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Data Insights: FOMC Minutes

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January minutes: key signaling language

… market participants appeared to interpret FOMC communications at the time of the December meeting as not fully appreciating the tightening of financial conditions and the associated downside risks to the U.S. economic outlook that had emerged since the fall. In addition, some market reports suggested that investors perceived the FOMC to be insufficiently flexible in its approach to adjusting the path for the federal funds rate or the process for balance sheet normalization in light of those risks. The deterioration in risk sentiment late in December was reportedly amplified by poor liquidity and thin trading conditions around year-end.

Early in the new year, market sentiment improved following communications by Federal Reserve officials emphasizing that the Committee could be "patient" in considering further adjustments to the stance of policy and that it would be flexible in managing the reduction of securities holdings in the SOMA. On balance, stock prices finished the period up almost 5 percent while corporate risk spreads narrowed, reversing a portion of the changes in these variables since the September FOMC meeting.

…Following the briefing, participants raised a number of questions about market reports that the Federal Reserve's balance sheet runoff and associated "quantitative tightening" had been an important factor contributing to the selloff in equity markets in the closing months of last year. While respondents assessed that the reduction of securities held in the SOMA would put some modest upward pressure on Treasury yields and agency mortgage-backed securities (MBS) yields over time, they generally placed little weight on balance sheet reduction as a prime factor spurring the deterioration in risk sentiment over that period. However, some other investors reportedly held firmly to the belief that the runoff of the Federal Reserve's securities holdings was a factor putting significant downward pressure on risky asset prices, and the investment decisions of these investors, particularly in thin market conditions around the year-end, might have had an outsized effect on market prices for a time. Participants also discussed the hypothesis that investors may have taken some signal about the future path of the federal funds rate based on perceptions that the Federal Reserve was unwilling to adjust the pace of balance sheet runoff in light of economic and financial developments.

…The staff briefing also included a discussion of factors relevant in judging the level of reserves that would support the efficient implementation of monetary policy. The staff suggested that maintaining a buffer of reserves above the minimum quantity that corresponds to the flat portion of the reserve demand curve could reduce the size and frequency of open market operations needed to maintain good control of the policy rate. The aggregate level of reserves had already declined by $1.2 trillion from a peak level of $2.8 trillion reached in October 2014; the decline stemmed from both reductions in asset holdings and increases in nonreserve liabilities such as Federal Reserve notes in circulation. Some recent survey information and other evidence suggested that reserves might begin to approach an efficient level later this year. Against this backdrop, the staff presented options for substantially slowing the decline in reserves by ending the reduction in asset holdings at some point over the latter half of this year and thereafter holding the size of the SOMA portfolio roughly constant for a time so that the average level of reserves would fall at a very gradual pace reflecting the trend growth in other Federal Reserve liabilities.

The staff also described options for communicating plans both for the operating regime and for the completion of the normalization of the size of the balance sheet. If the Committee reached a decision to continue using its current operating regime, announcing this decision after the current meeting would help reduce uncertainty about both the long-run implementation framework and the likely evolution of the balance sheet. In addition, the Committee could revise its previous communications to make clear that it was flexible in its approach to normalizing the balance sheet and was prepared to change the details of its balance sheet normalization plans in light of economic and financial developments if necessary to support the FOMC's broader policy goals…

Participants discussed market commentary that suggested that the process of balance sheet normalization might be influencing financial markets. Participants noted that the ongoing reduction in the Federal Reserve's asset holdings had proceeded smoothly for more than a year, with no significant effects on financial markets. The gradual reduction in securities holdings had been announced well in advance and, as intended, was proceeding largely in the background, with the federal funds rate remaining the Committee's primary tool for adjusting the stance of policy. Nonetheless, some investors might have interpreted previous communications as indicating that a very high threshold would have to be met before the Committee would be willing to adjust its balance sheet normalization plans. Participants observed that, although the target range for the federal funds rate was the Committee's primary means of adjusting the stance of policy, the balance sheet normalization process should proceed in a way that supports the achievement of the Federal Reserve's dual-mandate goals of maximum employment and stable prices. Consistent with this principle, participants agreed that it was important to be flexible in managing the process of balance sheet normalization, and that it would be appropriate to adjust the details of balance sheet normalization plans in light of economic and financial developments if necessary to achieve the Committee's macroeconomic objectives.

Almost all participants thought that it would be desirable to announce before too long a plan to stop reducing the Federal Reserve's asset holdings later this year. Such an announcement would provide more certainty about the process for completing the normalization of the size of the Federal Reserve's balance sheet. A substantial majority expected that when asset redemptions ended, the level of reserves would likely be somewhat larger than necessary for efficient and effective implementation of monetary policy; if so, many suggested that some further very gradual decline in the average level of reserves, reflecting the trend growth of other liabilities such as Federal Reserve notes in circulation, could be appropriate. In these participants' view, this process would allow the Federal Reserve to arrive slowly at an efficient level of reserves while maintaining good control of short-term interest rates without needing to engage in more frequent open market operations. A few participants judged that there would be little benefit to allowing reserves to continue to fall after the end of redemptions or that this approach could have costs, such as an undue risk of volatility in short-term interest rates, that would exceed its benefits. These participants thought that upon ending asset redemptions, the Federal Reserve should begin adding to its assets to offset growth in nonreserve liabilities, so as to keep the average level of reserves relatively stable. A couple of participants suggested that a ceiling facility to mitigate temporary unexpected pressures in reserve markets could play a useful role in supporting policy implementation at lower levels of reserves.

Participants commented that, in light of the Committee's longstanding plan to hold primarily Treasury securities in the long run, it would be appropriate once asset redemptions end to reinvest most, if not all, principal payments received from agency MBS in Treasury securities. Some thought that continuing to reinvest agency MBS principal payments in excess of $20 billion per month in agency MBS, as under the current balance sheet normalization plan, would simplify communications or provide a helpful backstop against scenarios in which large declines in long-term interest rates caused agency MBS prepayment speeds to increase sharply. However, some others judged that retaining the cap on agency MBS redemptions was unnecessary at this stage in the normalization process. These participants noted considerations in support of this view, including that principal payments were unlikely to reach the $20 billion level after 2019, that the cap could slightly slow the return to a portfolio of primarily Treasury securities, or that the Committee would have the flexibility to adjust the details of its balance sheet normalization plans in light of economic and financial developments. Participants commented that it would be important over time to develop and communicate plans for reinvesting agency MBS principal payments, and they expected to continue their discussion of balance sheet normalization and related issues at upcoming meetings.

Following the discussion, the Chairman proposed that the Committee communicate its intentions regarding monetary policy implementation and its willingness to adjust the details of its balance sheet normalization program by publishing a statement at the conclusion of the meeting. All participants agreed with the proposed statement.

…December FOMC communications were reportedly perceived by market participants as not fully appreciating the implications of tighter financial conditions and softening global data over recent months for the U.S. economic outlook. Subsequent communications from FOMC participants were interpreted as suggesting that the FOMC would be patient in assessing the implications of recent economic and financial developments. The market-implied path for the federal funds rate in 2019 was little changed, on net, over the intermeeting period and investors continued to expect no change to the target range for the federal funds rate at the January FOMC meeting. The market-implied path for 2020 shifted down somewhat.

…Participants continued to view a sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes over the next few years. Participants generally continued to expect the growth rate of real GDP in 2019 to step down somewhat from the pace seen over 2018 to a rate closer to their estimates of longer-run growth, with a few participants commenting that waning fiscal stimulus was expected to contribute to the step-down. Several participants commented that they had nudged down their outlooks for output growth since the December meeting, citing a softening in consumer or business sentiment, a reduction in the outlook for foreign economic growth, or the tightening in financial conditions that had occurred in recent months.

…Participants noted that growth of business fixed investment had moderated from its rapid pace earlier last year. Some participants highlighted that recent surveys of business sentiment or District contacts had indicated some weakening in optimism or confidence about the economic outlook, though available indicators suggested that the level of business sentiment had remained high. Concerns about the economic outlook were variously attributed to uncertainty or worries about slowing global economic growth, including in Europe and China; trade policy; waning fiscal policy stimulus; and the partial government shutdown. Manufacturing contacts in a number of Districts indicated that such factors were causing them to delay or defer capital expenditures. In addition, a few participants noted that recent declines in oil or gasoline prices had damped plans for capital expenditures in the energy sector. A few participants observed that conditions in the agricultural sector remained difficult, citing large inventories of agricultural commodities, uncertainty about international trade policies, and concerns regarding low prices of commodities and farmland. However, a few participants commented that business optimism had increased among contacts in their Districts, or that they were planning new capital expenditures.

Participants observed that both overall inflation and inflation for items other than food and energy remained near 2 percent on a 12-month basis. Participants continued to view inflation near the Committee's symmetric 2 percent objective as the most likely outcome. Some participants noted that some factors, such as the decline in oil prices, slower growth and softer inflation abroad, or appreciation of the dollar last year, had held down some recent inflation readings and may continue to do so this year. In addition, many participants commented that upward pressures on inflation appeared to be more muted than they appeared to be last year despite strengthening labor market conditions and rising input costs for some industries.

…Participants commented on a number of risks associated with their outlook for economic activity, the labor market, and inflation over the medium term. Participants noted that some risks to the downside had increased, including the possibilities of a sharper-than-expected slowdown in global economic growth, particularly in China and Europe, a rapid waning of fiscal policy stimulus, or a further tightening of financial market conditions. An increase in some foreign and domestic government policy uncertainties, including those associated with Brexit, an escalation in international trade policy tensions, and the potential for additional extended federal government shutdowns were also cited as downside risks. A few participants expressed concern that longer-run inflation expectations may be lower than levels consistent with the Committee's 2 percent inflation objective. Several participants judged that risks that could lead to higher-than-expected inflation had diminished relative to downside risks. The potential that various sources of uncertainty might abate more quickly than expected was mentioned as a potential upside risk for the economic outlook.

…Among those participants who commented on financial stability, a number expressed concerns about the elevated financial market volatility and the apparent decline in investors' willingness to bear risk that occurred toward the end of last year. Although these conditions had eased somewhat in recent weeks, a couple of participants noted that the strain in financial markets might have persisted or spread if it had occurred during a period of less favorable macroeconomic conditions. A couple of participants highlighted the role that decreased liquidity at the end of the year appeared to play in exacerbating changes in financial market conditions. They emphasized the need to monitor financial market structures or practices that may contribute to strained liquidity conditions. A few participants highlighted the importance of ensuring that financial institutions were able to withstand adverse financial market events--for instance, by maintaining adequate levels of capital.

In their consideration of monetary policy at this meeting, participants judged that information received since December indicated that real economic activity had been rising at a solid rate, labor market conditions had continued to strengthen, and inflation had been near the Committee's objective. Participants generally expected economic activity to continue expanding at a solid pace in the period ahead, with strong labor market conditions and inflation near 2 percent. At the time of the December meeting, the Committee had noted that it would continue to monitor global economic and financial developments and assess their implications for the economic outlook. Participants observed that since then, the economic outlook had become more uncertain. Financial market volatility had remained elevated over the intermeeting period, and, despite some easing since the December FOMC meeting, overall financial conditions had tightened since September. In addition, the global economy had continued to record slower growth, and consumer and business sentiment had deteriorated. The government policy environment, including trade negotiations and the recent partial federal government shutdown, was also seen as a factor contributing to uncertainty about the economic outlook.

Based on their current assessments, all participants expressed the view that it would be appropriate for the Committee to maintain the target range for the federal funds rate at 2-1/4 to 2-1/2 percent. With regard to the Committee's postmeeting statement, participants supported a proposed change in the forward guidance language that would replace the previous guidance referring to "some further gradual increases in the target range for the federal funds rate" with an indication that, in light of "global economic and financial developments and muted inflation pressures," the Committee would "be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate." Participants also supported a proposal to remove from the statement the characterization of risks to the economic outlook as "roughly balanced."

Participants pointed to a variety of considerations that supported a patient approach to monetary policy at this juncture as an appropriate step in managing various risks and uncertainties in the outlook. With regard to the domestic economic picture, additional data would help policymakers gauge the trajectory of business and consumer sentiment, whether the recent softness in core and total inflation and inflation compensation would persist, and the effect of the tightening of financial conditions on aggregate demand. Information arriving in coming months could also shed light on the effects of the recent partial federal government shutdown on the U.S. economy and on the results of the budget negotiations occurring in the wake of the shutdown, including the possible implications for the path of fiscal policy. A patient approach would have the added benefit of giving policymakers an opportunity to judge the response of economic activity and inflation to the recent steps taken to normalize the stance of monetary policy. Furthermore, a patient posture would allow time for a clearer picture of the international trade policy situation and the state of the global economy to emerge and, in particular, could allow policymakers to reach a firmer judgment about the extent and persistence of the economic slowdown in Europe and China.

Participants noted that maintaining the current target range for the federal funds rate for a time posed few risks at this point. The current level of the federal funds rate was at the lower end of the range of estimates of the neutral policy rate. Moreover, inflation pressures were muted, and asset valuations were less stretched than they had been a few months earlier. Many participants suggested that it was not yet clear what adjustments to the target range for the federal funds rate may be appropriate later this year; several of these participants argued that rate increases might prove necessary only if inflation outcomes were higher than in their baseline outlook. Several other participants indicated that, if the economy evolved as they expected, they would view it as appropriate to raise the target range for the federal funds rate later this year.

Participants observed that a patient posture in these circumstances was consistent with their general approach to setting the stance of policy, in which they were importantly guided by the implications of incoming data for the economic outlook. Some participants noted that, while global economic and financial developments had been important factors leading to a patient monetary policy posture, those developments mattered because they affected assessments of the policy rate path most consistent with achievement of the Committee's dual-mandate goals of maximum employment and price stability. Many participants observed that if uncertainty abated, the Committee would need to reassess the characterization of monetary policy as "patient" and might then use different statement language.

A few participants expressed concerns that in the current environment of increased uncertainty, the policy rate projections prepared as part of the Summary of Economic Projections (SEP) do not accurately convey the Committee's policy outlook. These participants were concerned that, although the individual participants' projections for the federal funds rate in the SEP reflect their individual views of the appropriate path for the policy rate conditional on the evolution of the economic outlook, at times the public had misinterpreted the median or central tendency of those projections as representing the consensus view of the Committee or as suggesting that policy was on a preset course. However, some other participants noted that the policy rate projections in the SEP are a valuable component of the overall information provided about the monetary policy outlook.

…In their discussion of monetary policy for the period ahead, members judged that information received since the Committee met in December indicated that the labor market had continued to strengthen and that economic activity had been rising at a solid rate. Job gains had been strong, on average, in recent months, and the unemployment rate had remained low. Household spending had continued to grow strongly, while growth of business fixed investment had moderated from its rapid pace earlier last year. On a 12-month basis, both overall inflation and inflation for items other than food and energy remained near 2 percent. Although market-based measures of inflation compensation had moved lower in recent months, survey-based measures of longer-term inflation expectations were little changed.

In their consideration of the economic outlook, members noted that financial conditions had tightened, on net, since September, and that global growth had moderated; members also observed that a number of uncertainties, including those pertaining to the evolution of policies of the U.S. and foreign governments, still awaited resolution. However, members continued to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes for the U.S. economy in the period ahead. In light of global economic and financial developments and muted inflation pressures, the Committee could be patient as it determined what future adjustments to the target range for the federal funds rate may be appropriate to support these outcomes.

After assessing current conditions and the outlook for economic activity, the labor market, and inflation, members decided to maintain the target range for the federal funds rate at 2-1/4 to 2-1/2 percent. Members agreed that in determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee would assess realized and expected economic conditions relative to the Committee's maximum employment and symmetric 2 percent inflation objectives. They reiterated that this assessment would take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments. More generally, members noted that decisions regarding near-term adjustments of the stance of monetary policy would appropriately remain dependent on the evolution of the outlook as informed by incoming data.

With regard to the postmeeting statement, members agreed to change the characterization of recent growth in economic activity from "strong" to "solid," consistent with incoming information that suggested that the pace of expansion of the U.S. economy had moderated somewhat since late last year. The description of indicators of inflation expectations was revised to recognize that the downward moves in market-based measures of inflation compensation that occurred in recent months had been sustained, while also noting that survey-based measures of longer-term inflation expectations were little changed. Members also agreed to several adjustments in the description of the outlook for the economy and monetary policy. The statement language was revised to indicate that the Committee continued to view sustained expansion of economic activity, strong labor market conditions, and inflation near 2 percent as "the most likely outcomes." Members also agreed to add a sentence indicating that, in light of "global economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support these outcomes." This sentence was intended to convey the Committee's view that a patient and flexible approach was appropriate at this time as a way to manage risks while assessing incoming information bearing on the economic outlook. In light of the range of uncertainties associated with global economic and financial developments, the Committee decided that it was not useful at this time to express a judgment about the balance of risks.

Source: Federal Reserve Board