Daiwa Capital Markets

U.S. FOMC Review

- FOMC: a friendly tilt; solidly on hold
- Balance sheet normalization: discussion of maturity composition; no decision

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FOMC

The minutes from the meeting of the Federal Open Market Committee on May 1 carried a balanced tone, although we read the summary as having a dovish or friendly tilt. On the upbeat side, officials noted improvement in the economic and financial environments (equity values had reversed much of their swoon in December, and growth prospects in foreign economies had picked up). Against this background a "few" officials felt that policy would need to be firmed if the economy evolved as expected.

However, an easing in inflation raised doubts about the need for additional rate hikes. The minutes noted the easing was likely to be transitory, but some officials argued that downside risks to inflation had increased. In addition, a "few" Fed officials argued that subdued inflation suggested that resource utilization was not as high as suggested by a low unemployment rate. Accordingly, there was broad-based support for patience in adjusting policy. Indeed, the minutes noted that the Committee favored a patient approach "even if global economic and financial conditions continued to improve."

The minutes did not explicitly mention an easing in policy, but officials talked of future "adjustments" in policy. We viewed the phrasing as noteworthy, as "adjustments" is a neutral term, one opening a door for either rate hikes or cuts.

The Committee spent considerable time discussing the normalization of the Fed's balance sheet, focusing on the maturity composition of the portfolio. Officials considered two options: a short-term alternative, where it holds securities with maturities of three years or less; and a proportional alternative, where holdings match the shares of outstanding Treasury securities across the maturity spectrum.

The minutes noted two advantages of a short-term portfolio: it would match more closely the maturity composition of the Fed's liabilities, thereby limiting interest-rate risk; and it would give the Committee the ability to provide stimulus through a maturity extension program (i.e. an operation twist, where the portfolio is held steady, but investments are shifted toward long-term securities).

Despite these advantages, officials had misgivings about a short-term portfolio. Most important, the shift to short-term securities would probably boost long-term interest rates from current levels, which could have a constraining effect on the economy. The resulting slower pace of growth would require the Fed to keep the federal funds rate lower than it would otherwise, thereby limiting the flexibility to utilize conventional monetary policy to stimulate the economy. In addition, some Fed officials had doubts about the effectiveness of maturity extension programs.

Although the minutes implied that the Committee was leaning in favor of a proportional portfolio, officials did not make any decisions on this issue. Moreover, officials felt that a decision would not need to be made for some time.