LH|M MONETARY POLICY ANALYTICS

FOMC Minutes

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Shift in Mood (Not the Forecast) Suggests No March Hike

The minutes of the December 2018 FOMC meeting reveal a clear shift in the mood among FOMC participants. While the outlook remains strong, FOMC participants were clearly uneasy about the downside risks that have preoccupied financial markets. This shift has also been apparent in recent remarks from FOMC participants. While markets have reduced substantially the probability of rate hikes at upcoming meetings, we have seen a March hike as a closer call because the U.S. economic outlook remains essentially intact and there is still a strong consensus within the Committee that "some further gradual increases" (plural) will be appropriate, as reflected in the December dots. After reading these minutes, which include the cautionary word "patient" and describe participants as expecting that only a "relatively limited amount of additional tightening likely would be appropriate," we no longer expect a March hike. The FOMC has the ability to be patient because of the still-muted inflation outlook. A pause in March reflects a risk management approach, emphasized by Powell, and accumulating downside risks. We still see a chance of a March hike, however, in which case there could still be two hikes in the first half, with the second coming in June.

Here is the key passage (bolding our emphasis):

> With an increase in the target range at this meeting, the federal funds rate would be at or close to the lower end of the range of estimates of the longer-run neutral interest rate, and participants expressed that recent developments, including the volatility in financial markets and the increased concerns about global growth, made the appropriate **extent and timing of future policy firming less clear than earlier**. Against this backdrop, many participants expressed the view that, especially in an environment of muted inflation pressures, the Committee could **afford to be patient** about further policy firming. A number of participants noted that, **before making further changes to the stance of policy, it was important for the Committee to assess factors such as how the risks that had become more pronounced in recent months might unfold and to what extent they would affect economic activity, and the effects of past actions to remove policy accommodation**, which were likely still working their way through the economy.

That is a very dovish passage. Moreover, it indicates a strong consensus: The first sentence refers simply to "participants," suggesting this was a widely held view, and the following sentences refer to the views of "many" participants and "a number" of participants. The minutes didn't mention any hawkish pushback. This suggests that the FOMC is likely to not raise rates in March.

However, we don't rule out a March hike entirely. The paragraph following the passage quoted above stresses that, "If incoming information prompted meaningful reassessments of the economic outlook and attendant risks, either to the upside or the downside, their policy outlook would change. Various factors, such as the recent tightening in financial conditions and risks to the global outlook…were noted in this context." There remains a strong consensus that this is a strong economy that is likely to warrant further tightening. The recent shift in mood among FOMC participants is primarily about market concerns about downside risks, and

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it is possible to envision a scenario in which sentiment improves markedly by the March meeting. For example, suppose that, by the March FOMC meeting, the U.S.-China trade dispute appears to be headed for a resolution, U.S. politicians have funded the federal government, the U.S. economic data have continued to be solid, and equities have rebounded further. Perhaps such a scenario would prompt "meaningful reassessments of the economic outlook and attendant risks."

FOMC participants were clearly wrestling with this tension between the incoming economic data and financial market stresses. The incoming U.S. economic data "were largely in line with participants' expectations and indicated continued strength of the economy." Indeed, the discussion of the incoming economic data was perhaps even more upbeat than we would have expected. For example, neither participants nor the Fed staff appeared to be very concerned about the weakness in residential investment, which was noted but not emphasized.

The paragraph discussing risks to the outlook concluded with the sentence that, "In general, participants agreed that risks to the outlook appeared roughly balanced, although some noted that downside risks may have increased of late." This seemed out of line with the overall tone of the minutes, which indicated that the shift in FOMC participants' mood was all about downside risks, particularly those risks that have been cited as causes of the recent market volatility. In their discussion of risks, "Various factors that could pose downside risks for domestic economic growth and inflation were mentioned, including the possibilities of a sharper-than-expected slowdown in global economic growth, a more rapid waning of fiscal stimulus, an escalation in trade tensions, a further tightening of financial conditions, or greater-than-anticipated negative effects from the monetary policy tightening to date." Too-low longer-run inflation expectations were also mentioned as a downside risk. The upside risks seemed primarily to be "that the effects of fiscal stimulus could turn out to be greater than expected and the uncertainties surrounding trade tensions or the global growth outlook could be resolved favorably." A couple participants also mentioned "risks to financial stability" and another couple "suggested that tightening resource utilization in conjunction with an increase in the ability of firms to pass through increases in input costs to consumer prices could generate undesirable upward pressure on inflation." The downside risks clearly seemed to outweigh the upside risks. It's especially striking how concerns about overheating and upside risks to inflation have faded, even as the labor market has continued to tighten.

The December minutes also made some effort in explaining the FOMC's thinking regarding changes to the postmeeting statement. The rationale for the decision to modify the phrase "the Committee expects that further gradual increases" to read "the Committee judges that some further gradual increases" had not been entirely clear to us. The minutes explained that "The use of the word 'judges' in the revised phrase was intended to better convey the data-dependency of the Committee's decisions regarding the future stance of policy." If you say so. The minutes also explained that "the reference to 'some' further gradual increases was viewed as helping indicate that, based on current information, the Committee judged that a relatively limited amount of additional tightening likely would be appropriate." This seems a bit odd, given that the median dots still showed three more hikes. As for the line in the statement saying that the FOMC would "continue to monitor global economic and financial developments and assess their implications for the economic outlook," the minutes didn't elaborate on the rationale for its inclusion, other than to say that "recent developments" warranted it despite risks appearing roughly balanced.

These minutes described further staff presentations on balance sheet policy and extensive discussion among FOMC participants on various related issues. Participants discussed "the advantages and disadvantages of allowing reserves to decline to a level that could put noticeable upward pressure on the federal funds rate, at least for a time." It was noted that "reducing reserves to a point very close to the level at which the reserve demand curve begins to slope upward could lead to a significant increase in the volatility in short-term interest

rates and require frequent sizable open market operations or new ceiling facilities to maintain effective interest rate control. These considerations suggested that it might be appropriate to instead provide a buffer of reserves sufficient to ensure that the Federal Reserve operates consistently on the flat portion of the reserve demand curve."

There appeared to be more openness among FOMC participants to changing the parameters of runoff policy than indicated by Powell's firmness at his press conference. Their discussion of "maintaining control of interest rates should upward pressures on money market rates emerge during the transition to a regime with lower excess reserves" included options such as "slowing the pace of the decline in reserves" or "ending portfolio redemptions with a relatively high level of reserves still in the system and then either maintaining that level of reserves or allowing growth in nonreserve liabilities to very gradually reduce reserves further." In addition, "Some participants expressed an interest in learning more about possible options for new ceiling tools to provide firmer control of the policy rate." Finally, there was what appeared to be a broad discussion of the liability side of the balance sheet, particularly nonreserve liabilities, as well as the asset side.

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December FOMC Meeting: Powell Under Pressure
FOMC Briefing: Laying the Groundwork for 2019
Macro Views: Tighter Financial Conditions and An Earlier End to Rate Hikes

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