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Data Insights: FOMC Minutes

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December minutes: key signaling language Featured Important Very important

…Participants began a discussion of a range of topics associated with the eventual normalization of the stance of monetary policy. The topics included the lessons learned from the Committee's previous experience with policy normalization, alternative approaches for removing policy accommodation, the timing and sequencing of policy normalization actions, and the appropriate size and composition of the Federal Reserve's balance sheet in the longer run. They agreed that their discussion at this meeting would be helpful background for the Committee's future decisions regarding policy normalization. No decisions regarding the Committee's approach were made at the meeting.

…Participants judged that several aspects of the previous approach remained applicable in the current environment. In particular, they noted that the principles and plans underlying policy normalization were communicated in advance of any decisions or actions, which enhanced the public's understanding and thus the effectiveness of monetary policy during that period. At the same time, participants remarked that the previous experience highlighted the benefits of maintaining the flexibility to adjust the details of the approach to normalization in response to economic and financial developments. Participants generally emphasized that, as in the previous normalization episode and as expressed in the Committee's Statement on Longer-Run Goals and Monetary Policy Strategy, changes in the target range for the federal funds rate should be the Committee's primary means for adjusting the stance of monetary policy in support of its maximum-employment and price-stability objectives. This preference reflected the view that there is less uncertainty about the effects of changes in the federal funds rate on the economy than about the effects of changes in the Federal Reserve's balance sheet. Moreover, participants stated that the federal funds rate is a more familiar tool to the general public and therefore is advantageous for communication purposes. A few participants also noted that when

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the federal funds rate is away from the effective lower bound (ELB), the Committee could more nimbly change interest rate policy than balance sheet policy in response to economic conditions.

Participants also discussed some key differences between current economic conditions and those that prevailed during the previous episode and remarked that the Committee would have to take these differences into account in removing policy accommodation. Most notably, participants remarked that the current economic outlook was much stronger, with higher inflation and a tighter labor market than at the beginning of the previous normalization episode. They also observed that the Federal Reserve's balance sheet was much larger, both in dollar terms and relative to nominal gross domestic product (GDP), than it was at the end of the third large-scale asset purchase program in late 2014. Participants noted that the current weighted average maturity of the Federal Reserve's Treasury holdings was shorter than at the beginning of the previous normalization episode. Some observed that, as a result, depending on the size of any caps put on the pace of runoff, the balance sheet could potentially shrink faster than last time if the Committee followed its previous approach in phasing out the reinvestment of maturing Treasury securities and principal payments on agency MBS. However, several participants raised concerns about vulnerabilities in the Treasury market and how those vulnerabilities could affect the appropriate pace of balance sheet normalization. A couple of participants noted that the SRF could help to mitigate such concerns. Participants also judged the Federal Reserve to be better positioned for normalization than in the past, as the ample-reserves framework and the Federal Reserve's current interest rate control tools, including interest on reserve balances and the overnight reverse repurchase agreement (ON RRP) facility, are in place and working well. Some participants judged that a significant amount of balance sheet shrinkage could be appropriate over the normalization process, especially in light of abundant liquidity in money markets and elevated usage of the ON RRP facility.

Participants had an initial discussion about the appropriate conditions and timing for starting balance sheet runoff relative to raising the federal funds rate from the ELB. They also discussed how this relative timing might differ from the previous experience, in which balance sheet runoff commenced almost two years after policy rate liftoff when the normalization of the federal funds rate was judged to be well

under way. Almost all participants agreed that it would likely be appropriate to initiate balance sheet runoff at some point after the first increase in the target range for the federal funds rate. However, participants judged that the appropriate timing of balance sheet runoff would likely be closer to that of policy rate liftoff than in the Committee's previous experience. They noted that current conditions included a stronger economic outlook, higher inflation, and a larger balance sheet and thus could warrant a potentially faster pace of policy rate normalization. They emphasized that the decision to initiate runoff would be data dependent.

Some participants commented that removing policy accommodation by relying more on balance sheet reduction and less on increases in the policy rate could help limit yield curve flattening during policy normalization. A few of these participants raised concerns that a relatively flat yield curve could adversely affect interest margins for some financial intermediaries, which may raise financial stability risks. However, a couple of other participants referenced staff analysis and previous experience in noting that many factors can affect longer-dated yields, making it difficult to judge how a different policy mix would affect the shape of the yield curve.

Many participants judged that the appropriate pace of balance sheet runoff would likely be faster than it was during the previous normalization episode. Many participants also judged that monthly caps on the runoff of securities could help ensure that the pace of runoff would be measured and predictable, particularly given the shorter weighted average maturity of the Federal Reserve's Treasury security holdings.

Participants discussed considerations regarding the longer-run size of the balance sheet consistent with the efficient and effective implementation of monetary policy in an ample-reserves regime. Participants noted that the current size of the balance sheet is elevated and would likely remain so for some time after the process of normalizing the balance sheet was under way. Several participants noted that the level of reserves that would ultimately be needed to implement monetary policy effectively is uncertain, because the underlying demand for reserves by banks is time varying. In light of this uncertainty and the Committee's previous experience, a couple of participants expressed a preference to allow for a substantial buffer level of reserves to support interest rate control. Participants noted that it would be important

to carefully monitor developments in money markets as the level of reserves fell to help inform the Committee's eventual assessment of the appropriate level for the balance sheet in the longer run. Some participants expressed the view that the SRF would help ensure interest rate control as the size of the balance sheet approached its longer-run level; several participants noted that the SRF could facilitate a faster runoff of the balance sheet than might otherwise be the case; several participants raised the possibility that the establishment of the SRF could reduce the demand for reserves in the longer run, suggesting that the longer-run balance sheet could be smaller than otherwise.

Participants also discussed the composition of the Federal Reserve's asset holdings. Consistent with the previous normalization principles, some participants expressed a preference for the Federal Reserve's asset holdings to consist primarily of Treasury securities in the longer run. To achieve such a composition, some participants favored reinvesting principal from agency MBS into Treasury securities relatively soon or letting agency MBS run off the balance sheet faster than Treasury securities.

…Inflation readings remained high, and various indicators suggested that inflationary pressures had broadened in recent months.

…The projection for U.S. consumer price inflation prepared by the staff for the December FOMC meeting was higher than in the November projection. The near-term outlook was revised up, reflecting faster-than-expected increases both for a broad array of consumer prices and for wages. Supply chain bottlenecks were seen as continuing to put upward pressure on prices. As a result, the 12-month change in PCE prices was projected to move up further relative to October's pace and to end the year around 5 percent. Over the following two years, the boost to consumer prices caused by supply issues was expected to partly reverse, and energy prices were projected to decline. PCE price inflation was therefore expected to step down to 2.1 percent in 2022 and to remain there in 2023 and 2024. Projected inflation over this period was a little higher than in the previous projection, as supply bottlenecks were assumed to resolve more gradually and as the salience of this year's higher inflation readings was assumed to raise the underlying trend in inflation relative to the previous forecast. Longer-run inflation was still assumed to remain anchored at 2 percent.

…In their discussion of current economic conditions, participants noted that, with progress on vaccinations and strong policy support, indicators of economic activity and employment had continued to strengthen. The sectors most adversely affected by the pandemic had improved in recent months but continued to be affected by COVID-19. Job gains had been solid in recent months, and the unemployment rate had declined substantially. Supply and demand imbalances related to the pandemic and the reopening of the economy had continued to contribute to elevated levels of inflation. Overall financial conditions remained accommodative, in part reflecting policy measures to support the economy and the flow of credit to U.S. households and businesses. Participants commented that the path of the economy continued to depend on the course of the virus. An easing of supply constraints was expected to support continued gains in economic activity and employment as well as a reduction in inflation. Risks to the economic outlook remained, including from new variants of the virus.

…Participants noted that supply chain bottlenecks and labor shortages continued to limit businesses' ability to meet strong demand. They judged that these challenges would likely last longer and be more widespread than previously thought. Participants generally expected global supply chain bottlenecks to persist well into next year at least. While several participants pointed to signs of incremental improvement in supply chains, a few others remarked that business contacts were experiencing deteriorating supply conditions that could be exacerbated by the emergence of new variants of the virus. A couple of participants reported that some contacts were implementing permanent changes in their business models to help weather current and future disruptions, including holding larger inventories or building domestic manufacturing capacity. Many business contacts continued to experience difficulty hiring workers across all skill levels, noting the lack of qualified candidates as well. Some participants noted that businesses were offering higher wages, larger bonuses, or more flexible work arrangements to compete for workers.

Participants judged that labor markets continued to strengthen, with the unemployment rate falling rapidly and payrolls growing at a solid pace. A few participants noted the recent decline in the unemployment rates of African Americans and Hispanics and the narrowing of the racial and ethnic gap in the prime-age employment-to-population ratio as suggesting a more inclusive labor market recovery.

Some participants discussed the modest increase in the labor force participation rate in November. A number of participants judged that a substantial improvement in labor force participation would take longer than previously expected. A few others assessed that any further improvement in labor force participation would be quite modest. Participants cited a number of pandemic and economic factors likely depressing labor force participation, such as increased caregiving needs amid a shortage of workers in the caregiving industry, remaining concerns about the virus, and healthy balance sheets for households, including for those who retired early. A couple of participants cited factors that could support higher labor force participation over the next few years, including waning fiscal stimulus; depleted savings, particularly for lower-income households; and the historical tendency for labor force participation to lag improvement in the labor market.

…Participants remarked that inflation readings had been higher and were more persistent and widespread than previously anticipated. Some participants noted that trimmed mean measures of inflation had reached decade-high levels and that the percentage of product categories with substantial price increases continued to climb. While participants generally continued to anticipate that inflation would decline significantly over the course of 2022 as supply constraints eased, almost all stated that they had revised up their forecasts of inflation for 2022 notably, and many did so for 2023 as well. In discussing their revisions to the inflation outlook, participants pointed to rising housing costs and rents, more widespread wage growth driven by labor shortages, and more prolonged global supply-side frictions, which could be exacerbated by the emergence of the Omicron variant. Moreover, participants widely cited business contacts feeling confident that they would be able to pass on higher costs of labor and material to customers. Participants noted their continuing attention to the public's concern about the sizable increase in the cost of living that had taken place this year and the associated burden on U.S. households, particularly those who had limited scope to pay higher prices for essential goods and services.

In their comments on inflation expectations, some participants discussed the risk that recent elevated levels of inflation could increase the public's longer-term expectations for inflation to a level above that consistent with the Committee's longer-run inflation objective. They noted that the realization of such a development could make it harder for the Committee to achieve 2 percent inflation over the longer

run. A couple of participants pointed to reports of higher inflation expectations of businesses and of increased use of cost-of-living adjustments in wage negotiations as early developments that could potentially affect the anchoring of inflation expectations. A few participants, however, noted that long-term inflation expectations remained well anchored, citing stable readings of market-based inflation compensation measures or the generally low level of longer-term bond yields.

Participants observed that uncertainty about the economic outlook remained high. Most agreed that risks to inflation were weighted to the upside. Several participants pointed to the possibility that structural factors that kept inflation low in the previous decade, such as technological changes, demographics, and the proximity of the ELB in an environment of low equilibrium interest rates, may reemerge when the effects of the pandemic abate. A couple of others noted the risk that persistent real wage growth in excess of productivity growth could trigger inflationary wage–price dynamics. Participants generally continued to stress uncertainties associated with the labor market—in particular, the evolution of labor force participation—and with the length of time required to resolve the supply chain situation. Many participants noted that the pandemic, particularly new variants of the virus, continued to pose downside risks to economic activity and upside risks to inflation.

In their consideration of the stance of monetary policy, participants reaffirmed the Federal Reserve's commitment to using its full range of tools to support the U.S. economy during this challenging time, thereby promoting the Committee's statutory goals of maximum employment and price stability. Participants discussed the progress the economy had made toward the criteria the Committee had specified in its forward guidance for the federal funds rate. Participants agreed that the Committee's criteria of inflation rising to 2 percent and moderately exceeding 2 percent for some time had been more than met. All participants remarked that inflation had continued to run notably above 2 percent, reflecting supply and demand imbalances related to the pandemic and the reopening of the economy. With respect to the maximum-employment criterion, participants noted that the labor market had been making rapid progress as measured by a variety of indicators, including solid job gains reported in recent months, a substantial further decline in a range of unemployment rates to levels well below those prevailing a year ago, and a labor

force participation rate that had recently edged up. Many participants judged that, if the current pace of improvement continued, labor markets would fast approach maximum employment. Several participants remarked that they viewed labor market conditions as already largely consistent with maximum employment.

In support of the Committee's goals of maximum employment and inflation at the rate of 2 percent over the longer run, participants judged that it would be appropriate for the Committee to keep the target range for the federal funds rate at 0 to 1/4 percent until labor market conditions had reached levels consistent with the Committee's assessments of maximum employment, a condition most participants judged could be met relatively soon if the recent pace of labor market improvements continued. A few participants remarked that maximum employment consistent with price stability evolves over time and that further improvements in labor markets were likely over subsequent years as the economy continued to expand. Some participants also remarked that there could be circumstances in which it would be appropriate for the Committee to raise the target range for the federal funds rate before maximum employment had been fully achieved—for example, if the Committee judged that its employment and price-stability goals were not complementary in light of economic developments and that inflation pressures and inflation expectations were moving materially and persistently higher in a way that could impede the attainment of the Committee's longer-run goals.

In light of elevated inflation pressures and the strengthening labor market, participants judged that the increase in policy accommodation provided by the ongoing pace of net asset purchases was no longer necessary. They remarked that a quicker conclusion of net asset purchases would better position the Committee to set policy to address the full range of plausible economic outcomes. Participants judged that it would be appropriate to double the pace of the ongoing reduction in net asset purchases. Such a change would result in reducing the monthly pace of net purchases of Treasury securities by $20 billion and of agency MBS by $10 billion starting in January. Participants also expected that economic conditions would evolve in a manner such that similar reductions in the pace of net asset purchases would be appropriate each subsequent month, resulting in an end to net asset purchases in mid-March, a few months sooner than participants had anticipated at the November FOMC meeting. In addition, participants remarked that the Committee should

continue to be prepared to adjust the pace of purchases if warranted by changes in the economic outlook.

Participants continued to stress that maintaining flexibility to implement appropriate policy adjustments on the basis of risk-management considerations should be a guiding principle in conducting policy in the current highly uncertain environment. Participants generally noted that, given their individual outlooks for the economy, the labor market, and inflation, it may become warranted to increase the federal funds rate sooner or at a faster pace than participants had earlier anticipated. Some participants also noted that it could be appropriate to begin to reduce the size of the Federal Reserve's balance sheet relatively soon after beginning to raise the federal funds rate. Some participants judged that a less accommodative future stance of policy would likely be warranted and that the Committee should convey a strong commitment to address elevated inflation pressures. These participants noted, however, that a measured approach to tightening policy would help enable the Committee to assess incoming data and be in position to react to the full range of plausible economic outcomes.

…As elevated inflation had persisted for longer than they had previously anticipated, members agreed that it was appropriate to remove the reference to "transitory" factors affecting inflation in the postmeeting statement and instead note that supply and demand imbalances have continued to contribute to elevated inflation.

Source: Federal Reserve Board