RESEARCH

Fed Watch

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Economic Analysis

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FOMC Minutes: October 29th – 30th

Action Plan for Taper and Effective Forward Guidance Put in Place

- **FOMC timing to trim the pace of asset purchases indicated as: "in coming months" and "in one of its next few meetings"**
- **Committee continues to perceive the unemployment rate as "a reasonably accurate signal about the strength of the labor market"**
- **Preparatory steps discussed regarding the mechanics of a month-to-month reduction of the pace of purchases, and the split of the reduction between Treasuries and MBS**
- **FOMC statement modifications to the forward guidance were on the table while implementation of such modifications was postponed**
- **Committee discussed a possible reduction in interest rate paid on excess reserve**

The FOMC minutes from the October 29th – 30th meeting reflect the Fed taking preparatory steps and putting in place an action plan for a possible reduction in the pace of large scale asset purchases (LSAP) in "one of its next few meetings." Aside from the usual review of the economic outlook, wherein the set of data available to review was limited due to the delays associated with the October government shutdown, the Committee's main focus was medium term policy planning. The Committee discussed strategic and communication issues related to the asset purchase program as well as the forward guidance. The FOMC minutes taper-talk led to two-month high, a 9 basis point increase in the 10-Year Treasury yield to 2.80%.

Despite mixed or a lack of economic data in October, FOMC members judged the labor market outlook as continuing to improve. The Committee addressed the decline in the participation rate concluding that "the historical relationship between real GDP growth rate and changes in the unemployment rate had remained broadly in place." Thus the unemployment rate "continued to provide a reasonably accurate signal about the strength of the labor market and the degree of slack in the economy."

The range of policy planning issues discussed in the October meeting encompassed two scenarios when tapering might be initiated: 1) a reduction in purchases when the economic data "would prove consistent with the Committee's outlook" for improvement and 2) a possible wind-down "before an unambiguous further improvement in the outlook was apparent," thus driven by the concerns about the efficacy or costs of further asset purchases. While only a couple of participants considered the latter case of wind-down as a premature discussion, the overall agreement among participants was to enhance communications regarding all the criteria of the asset purchases program.

Looking forward, two other taper related issues on the FOMC table were 1) how to implement and communicate month-to-month reductions in the pace of the asset purchases, and 2) how to split the trim of asset purchases between the Treasuries and the Mortgage-Backed Securities (MBS).

Mechanics of the Taper

The minutes reveal the following suggestions on how to implement the wind-down of asset purchases:

- introduction of a mechanical rule that would automatically adjust the pace of purchases based on improvements in an economic variable (unemployment or payroll employment)
- announcing a total size of remaining purchases
- a "calendar-based step-down" – introducing a timetable for the reduction in purchases

All these suggestions represent the same old quandary for the FOMC – the eagerness of stressing the data-dependent nature of LSAP and the necessity of curbing market expectations while separating asset purchase program expectations from the future path of the policy rate. Overall, Committee members were doubtful regarding the reliability of a simple mechanical rule to guide the path of the asset purchases. At the same time the participants recognized that a "calendar-based" wind-down could be easy to communicate but would be in disaccord with the "state-contingent nature" of the program.

Treasuries or MBS First to Go

The minutes do not provide a clear picture, but they do reveal that *a number of participants* supported a "roughly equal adjustment" to the purchases of Treasuries and MBS would be an appropriate and easy to communicate measure. At the same time, *some others* indicated their preference to back a more rapid reduction in Treasuries vs. MBS, which would signal further support for the housing market. Finally, *one participant* expressed a preference to trim MBSs first to "reduce potential for distortion in credit allocation."

Forward Guidance

FOMC further discussion centered around the possible modifications to the forward guidance. Only a *couple participants* favored a reduction in the 6.5 percent unemployment threshold, since concerns were raised regarding the "durability of the Committee's commitment to the thresholds." The Committee members debated several possible language modifications to the forward guidance, to communicate a low trajectory for the federal funds rate, such as the intention to keep the federal funds rate below its long-run equilibrium after the unemployment threshold is reached. *Few participants* were inclined to add a lower bound inflation rate threshold to the forward guidance. At the same time, *several participants* would prefer to provide a wide range of additional qualitative information that the Committee would evaluate in relation to the policy rate. While no modifications to the forward guidance were made in the October statement, they are likely to be implemented in the near future, especially in conjunction with the decision to taper "as part of a rebalancing of the Committee's tools."

Another tool considered by the FOMC to signal the intention of keeping short-term rates low was a reduction in the interest rate paid on excess reserves, which *a number of participants* considered worthy of further study. Today's release of FOMC minutes, with the consideration of even lower than current 0.25 percent excess reserve interest rate, coincides with news from Europe that the ECB is considering imposing a negative interest rate on the excess reserves of commercial lenders.

Bottom Line: FOMC Policy Planning "Laying the Groundwork" for a Taper

FOMC did not discuss the possible taper in October but was busy "laying the groundwork" for the reduction in asset purchases. The Committee perceived fiscal restraints as less restrictive in the future and the labor market as improving while seeing a positive shift in the financial outlook. FOMC tackled the complexities associated with communication regarding the policy tools. Conditional on the economic data yet to be released before the December 17th meeting, the possible reduction in the pace of LSAP would be discussed in December or could be postponed to 1Q14.