Central Banks

FOMC Minutes: December 16th – 17th Meeting

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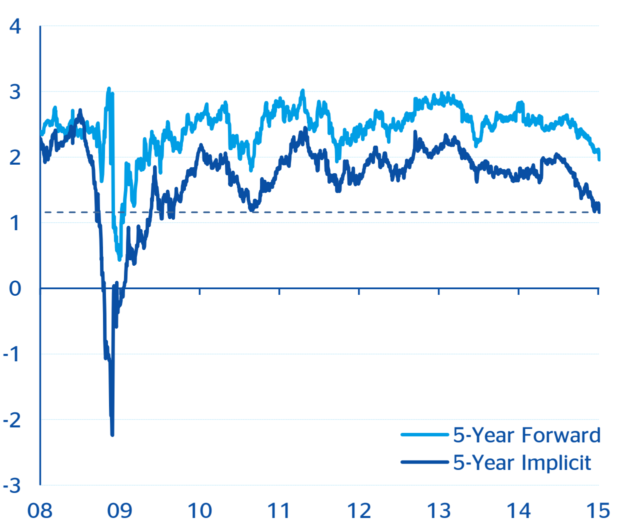
Committee Stresses Importance of Data-Dependent Policy

- **FOMC views remain consistent with the past despite the change in forward guidance language from "considerable time" to "patient"**
- **The dispersion of the FOMC federal fund rate projections in 2015 narrowed as members' stances on the start of the first rate increase remains unchanged**
- **FOMC economic outlook is optimistic with main downside risks tilted toward slow growth abroad**
- **The 3 dissenters crossed the hawkish-dovish spectrum, with one arguing for more accommodative policy while others felt the need for a more immediate liftoff**

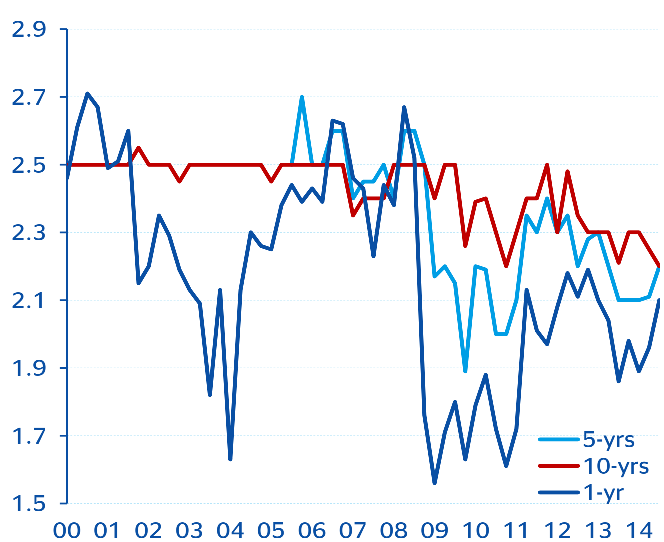
The minutes from December's FOMC meeting revealed that most of the Committee members judged that the change in the forward guidance language was necessary due to the previous outdated reference to the asset purchase program. At the same time, the use of the word "patient," with regard to the FOMC being "patient in beginning to normalize the stance of monetary policy" had it supporters and dissenters. While most participants believed that "patient" would mean that the Committee is unlikely to begin the normalization process "for at least the next couple of meetings," some considered that the language communicates a calendar date, specifically "a narrow range of dates around mid-2015." Only a few participants suggested focusing on specific economic conditions that would warrant the liftoff.

Chart 1
Market Inflation Expectations (%)



Source: FRB & BBVA Research

Chart 2
Survey Inflation Expectations (%)



Source: FRB & BBVA Research

In line with the language change, the FOMC stance on policy normalization remained unchanged. The minutes convey the Committee's positive outlook for further economic growth and acceptance of current low inflation levels. The minutes state that the Fed "might begin normalization at a time when core inflation was near current levels," although with the necessary belief that inflation will move back toward the 2% target "over time." According to the FOMC projected path of the federal funds rate, the dispersion of the appropriate rate for 2015 narrowed. The median values of the federal funds rate for the end of 2015 and 2016 are at 1.13% and 2.50%, respectively. The mean values for the same years are similar at 1.13% and 2.54% respectively. Our projection for the path of the federal funds rate remains slightly less aggressive compared to the FOMC projections.

December's FOMC statement provoked three dissenters – the most since August 2011 with the exact same committee members voting against the action (Plosser, Fisher, and Kocherlakota). The details of the meeting minutes emphasized the different reasons behind each dissent. Charles Plosser (FRB Philadelphia) felt that the forward guidance should be more data dependent rather than time dependent given the greater-than-expected improvement in economic conditions, arguing that "the statement should communicate that there is a measurable probability that liftoff may occur in the first quarter of next year (2015), even if the most likely scenario is for normalization to begin around midyear." He also highlighted the dangers of waiting too long to increase interest rates and the potential need for more aggressive monetary policy action as a consequence. Similarly, Richard Fisher (FRB Dallas) argued that with the ongoing improvement in economic data, it would likely be appropriate to hike rates sooner than the statement implied. Finally, Narayana Kocherlakota (FRB Minneapolis) felt that the statement needed to better emphasize below-target inflation and falling expectations, suggesting that "the Committee's 2 percent inflation target was at risk, calling for a more accommodative policy stance."

Overall, the Committee's outlook on the U.S. was quite optimistic with strong manufacturing activity, consumer and business confidence, supported by falling energy prices, while the international situation and slow economic growth abroad was seen as most likely source of downside risks. Meeting participants regarded that the net effect of the downfall of energy prices is likely to be positive for economic activity and employment. At the same time, the minutes also address the possible isolated regional slowdown due to the reduction in capital investment in the oil and gas industries and reduced drilling activity.

Inflation concerns were certainly addressed in the meeting, although the statement suggests that the Committee still sees low inflation as only transitory. Members did agree that inflation was likely to fall further (which we have already seen since the meeting occurred) with the idea that it would gradually move towards their target "as the labor market improved further in an environment of well-anchored inflation expectations." FOMC participants acknowledged that declining inflation compensation was a reflection of lower inflation risk premiums instead of a drop in expectations. Still, some members noted the potential severity of this downward trend in inflation compensation as it relates to investor concerns of weaker economic activity.

Bottom Line

The details of the December meeting minutes did not shift market expectations regarding the pace of policy normalization. FOMC members' commentary touched upon the important economic factors with expectations of continued strong growth, increasing employment, and slow return of inflation to their target of 2.0%. The Fed continues to believe that the highly accommodative monetary policy stance will remain appropriate even after the rate hike as they intend to keep holdings of long-term securities unchanged. The probability of an early rate hike remains positive given the solid improvement in labor market conditions. However, downward pressures on prices may create greater concerns within the FOMC if the low inflationary environment is perceived to be more long-lasting. Therefore, we maintain our baseline scenario for a liftoff in mid-2015.