Daiwa Capital Markets

U.S. FOMC Review

- FOMC minutes: open to shifts of 50 basis points…
  …anxious to start balance sheet reduction

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The March FOMC Meeting

The dot plot published by the Federal Open Market Committee in March suggested an aggressive pace of tightening this year, with the median dot showing an increase of 175 basis points in the federal funds rate. Not surprisingly, the minutes carried a strong hawkish tone, noting that policy makers wished to move "expeditiously" to a neutral stance, and then possibly shift to a tighter setting. Many market participants are expecting one or more shifts of 50 basis points in coming months, and the FOMC is leaning in that direction as well. "Many" policymakers in March favored a change of 50 basis points, but uncertainty associated with the Russia-Ukraine conflict led them to limit the initial change to 25 basis points. (James Bullard of the St. Louis Fed dissented from the Committee's decision because he preferred a change of 50 basis points.) The minutes noted that "many" officials believed that a change of 50 basis points could be warranted at future meetings. Given the mood of Fed officials in March, we would be shocked if the Committee did not hike the federal funds rate by 50 basis points in May.

Obviously, rapid inflation is the driving force behind the aggressive tack planned by the FOMC, and the minutes noted several reasons for concern. Inflation was becoming more broadly based, as shown by a surge in the trimmed mean inflation gauge of the Dallas Fed (highest since the early 1980s) and by the number of categories showing inflation rates in excess of 4 percent. In addition, business contacts of Fed officials noted that they were able to pass on higher input and labor costs without any significant reduction in demand. Businesses also remained challenged by supply-chain disruptions that might require a "lengthy period" to resolve. The minutes noted the Russia-Ukraine conflict several times, with the upside implications for inflation seen as more notable than the downside risks on growth. Finally, and perhaps most important, recent inflation rates, if they persist, could affect "future inflation dynamics." That is, inflation expectations could become unanchored.

Fed officials are anxious to remove policy accommodation, and they view balance sheet reduction as an important element in this effort. The minutes noted that officials made good progress in forming a plan and that the process could begin "as early as after the conclusion of its upcoming meeting in May." The minutes provided only a few details on the plan under consideration. As in the previous quantitative tightening program in 2017-19, the Committee will initially reduce its portfolio only through redemptions of maturing securities or repaid principle (i.e. no outright sales). Officials plan to have monthly caps on the amount of trimming, with the limits gradually increased. The minutes noted that the upcoming program would increase the monthly caps at a faster pace than they did in 2017-19 and that the final monthly cap would be larger. (The 2017-19 effort began with maximum monthly reductions of $6 billion for Treasuries and $4 billion of MBS. These totals were increased by these same amounts every three months until the maximums reached $30 billion for Treasuries and $20 for MBS.) The minutes noted possible maximum caps of $60 billion for Treasuries and $35 for MBS. Once the QT effort is well under way, the Committee might consider outright sales of MBS to hasten the move to a portfolio of primarily Treasury securities.

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