold, and balance sheet policies, involving increases in the size or duration of the Federal Reserve's asset holdings.

The staff's analysis indicated that under various policy rules, including those prescribing aggressive reductions in the federal funds rate in response to adverse economic shocks, there was a meaningful risk that the ELB could bind sometime during the next decade. That analysis also implied that threshold-based forward guidance and balance sheet actions could provide additional accommodation that could help support economic activity and mitigate disinflationary pressures in these episodes. In the model simulations, because of unanticipated shocks and lags in the transmission of the effects of monetary policy actions on economic activity and inflation, the effectiveness of monetary policy in general, including forward-guidance and balance sheet policies, was limited in mitigating the initial downturn in the economy. The staff noted that there was considerable uncertainty surrounding the estimated effects of those policies on the economy; in addition, estimates of how frequently the ELB could bind in the future differed across the models that the staff examined.

In the discussion that followed the staff's briefing, participants generally agreed that their current toolkit could provide significant accommodation but expressed concern about the potential limits on policy effectiveness stemming from the ELB. They viewed it as a matter of prudent planning to evaluate potential policy options in advance of such ELB events. Many participants commented on the monetary policy implications of the apparent secular decline in neutral real interest rates. That decline was viewed as likely driven by various factors, including slower trend growth of the labor force and productivity as well as increased demand for safe assets. In such circumstances, those participants saw monetary policy as having less scope than in the past to reduce the federal funds rate in response to negative shocks. Accordingly, in their view, spells at the ELB could become more frequent and protracted than in the past, consistent with the staff's analysis. Moreover, the secular decline in interest rates was a global phenomenon, and a couple of participants emphasized that this decline increased the likelihood that the ELB could bind simultaneously in a number of countries. A few other participants raised the concern that frequent or extended ELB episodes could result in expectations for inflation that were below the Committee's symmetric 2 percent objective, further limiting the scope for reductions in the federal funds rate to serve as a buffer for the economy and increasing the likelihood of ELB episodes. Fiscal policy was viewed as a potentially important tool in addressing a future economic downturn in which monetary policy was constrained by the ELB; however, countercyclical fiscal policy actions in the United States may be constrained by the high and rising level of federal government debt. A couple of participants saw macroprudential and regulatory policies as tools that could be used to mitigate the risk of financial imbalances inducing an economic downturn in which the ELB constrained the federal funds rate.

Participants generally agreed that both forward guidance and balance sheet actions would be effective tools to use if the federal funds rate were to become constrained by the ELB. In the Addendum to the Policy Normalization Principles and Plans statement issued in June 2017, the Committee indicated that it would be prepared to use its full range of tools, including altering the size and composition of its balance sheet, if future economic conditions were to warrant a more accommodative monetary policy than can be achieved solely by reducing the federal funds rate. However, participants acknowledged that there may be limits to the effectiveness of these tools in addressing an ELB episode. They also emphasized that there was considerable uncertainty about the economic effects of these tools. Consistent with that view, a few participants noted that economic researchers had not yet reached a consensus about the effectiveness of unconventional policies. A number of participants indicated that there might be significant costs associated with the use of unconventional policies, and that these costs might limit, in particular, the extent to which the Committee should engage in large-scale asset purchases.

…In their discussion of the economic situation and the outlook… Several participants stressed the possibility that real GDP growth in the second quarter may have been boosted by transitory factors, including an outsized increase in U.S. exports. For the second half of the year, participants generally expected that GDP growth would likely slow from its second-quarter rate but would still exceed that of potential output. Participants noted a number of favorable economic factors that were supporting above-trend GDP growth; these included a strong labor market, stimulative federal tax and spending policies, accommodative financial conditions, and continued high levels of household and business confidence. Participants generally viewed the risks to the economic outlook as roughly balanced.

Reports from business contacts confirmed a robust pace of expansion in several sectors of the economy, including energy, manufacturing, and services. Crude oil production was reported as having grown rapidly. In contrast to other sectors, residential construction activity appeared to have softened somewhat, possibly reflecting declining home affordability, higher mortgage rates, scarcity of available lots in certain cities, and delays in building approvals. However, a couple of participants reported vibrancy in industrial and multifamily construction activity. Business contacts in various sectors had cited labor shortages and other supply constraints as impediments to production. Furthermore, recent tariff increases had put upward pressure on input prices. Business contacts in a few Districts reported that uncertainty regarding trade policy had led to some reductions or delays in their investment spending. Nonetheless, a number of participants indicated that most businesses concerned about trade disputes had not yet cut back their capital expenditures or hiring but might do so if trade tensions were not resolved soon. Several participants observed that the agricultural sector had been adversely affected by significant declines in crop and livestock prices over the intermeeting period. A couple of participants noted that this development likely partly flowed from trade tensions.

…Many participants commented on the fact that measures of aggregate nominal wage growth had so far picked up only modestly. Among the factors cited as containing the pickup in wage growth were low trend productivity growth, lags in the response of nominal wage growth to resource pressures, and improvements in the terms of employment that were not recorded in the wage data. Alternatively, the recent pace of nominal wage growth might indicate continued slack in the labor market. However, some participants expected a pickup in aggregate nominal wage growth to occur before long, with a number of participants reporting that wage pressures in their Districts were rising or that firms now exhibited greater willingness to grant wage increases.

Participants noted that both overall inflation and inflation for items other than food and energy remained near 2 percent on a 12-month basis. A few participants expressed increased confidence that the recent return of inflation to near the Committee's longer-term 2 percent objective would be sustained. Several participants commented that increases in the prices of particular goods, such as those induced by the tariff increases, would likely be one source of short-term upward pressure on the inflation rate, although offsetting influences--including the negative effects that trade developments were having on agricultural prices--were also noted. Reports from several Districts suggested that firms had greater scope than in the recent past to raise prices in response to strong demand or increases in input costs, including those associated with tariff increases and recent rises in fuel and freight expenses. Many participants anticipated that, over the medium term, high levels of resource utilization and stable inflation expectations would keep inflation near 2 percent. However, some participants observed that inflation in recent years had shown only a weak connection to measures of resource pressures or indicated that they would like to see further evidence that measures of underlying inflation or readings on inflation expectations were on course to attain levels consistent with sustained achievement of the Committee's symmetric 2 percent inflation objective. Although a few participants observed that the trimmed mean measure of inflation calculated by the Federal Reserve Bank of Dallas was still below 2 percent, a couple noted forecasts that this measure would reach 2 percent by the end of the year. Some participants raised the concern that a prolonged period in which the economy operated beyond potential could give rise to inflationary pressures or to financial imbalances that could eventually trigger an economic downturn.

Participants commented on a number of risks and uncertainties associated with their outlook for economic activity, the labor market, and inflation over the medium term. They generally continued to see fiscal policy and the strengthening of the labor market as supportive of economic growth in the near term. Some noted larger or more persistent positive effects of these factors as an upside risk to the outlook. A few participants indicated, however, that a faster-than-expected fading of the fiscal impetus or a greater-than-anticipated subsequent fiscal tightening constituted a downside risk. In addition, all participants pointed to ongoing trade disagreements and proposed trade measures as an important source of uncertainty and risks. Participants observed that if a large-scale and prolonged dispute over trade policies developed, there would likely be adverse effects on business sentiment, investment spending, and employment. Moreover, wide-ranging tariff increases would also reduce the purchasing power of U.S. households. Further negative effects in such a scenario could include reductions in productivity and disruptions of supply chains. Other downside risks cited included the possibility of a significant weakening in the housing sector, a sharp increase in oil prices, or a severe slowdown in EMEs.

…In their consideration of monetary policy, participants discussed the implications of recent economic and financial developments for the economic outlook and the associated risks to that outlook. Participants remarked on recent above-trend growth in real GDP and on indicators of resource utilization. Some commented that consumer spending had been quite strong in the second quarter, confirming their impressions that the first-quarter weakness had been temporary. Several participants also pointed to the continued strength in business fixed investment, although the persistent weakness and the risk of a further slowdown in residential investment were also noted. A few participants suggested there could still be some labor market slack, citing recent increases in labor force participation rates relative to prevailing demographically driven downward trends; the participation rate of prime-age men, in particular, was still below its previous business cycle peak. Other participants judged that labor market conditions were tight, pointing to other data, including job quits and openings rates, and anecdotes from contacts.

…Participants generally judged that the current stance of monetary policy remained accommodative, supporting strong labor market conditions and inflation of around 2 percent. Participants agreed that it would be appropriate for the Committee to leave the target range for the federal funds rate unchanged at this meeting.

With regard to the medium term, various participants indicated that information gathered since the Committee met in June had not significantly altered their outlook for the U.S. economy. Many participants suggested that if incoming data continued to support their current economic outlook, it would likely soon be appropriate to take another step in removing policy accommodation. Participants generally expected that further gradual increases in the target range for the federal funds rate would be consistent with a sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective over the medium term. Many participants reiterated that the actual path for the federal funds rate would ultimately depend on the incoming data and on how those data affect the economic outlook.

Participants discussed the economic forces and risks they saw as providing the rationale for gradual increases in the federal funds rate as well as scenarios that might cause them to depart from this expected path. Among other factors, they pointed to uncertainty about the appropriate level of the federal funds rate over the longer run and to constraints on the provision of monetary accommodation during ELB episodes as reasons for proceeding gradually in the removal of accommodation. Some participants noted that stronger underlying momentum in the economy was an upside risk; most expressed the view that an escalation in international trade disputes was a potentially consequential downside risk for real activity. Some participants suggested that, in the event of a major escalation in trade disputes, the complex nature of trade issues, including the entire range of their effects on output and inflation, presented a challenge in determining the appropriate monetary policy response.

Participants also discussed the possible implications of a flattening in the term structure of market interest rates. Several participants cited statistical evidence for the United States that inversions of the yield curve have often preceded recessions. They suggested that policymakers should pay close attention to the slope of the yield curve in assessing the economic and policy outlook. Other participants emphasized that inferring economic causality from statistical correlations was not appropriate. A number of global factors were seen as contributing to downward pressure on term premiums, including central bank asset purchase programs and the strong worldwide demand for safe assets. In such an environment, an inversion of the yield curve might not have the significance that the historical record would suggest; the signal to be taken from the yield curve needed to be considered in the context of other economic and financial indicators.

…Many participants noted that it would likely be appropriate in the not-too-distant future to revise the Committee's characterization of the stance of monetary policy in its postmeeting statement. They agreed that the statement's language that "the stance of monetary policy remains accommodative" would, at some point fairly soon, no longer be appropriate. Participants noted that the federal funds rate was moving closer to the range of estimates of its neutral level. A number of participants emphasized the considerable uncertainty in estimates of the neutral rate of interest, stemming from sources such as fiscal policy and large-scale asset purchase programs. Against this background, continuing to provide an explicit assessment of the federal funds rate relative to its neutral level could convey a false sense of precision.

Source: Federal Reserve Board