Daiwa Capital Markets

U.S. FOMC Review

- FOMC December minutes: preparing to tighten policy

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The December FOMC Meeting

The Federal Open Market Committee quickened the pace of tapering its quantitative easing program at the December meeting, but this decision received little coverage in the minutes of that meeting, suggesting the issue was in no way controversial. The Committee, though, received staff briefings and discussed extensively how it might proceed with trimming the enlarged size of the Fed's balance sheet; that is, when and how it will proceed with quantitative tightening (QT). Officials did not make any decisions at the meeting, but there seemed to be broad agreement that the process could begin soon after interest rate liftoff and could proceed at a faster pace than it did in the aftermath of the financial crisis.

The Committee quickened the pace of tapering presumably to prepare the way for increases in interest rates in order to contain inflation, and the minutes provided substantial evidence to support this view. Notably, views on inflation had shifted dramatically. Officials now expect supply-chain disruptions to be longer-lasting and more widespread than previously believed.

In addition, officials were concerned about the inflation implications of tight labor markets. "Several" policymakers viewed labor market conditions as already largely consistent with the Committee's employment goal, and "many" saw the labor market as making rapid progress toward maximum employment. Even if the economy is still shy of maximum employment, "some" Fed officials noted that there could be circumstances where the Committee should hike interest rates before maximum employment had been reached (e.g. if inflation required special attention). An increase in the labor force participation rate could ease the tightness in the labor market and delay policy tightening, but officials expressed doubts about the potential for a sizeable increase in participation in the near term.

The final paragraph of the policy discussion noted that "the Committee should convey a strong commitment to address elevated inflation pressures." Accordingly, the minutes noted that the FOMC might need to hike the federal funds rates sooner or at a faster pace than earlier anticipated. In addition, it might be appropriate to begin reducing the size of the Fed's balance sheet soon after beginning to raise interest rates. Tighter monetary policy is on the horizon.