Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

# Data Insights: FOMC Minutes

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## May minutes: key signaling language

### Balance Sheet Normalization

Participants resumed their discussion of issues related to balance sheet normalization with a focus on the long-run maturity composition of the System Open Market Account (SOMA) portfolio. The staff presented two illustrative scenarios as a way of highlighting a range of implications of different long-run target portfolio compositions. In the first scenario, the maturity composition of the U.S. Treasury securities in the target portfolio was similar to that of the universe of currently outstanding U.S. Treasury securities (a "proportional" portfolio). In the second, the target portfolio contained only shorter-term securities with maturities of three years or less (a "shorter maturity" portfolio). The staff provided estimates of the capacity that the Committee would have under each scenario to provide economic stimulus through a maturity extension program (MEP). The staff also provided estimates of the extent to which term premiums embedded in longer-term Treasury yields might be affected under the two different scenarios. Based on the staff's standard modeling framework, all else equal, a move to the illustrative shorter maturity portfolio would put significant upward pressure on term premiums and imply that the path of the federal funds rate would need to be correspondingly lower to achieve the same macroeconomic outcomes as in the baseline outlook. However, the staff noted the uncertainties inherent in the analysis, including the difficulties in estimating the effects of changes in SOMA holdings on longer-term interest rates and the economy more generally.

The staff presentation also considered illustrative gradual and accelerated transition paths to each long-run target portfolio. Under the illustrative "gradual" transition, reinvestments of maturing Treasury holdings, principal payments on agency mortgage-backed securities (MBS), and purchases to accommodate growth in Federal

Reserve liabilities would be directed to Treasury securities with maturities in the long-run target portfolio. Under the illustrative "accelerated" transition, the reinvestment of principal payments on agency MBS and purchases to accommodate growth in Federal Reserve liabilities would be directed to Treasury bills until the weighted average maturity (WAM) of the SOMA portfolio reached the WAM associated with the target portfolio. Depending on the combination of long-run target composition and the transition plan for arriving at that composition, the staff reported that, in the illustrative scenarios, it could take from 5 years to more than 15 years for the WAM of the SOMA portfolio to reach its long-run level.

In its Statement Regarding Monetary Policy Implementation and Balance Sheet Normalization, the Committee noted that it is prepared to adjust the size and composition of the balance sheet to achieve its macroeconomic objectives in a scenario in which the federal funds rate is constrained by the effective lower bound. Against this backdrop, participants discussed the benefits and costs of alternative long-run target portfolio compositions in supporting the use of balance sheet policies in such scenarios.

In their discussion of a shorter maturity portfolio, many participants noted the advantage of increased capacity for the Federal Reserve to conduct an MEP, which could be helpful in providing policy accommodation in a future economic downturn given the secular decline in neutral real interest rates and the associated reduced scope for lowering the federal funds rate in response to negative economic shocks. Several participants viewed an MEP as a useful initial option to address a future downturn in which the Committee judged that it needed to employ balance sheet actions to provide appropriate policy accommodation. Participants acknowledged the staff analysis suggesting that creating space to conduct an MEP by moving to a shorter maturity portfolio composition could boost term premiums and result in a lower path for the federal funds rate, reducing the capacity to ease financial conditions with adjustments in short-term rates. A number of participants noted, however, that the estimates of the effect of a move to a shorter-maturity portfolio composition on the long-run neutral federal funds rate are subject to substantial uncertainty and are based on a number of strong modeling assumptions. For example, estimates of term premium effects based on experience during the crisis could overstate the effects that would be associated with a gradual evolution of the composition of the SOMA portfolio. In addition, a shift in the composition of the SOMA portfolio could result in changes in the supply of securities that would tend to offset upward pressure on term premiums. Nonetheless, other participants expressed concern about the potential that a shorter maturity portfolio composition could result in a lower long-run neutral federal funds rate. Moreover, while a shorter maturity portfolio would provide substantial capacity to conduct an MEP, some participants raised questions about the effectiveness of MEPs as a policy tool relative to that of the federal funds rate or other unconventional policy tools. These participants noted that, in a situation in which it would be appropriate to employ unconventional policy tools, they likely would prefer to employ forward guidance or large-scale purchases of assets ahead of an MEP. In the view of these participants, the potential benefit of transitioning to a shorter maturity SOMA composition in terms of increased ability to conduct an MEP might not be worth the potential costs.

In their discussion of a proportional portfolio composition, participants observed that moving to this target SOMA composition would not be expected to have much effect on current staff estimates of term premiums and thus would likely not reduce the scope for lowering the target range for the federal funds rate target in response to adverse economic shocks. As a result, several participants judged the proportional target composition to be well aligned with the Committee's previous statements that changes in the target range for the federal funds rate are the primary means by which the Committee adjusts the stance of monetary policy. In addition, several participants noted that while the staff analysis suggested a proportional portfolio would not contain as much capacity to conduct an MEP as a shorter maturity portfolio, it still would contain meaningful capacity along these lines. Some participants noted that a proportional portfolio would also help maintain the traditional separation between the Federal Reserve's decisions regarding the composition of the SOMA portfolio and the maturity composition of Treasury debt held by the private sector. However, a number of participants judged that it would be desirable to structure the SOMA portfolio in a way that would provide more capacity to conduct an MEP than in the proportional portfolio. In addition, a couple of participants noted that a shorter maturity portfolio would maintain a narrow gap between the average maturity of the assets in the SOMA portfolio and the short average maturity of the Federal Reserve's primary liabilities.

Participants also discussed the financial stability implications that could be associated with alternative long-run target portfolio compositions. A couple of participants noted that a proportional portfolio could imply a relatively flat yield curve, which could result in greater incentives for "reach for yield" behavior in the financial system. That said, a few participants noted that a shorter maturity portfolio could affect financial stability risks by increasing the incentives for the private sector to issue short-term debt. A couple of participants judged that financial market functioning might be adversely affected if the holdings in the shorter maturity portfolio accounted for too large a share of total shorter maturity Treasury securities outstanding.

In discussing the transition to the desired long-run SOMA portfolio composition, several participants noted that a gradual pace of transition could help avoid unwanted effects on financial conditions. However, participants observed that the gradual transition paths described in the staff presentation would take many years to complete. Against this backdrop, a few participants discussed the possibility of following some type of accelerated transition, perhaps including sales of the SOMA's residual holdings of agency MBS. In addition, several participants suggested that the Committee could communicate its plans about the SOMA portfolio composition in terms of a desired change over an intermediate horizon rather than a specific long-run target.

Several participants expressed the view that a decision regarding the long-run composition of the portfolio would not need to be made for some time, and a couple of participants highlighted the importance of making such a decision in the context of the ongoing review of the Federal Reserve's monetary policy strategies, tools, and communications practices. Some participants noted the importance of developing an effective communication plan to describe the Committee's decisions regarding the long-run target composition for the SOMA portfolio and the transition to that target composition.

The TGA was volatile during the intermeeting period. In early April, the Treasury reduced bill issuance and allowed the TGA balance to fall in anticipation of individual tax receipts. As tax receipts arrived after the tax date, the TGA rose to more than $400 billion, resulting in a sharp decline in reserves over the last two weeks of April.

Against this backdrop, the distribution of rates on traded volumes in overnight unsecured markets shifted higher. The effective federal funds rate (EFFR) moved up to 2.45 percent by the end of the intermeeting period, 5 basis points above the interest on excess reserves (IOER) rate.

Several factors appeared to spur this upward pressure. Tax-related runoffs in deposits at banks reportedly led banks to increase short-term borrowing, particularly through Federal Home Loan Bank (FHLB) advances and in the federal funds market. Although some banks continued to hold large quantities of reserves, other banks were operating with reserve balances closer to their lowest comfortable levels as reported in the most recent Senior Financial Officer Survey. This distribution of reserves may have contributed to somewhat more sustained upward pressure on the federal funds rate than had been experienced in recent years around tax-payment dates. In addition, rates on Treasury repurchase agreements (repo), were, in part, pushed higher by tax-related outflows from government-only money market mutual funds and a corresponding decline in repo lending by those funds. Elevated repo rates contributed to upward pressure on the federal funds rate, as FHLBs reportedly shifted some of their liquidity investments out of federal funds and into the repo market. In addition, some market participants pointed to heightened demand for federal funds at month end by some banks in connection with their efforts to meet liquidity coverage ratio requirements as contributing to upward pressure on the federal funds rate.

…A technical adjustment would reduce the spread between the IOER rate and the ON RRP offering rate to 10 basis points, the smallest since the introduction of the ON RRP facility. The staff judged that the narrower spread did not pose a significant risk of increased take-up at the ON RRP facility because repo rates had been trading well above the ON RRP offer rate for some time. However, if it became appropriate in the future to further lower the IOER rate, the staff noted that the Committee might wish to first consider where to set the ON RRP offer rate relative to the target range for the federal funds rate to mitigate this risk.

…Participants agreed that labor markets had remained strong over the intermeeting period and that economic activity had risen at a solid rate. Job gains had been solid, on average, in recent months, and the unemployment rate had stayed low. Participants also observed that growth in household spending and business fixed investment had slowed in the first quarter. Overall inflation and inflation for items other than food and energy, both measured on a 12-month basis, had declined and were running below 2 percent. On balance, market-based measures of inflation compensation had remained low in recent months, and survey-based measures of longer-term inflation expectations were little changed.

Participants continued to view sustained expansion of economic activity, with strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes. Participants noted the unexpected strength in first-quarter GDP growth, but some observed that the composition of growth, with large contributions from inventories and net exports and more modest contributions from consumption and investment, suggested that GDP growth in the near term would likely moderate from its strong pace of last year. For this year as a whole, a number of participants mentioned that they had marked up their projections for real GDP growth, reflecting, in part, the strong first-quarter reading.

…In their discussion of the household sector, participants discussed recent indicators, including retail sales and light motor vehicle sales for March, which rose from relatively weak readings in some previous months. Taken together, these developments suggested that the first-quarter softness in household spending was likely to prove temporary. With the strong jobs market, rising incomes, and upbeat consumer sentiment, growth in PCE in coming months was expected to be solid. Several participants also noted that while the housing sector had been a drag on GDP growth for some time, recent data pointed to some signs of stabilization. With mortgage rates at their lowest levels in more than a year, a few participants thought that residential construction could begin to make positive contributions to GDP growth in the near term; a few others were less optimistic.

Participants noted that growth of business fixed investment had moderated in the first quarter relative to the average pace recorded last year and discussed whether this more moderate growth was likely to persist. A number of participants expressed optimism that there would be continued growth in capital expenditures this year, albeit probably at a slower pace than in 2018. Several participants observed that financial conditions and business sentiment had continued to improve, consistent with reports from business contacts in a number of Districts; however, a few others reported less buoyant business sentiment Many participants suggested that their own concerns from earlier in the year about downside risks from slowing global economic growth and the deterioration in financial conditions or similar concerns expressed by their business contacts had abated to some extent. However, a few participants noted that ongoing challenges in the agricultural sector, including those associated with trade uncertainty and low prices, had been exacerbated by severe flooding in recent weeks.

Participants observed that inflation pressures remained muted and that the most recent data on overall inflation, and inflation for items other than food and energy, had come in lower than expected. At least part of the recent softness in inflation could be attributed to idiosyncratic factors that seemed likely to have only transitory effects on inflation, including unusually sharp declines in the prices of apparel and of portfolio management services. Some research suggests that idiosyncratic factors that largely affected acylical sectors in the economy had accounted for a substantial portion of the fluctuations in inflation over the past couple of years. Consistent with the view that recent lower inflation readings could be temporary, a number of participants mentioned the trimmed mean measure of PCE price inflation, produced by the Federal Reserve Bank of Dallas, which removes the influence of unusually large changes in the prices of individual items in either direction; these participants observed that the trimmed mean measure had been stable at or close to 2 percent over recent months. Participants continued to view inflation near the Committee's symmetric 2 percent objective as the most likely outcome, but, in light of recent, softer inflation readings, some viewed the downside risks to inflation as having increased. Some participants also expressed concerns that long-term inflation expectations could be below levels consistent with the Committee's 2 percent target or at risk of falling below that level.

…Participants commented on risks associated with their outlook for economic activity over the medium term. Some participants viewed risks to the downside for real GDP growth as having decreased, partly because prospects for a sharp slowdown in global economic growth, particularly in China and Europe, had diminished. These improvements notwithstanding, most participants observed that downside risks to the outlook for growth remain.

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 2-1/4 to 2-1/2 percent. Participants judged that the labor market remained strong, and that information received over the intermeeting period showed that economic activity grew at a solid rate. However, both overall inflation and inflation for items other than food and energy had declined and were running below the Committee's 2 percent objective. A number of participants observed that some of the risks and uncertainties that had surrounded their outlooks earlier in the year had moderated, including those related to the global economic outlook, Brexit, and trade negotiations. That said, these and other sources of uncertainty remained. In light of global economic and financial developments as well as muted inflation pressures, participants generally agreed that a patient approach to determining future adjustments to the target range for the federal funds rate remained appropriate. Participants noted that even if global economic and financial conditions continued to improve, a patient approach would likely remain warranted, especially in an environment of continued moderate economic growth and muted inflation pressures.

Participants discussed the potential policy implications of continued low inflation readings. Many participants viewed the recent dip in PCE inflation as likely to be transitory, and participants generally anticipated that a patient approach to policy adjustments was likely to be consistent with sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective. Several participants also judged that patience in adjusting policy was consistent with the Committee's balanced approach to achieving its objectives in current circumstances in which resource utilization appeared to be high while inflation continued to run below the Committee's symmetric 2 percent objective. However, a few participants noted that if the economy evolved as they expected, the Committee would likely need to firm the stance of monetary policy to sustain the economic expansion and keep inflation at levels consistent with the Committee's objective, or that the Committee would need to be attentive to the possibility that inflation pressures could build quickly in an environment of tight resource utilization. In contrast, a few other participants observed that subdued inflation coupled with real wage gains roughly in line with productivity growth might indicate that resource utilization was not as high as the recent low readings of the unemployment rate by themselves would suggest. Several participants commented that if inflation did not show signs of moving up over coming quarters, there was a risk that inflation expectations could become anchored at levels below those consistent with the Committee's symmetric 2 percent objective—a development that could make it more difficult to achieve the 2 percent inflation objective on a sustainable basis over the longer run. Participants emphasized that their monetary policy decisions would continue to depend on their assessments of the economic outlook and risks to the outlook, as informed by a wide range of data.

Members observed that a patient approach to determining future adjustments to the target range for the federal funds rate would likely remain appropriate for some time, especially in an environment of moderate economic growth and muted inflation pressures, even if global economic and financial conditions continued to improve.

Source: Federal Reserve Board