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Data Insights: FOMC Minutes

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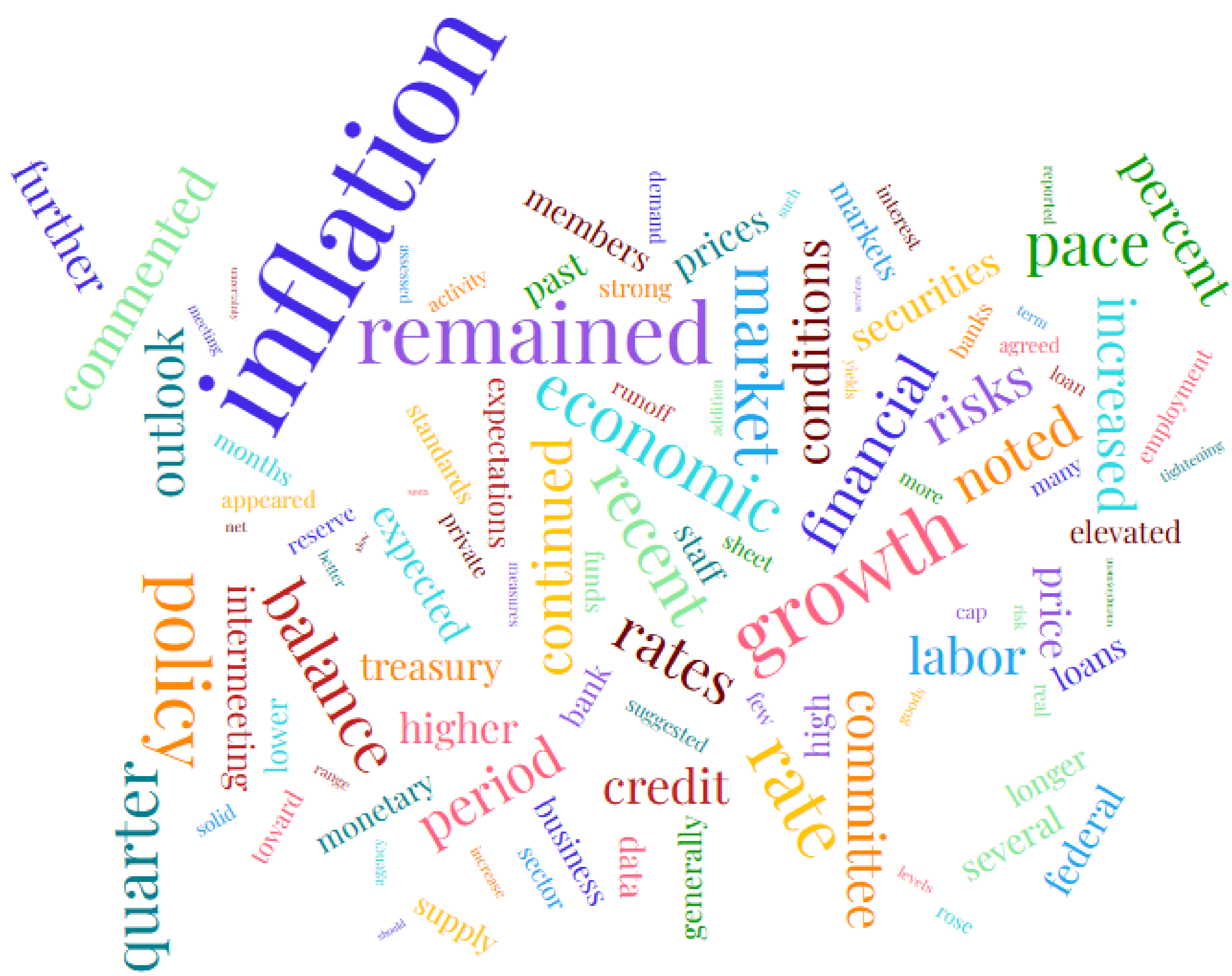

Review of Monetary Policy Strategy, Tools, and Communications

Committee participants continued their discussions related to their review of the Federal Reserve's monetary policy framework, with a focus on the price-stability side of the dual mandate and the FOMC's monetary policy strategy. The staff briefed policymakers on lessons drawn from the experiences of the U.S. and other economies with inflation over the past five years and the possible implications for monetary policy. The staff discussed the role of large and persistent demand and supply shifts, the way production capacity constraints amplified supply–demand imbalances, and the degree to which labor market tightness contributed to inflation both in the U.S. and abroad.

The staff considered the role of stable longer-term inflation expectations in limiting the magnitude and persistence of the post-pandemic inflation surge and facilitating disinflation without significant damage to the labor market. The staff also considered whether medium-term inflation risks have become more balanced around the 2 percent objective than they were during the pre-pandemic period, when the proximity of the policy rate to the effective lower bound (ELB) appeared to contribute to inflation running persistently below 2 percent. They presented model-based analysis of the costs and benefits of different inflation-targeting strategies in conditions of low levels of aggregate demand and inflation as well as in situations in which simultaneously high inflation and unemployment lead to a tradeoff between the Committee's inflation and employment objectives.

In their discussions, participants strongly reaffirmed their commitment to the 2 percent longer-run inflation objective and to the importance of longer-term inflation expectations being firmly anchored at that target rate. They emphasized that anchored inflation expectations help the Committee in achieving price stability, thereby enhancing the Committee's ability to promote maximum employment. Some participants also noted that short-term inflation expectations matter for economic decisions and can affect the persistence of inflation. Participants agreed that a commitment to its explicit 2 percent inflation objective, along with anchored longer-term inflation expectations at that level, enhances the Committee's transparency and accountability and bolsters the effectiveness of monetary policy.

Participants discussed the advantages and disadvantages of flexible average inflation targeting, under which monetary policy seeks to make up for persistently below-objective inflation to achieve average inflation of 2 percent, and flexible inflation targeting, under which policy seeks to return inflation to 2 percent without making up for previous deviations from target. Participants generally observed that when the risks of the policy rate hitting the ELB were more prominent and inflation was persistently running below the target, flexible average inflation targeting could have potentially limited the risk of longer-run inflation expectations becoming unanchored to the downside. Participants noted, however, that the strategy of flexible average inflation targeting has diminished benefits in an environment with a substantial risk of large inflationary shocks or when ELB risks are less prominent. Participants indicated that they thought it would be appropriate to reconsider the average inflation--targeting language in the Statement on Longer-Run Goals and Monetary Policy Strategy. Participants noted that an effective monetary policy strategy must be robust to a wide variety of economic environments. They viewed flexible inflation targeting as a more robust policy strategy capable of correcting persistent deviations of inflation from either side of the Committee's 2 percent longer-run objective. Participants also noted that the Committee's strategy should reflect its willingness to make forceful use of all available tools as appropriate should the risks of hitting the ELB again materialize.

Developments in Financial Markets and Open Market Operations

The manager turned first to a review of financial market developments…

Market contacts suggested that, rather than disinvesting away from U.S. assets, global investors had instead sought to increase their hedging against the risk of further dollar depreciation. The manager noted that no evidence indicated that foreign investors had sold material amounts of U.S. assets. Available data pointed to modest outflows from fixed-income securities that were largely offset by inflows into equity securities. The manager, however, observed that large global investors tend to change their investment strategies only slowly and that potential future geographic asset re-allocations will depend on the evolution of the global economic outlook…

Participants observed that, even though swings in net exports had affected the data, the available data indicated that economic activity had continued to expand at a solid pace and labor market conditions continued to be solid, but inflation remained somewhat elevated. Participants assessed that the tariff increases announced so far had been significantly larger and broader than they had anticipated. Participants observed that there was considerable uncertainty surrounding the evolution of trade policy as well as about the scale, scope, timing, and persistence of associated economic effects. Significant uncertainties also surrounded changes in fiscal, regulatory, and immigration policies and their economic effects. Taken together, participants saw the uncertainty about their economic outlooks as unusually elevated. Overall, participants judged that downside risks to employment and economic activity and upside risks to inflation had risen, primarily reflecting the potential effects of tariff increases.

Participants observed that inflation had eased significantly since its peak in 2022 but remained somewhat elevated relative to the Committee's 2 percent longer-run goal. Participants noted that progress on disinflation had been uneven recently, with elevated monthly readings in January and February having been followed by a relatively low reading in March. With regard to the outlook for inflation, participants judged that it was likely to be boosted by the effects of higher tariffs, although significant uncertainty surrounded those effects. Many participants remarked that reports from their business contacts or surveys indicated that firms generally were planning to either partially or fully pass on tariff-related cost increases to consumers. Several participants noted that firms not directly subject to tariffs might take the opportunity to increase their prices if other prices rise. Some participants assessed that the recent increase in short-term inflation expectations, as indicated by various survey- and market-based measures, or the fact that the economy had gone through a period of high inflation recently could make firms more willing to raise prices. While most indicators had suggested that longer-term inflation expectations remained well anchored, some participants saw the risk that they could drift upward, which could put additional upward pressure on inflation. Some participants assessed that tariffs on intermediate goods could contribute to a more persistent increase in inflation. A few participants noted that supply chain disruptions caused by tariffs also could have persistent effects on inflation, reminiscent of such effects during the pandemic. Several participants highlighted factors that might help mitigate the magnitude and persistence of potential increases in inflation, such as reductions of tariff increases from ongoing trade negotiations, less tolerance for price increases by households, a weakening of the economy, reduced housing inflation pressures from lower immigration, or a desire by some firms to increase market share rather than raise prices on items not affected by tariffs.

Participants judged that labor market conditions remained broadly in balance. The unemployment rate remained low and had stayed in a narrow range over the past year. Payroll employment gains were solid in April and at levels consistent with the unemployment rate being stable given a flat participation rate and low immigration. Layoffs remained low. Some participants noted, however, that their contacts and business survey respondents reported limiting or pausing hiring because of elevated uncertainty. Participants assessed that there was a risk that the labor market would weaken in coming months, that considerable uncertainty surrounded the outlook for the labor market, and that outcomes would depend importantly on the evolution of trade policy as well as other government policies. Nominal wage growth continued to moderate. Several participants commented that labor market conditions were unlikely to be a source of inflationary pressure.

Participants observed that the available data suggested that the economy had continued to grow at a solid pace. Real GDP edged down in the first quarter, but several participants observed that the decline may be the result of measurement issues, as a surge of imports ahead of expected tariff increases likely was not fully reflected in the data for inventories and spending. PDFP, which is often a better indicator than GDP of underlying economic momentum, rose at a solid pace in the first quarter.

Participants observed that consumer spending grew solidly in March. Several participants commented that, other than apparent front-running effects seen in some spending categories, effects of tariff-related developments were not widely evident in the aggregate consumer spending data. However, participants noted that various surveys indicated a sharp deterioration in consumer sentiment, though several also commented that consumer sentiment had not been a good predictor of consumer spending in recent years. Several participants noted that factors such as elevated economic uncertainty and a possible decline in real disposable income due to tariff-related increases in prices could lead to increased precautionary saving and reduced consumer demand. A couple of participants noted that a deterioration in financial market sentiment could also weigh on consumer demand. Regarding factors that might mitigate negative effects of tariffs on consumer spending, a few participants observed that the strength in the balance sheets of many households could help them absorb a tariff-induced reduction in their purchasing power; lower energy prices might help lessen strains on households' budgets; and households might shift spending from goods to services, which are likely to be less affected by tariffs.

With regard to the business sector, participants observed that the growth in business fixed investment was solid in the first quarter. However, participants also noted that their contacts or surveys reported sharp declines in business sentiment, and many participants remarked that those reports also revealed that many firms were pausing or delaying their capital expenditure plans amid increased uncertainty. Several participants noted that sentiment was generally downbeat among manufacturers because of a rise or prospective rise in input costs as well as concerns about potential supply chain disruptions. A few participants commented that retailers were downbeat because the breadth of tariffs made cost increases unavoidable for them. Several participants commented that small businesses could be especially vulnerable to the effects of tariffs, as they had less capacity to absorb margin reductions and were likely less able to diversify away from imported items. Several participants highlighted the strains faced by the agricultural sector, as tariffs threatened to further compress farm profit margins by lowering farm export prices and raising input costs. A couple of participants noted that their contacts in the energy sector expected growth in the sector to be limited, as energy prices had declined to near the level at which expanding capacity is no longer profitable for many domestic producers. Several participants noted that some hospital systems, universities, and nonprofit organizations were under strains due to government funding cuts and restrictions on immigration. Some participants discussed various considerations that could help alleviate anticipated pressures on the business sector, including less restrictive regulations and lower business taxes; relatively strong firm balance sheets, which could help firms absorb a tariff-related hit to profit margins; ongoing trade negotiations to lower tariffs; and increased demand directed to firms that are less affected by tariffs.

In their discussion of financial stability, participants who commented noted vulnerabilities to the financial system that they assessed warranted monitoring. Some participants discussed the heightened volatility seen across a range of asset markets over the first half of April, noting that markets had continued to function and were able to accommodate a surge in trading volumes despite lower measures of liquidity. Several participants observed that resilience in the Treasury market was of special importance and had been a focus of attention for a number of years. Some participants commented on a change from the typical pattern of correlations across asset prices during the first half of April, with longer-term Treasury yields rising and the dollar depreciating despite the decline in the prices of equities and other risky assets. These participants noted that a durable shift in such correlations or a diminution of the perceived safe-haven status of U.S. assets could have long-lasting implications for the economy. While noting that asset prices had declined somewhat, several participants observed that downside risks to the outlook had increased, leading them to question whether asset prices had actually gotten closer to fundamental valuations. Some participants mentioned high levels of leverage at hedge funds or potential concerns about private credit and equity. While judging that balance sheet conditions for households, nonfinancial businesses, and banks appeared to be solid, several participants noted that an economic downturn or higher interest rates could lead to a deterioration in those conditions. A few participants commented that central clearing of the SRF could encourage its use during times of market stress, which would help alleviate such stresses.

In their consideration of monetary policy at this meeting, participants noted that inflation remained somewhat elevated. Participants also observed that recent indicators suggested that economic activity had continued to expand at a solid pace. They noted that swings in net exports appeared to have not been fully reflected in inventory and spending data, which complicated the interpretation of the recent data on economic activity. Participants further noted that the unemployment rate had stabilized at a low level and that labor market conditions had remained solid in recent months. In this context, and amid a further increase in uncertainty about the economic outlook and a rise in the risks of both higher unemployment and higher inflation, all participants viewed it as appropriate to maintain the target range for the federal funds rate at 4-1/4 to 4-1/2 percent. Participants judged it appropriate to continue the process of reducing the Federal Reserve's securities holdings.

In considering the outlook for monetary policy, participants agreed that with economic growth and the labor market still solid and current monetary policy moderately restrictive, the Committee was well positioned to wait for more clarity on the outlooks for inflation and economic activity. Participants agreed that uncertainty about the economic outlook had increased further, making it appropriate to take a cautious approach until the net economic effects of the array of changes to government policies become clearer. Participants noted that monetary policy would be informed by a wide range of incoming data, the economic outlook, and the balance of risks.

In discussing risk-management considerations that could bear on the outlook for monetary policy, participants agreed that the risks of higher inflation and higher unemployment had risen. Almost all participants commented on the risk that inflation could prove to be more persistent than expected. Participants emphasized the importance of ensuring that longer-term inflation expectations remained well anchored, with some noting that expectations might be particularly sensitive because inflation had been above the Committee's target for an extended period. Participants noted that the Committee might face difficult tradeoffs if inflation proves to be more persistent while the outlooks for growth and employment weaken. Participants observed, however, that the ultimate extent of changes to government policy and their effects on the economy was highly uncertain. A few participants additionally noted that higher uncertainty could restrain business and consumer demand and that inflationary pressures could be damped if downside risks to economic activity or the labor market materialized.

Source: Federal Reserve Board