Central Banks

FOMC Minutes: June 17th – 18th

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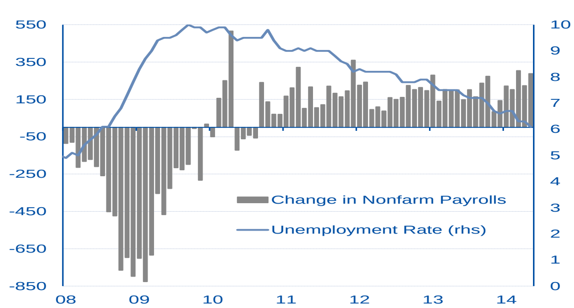
Tapering and Rate Hike on Par with Expectations alongside Heightened Discussion on Exit Strategy

- **FOMC in favor of final $15bn reduction in October to end QE3 rather than carrying over an additional $5bn to the next meeting**
- **Interest rate on excess reserves and overnight reverse repurchase agreement facility targeted as key tools for policy normalization process**
- **Exit strategy communication expected to intensify as the year progresses**

Details from the June FOMC meeting minutes were on par with our expectations regarding the ongoing pace of tapering and the communication surrounding future monetary policy accommodation. First and foremost, the minutes were straightforward in divulging the plan for tapering, noting that the final reduction of $15bn could be announced in the October meeting (pending any significant changes to incoming economic data) rather than prolonging the process for the remaining $5bn to be cut in December. This is in line with our expectations outlined in our baseline scenario.

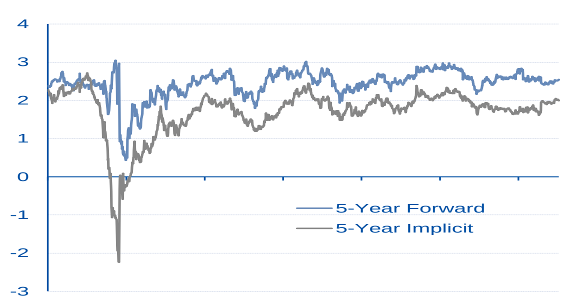
The recent bout of positive employment data has again brought about questions on the timing of the first federal funds rate hike and whether this could occur much sooner than currently anticipated. However, the FOMC discussion did not hint at any change at this point, and we therefore maintain our expectations for the first hike in mid-2015. Looking at the Summary of Economic Projections, the dispersion of projections for the target federal funds rate was little changed in 2015 but widened slightly in 2016. Relative to their projections in March, the median values of the federal funds rate at the end of 2015 and 2016 increased 13 basis points and 25 basis points to 1.13% and 2.50%, respectively. At the same time, the mean values rose 7 basis points and 11 basis points to 1.18% and 2.53%, respectively. As has been the case in prior meetings, some participants did express concern that growth may accelerate faster than expected, ultimately requiring a more immediate rate hike to “avoid significantly overshooting the Committee’s unemployment and inflation objectives.”

Chart 1
Unemployment Rate and Nonfarm Payrolls (% and MoM Change in K)



Source: BLS & BBVA Research

Chart 2
Inflation Expectations (%)



Source: FRB & BBVA Research

There was no clear path outlined but it seems as though Committee members are at least moving closer towards a more common ideology when it comes to an exit strategy. One of the challenges facing the FOMC is to determine what will compose the core of the Committee's operating framework and communication during the normalization process. Individual member opinions on the subject diverge with the majority agreeing that the fed funds rate should continue to play a central role in FOMC communication. However, a few participants suggested that the "administered rate" may be a better tool to communicate monetary policy during the normalization period. In addition, the FOMC assessed possibilities for changing the calculation of the effective fed funds rate in a way that would be helpful to obtain a more robust measure of overnight bank funding rates.

Along with the usual interpretation of incoming economic data, the minutes also revealed further discussion on the Fed's "eventual normalization of the stance and conduct of monetary policy." The minutes were careful to note that this discussion by no means implied a more immediate start date for normalization but were just part of the broader strategy for "prudent planning".

Of the monetary policy tools discussed for normalization, most FOMC members agreed that adjusting the rate of interest on excess reserves while utilizing overnight reverse repurchase agreement (ON RRP) facility would be an important strategy in establishing a firm floor under money market interest rates. Most FOMC participants consider the adjustment of those two tools sufficient enough to play a central role during the normalization process while sustaining a large balance sheet. Many participants judged that a relatively wide spread (near or above the current level of 20 basis points) would "support trading in the federal funds market and provide adequate control over market interest rates." Certainly, the Committee would be prepared to utilize other policy tools, such as term deposits and reverse repurchase agreements, if necessary.

Despite the fact that the FOMC is largely in agreement on using the above mentioned tools, there are risks associated with ON RRP that could arise in times of financial stress and that committee members would not be able to disregard completely. One of the risks highlighted in the minutes is that "the facility's counterparties could shift investments toward the facility and away from financial and nonfinancial corporations, possibly causing disruptions in funding that could magnify the stress." Another concern by a number of participants is that a relatively large ON RRP facility may have the potential "to expand the Federal Reserve's role in financial intermediation and reshape the financial industry in ways that were difficult to anticipate."

As it was argued in our previous Fed Watch, most FOMC members insisted that stopping reinvestment before the federal funds rate increase may suggest the rapid tightening of policy rates and therefore presents risks to the economic outlook. The following ordering of events may also add complexity to the Committee's communications at a crucial time when clear signaling of changes in policy becomes necessary. Thus, most participants prefer to end reinvestments after the zero-bound lift off, with several more comfortable doing it at the same time as a lift off. Nevertheless, some members still favor ending reinvestments prior to the first firming in policy interest rates, in accordance with the FOMC's exit strategy principles announced in June 2011. In any case, a "graduated approach with respect to winding down reinvestments or to manage reinvestments in a manner that would smooth the decline in the balance sheet" would be highly preferred, not just by a number of FOMC participants but also by markets in order to set market expectations on a right path.

Bottom Line: Normalization talk in progress, but still a long road ahead

June's FOMC meeting minutes were slightly more detailed than what we have seen thus far, but in general, the discussion does not change our expectations for the near term. We continue to expect the end to tapering in 4Q14, with the first rate hike occurring in mid-2015. Furthermore, we expect that the Fed will continue to adjust policy plans dependent on incoming data. Committee members are on board with a "simple and clear approach to normalization" that requires a significant effort on their part when it comes to communication and transparency. The meeting minutes confirmed that "it would be useful for the Committee to develop and communicate its plans to the public later this year, well before the first steps in normalizing policy become appropriate." As such, we expect to see more intense discussion on the subject throughout the next year, particularly in early 2015 once we have finally moved past QE3 tapering.