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Data Insights: FOMC Minutes

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November minutes: key signaling language

…Committee participants resumed their discussion of potential long-run frameworks for monetary policy implementation, a topic last discussed at the November 2016 FOMC meeting. The staff provided briefings that described changes in recent years in banks' uses of reserves, outlined tradeoffs associated with potential choices of operating regimes to implement monetary policy and control short-term interest rates, reviewed potential choices of the policy target rate, and summarized developments in the policy implementation frameworks of other central banks.

The staff noted that banks' liquidity management practices had changed markedly since the financial crisis, with large banks now maintaining substantial buffers of reserves, among other high-quality liquid assets, to meet potential outflows and to comply with regulatory requirements. Information from bank contacts as well as a survey of banks indicated that, in an environment in which money market interest rates were very close to the interest rate paid on excess reserve balances, banks would likely be comfortable operating with much lower levels of reserve balances than at present but would wish to maintain substantially higher levels of balances than before the crisis. On average, survey responses suggested that banks might reduce their reserve holdings only modestly from those "lowest comfortable" levels if money market interest rates were somewhat above the interest on excess reserves (IOER) rate. Across banks, however, individual survey responses on this issue varied substantially.

The staff highlighted how changes in the determinants of reserve demand since the crisis could affect the tradeoffs between two types of operating regimes: (1) one in which aggregate excess reserves are sufficiently limited that money market interest rates are sensitive to small changes in the supply of reserves and (2) one in which aggregate excess reserves are sufficiently abundant that money market interest rates are not sensitive to small changes in reserve supply. In the former type of regime, the Federal Reserve actively adjusts reserve supply in order to keep its policy rate close to target. This technique worked well before the financial crisis, when reserve demand was fairly stable in the aggregate and largely influenced by payment needs and reserve requirements. However, with the increased use of reserves for precautionary liquidity purposes following the crisis, there was some uncertainty about whether banks' demand for reserves would now be sufficiently predictable for the Federal Reserve to be able to precisely target an interest rate in this way. In the latter type of regime, money market interest rates are not sensitive to small fluctuations in the demand for and supply of reserves, and the stance of monetary policy is instead transmitted from the Federal Reserve's administered rates to market rates--an approach that has been effective in controlling short-term interest rates in the United States since the financial crisis, as well as in other countries where central banks have used this approach.

The staff briefings also examined the tradeoffs between alternative policy rates that the Committee could choose in each of the regimes. In a regime of limited excess reserves, the Federal Reserve's policy tools most directly affect overnight unsecured rates paid by banks, such as the effective federal funds rate (EFFR) and the overnight bank funding rate (OBFR). These rates could also be targeted with abundant excess reserves, as could interest rates on secured funding or a mixture of secured and unsecured rates.

Participants commented on the advantages of a regime of policy implementation with abundant excess reserves. Based on experience over recent years, such a regime was seen as providing good control of short-term money market rates in a variety of market conditions and effective transmission of those rates to broader financial conditions. Participants commented that, by contrast, interest rate control might be difficult to achieve in an operating regime of limited excess reserves in view of the potentially greater unpredictability of reserve demand resulting from liquidity regulations or changes in risk appetite, or the increased variability of factors affecting reserve supply. Participants also observed that regimes with abundant excess reserves could provide effective control of short-term rates even if large amounts of liquidity needed to be added to address liquidity strains or if large-scale asset purchases needed to be undertaken to provide macroeconomic stimulus in situations where short-term rates are at their effective lower bound. Monetary policy operations in this regime would also not require active management of reserve supply. In addition, the provision of sizable quantities of reserves could enhance financial stability and reduce operational risks in the payment system by maintaining a high level of liquidity in the banking system.

A number of participants commented that the attractive features of a regime of abundant excess reserves should be weighed against the potential drawbacks of such a regime as well as the potential benefits of returning to a regime similar to that employed before the financial crisis. Potential drawbacks of an abundant reserves regime included challenges in precisely determining the quantity of reserves necessary in such systems, the need to maintain relatively sizable quantities of reserves and holdings of securities, and relatively large ongoing interest expenses associated with the remuneration of reserves. Some noted that returning to a regime of limited excess reserves could demonstrate the Federal Reserve's ability to fully unwind the policies used to respond to the crisis and might thereby increase public acceptance or effectiveness of such policies in the future. Participants noted that the level of reserve balances required to remain in a regime where rate control does not entail active management of the supply of reserves was quite uncertain, but they thought that reserve supply could be reduced substantially below its current level while remaining in such a regime. They expected to learn more about the demand for reserves as the balance sheet continued to shrink in a gradual and predictable manner. They also observed that it might be possible to adopt strategies that provide incentives for banks to reduce their demand for reserves. Participants judged that if the level of reserves needed for a regime with abundant excess reserves turned out to be considerably higher than anticipated, the possibility of returning to a regime in which excess reserves were limited and adjustments in reserve supply were used to influence money market rates would warrant further consideration…

…In their discussion of the economic situation and the outlook, meeting participants agreed that information received since the FOMC met in September indicated that the labor market had continued to strengthen and that economic activity had been rising at a strong rate. Job gains had been strong, on average, in recent months, and the unemployment rate had declined. Household spending had continued to grow strongly, while growth of business fixed investment had moderated from its rapid pace earlier in the year. On a 12-month basis, both overall inflation and core inflation, which excludes changes in food and energy prices, had remained near 2 percent. Indicators of longer-term inflation expectations were little changed on balance.

Based on recent readings on spending, prices, and the labor market, participants generally indicated little change in their assessment of the economic outlook, with above-trend economic growth expected to continue before slowing to a pace closer to trend over the medium term. Participants pointed to several factors supporting above-trend growth, including strong employment gains, expansionary federal tax and spending policies, and continued high levels of consumer and business confidence. Several participants observed that the stimulative effects of fiscal policy would likely diminish over time, while the lagged effects of reductions in monetary policy accommodation would show through more fully, with both factors contributing to their expectation that economic growth would slow to a pace closer to trend.

In their discussion of the household sector, participants generally continued to characterize consumption growth as strong. This view was supported by reports from District contacts, which were mostly upbeat regarding consumer spending. Although household spending overall was seen as strong, most participants noted weakness in residential investment. This weakness was attributed to a variety of factors, including increased mortgage rates, building cost increases, and supply constraints.

Participants observed that growth in business fixed investment slowed in the third quarter following several quarters of rapid growth. Some participants pointed to anecdotal evidence regarding higher tariffs and uncertainty about trade policy, slowing global demand, rising input costs, or higher interest rates as possible factors contributing to the slowdown. A couple of others noted that business investment growth can be volatile on a quarterly basis and factors such as the recent cuts in corporate taxes and high levels of business sentiment were expected to support investment going forward.

…Contacts in many Districts continued to report tight labor markets with difficulties finding qualified workers. In some cases, firms were responding to these difficulties by increasing training for less-qualified workers, outsourcing work, or automating production, while in other cases, firms were responding by raising wages. Contacts in a couple of Districts indicated that labor shortages, particularly for skilled labor, might be constraining activity in certain industries. Participants observed that, at the national level, measures of nominal wage growth appeared to be picking up. Many participants noted that the recent pace of aggregate wage gains was broadly consistent with trends in productivity growth and inflation.

Participants observed that both overall and core PCE price inflation remained near 2 percent on a 12-month basis. In general, participants viewed recent price developments as consistent with their expectation that inflation would remain near the Committee's symmetric 2 percent objective on a sustained basis. Reports from business contacts and surveys in a number of Districts were consistent with some firming in inflationary pressure. Contacts in many Districts indicated that input costs had risen and that increased tariffs were raising costs, especially for industries relying heavily on steel and aluminum. In a few Districts, transportation costs had reportedly increased. Some contacts indicated that while input costs were higher, it appeared that the pass-through of these higher costs to consumer prices was limited.

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. A few participants indicated that uncertainty had increased recently, pointing to the high levels of uncertainty regarding the effects of fiscal and trade policies on economic activity and inflation. Some participants viewed economic and financial developments abroad, including the possibility of further appreciation of the U.S. dollar, as posing downside risks for domestic economic growth and inflation. A couple of participants expressed the concern that measures of inflation expectations would remain low, particularly if economic growth slowed more than expected. Several participants were concerned that the high level of debt in the nonfinancial business sector, and especially the high level of leveraged loans, made the economy more vulnerable to a sharp pullback in credit availability, which could exacerbate the effects of a negative shock on economic activity. The potential for an escalation in tariffs or trade tensions was also cited as a factor that could slow economic growth more than expected. With regard to upside risks, participants noted that greater-than-expected effects of fiscal stimulus and high consumer confidence could lead to stronger-than-expected economic outcomes. Some participants raised the concern that tightening resource utilization in conjunction with an increase in the ability of firms to pass through increases in tariffs or in other input costs to consumer prices could generate undesirable upward pressure on inflation. In general, participants agreed that risks to the outlook appeared roughly balanced.

In their discussion of financial developments, participants observed that financial conditions tightened over the intermeeting period, as equity prices declined, longer-term yields and borrowing costs for most sectors increased, and the foreign exchange value of the dollar rose. Despite these developments, a number of participants judged that financial conditions remained accommodative relative to historical norms.

…In their discussion of monetary policy, participants agreed that it would be appropriate to maintain the current target range for the federal funds rate at this meeting. Participants generally judged that the economy had been evolving about as they had anticipated, with economic activity rising at a strong rate, labor market conditions continuing to strengthen, and inflation running at or near the Committee's longer-run objective. Almost all participants reaffirmed the view that further gradual increases in the target range for the federal funds rate would likely be consistent with sustaining the Committee's objectives of maximum employment and price stability.

Consistent with their judgment that a gradual approach to policy normalization remained appropriate, almost all participants expressed the view that another increase in the target range for the federal funds rate was likely to be warranted fairly soon if incoming information on the labor market and inflation was in line with or stronger than their current expectations. However, a few participants, while viewing further gradual increases in the target range of the federal funds rate as likely to be appropriate, expressed uncertainty about the timing of such increases. A couple of participants noted that the federal funds rate might currently be near its neutral level and that further increases in the federal funds rate could unduly slow the expansion of economic activity and put downward pressure on inflation and inflation expectations.

Participants emphasized that the Committee's approach to setting the stance of policy should be importantly guided by incoming data and their implications for the economic outlook. They noted that their expectations for the path of the federal funds rate were based on their current assessment of the economic outlook. Monetary policy was not on a preset course; if incoming information prompted meaningful reassessments of the economic outlook and attendant risks, either to the upside or the downside, their policy outlook would change. Various factors such as the recent tightening in financial conditions, risks in the global outlook, and some signs of slowing in interest-sensitive sectors of the economy on the one hand, and further indicators of tightness in labor markets and possible inflationary pressures, on the other hand, were noted in this context. Participants also commented on how the Committee's communications in its postmeeting statement might need to be revised at coming meetings, particularly the language referring to the Committee's expectations for "further gradual increases" in the target range for the federal funds rate. Many participants indicated that it might be appropriate at some upcoming meetings to begin to transition to statement language that placed greater emphasis on the evaluation of incoming data in assessing the economic and policy outlook; such a change would help to convey the Committee's flexible approach in responding to changing economic circumstances.

Source: Federal Reserve Board