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

Data Insights: FOMC Minutes

Wednesday, May 20, 2020

April minutes: key signaling language Featured Important Very important

… Open Market Desk surveys suggested that market participants anticipated a sharp near-term decline in economic activity, followed by some recovery later this year. Against this backdrop, market participants generally expected the target range for the federal funds rate to remain at the effective lower bound for the next couple of years. Respondents to Desk surveys attached almost no probability to the FOMC implementing negative policy rates. Some survey respondents indicated that they expected modifications to the Committee's forward guidance, but not at the current meeting.

…Commercial and industrial (C&I) lending conditions were somewhat tight. Although C&I loans increased strongly, this increase was largely driven by firms drawing down existing lines of credit; they reportedly did so to shore up liquidity for precautionary motives and to meet funding needs. In the April Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS), banks reported having tightened their C&I lending standards and terms for firms of all sizes. …

The staff assessed the stability of the financial system during the coronavirus outbreak. The banking sector, including the large banks, was resilient coming into this period. Banks were able to meet surging demand for draws on credit lines while also building loan loss reserves to absorb higher expected defaults. In other parts of the financial system, however, some notable vulnerabilities that had been identified in previous financial stability assessments exacerbated financial strains. In March, institutional prime MMFs and other institutions relying on unstable funding sources faced significant stress, a situation that put in jeopardy the orderly functioning of some financial markets. Federal Reserve actions to enhance the liquidity and functioning of key markets reduced these stresses notably. Open-end mutual funds that invest in corporate bonds and loans—institutions that typically face a timing mismatch between investors' ability to redeem shares and the funds' ability to sell assets—experienced heavy outflows and liquidity strains in mid-March. Redemptions later eased, however, amid the general improvement in financial markets. Business debt, which appeared to be high compared with fundamentals before the coronavirus outbreak, seemed poised to rise further as businesses borrowed to maintain their capacity to restart operations. Values of CRE faced the risk of large declines in response to the coronavirus outbreak, although updated readings were not yet available. The staff provided a preliminary reading on potential emerging risks to financial stability in the aftermath of the coronavirus outbreak. This reading highlighted possible vulnerabilities in mortgage servicers, insurance companies, and large, highly leveraged financial intermediaries.

…Participants noted that the coronavirus outbreak was causing tremendous human and economic hardship across the United States and around the world. The virus and the measures taken to protect public health were inducing sharp declines in economic activity and a surge in job losses. Weaker demand and significantly lower oil prices were holding down consumer price inflation. The disruptions to economic activity here and abroad had significantly affected financial conditions and had impaired the flow of credit to U.S. households and businesses.

Participants judged that the effects of the coronavirus outbreak and the ongoing public health crisis would continue to weigh heavily on economic activity, employment, and inflation in the near term and would pose considerable risks to the economic outlook over the medium term. Participants assessed that the second quarter would likely see overall economic activity decline at an unprecedented rate. Participants relayed information from their Districts that the burdens of the present crisis would fall disproportionately on the most vulnerable and financially constrained households in the economy. Participants agreed that recently enacted fiscal programs were delivering valuable direct financial aid to households, businesses, and communities that would provide some relief during the economic shutdown. In addition, economic activity was being supported by actions taken by the Federal Reserve, including lending facilities created under the authority of section 13(3) of the Federal Reserve Act, some of which included capital allocated by the U.S. Treasury. These programs had helped maintain the flow of credit to households, businesses, and state and local governments, while supporting the smooth functioning of financial markets.

Regarding the economic activity of households, participants noted that the pandemic and efforts to mitigate the spread of the disease were having severely adverse effects on aggregate household spending and consumer confidence. Participants reported that consumer spending had plummeted across all parts of the country and in most categories of spending, with especially sharp declines in expenditures for categories that had been most affected by social distancing, such as hotel, fuel, air travel, restaurant, theater, and other retail products and services. Participants noted that even after government-imposed social-distancing restrictions came to an end, consumer spending in these categories likely would not return quickly to more normal levels. Survey-based measures of consumer confidence also plunged, a development that participants and District contacts attributed to households' concerns regarding the risk of job loss or difficulty in meeting financial obligations. Participants noted that some households experiencing job losses may not immediately face lower total income because of the support from recently enacted fiscal programs. Even in such cases, however, participants observed that household spending would likely be held down by a decrease in confidence and an increase in precautionary saving.

Participants noted that business activity and investment spending had also fallen dramatically since the previous meeting as a result of efforts to contain the coronavirus outbreak. Manufacturing output declined sharply in March and was expected by participants to drop even more rapidly in April. In all Districts, some businesses had been forced to close temporarily because of social distancing restrictions. Businesses that were able to remain open to some degree were also substantially affected by the pandemic, with many experiencing either substantial drops in new orders and sales or supply chain disruptions. There were widespread reports from District contacts of firms reducing their payrolls and curtailing plans for investment spending. Some industries were especially hard hit, including airlines, cruise ships, restaurants, and tourism. Participants reported that many firms were seeking loans, payment deferrals, or grants to help address critical financial obligations and that the Paycheck Protection Program (PPP) was providing valuable assistance to small businesses in this respect. Participants also noted the disproportionate burdens or particular challenges being faced by small businesses;

these challenges included lower cash buffers, fewer financing options, and, more recently, tighter lending standards. Participants expressed concerns that a large number of small businesses may not be able to endure a shock that had long-lasting financial effects. Participants were further concerned that even after social-distancing requirements were eased, some business models may no longer be economically viable, which could occur, for example, if consumers voluntarily continued to avoid participating in particular forms of economic activity. In addition, participants expressed concern that the possibility of secondary outbreaks of the virus may cause businesses for some time to be reluctant to engage in new projects, rehire workers, or make new capital expenditures.

Participants observed that conditions in the energy sector had become especially difficult. A sharp reduction in global demand for petroleum had led to unused supply that was overwhelming storage capacity, resulting in a plunge in oil prices. Some participants expressed concern that low energy prices, if they were to persist, had the potential to create a wave of bankruptcies in the energy sector. In addition, the agricultural sector was under severe stress due to falling prices for some farm commodities and pandemic-related disruptions, such as the closing of some food processing plants.

With regard to the labor market, participants noted that incoming data confirmed that an extreme decline in employment was under way. Nationally, initial claims for unemployment insurance benefits had totaled more than 25 million from mid-March to the time of the meeting, and participants expected that the unemployment rate would soon reach the highest levels of the post–World War II period. District contacts reported that a significant portion of workers had been able to switch to working remotely. Although many employers were trying to keep workers on their payrolls, over time, as conditions persisted, there had begun to be widespread furloughs and layoffs. Participants were concerned that temporary layoffs could become permanent, and that workers who lose employment could face a loss of job-specific skills or may become discouraged and exit the labor force. Participants were additionally concerned that employees who were on low incomes would be the most severely affected by job cuts because they were employed in the industries most affected by the response to the outbreak or because their jobs were not amenable to being carried out remotely.

With regard to inflation, participants noted that it had been running below the Committee's 2 percent longer-run objective before the coronavirus outbreak. While the pandemic had created some supply constraints, which had generated upward pressure on the prices of some goods, the pandemic had also reduced demand, which had exerted downward pressure on prices. The overall effect of the outbreak on prices was seen as disinflationary. In addition, a stronger dollar and lower oil prices were factors likely to put downward pressure on inflation, and market-based measures of inflation compensation remained very low. Participants observed that the return of inflation to the Committee's 2 percent longer-run objective would likely be further delayed but that the accommodative stance of monetary policy would be helpful in achieving the 2 percent inflation objective over the longer run.

Participants noted that recently enacted fiscal programs were crucial for limiting the severity of the economic downturn. In particular, the Cares Act and other legislation, which represented more than $2 trillion in federal spending in total, had provided direct help to households, businesses, and communities. For example, the PPP was providing a financial lifeline to small businesses, the expansion of unemployment benefits was helping restore lost income for laid-off workers, and the Treasury had provided a necessary financial backstop to many Federal Reserve lending facilities. Participants acknowledged that even greater fiscal support may be necessary if the economic downturn persists.

Participants commented that, in addition to weighing heavily on economic activity in the near term, the economic effects of the pandemic created an extraordinary amount of uncertainty and considerable risks to economic activity in the medium term. Participants discussed several alternative scenarios with regard to the behavior of economic activity in the medium term that all seemed about equally likely. These scenarios differed in the assumed length of the pandemic and the consequent economic disruptions. On the one hand, a number of participants judged that there was a substantial likelihood of additional waves of outbreak in the near or medium term. In such scenarios, it was believed likely that there would be further economic disruptions, including additional periods of mandatory social distancing, greater supply chain dislocations, and a substantial number of business closures and loss of income; in total, such developments could lead to a protracted period of severely reduced economic activity. On the other hand, economic activity could recover more quickly if the pandemic subsided enough for households and businesses to become sufficiently confident to relax or modify social-distancing behaviors over the next several months. Beyond these considerations, participants noted the risk that foreign economies, particularly EMEs, could come under extreme pressure as a result of the pandemic and that this strain could spill over to and hamper U.S. economic activity. Participants stressed that measures taken in the areas of health-care policy and fiscal policy, together with actions by the private sector, would be important in shaping the timing and speed of the U.S. economy's return to more normal conditions. In addition, participants agreed that recent actions taken by the Federal Reserve were essential in helping reduce downside risks to the economic outlook.

Participants also noted several risks to long-term economic performance that were posed by the pandemic. One of these risks was that workers who lose employment as a result of the pandemic may experience a loss of skills, lose access to adequate childcare or eldercare, or become discouraged and exit the labor force. The longer-term behavior of firms could be affected as well—for instance, if necessary but costly transmission-mitigation strategies lowered firms' productivity; if business investment shifted down permanently; if many firms need to adjust their business models in the aftermath of the pandemic; or if business closures, particularly those of small firms, became widespread. A few participants noted that higher levels of government indebtedness, which would be exacerbated by fiscal expenditures that were necessary to combat the economic effects of the pandemic, could put downward pressure on growth in aggregate potential output.

Regarding developments in financial markets, participants agreed that ongoing actions by the Federal Reserve had been instrumental in easing strains in some essential financial markets and supporting the flow of credit. These actions included large-scale purchases of Treasury securities and agency MBS, measures to reduce strains in global U.S. dollar funding markets, and the launch of programs to support the flow of credit in the economy for households, businesses of all sizes, and state and local governments. Banks had entered the crisis well capitalized and had been able to provide necessary credit to businesses and households.

A number of participants commented on potential risks to financial stability. Participants were concerned that banks could come under greater stress, particularly if adverse scenarios for the spread of the pandemic and economic activity were realized, and so this sector should be monitored carefully. Participants saw risks to banks and some other financial institutions as exacerbated by high levels of indebtedness among nonfinancial corporations that prevailed before the pandemic; this indebtedness increased these firms' risk of insolvency. The upcoming financial stress tests for banks were seen as important for measuring the ability of large banks to withstand future downside scenarios. A number of participants emphasized that regulators should encourage banks to prepare for possible downside scenarios by further limiting payouts to shareholders, thereby preserving loss-absorbing capital. Indeed, historical loss models might understate losses in this context. A few participants stressed that the activities of some nonbank financial institutions presented vulnerabilities to the financial system that could worsen in the event of a protracted economic downturn and that these institutions and activities should be monitored closely.

In their consideration of monetary policy at this meeting, participants noted that the Federal Reserve was committed to using its full range of tools to support the U.S. economy in this challenging time, thereby promoting its maximum employment and price stability goals. In light of their assessment that the ongoing public health crisis would weigh heavily on economic activity, employment, and inflation in the near term and posed considerable risks to the economic outlook over the medium term, all participants judged that it would be appropriate to maintain the target range for the federal funds rate at 0 to 1/4 percent. Keeping the target range at the effective lower bound, after quickly reducing it by 150 basis points in March, would continue to provide support to the economy and promote the Committee's maximum employment and price stability goals. Participants also judged that it would be appropriate to maintain the target range for the federal funds rate at its present level until policymakers were confident that the economy had weathered recent events and was on track to achieve the Committee's maximum employment and price stability goals.

Participants also assessed that it was appropriate for the Federal Reserve to continue to purchase Treasury securities and agency residential-mortgage-backed securities (RMBS) and CMBS in the amounts needed to support smooth market functioning. These open market purchases would continue to support the flow of credit to households and businesses and thereby foster the effective transmission of monetary policy to broader financial conditions. In addition, the Desk would continue to offer large-scale overnight and term repo operations. Participants noted that it was important to continue to monitor market conditions closely and that the Committee was prepared to adjust its plans as appropriate to support smooth functioning in the markets for these securities.

Participants also commented that the multiple lending facilities established by the Federal Reserve under the authority of section 13(3) of the Federal Reserve Act and, in some cases, involving capital allocated by the Treasury were supporting financial market functioning and the flow of credit to households, businesses of all sizes, and state and local governments. In this way, these emergency lending facilities were intended to help support the economy until pandemic-related credit market disruptions had abated. Several participants commented further that it would be important for the Federal Reserve to remain ready to adjust these emergency lending facilities as appropriate based on its monitoring of financial market functioning and credit conditions.

While participants agreed that the current stance of monetary policy remained appropriate, they noted that the Committee could, at upcoming meetings, further clarify its intentions with respect to its future monetary policy decisions. Some participants commented that the Committee could make its forward guidance for the path for the federal funds rate more explicit. For example, the Committee could adopt outcome-based forward guidance that would specify macroeconomic outcomes—such as a certain level of the unemployment rate or of the inflation rate—that must be achieved before the Committee would consider raising the target range for the federal funds rate. The Committee could also consider date-based forward guidance that would indicate that the target range could be raised only after a specified amount of time had elapsed. These participants noted that such explicit forms of forward guidance could help ensure that the public's expectations regarding the future conduct of monetary policy continued to reflect the Committee's intentions. Several participants observed that the completion, most likely later this year, of the monetary policy framework review, together with the announcement of the conclusions arising from the review, would help further clarify the Committee's intentions with respect to its future monetary policy actions. Several participants also remarked that the Committee may need to provide further clarity regarding its intentions for purchases of Treasury securities and agency MBS; these participants noted that, without further communication on this matter, uncertainty about the evolution of the Federal Reserve's asset purchases could increase over time. Several participants remarked that a program of ongoing Treasury securities purchases could be used in the future to keep longer-term yields low. A few participants also noted that the balance sheet could be used to reinforce the Committee's forward guidance regarding the path of the federal funds rate through Federal Reserve purchases of Treasury securities on a scale necessary to keep Treasury yields at short- to medium-term maturities capped at specified levels for a period of time.

Source: Federal Reserve Board