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Fed Watch

US

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Economic Analysis

US

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FOMC Minutes: December 18th - 19th

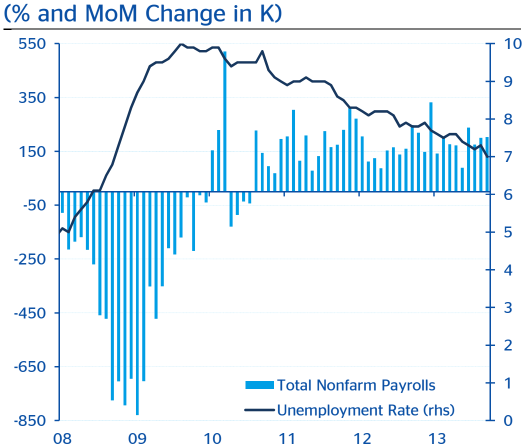
Converging Committee Views on Tapering and Forward Guidance

- **Diminishing risks from the "disruptive political impasse" was the leading influence behind the December tapering announcement**
- **Committee members see declining marginal efficacy of asset purchases**
- **Despite continuous deliberation, FOMC members agreed to maintain current forward guidance thresholds**

The FOMC meeting in December took a step forward towards policy normalization and announced the start of tapering, reducing the Fed's monthly Large Scale Asset Purchases (LSAP) by $10bn. Given that there was only one dissenter (Rosengren, FRB Boston), details in the meeting minutes reveal the participants' broad agreement and confidence regarding the appropriateness of the timing of the tapering announcement. At the same time, the minutes also reflected the cautiousness of the Committee to craft a message that would avoid causing further financial market tightening. Consequently, the minutes were also communicated in a neutral language with a light dovish spin of an optimistic economic outlook, highlighting the fact that Fed policy remains highly accommodative with an increasing balance sheet that crossed the $4tn mark in January.

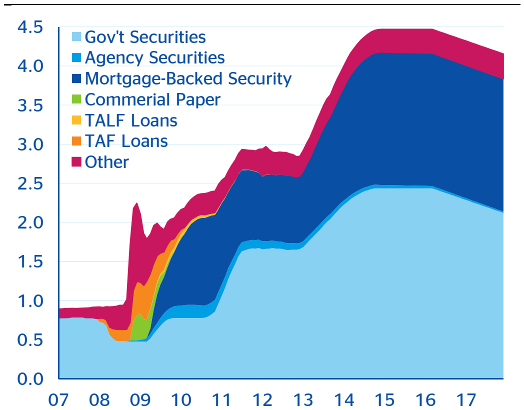
Two major factors behind the decision to taper were the decline in the marginal efficacy of LSAP and the lowered risks of "disruptive political impasse" by Congress. Across the board among meeting participants, there were no substantial changes in "broad contours" of the economic outlook, such as real growth, labor market and inflation, but members did see improved confidence in the outlook as the negative risks of the first half of 2013 subsided. The overall optimistic views of the Committee were driven by diminished fiscal restraints, a pickup in global economic growth and the subsequent boost to U.S. exports, further easing credit conditions and improvements in household balance sheets.

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



Source: BLS & BBVA Research

Chart 2
Federal Reserve Balance Sheet ($bn)



Source: FRB & BBVA Research

When the FOMC announced the forward guidance thresholds of 6.5% unemployment and 2.0% inflation, their economic projection for unemployment was broadly consistent with the pace of policy firming, which the majority of FOMC members expected in 2015. While the FOMC expects the unemployment rate to hit 6.5% in 2014, it also pushed back the expected path of the policy rate.

As a result of improved labor market conditions, some market participants are discounting an earlier tightening schedule which could result in faster and higher interest rate increases than what the FOMC would like to see. But as revealed by the FOMC projections, most members would prefer a late rate hike to avoid premature policy tightening. Thus the question is what the committee can do when thresholds and expectations of policy firming are misaligned, without generating elevated uncertainty and sacrificing credibility of forward guidance tool.

To maintain the credibility of forward guidance, assure clear communication and support financial stability, the minutes reveal that most participants were against changing the unemployment rate threshold, although a few did favor lowering the rate to 6.0%. Others would like to add additional labor market indicators to assess the appropriate stance of policy once the threshold has been crossed. A number of members thought that the forward guidance should emphasize the importance of inflation as a factor in their decisions. Despite this inconsistency in opinions, all members agreed to include in the statement the language "that it would be appropriate to maintain the current target range for the federal funds rate well past the time that the unemployment rate declines below 6 ½ percent."

Still, concerns remain that this language may reflect a calendar-based policy rather than data-dependent. These discussions reflect the learning experience within the FOMC of using forward guidance and other unconventional monetary policy strategies, and the problems that can arise when some of these strategies are at odds. It is gaining time by blurring the significance of its thresholds, which in addition gives the committee ample flexibility going forward. If the economy continues outperforming, the FOMC will have to bring forward its expectations of rate hikes and realign them once again with its thresholds. Nevertheless, the FOMC will not change its timing of policy firming until it is certain that the economy can absorb an earlier tightening.

Bottom Line

The learning process between markets and the Fed has been rocky but will improve over time as both sides understand the implications of forward guidance and the evolution of Fed communication. Nevertheless, the risk of a disorderly exit process remains. The path of asset purchases remain data driven while the Fed's communication emphasizes that there would be no "preset course" for tapering and further reductions should be expected in "measured steps." 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.