U.S. FOMC Review

- FOMC: ready to tighten, perhaps aggressively

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Monetary Policy

The Federal Open Market Committee left no doubt that monetary policy will soon be tightened, as the latest guidance noted that Fed officials expect "it will soon be appropriate to raise the target range for the federal funds rate." The policy statement justified this view by noting that inflation was "well above" two percent, a stronger characterization than that in the prior statement, when officials indicated that inflation had "exceeded 2 percent for some time". In addition, the new statement noted that the labor market was "strong". The Committee stopped short of indicating that the labor market had reached maximum employment, but Chair Powell noted in his press conference that he viewed the current situation as consistent with maximum employment. Indeed, during the press conference, Chair Powell was effusive in his description of the labor market (remarkable, very very strong).

Reporters at the press conference, of course, asked about the path of rate increases, some raising the possibility of moving at every meeting over the balance of the year and perhaps in adjustments of 50 basis points. Chair Powell indicated that no decisions had been made, but he also noted that the current cycle is vastly different than the one that followed the financial crisis: the economy and labor market are stronger and inflation is running faster. He implied that an aggressive policy response might be needed. He noted at one point that he saw "quite a bit of room" to increase interest rates without hurting the labor market. We had been thinking of 25 basis point changes at every other meeting. We would no longer dismiss the possibility of 50 basis point shifts or rate hikes at every FOMC meeting this year.

Interestingly, reporters did not focus on the implications of the swoon in the equity market for monetary policy. The issue was raised once, and Chair Powell noted that the FOMC monitors a broad set of factors in assessing financial conditions. In other words, the recent volatility and net retreat in the equity market will not at this point disrupt the Fed's intentions to remove accommodation. Market participants should not expect a "Powell put".

The outlook for interest rate policy is reasonably clear: the Fed will be moving aggressively before long. However, many questions remain unanswered on balance-sheet policy. Officials discussed the issue and released a broad set of principles that will guide the adjustment of the Fed's balance sheet (next page), but those principles offered no insight into timing, pace, and composition of the adjustment.

Chair Powell added only a little additional information on balance sheet adjustment in the press conference. He noted that the FOMC will probably require two more meetings to reach decisions, meaning that the process will not begin until the late spring at the earliest; the summer seems more likely as a start date. We read Mr. Powell's comments as suggesting that officials were not in a rush to start this process. In addition, he did not seem to view balance sheet reduction as a key element in recalibrating policy. He saw it as an adjustment that will be "running in the background".

FOMC Principles for Balance Sheet Reduction

- The Committee views changes in the target range for the federal funds rate as its primary means of adjusting the stance of monetary policy.
- The Committee will determine the timing and pace of reducing the size of the Federal Reserve's balance sheet so as to promote its maximum employment and price stability goals. The Committee expects that reducing the size of the Federal Reserve's balance sheet will commence after the process of increasing the target range for the federal funds rate has begun.
- The Committee intends to reduce the Federal Reserve's securities holdings over time in a predictable manner primarily by adjusting the amounts reinvested of principal payments received from securities held in the System Open Market Account (SOMA).
- Over time, the Committee intends to maintain securities holdings in amounts needed to implement monetary policy efficiently and effectively in its ample reserves regime.
- In the longer run, the Committee intends to hold primarily Treasury securities in the SOMA, thereby minimizing the effect of Federal Reserve holdings on the allocation of credit across sectors of the economy.
- The Committee is prepared to adjust any of the details of its approach to reducing the size of the balance sheet in light of economic and financial developments.

Source: Federal Open Market Committee