Central Banks

FOMC Minutes: June 16th – 17th Meeting

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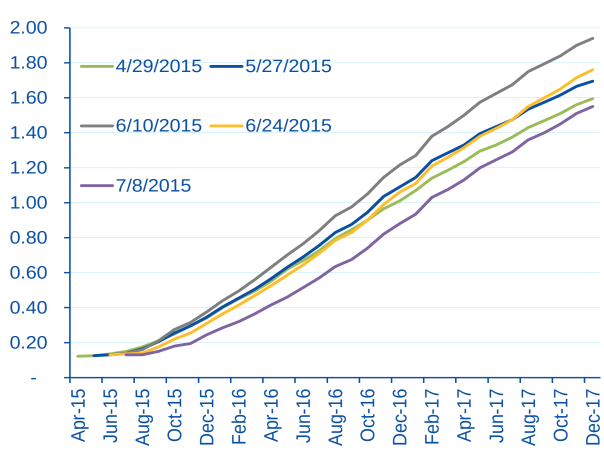
Discussion Highlights Risks to Delaying Liftoff Despite Global Concerns

- **FOMC commits to new "implementation note" as additional post-meeting publication for communicating policy normalization plans**
- **Discussion centered on risks of delaying liftoff signals that the FOMC is ready to act**
- **However, developments in Greece and China could rebalance downside risks to liftoff**

June's FOMC meeting minutes lacked the clarity we had been hoping for on the timing of the first federal funds rate hike. However, the Committee did agree to additional communication tools to be released "around the time of the first increase in the target range", signaling that liftoff may not be too far away. Discussions on economic activity were as expected and did not stray from the data-dependent strategy, but recent developments since the meeting highlight risks to the outlook and will warrant further debate in future meetings.

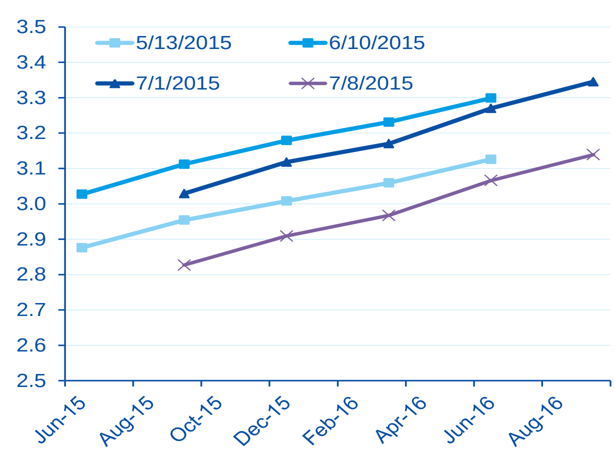
Most FOMC members were in agreement that "conditions for policy firming had not been achieved" at the time of the June meeting, and many argued the need for additional information before moving forward with policy normalization. One member was in favor of increasing rates at the meeting but was willing to wait "another meeting or two" to see how economic data continue to evolve. Still, it is clear that participants are aware of the many risks associated with delaying liftoff, putting the pressure on to increase rates as soon as their data-dependent strategy will allow. One of the major risks identified was that the FOMC might need to tighten monetary policy at a faster pace than what markets are expecting, potentially resulting in a jump in long-term rates and increased financial market volatility. Furthermore, the Committee cited an "undesirable increase in inflation" as a primary risk of delaying the first rate hike. It was also noted that a start to normalization would likely signal a more confident FOMC outlook, which could then fuel further improvement in the economy.

Chart 1
Federal Funds Rate Probabilities (%)



Source: Bloomberg & BBVA Research

Chart 2
10-Year Treasury Yield Futures (%)



Source: Bloomberg & BBVA Research

With most of the FOMC thinking that liftoff will occur sometime this year, members felt it necessary to derive a new method for communicating the “operational details.” This “implementation note” will highlight the specific policy measures relating to normalization, along with each FOMC statement. The Committee agreed that this was advantageous for multiple reasons, one of which is that it will ensure the FOMC’s policy plans are focused in one place, separate from the economic review in the post-meeting statement.

The FOMC’s review on economic conditions was mostly backward looking touching on ongoing improvements in the labor market, the recent stabilization of energy prices, and weak 1Q15 growth. Underutilization in the labor market remains a key issue, with some expecting to see this gap close by the end of the year and others arguing that slack had already been sufficiently reduced. The stabilization of oil prices was a positive in regards to the FOMC’s inflation outlook, but there was concern that this prolonged period of low inflation would eventually pass through to lower inflation expectations. Committee members also touched on long-term interest rates, downplaying the rise in the 10-year Treasury yield and reiterating the importance of the Fed’s communication plans in limiting extreme financial market volatility.

Participants were particularly wary of the seasonal adjustment issues in first quarter GDP calculations, with their own models suggesting that economic activity was probably stronger during 1Q15 than what was officially reported by the BEA. Although they saw 2Q15 economic activity as “expanding moderately”, FOMC participants discussed in depth the risks to growth, noting both domestic and global concerns. Some argued that weak first quarter growth may be a sign of a more prolonged constraint on economic activity, particularly in sectors that were negatively impacted by low oil prices and/or the stronger USD. Furthermore, consumption has not picked up as much as expected due to the drop in oil prices, and “the rise in the saving rate since last fall may signal more cautious behavior among households that might last for some time.” Productivity growth was also a concern, as continued weakness might influence a faster-than-expected rise in inflation whereas an increase in productivity could limit job growth and other ongoing improvements in the labor market. Global risks were discussed briefly as well, with specific mention on Greece and China.

The biggest difficulty in interpreting the minutes is that they are delayed a few weeks, so everything that has happened since mid-June has not yet been discussed. Most notably, the sharp drop in equity prices in China have raised concerns regarding the increased uncertainty on the impact on the U.S. economy. In addition, the individual views and opinions revealed in the meeting minutes may be outdated given the latest developments in Europe. Many Fed members have argued that the situation in Greece poses little risk to the timing of the first rate hike. However, a Greek exit from the Eurozone is becoming more of a reality, and if conditions deteriorate further by the July 29th meeting, we could see additional votes to push back liftoff.

Bottom Line: FOMC Weighing Global Risks with Cost of Delaying Liftoff

The Fed is between a rock and a hard place, holding strong on their data-dependent strategy but recognizing the increased risks to delaying the start of policy normalization. June’s meeting minutes did not reveal any specifics on when the first rate hike might occur, but establishing the new “implementation note” suggests that the timing may not be that far off. Review of the economic data will likely be catered more towards global developments in July’s meeting discussion. Although most FOMC members have argued that the situation in Greece will have minimal impact on the timing of liftoff, there will be more reaction to the recent activity in China. We continue to expect that the Fed will increase the federal funds rate in September, though increasing global concerns over the next few months could delay liftoff to the end of the year.

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