Economic Research Department

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US

Fedwatch

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FOMC Minutes December 11 Meeting

- **Both inflation and growth risks have intensified since the October meeting**
- **FOMC members discussed how worsening financial conditions increased the downside risks to economic growth**
- **The action at the December meeting did not include a risk assessment statement, which signs increasing uncertainty about the economic outlook as well as worries about the upside risks to inflation**

In the forecast prepared for the meeting, the staff lowered the projection on aggregate economic growth for the fourth quarter of 2007. The revision is due to the mixed data from capital markets, lower than anticipated correction in the trade balance, and worsening housing sector readings. In addition, FOMC members recognized that headline inflation increased in September and October, while core inflation readings appear contained, at least in the short term; both inflation and growth risks have intensified since the October meeting.

The FOMC action at the October meeting was anticipated by market participants, and committee members stated that "the upside risks to inflation balanced the downside risks to growth". In contrast, the action at the December meeting, while largely expected, did not include a risk assessment statement, which signs increasing uncertainty about the economic outlook as well as worries about the upside risks to inflation.

Turbulence in financial markets has led market participants to revise down the expected economic growth as well as the path for policy, as significant losses at large financial institutions could impact negatively the availably of credit and overall economic growth. In addition, FOMC members discussed the small impact that the economic projections, released during the inter-meeting period, had on the market.

In our view, this rate cut was based on the less favorable readings in economic activity for the last quarter of 2007 and the restriction on credit availability derived from the turmoil in financial markets and the losses reported at some large financial institutions. It is likely that given an improvement in financial market conditions the attention could shift back to inflation, which means a hold on policy or even a change in the current downward path.

Our policy expectations are consistent with a 25-50 bp rate cut during the next quarter, depending on either a small improvement or a deeper adjustment in financial markets.

Fed Funds: 4.25%
Next FOMC Meeting: January 29-30
Minutes Release: February 20

FOMC Meeting Minutes – December 11

Discussion on growth: "The information reviewed at the December meeting indicated that, after the robust gains of the summer, economic activity decelerated significantly in the fourth quarter. Consumption growth slowed, and survey measures of sentiment dropped further. Many readings from the business sector were also softer: Industrial production fell in October, as did orders and shipments of capital goods. Employment gains stepped down during the four months ending in November from their pace earlier in the year."

Discussion on inflation: "headline consumer price inflation increased in September and October from its low rates in the summer as the surge in crude oil prices began to be reflected in retail energy prices. In addition, though the rise in food prices in October was slower than in August and September, it remained above that of core consumer prices. Excluding food and energy, inflation was moderate, although it was up from its low rates in the spring. The pickup in core consumer inflation over this period reflected an acceleration in some prices that were unusually soft last spring, such as those for apparel, prescription drugs, and medical services, as well as nonmarket prices."

Discussion on monetary policy: "Market participants marked down their expected path for policy substantially, and by the time of the December meeting, investors were virtually certain of a rate cut. Two-year Treasury yields fell on net over the intermeeting period by an amount about in line with revisions to policy expectations. Ten-year Treasury yields also declined, but less than shorter-term yields. The steepening of the yield curve was due mostly to sharply lower short- and intermediate-term forward rates, consistent with investors' apparently more pessimistic outlook for economic growth."

Discussion on financial markets: "After showing some signs of improvement in late September and October, conditions in financial markets worsened over the intermeeting period. Heightened worries about counterparty credit risk, balance sheet constraints, and liquidity pressures affected interbank funding markets and commercial paper markets, where spreads over risk-free rates rose to levels that were, in some cases, higher than those seen in August. Strains in those markets were exacerbated by concerns related to year-end pressures. In longer-term corporate markets, both investment- and speculative-grade credit spreads widened considerably; issuance slowed but remained strong. In housing finance, subprime mortgage markets stayed virtually shut, and spreads on jumbo loans apparently widened. "