RESEARCH

Fed Watch

US

18 May 2011

Economic Analysis

US

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FOMC Minutes: April 26-7

Members ratchet up discussion of normalization

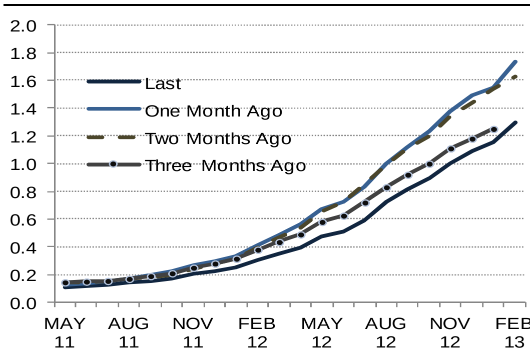
- **Conceptual obstacles in normalization arise via pace or timing asset sales**
- **Staff suggests decoupling normalization of conduct from stance**
- **FOMC members eye eventual return to Fed Funds as primary instrument**

Meeting participants agree on broad principles for normalization process

According to today's release of the minutes from the April 26-7 Federal Open Market Committee (FOMC), members extensively discussed different strategies for reversing extraordinary monetary policy arising from the 2008 crisis. In particular, Federal Reserve staff divided the strategic imperative into two buckets: normalizing the accommodative stance versus normalizing the conduct of policy. In turn, FOMC members focused on three issues: the optimal combination of sales and rate hikes, the degree of responsiveness to market conditions in asset sales, and a set of principles to guide the process through which policy is normalized. First, Federal Reserve staff suggested that once a time and a degree of accommodation is decided upon, the FOMC must consider the desired combination of asset sales and rate hikes as both "achieve similar outcomes" in terms of the end result on the economy. For example, the FOMC may decide to sell assets sooner and faster, while having slower and a later start to rate hikes, or the complete opposite. Second, the degree of variance to economic conditions in asset sales may lock out particular policy tools. The staff noted the example that if the FOMC decides to predetermine the pace and timing of asset sales, then the FOMC would be left with the Fed Funds target rate, which may be "more straightforward" as a tool in certain cases. Lastly, FOMC members agree on some broad principles to guide their decision-making regarding normalization. Naturally, FOMC members will continue to be guided by the Federal Reserve's dual mandate of price stability and maximum employment. The FOMC also believes that the eventual goal is a reduction of the System Open Market Account (SOMA) to a point where the Fed Funds rate becomes again the primary active policy instrument. Eventually the SOMA will hold only Treasury securities, implying sales of agency securities at some point. Finally, the FOMC believes that asset sales should be communicated to the public in advance and possibly tied to economic conditions.

Chart 1

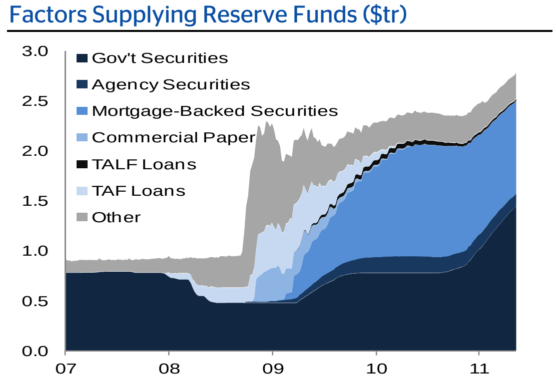
Fed Funds Futures Contracts (%)



Source: Haver Analytics & BBVA Research

Chart 2

Factors Supplying Reserve Funds ($tr)



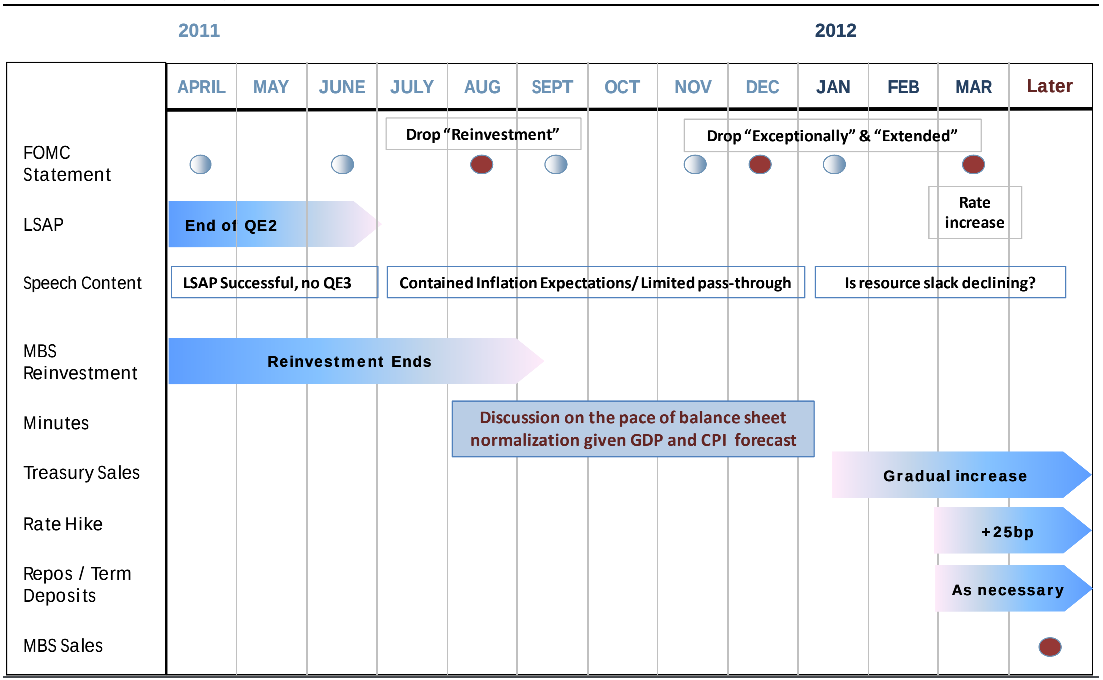
Source: Haver Analytics & BBVA Research

On this last issue, FOMC members appeared divided on the role of asset sales in policy normalization and changes in stance from a reading of the minutes. Nearly all participants agreed that a first step in normalization would be the cessation of reinvestment of principal from maturing SOMA securities, although the minutes implied this would be a strong signal to the market. Most participants expressed a desire to place asset sales on a "largely predetermined and preannounced path," although they acknowledged that material changes to economic conditions will trigger alterations. Other participants expressed a preference for less predetermination, suggesting instead that the pace of asset sales become a key policy tool and vary in response to economic conditions. Participants also differed over the timing of asset sales in the context of the first rate hike, with the main differences in opinion stemming from what sequencing of sales and rate hikes would be most effective at extricating policy from the problem of the zero bound and the commensurate effect on policy tools available further down the line in the normalization process. Differences in opinion on whether asset sales would occur before, simultaneously, or following rate hikes tended to revolve around the unfolding outlook for inflation and different speeds of balance sheet normalization,

Minutes discussion consistent with Fed taking time to carefully consider next move

Although the FOMC members are still hashing out the details, the main theme of their discussion is an eventual return to a focus on the Fed Funds target, but with increased use of a corridor system bounded by the discount rate and interest on excess reserves. Overall, the Fed remains in no rush to raise interest rates as a result of excess resource slack, although it is increasingly focused on the evolution of measures of inflation expectations. Due to uncertainty over the sustainability of the recovery, the timing of policy actions (balance sheet normalization, in particular), will depend on the evolution of data over the summer. We continue to expect a first rate hike in March 2012. The minutes are also consistent with our expected sequencing of policy (Chart 3).

Chart 3
Expected Sequencing of Federal Reserve Monetary Policy



Source: BBVA Research