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Data Insights: FOMC Minutes

Wednesday, April 10, 2024

March minutes Key signaling language: Featured Important Very important

...Considerations for Slowing the Pace of Balance Sheet Reduction

Participants began a discussion related to slowing the pace of balance sheet runoff consistent with the Committee's Plans for Reducing the Size of the Federal Reserve's

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Balance Sheet announced in May 2022. Those plans indicated that in order to ensure a smooth transition, the Committee intends to slow and then stop the decline in the size of the balance sheet when reserve balances are somewhat above the level it judges to be consistent with ample reserves. Since balance sheet runoff began in June 2022, the Federal Reserve's total securities holdings had declined roughly $1.5 trillion. In light of the ongoing sizable decline in the balance sheet, and the prospect of a more rapid decline in reserve balances, participants agreed that their discussions at this meeting would help inform the Committee's future decisions regarding how and when to slow the pace of runoff. No decisions about adjusting the pace of balance sheet runoff were made at the meeting.

The participants' discussion was preceded by staff presentations. The staff reviewed the 2017–19 balance sheet runoff episode and the lessons learned from that experience, including the importance of monitoring money market conditions in light of the uncertainty surrounding the level of reserves consistent with operating in an ample-reserves regime. The staff presented a set of simulations in which the current monthly pace of securities runoff was reduced to illustrate how the choice of when to start slowing the pace of runoff could affect the paths for the balance sheet and reserve balances. The simulations showed how various options for when to slow the pace of runoff could affect the duration of each of the expected phases of the transition to an ample level of reserves.

Participants observed that balance sheet runoff was proceeding smoothly. Nevertheless, taking into account the experience around the end of the 2017–19 balance sheet runoff episode, participants broadly assessed it would be appropriate to take a cautious approach to further runoff. The vast majority of participants thus judged it would be prudent to begin slowing the pace of runoff fairly soon. Most of these participants noted that, despite significant balance sheet reduction, reserve balances had remained elevated because the decline in usage of the ON RRP facility had shifted Federal Reserve liabilities toward reserves. However, with the extent of future declines in ON RRP take-up becoming more limited, further balance sheet runoff will likely translate more directly into declines in reserve balances, potentially at a rapid pace. In light of the uncertainty regarding the level of reserves consistent with operating in an ample-reserves regime, slowing the pace of balance sheet runoff sooner rather than later would help facilitate a smooth transition from abundant to

ample reserve balances. Slower runoff would give the Committee more time to assess market conditions as the balance sheet continues to shrink. It would allow banks, and short-term funding markets more generally, additional time to adjust to the lower level of reserves, thus reducing the probability that money markets experience undue stress that could require an early end to runoff. Therefore, the decision to slow the pace of runoff does not mean that the balance sheet will ultimately shrink by less than it would otherwise. Rather, a slower pace of runoff would facilitate ongoing declines in securities holdings consistent with reaching ample reserves. A few participants, however, indicated that they preferred to continue with the current pace of balance sheet runoff until market indicators begin to show signs that reserves are approaching an ample level. All participants emphasized the importance of communicating that a decision to slow the pace of runoff would have no implications for the stance of monetary policy, as it would mean implementing one of the transitional steps previously announced in the Committee's balance sheet plans.

In their discussions regarding how to adjust the pace of runoff, participants generally favored reducing the monthly pace of runoff by roughly half from the recent overall pace. With redemptions of agency debt and agency mortgage-backed securities (MBS) expected to continue to run well below the current monthly cap, participants saw little need to adjust this cap, which also would be consistent with the Committee's intention to hold primarily Treasury securities in the longer run. Accordingly, participants generally preferred to maintain the existing cap on agency MBS and adjust the redemption cap on U.S. Treasury securities to slow the pace of balance sheet runoff.

Participants also shared their initial perspectives on longer-term aspects of balance sheet policy beyond the more immediate issues concerning slowing the pace of runoff. Although they saw the current level of reserves as abundant, participants emphasized the underlying uncertainty about the level of reserves consistent with operating in an ample-reserves regime. They noted various price and quantity metrics that they saw as important real-time indicators of conditions in short-term funding markets that could provide signals that reserves are approaching a level somewhat above ample. Some participants also mentioned the importance of both the discount window and the standing repo facility as liquidity backstops as reserves decline.

Many participants commented on aspects of the composition of the Federal Reserve's securities holdings, including the appropriate longer-run maturity composition of the System Open Market Account portfolio and options to achieve in the longer run a portfolio that consists primarily of Treasury securities.

…Participants' Views on Current Conditions and the Economic Outlook

…In their discussion of inflation, participants observed that significant progress had been made over the past year toward the Committee's 2 percent inflation objective even though the two most recent monthly readings on core and headline inflation had been firmer than expected. Some participants noted that the recent increases in inflation had been relatively broad based and therefore should not be discounted as merely statistical aberrations. However, a few participants noted that residual seasonality could have affected the inflation readings at the start of the year. Participants generally commented that they remained highly attentive to inflation risks but that they had also anticipated that there would be some unevenness in monthly inflation readings as inflation returned to target.

In their outlook for inflation, participants noted that they continued to expect that inflation would return to 2 percent over the medium term. They remained concerned that elevated inflation continued to harm households, especially those least able to meet the higher costs of essentials like food, housing, and transportation. A few participants remarked that they expected core nonhousing services inflation to decline as the labor market continued to move into better balance and wage growth moderated further. Participants discussed the still-elevated rate of housing services inflation and commented on the uncertainty regarding when and by how much lower readings for rent growth on new leases would pass through to this category of inflation. Several participants noted that the disinflationary pressure for core goods that had resulted from the receding of supply chain bottlenecks was likely to moderate. Other factors related to aggregate supply, such as increases in the labor force or better productivity growth, were viewed by several participants as likely to support continued disinflation. Some participants reported that business contacts had indicated that they were less able to pass on price increases or that consumers were becoming more sensitive to price changes. Some participants observed that longer-term inflation expectations appeared to remain well anchored, as reflected in a broad

range of surveys of households, businesses, and forecasters, as well as measures from financial markets.

…Participants assessed that demand and supply in the labor market were continuing to come into better balance, although conditions generally remained tight. Participants noted strong recent payroll growth, while the unemployment rate remained low. Participants cited a variety of indicators that suggested some easing in labor market conditions, including declining job vacancies, a lower quits rate, and a reduced ratio of job openings to unemployed workers. Some participants indicated that business contacts had reported less difficulty in hiring or retaining workers. Several participants noted that the better balance between labor supply and demand had contributed to an easing of nominal wage pressures. Nevertheless, some participants observed that portions of the labor market, such as the health-care sector and in less urban areas, remained very tight. Most participants noted that, during the past year, labor supply had been boosted by increased labor force participation as well as by immigration. Participants further commented that recent estimates of greater immigration in the past few years and an overall increase in labor supply could help explain the strength in employment gains even as the unemployment rate had remained roughly flat and wage pressures had eased.

…In discussing the policy outlook, participants judged that the policy rate was likely at its peak for this tightening cycle, and almost all participants judged that it would be appropriate to move policy to a less restrictive stance at some point this year if the economy evolved broadly as they expected. In support of this view, they noted that the disinflation process was continuing along a path that was generally expected to be somewhat uneven. They also pointed to the Committee's policy actions together with the ongoing improvements in supply conditions as factors working to move supply and demand into better balance. Participants noted indicators pointing to strong economic momentum and disappointing readings on inflation in recent months and commented that they did not expect it would be appropriate to reduce the target range for the federal funds rate until they had gained greater confidence that inflation was moving sustainably toward 2 percent. Participants remarked that in considering any adjustments to the target range for the federal funds rate at future meetings, they would carefully assess incoming data, the evolving outlook, and the balance of risks. Participants noted the importance of continuing to communicate clearly the

Committee's data-dependent approach in formulating monetary policy and the strong commitment to achieve its dual-mandate objectives of maximum employment and price stability.

In discussing risk-management considerations that could bear on the policy outlook, participants generally judged that risks to the achievement of the Committee's employment and inflation goals were moving into better balance. They remarked that it was important to weigh the risks of maintaining a restrictive stance for too long, which could unduly weaken economic activity and employment, against the risks of easing policy too quickly, which could stall or even reverse progress in returning inflation to the Committee's 2 percent inflation objective. Regarding the latter risk, participants emphasized the importance of carefully assessing incoming data to judge whether inflation is moving down sustainably to 2 percent. Participants noted various sources of uncertainty associated with their outlooks for economic activity, the labor market, and inflation, with some participants additionally mentioning uncertainty about the extent to which past monetary policy actions or the current stance of policy would weigh further on aggregate demand. Participants agreed, however, that monetary policy remained well positioned to respond to evolving economic conditions and risks to the outlook, including the possibility of maintaining the current restrictive policy stance for longer should the disinflation process slow, or reducing policy restraint in the event of an unexpected weakening in labor market conditions.

Source: Federal Reserve Board