Central Banks

FOMC Minutes: January 27th – 28th Meeting

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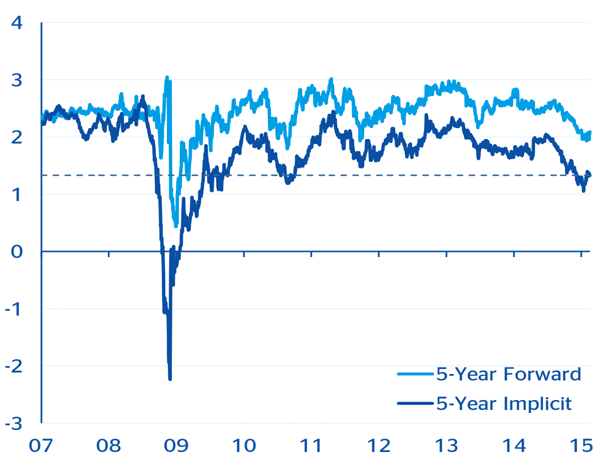
Fed's Boundaries of "Patient" Expand with Uncertainty on Inflation Outlook

- **Many participants "inclined" to keep the policy rate at its lower bound for a longer time**
- **Fed is challenged to craft communication that underscores the data dependency of liftoff**
- **Diverged opinions on how transitory is the current downward pressure on inflation**

The central piece of the FOMC January meeting minutes, the policy planning discussion, revealed participants' further debate regarding the earlier vs. later date of policy firming. The discussion had many participants "inclined toward keeping the federal funds rate at its effective lower bound for a longer time." Only some participants were concerned that the policy rate may "have already been kept at its lower bound for a sufficient length of time, and that it might be appropriate to begin policy firming in the near term."

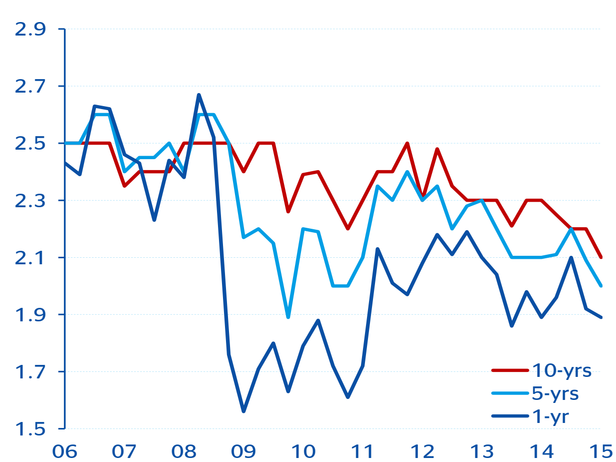
Meanwhile, the key challenge ahead was associated not as much with the choice of the liftoff-date but rather with the complexities of signaling that the policy normalization will begin relatively soon, when that time becomes appropriate. The minutes uncover the FOMC's eagerness to modify the forward guidance, while we expect the Committee to be pulled back due to difficulty in finding common ground on what would be an effective step forward in Fed communication. Many participants found that "dropping the 'patient' language" from the forward guidance would risk a shift in market expectations toward a narrow range of liftoff dates, and could result in unintended tightening of financial conditions. There was also "wide agreement" among meeting participants that "it would be difficult to specify in advance an exhaustive list of economic indicators and the values that these indicators would need to take." A number of participants acknowledged the limitations of the forward guidance to communicate the timing of policy normalization, while some focused on the benefits of "streamlining" the post-meeting statement once normalization has started.

Chart 1
Market Inflation Expectations (%)



Source: FRB & BBVA Research

Chart 2
Survey Inflation Expectations (%)



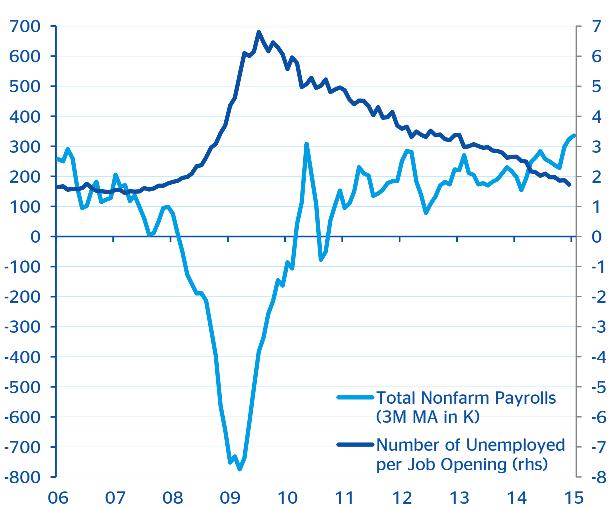
Source: FRB & BBVA Research

The uncertainty regarding the inflation outlook continued to take center stage in the FOMC discussion. The Committee members' opinions differed on how transitory the current downward pressure on inflation is, as well as on the causes of low inflation expectation readings. Several participants were concerned with weakness in core inflation measures, while some participants expressed their confidence in inflation returning to the 2% target and encouraged the Committee to monitor core PCE inflation as well as alternative measures such as trimmed mean or median inflation. The participants' opinions continue to diverge regarding the importance of nominal wage growth as an indicator of upward pressure on inflation. Likewise, the participants diverged in their measurements on the remaining labor underutilization. While some participants, likely dovish, lowered their estimates of the longer-run normal rate of unemployment due to continued softness in inflation, few others anticipated a soon end to labor force underutilization. Overall, the Committee's assessment of improvements in the labor outlook conditions was characterized as "broad-based."

With regard to the substantial decline in nominal longer-term interest rates, the FOMC discussed the possible shifts of funds from abroad that put downward pressure on term premium, while also noting that foreign investment flows also likely resulted in the decline of TIPS-based measures of inflation compensation. The flattened Treasury yield curve caused a hawkish-dovish divide, as some participants found financial conditions accommodative for a "somewhat higher path" for the federal funds rate, while others expressed concerns about growth abroad and "less clear" implications for U.S. monetary policy.

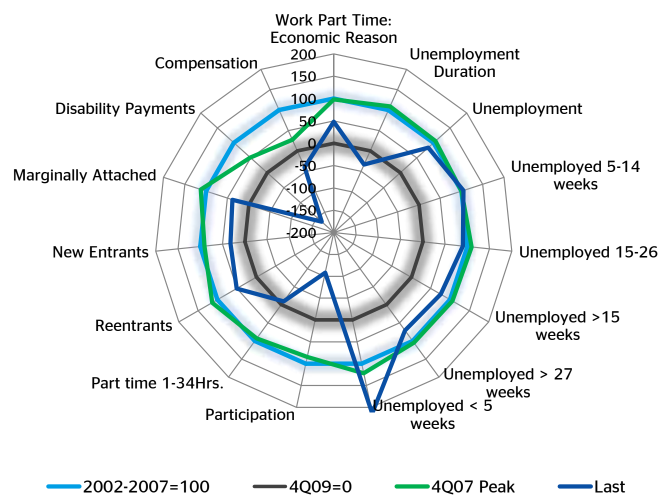
In line with the last statement's language alterations, many participants viewed that the "deterioration in the foreign economic situation" can pose a downside risk for domestic growth, with particular attention paid to the slowdown of growth in China, which the Fed staff's analysis suggested also contributed to slowing GDP in Korea and the United Kingdom. At the same time, the accommodative policy actions by foreign central banks and the decline in energy prices were regarded as intermediate term events that will mitigate global risks to U.S. growth.

Chart 3
Nonfarm Payrolls and Unemployed per Job Opening



Source: BLS & BBVA Research

Chart 4
Labor Market Utilization (%)



Source: BLS, DoL, NABE, NFIB, ISM & BBVA Research

Bottom Line

We maintain our baseline scenario for a liftoff in mid-2015. The minutes highlight that the precise date of the policy rate liftoff will bear less importance on economic outcomes under the assumption that the Committee will implement an effective strategy to communicate the data-dependent path for the federal funds rate. The implementation of clear communication in a manner that will “underscore” the data dependency of the monetary policy decisions, such as setting expectations for investors and policymakers that unanticipated economic developments can warrant a federal funds path that is different from the one currently expected, presented its own challenges. The FOMC remained concerned with downward pressures on prices and the risk that the low inflationary environment will be more long-lasting than currently expected.