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Fed Watch

US

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Economic Analysis

US

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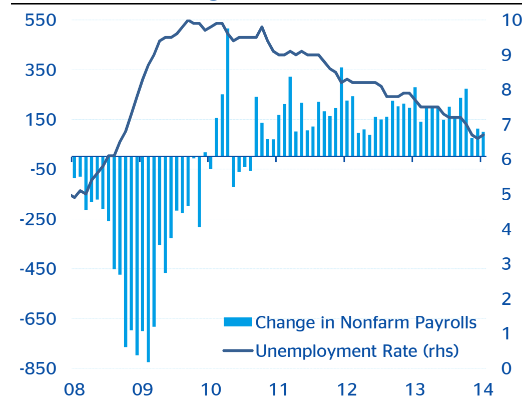
FOMC Minutes: January 28th - 29th

Fed Debates Timing to Lift Federal Funds Near-Zero Rate

- **Few participants solicit for 2014 increase in policy rate but majority disagreed**
- **FOMC acknowledged the need to modify forward guidance but still lacking a common denominator on how it should be done**
- **Committee is in agreement and at ease with $10bn monthly reductions in QE3**
- **Concerns are voiced in FOMC over the persistence of low inflation**
- **Monitoring closely the turmoil in the emerging markets the Committee finds no direct risks to the U.S. economy**

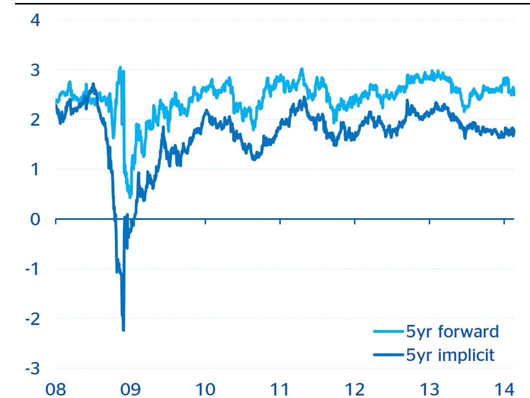
The FOMC minutes from the January meeting carried a hawkish undertone, revealing for the first time since the federal funds rate had been at the zero lower bound a debate over the timing of the initial policy rate increase. Throughout the discussion, a "couple" of participants noted that with the "standard policy rules", it would be appropriate to increase the policy rate "before the middle of this year." At the same time, the majority of the Committee members felt strongly that the "standard policy rules" should not be applicable for the current circumstances. While only a few participants mentioned the possibility of a federal funds rate increase "relatively soon", the pure notion of the debate over the timing of the first policy rate hike can have near-term adverse effect on the market participants expectations of the path of federal funds rate, particularly when coupled with the soon-to-be-crossed 6.5% unemployment rate threshold. The hawkish message of the minutes was further endorsed by Bullard's (FRB St. Louis) speech today which stated that "the observed unemployment rate remains as good an indicator of overall labor market health as it has been historically," further noting that "the recent, relatively rapid declines in unemployment can be understood as representing an improving labor market," and finally concluding that "this is the judgment that should inform monetary policy going forward."

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



Source: BLS & BBVA Research

Chart 2
Inflation Expectations (%)



Source: FRB & BBVA Research

To balance the above preconceptions, and faced with a faster-than-expected approach toward the 6.5% unemployment rate threshold, the FOMC acknowledged the need for modification, stating that "it would be soon appropriate to change its forward guidance in order to provide information about its decisions regarding the federal funds rate after that threshold was crossed." However there was much disagreement on the range of adjustment that could potentially be incorporated into the forward guidance. The list of possibilities discussed included the usual quantitative (change of thresholds) and qualitative (providing additional information) approaches to modify forward guidance. Participants' suggestions encompassed explicit reference to the risks to financial stability, persistently low inflation, and reliance on the Summary of Economic Projections as guidelines for the FOMC decision on the path of the policy rate once the 6.5% unemployment rate threshold is crossed. Meanwhile, there was a consensus among participants to stay put with current thresholds and the language and qualitative descriptions of the labor market and inflation introduced in the December 2013 statement guidelines.

In line with our expectations, there was a clear consensus among the Committee members on the current pace of reducing monthly asset purchases. The minutes stated that "in the absence of appreciable change in the economic outlook, there should be a clear presumption in favor of continuing to reduce the pace of purchases by a total of $10 billion at each FOMC meeting." At the same time the cautiousness is in place as the trajectory of the purchases will be changed "if the economy deviated substantially from its expected path."

Voicing concerns over persistently low inflation rates both domestic and overseas, coupled with the fact that short and medium term inflation expectations might not be as well anchored as long-term expectations, the FOMC vowed to monitor inflation developments carefully. Meeting participants emphasized that "inflation persistently below the Committee's objective would pose risks to economic performance." Committee members continue to expect that inflation will return closer to their 2.0% target in the coming year.

The January FOMC statement did not mention anything specific in regards to rising threats from emerging markets. However, the minutes revealed some discussion on the topic, and FOMC members agreed that risks remain contained given that "volatility had not been large enough" and spillover effects on the U.S. financial markets to date "were likely to be modest." It is interesting to note that the meeting minutes specifically mentioned for the first time a concern over the financing issues in Puerto Rico. As with other risks, the Committee will continue to monitor the situation closely.

Bottom Line

Looking at the economic situation as a whole, the current FOMC prospective is that the risks around their outlook for the unemployment rate and inflation had become "more nearly balanced." At the same time, the trajectory of the pace of asset purchases is data-dependent and therefore subject to change in upcoming meetings, particularly when it concerns persistently low inflation or deteriorating emerging market conditions. As it stands, the FOMC considers that current market expectations for asset purchases and the future path of the federal funds rate are "reasonably well-aligned" with its own expectations. However, it will be important for the Committee to curb its hawkish undertone, at least temporarily, and strengthen forward guidance to avoid future misalignments and premature monetary policy tightening. Consistent with our prior projections, we continue to expect a gradual tapering process throughout 2014. Assuming that the Fed maintains the $10bn per month incremental reductions, asset purchases will likely continue until 4Q14. We maintain our expectations for the first federal funds rate hike in 3Q15.

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