Central Banks

FOMC Minutes: July 29th – 30th

Shushanik Papanyan / Boyd Nash-Stacey

Worries over Overshooting Economic Goals in Medium-Term

- **Most participants agreed on a tentative plan for policy normalization**
- **Committee views labor outlook improvement as sufficient enough; upgrade of forward guidance characterization of "labor market underutilization" on the horizon**

The FOMC continued its delicate balancing act of transparent and clear communication, while preserving the flexibility to remain data-driven. The July minutes reveal a tentative plan on policy normalization that most participants agree upon. At the same time, the minutes did not provide any new details on the exit strategy, communicating only general outline to the exit strategy approach. Meanwhile, in light of the importance to communicate a clear plan regarding the details on normalization, the FOMC committed to provide additional information to the public "later this year" and "well before most participants anticipate the first steps in reducing policy accommodation to become appropriate."

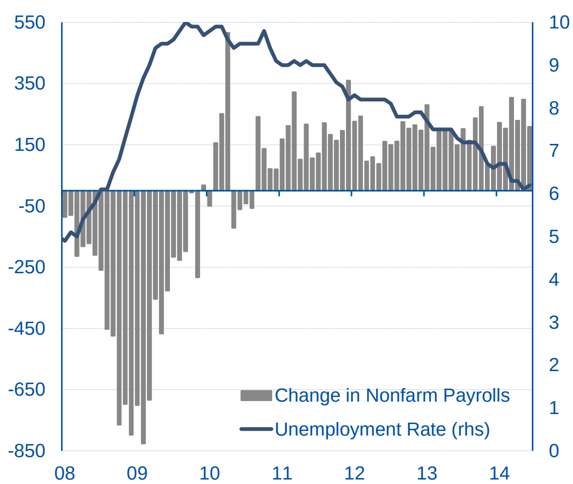
The general approach to the normalization policy tools and strategies that most of participants agree on are to:

- retain the federal funds rate as the key policy rate, and support continuing to target a range of 25 basis points for this rate at the time of liftoff and for some time thereafter;
- use adjustments in the interest on excess reserves (IOER) rate as the primary tool to move the federal funds rate into its target range and influence other money market rates;
- temporary use of a limited-scale overnight reverse repurchase agreement (ON RRP) facility to help set a firmer floor under money market interest rates during normalization, agreeing that the ON RRP facility should be only as large as needed for effective monetary policy implementation and should be phased out when it is no longer needed for that purpose;
- set (at least initially) the IOER rate at the top of the target range for the federal funds rate, and the ON RRP rate at the bottom of the federal funds target range;
- reduce or end reinvestment sometime after the first increase in the target range for the federal funds rate.

Overall, meeting participants were also in agreement regarding the approaches to normalize the size and composition of balance sheet, with only a few participants dissenting in favor of tighter policy with faster balance reduction. In general, most of the participants agreed that the size of the balance sheet should be reduced gradually and predictably, and that in the long run, the balance sheet should consist primarily of Treasury securities and reduced to the "smallest level consistent with efficient implementation of monetary policy." Additionally, most participants continued to anticipate that the sale of mortgage-backed securities (MBS) would occur only to eliminate residual holdings.

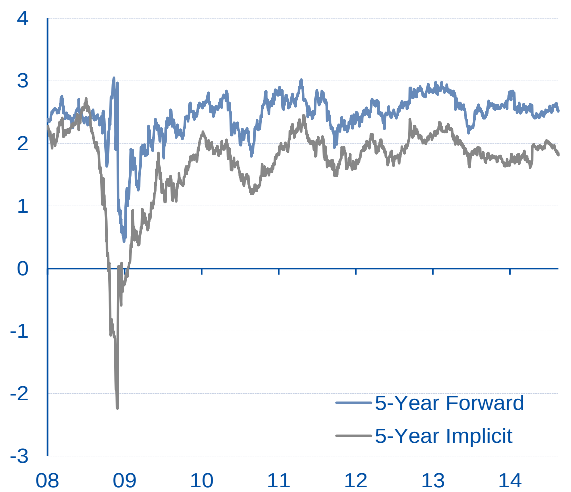
The unexpected highlight of the minutes was the Committee's assessment of medium-term economic projections which revealed many FOMC participants' worries over possibility of quicker than anticipated convergence of economic outlook toward the FOMC goals. Likewise, this can prompt earlier than expected removal of accommodative policy. The minute's state: "many participants noted that if convergence toward the Committee's objectives occurred more quickly than expected, it might become appropriate to begin removing monetary policy accommodation sooner than they currently anticipated." Additionally, many FOMC members also expressed that the FOMC statement characterization of "labor market underutilization might have to change before long" if progress in the labor market "continued to be faster than anticipated." Some, more hawkish participants, likely including voting against FOMC action Plosser (FRB Philadelphia), felt "increasingly uncomfortable with the Committee's forward guidance" expressing that "the actual and expected progress toward the Committee's goals as sufficient to call for a relatively prompt move toward reducing policy accommodation to avoid overshooting the Committee's unemployment and inflation objectives over the medium term."

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



Source: BLS & BBVA Research

Chart 2
Inflation Expectations (%)



Source: FRB & BBVA Research

Bottom Line

The FOMC is closer to an agreement on policy normalization strategies with details anticipated to be announced "later this year." We continue to expect the end to tapering in 4Q14, with the first rate hike occurring in mid-2015. Likewise, we expect that the Fed will continue to adjust policy plans dependent on incoming data. Despite many participants' concerns over overshooting economic objectives in medium-term, FOMC was vastly in agreement that any change in the expectations regarding the first rate increase and the overall trajectory of federal fund rate would depend on further projections of economic activity, the labor market and inflation.