Central Banks

FOMC Minutes July 28-29th: Fed narrows its focus on policy guidance and asset purchases

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Today's minutes confirmed that the improvement in the economic outlook since April allowed the committee to use July's meeting to discuss policy options as the strategy shifts from "stabilization to accommodation". Most members continue to view the outlook as extremely uncertain, confirmed by the risk assessment of the staff, which concluded "that a more pessimistic projection was no less plausible than the baseline forecast."

Moreover, the committee outlook continues to be anchored to Covid-19 and its evolution due to extraordinarily high levels of uncertainty and risks; slowing the spread of the virus remains essential to a "durable reopening." Similarly, labor market improvements depend on sustained reopening of businesses and thus the containment of the virus. Since resource slack remains elevated in this scenario, expectations for inflation remain tilted to the downside with an increased likelihood of remaining below 2% for some time.

As we expected, the committee is getting closer to adjust the Statement on Longer-Run Goals and Monetary Policy Strategy, indicating a desire to "finalize all changes to the statement in the near future", which we interpret as the September meeting. Given the high level of uncertainty and more pessimistic view on the recovery, the committee discussed available and reasonable policy options to both support the economic recovery and reinforce the pending release of its monetary policy strategy review.

Figure 1. **INFLATION EXPECTATIONS (%)**

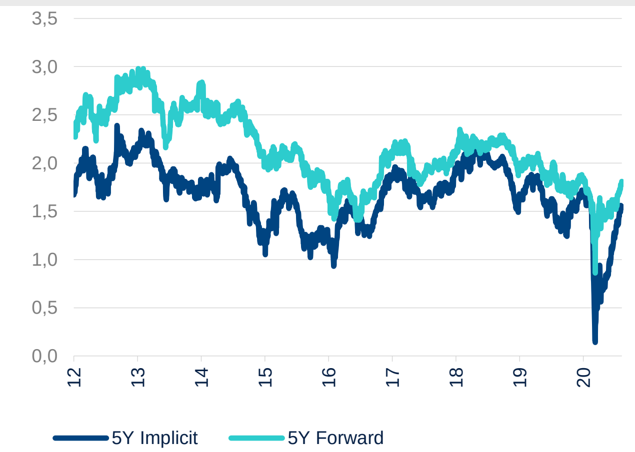

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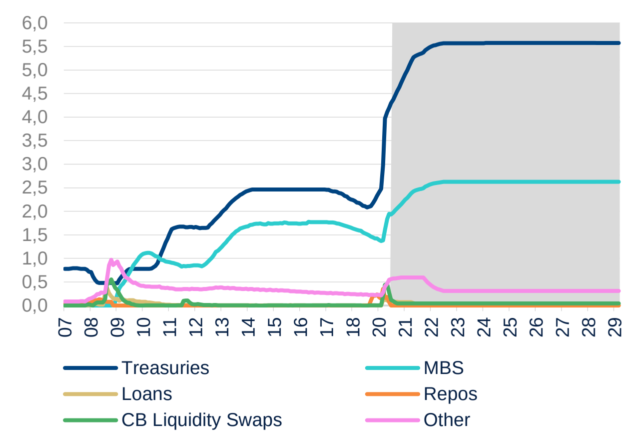
Figure 2. **FACTORS SUPPLYING RESERVE FUNDS**



Source: BBVA Research & FRB

Among the multiple options, the committee signaled a desire to firm their forward guidance using a possible combination of calendar and quantitative-based guidance, which could be strengthened by an update to the statement. Considering the pros and cons of both options, we expect the committee to lean toward goals-based forward guidance.

In addition, the willingness to provide support to households, business and financial conditions by way of a faster pace of asset purchases remains possible. In fact, several members highlighted that current asset purchases, which were designed to support the normalization of financial markets, are “likely also providing a degree of policy accommodation.” This implies that the Fed will, at the very least, maintain the pace of current asset purchases and shift its communication strategy around QE, highlighting its benefits in terms of easing financial conditions and supporting the economic recovery.

In contrast, the probability of Yield Curve Targeting (YCT) seems limited. On the one hand, only a couple of participants defended YCT arguing that it could provide “insurance against adverse movements in market expectations” and “as a tool that could help limit the amount of asset purchases.” However, on the other hand, the minutes highlighted that “[o]f those participants who discussed this option, most judged that yield caps and targets would likely provide only modest benefits in the current environment, as the Committee's forward guidance regarding the path of the federal funds rate already appeared highly credible.” Moreover, participants mentioned some potential costs such as “an excessively rapid expansion of the balance sheet” and difficulties in communication and termination of such strategy. The lack of consensus and bias against YCT implies that it will remain on the shelf.

Today’s minutes suggest that while the committee is close to announcing its new policy framework, it continues debating policy options and building consensus around the potential tools that will remain in place to both support the economic recovery and strengthen the credibility of the new strategy. In all likelihood, an enhanced form of forward guidance and an open-ended QE will be the prefered options. Although YCT cannot be ruled out, it seems that only a few members are convinced about its benefits. Finally, the Fed will have to decide between a comprehensive package or make the new strategy announcement and leave the changes to forward guidance and QE for a later date.