TD Economics

January 7, 2015

Data Release: A "patient" Fed looking for flexibility in responding to economic developments

- The minutes of the Federal Open Market Committee's (FOMC) December meeting showed a growing confidence in the economic outlook, but also high level of internal debate around forward guidance and in particular the decision to indicate "patience" in normalizing monetary policy.

- Most participants saw the addition of "patience" as allowing for more flexibility in responding to new information. However, some worried that it would tie the Fed "to a narrow range of dates around mid-2015... not adequately allowing for the possibility that economic conditions might evolve in a way that could call for either an earlier or a later liftoff date."

- In general, the minutes emphasized the improvement in domestic economic data, with some participants even noting that it had "increased their confidence in the outlook for growth going forward."

- The minutes downplayed concerns about weak inflation, even going so far as to note "that the Committee might begin normalization at a time when core inflation was near current levels." This further emphasized the consensus view that current weakness will prove temporary and that it will not dislodge the momentum in U.S. economic growth.

- At the same time, the minutes showed a more nuanced view of market-based measures of inflation expectations, with further discussion of what their decline might mean for the inflation outlook. Of special interest, the minutes noted that "even if the declines in inflation compensation reflected lower inflation risk premiums rather than a reduction in expected inflation, policymakers might still want to take them into account because such changes could reflect increased concerns on the part of investors about adverse outcomes in which low inflation was accompanied by weak economic activity."

- While noting the downside risks to economic growth from events abroad, the minutes also noted that participants viewed these as "nearly balanced by risks to the upside." Counterweighing the downside risks, participants pointed to the improvement in consumer and business confidence, solid payroll growth, and a larger-than-expected boost to spending from lower energy prices.

Key Implications

- The most important word in these minutes was "flexibility." The Federal Reserve's somewhat-confusing December statement was primarily an attempt to release itself from the "considerable time" straightjacket without shocking financial markets. It did this by adding the reference to patience, but also indicating the consistency of its statement with previous ones. As the debate in the minutes show, flexibility is hard to achieve while maintaining forward guidance.

- The Fed's guiding principle continues to be data dependence. Abstracting from movements in asset prices and global commodity markets, the Fed has seen U.S. economic data continue to point to improving momentum. This has lead FOMC participants to stick to the script that the economy is getting better and will withstand the headwinds from weak global growth. Until the Fed sees signs that the economy is reacting negatively to these outside forces, it will declare its patience, but will still see the normalization of policy as no more than a few meetings away.

- The other important point in these minutes – also emphasized by Yellen during her press conference – is that the beginning of policy normalization may not be the change that some anticipate it to be. Moving rates off the zero lower bound may not mean increasing them in a lockstep way back to neutral. Low, but not as low, is still very much the name of the game.

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