Special Report

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FOMC Meeting Preview

- **Further tapering amidst continued faith in forecasts seems certain, while the Federal Reserve is likely to begin the process of revising forward rate guidance and shifting to a different policy rate.**

The Federal Reserve's second policy meeting of 2014 (and Janet Yellen's first as Chair) is scheduled to start on Tuesday and result in the statement, updated forecasts and Yellen's press conference on Wednesday. Key to a summary of our expectations is the likelihood that this meeting will be more about altering the way in which the Fed guides markets toward rate hike expectations.

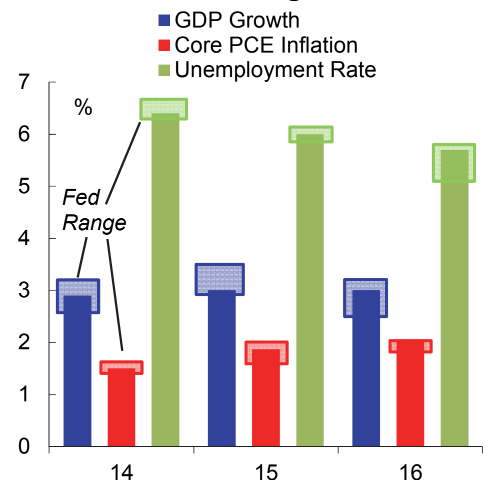
1. Further Tapering

The better-than-expected nonfarm payrolls print for February cemented **a further $10 billion reduction in bond purchases** that we think will be evenly split between Treasuries and agency MBS, if that wasn't already the case before nonfarm. Communications from FOMC officials have set a very high bar against deviating from further 'tapering'. There are short-term risk factors to this view such as highly uncertain developments in Crimea, but barring much worse developments our base case is that we don't think this will cause the Fed to deviate from its plans at this juncture.

2. Revised Forward Rate Guidance

The focus is likely to be upon how to change Fed funds target rate guidance. FOMC officials like NY Fed President William Dudley have made it sound likely that this is the meeting to do so, and he said "This is probably a reasonable time to revamp…to take out that 6.5 percent threshold." With the unemployment rate presently at 6.7% and the Fed's preferred inflation gauge presently sitting at 1.2% y/y and well below the longer-run target of 2%, the numerical thresholds used as a guide to rate hike expectations have become less meaningful. One way of addressing this could be to simply alter the numerical policy thresholds such as lowering the unemployment rate above which the Fed is unlikely to raise rates with a lag. More likely than that in our view would be scrapping the explicit numerical thresholds in favour of qualitative guidance that would be like a return to the Fed statements of old before the thresholds experiment was introduced but supplemented with calendar-based guidance. A restraining factor preventing the Fed from fully relying upon a BoC-style output gap framework that has recently been taken to the BoE by Governor Carney is that the Fed has a dual mandate to achieve full employment and price stability and may find the broad output gap framework does not adequately speak to its full employment mandate. Perhaps the simplest approach would be to either alter or explicitly emphasize the Fed funds rate forecasts provided by FOMC officials as an anonymous scatterplot such as figure 2 here. Eventually the Fed is likely to put growing emphasis upon shifting communication toward increased reliance upon alternative rates including Interest on Excess Reserves (IOER). We think the Fed is unlikely to fundamentally alter its main message that rate hikes remain in sight by next year at the earliest at a measured pace.

Chart 1



Source: Federal Reserve, Bloomberg, Scotiabank Economics.

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3. No Need To Change Forecasts

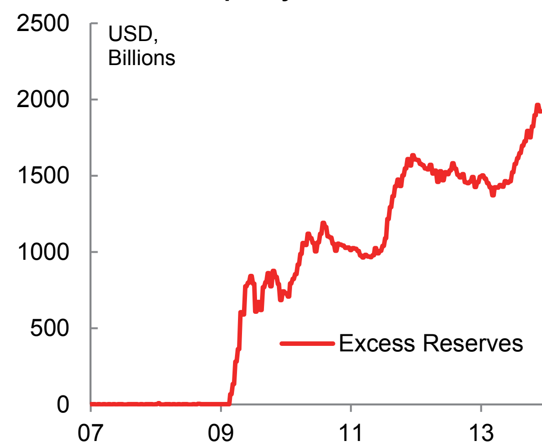
There is a low likelihood of significant forecast revisions. The December 2013 FOMC projections for growth, the unemployment rate and inflation are still generally tracking the Bloomberg consensus (chart 1), and FOMC officials have strongly stated a tendency to look through mixed but often soft readings in Q1 due to temporary effects like weather (and we think inventories). This implies no willingness to change full-year forecasts. The risk here is that, should temporarily interrupted activity in Q1 not wind up simply being transferred into Q2, then the Federal Reserve may need to revisit its tendency to look through near-term softness. We think that's a low risk as we are also of the view that pent-up demand is likely to be unleashed into Q2.

4. Stronger Hint Of A Different Rate Target

The eventual normalization of monetary policy will require an increase in administered interest rates — but which ones? One of the paramount challenges confronting the Fed is that the Federal Funds rate is not an ideal tool for dealing with looming monetary policy issues. The Fed has controlled liquidity in U.S. markets by regulating the cost of borrowing (the Federal Funds rate) for decades. The Federal Funds rate was a good policy tool for a period when the principal monetary policy transmission mechanism was the borrowing of money by commercial banks from the Fed. That period is over. Regulating the cost of marginal borrowing by banks no longer seems like a good way to increase or diminish liquidity. In fact, banks have too much liquidity (chart 2). Indeed, to date this has been one reason why inflation has remained so low despite aggressive balance sheet expansion by the Federal Reserve as banks have put nearly every last nickel of such stimulus right back to the liability side of the Fed's balance sheet through excess reserves and thus not used the funds as fodder for traditional loans. Another reason is that Fed balance sheet expansion has simply filled the pit left behind by the implosion of the broader financial system in 2008-09 such that on net very broad measures of money supply have been flat for years (see chart 3). **Going forward, however, the principal policy issue for the Fed is ensuring that the abundance of reserves held at the Fed aren't transformed into too drastic a torrent of loans and a concomitant explosion of inflation.** We don't think we're there yet, however, and the Fed needs to be mindful of the two-tail risks associated with stepping back from monetary policy stimulus too quickly and too slowly.

The need to constrain liquidity moving forward will ultimately impel the Fed to rely on policy tools that are better suited to attracting excess reserves — and keeping them stuck at the Fed or draining them from the financial system. We think that the reverse repo tool and the interest paid on reserves (IOER) will probably form the backbone of this policy approach. The Fed has been testing its reverse repo facility for years and will likely step up these tests in the months and quarters to come. Discussion of these activities has increased in recent months and got additional attention in the most recent FOMC meeting minutes. It could get further airtime in Chair Yellen's press conference as the Fed begins the difficult task of communicating what these tools are, why they should work, and why they need to be used to regulate monetary policy as opposed to the Federal Funds rate. Communications about the tools that will be used to tighten policy becomes more important as tightening approaches.

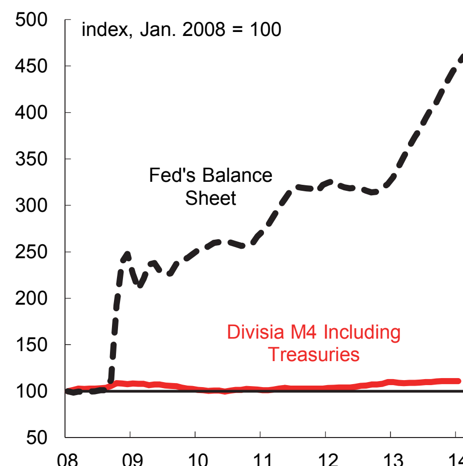
Chart 2 Fed: Liquidity is not an Issue



Source: Scotiabank Economics, Federal Reserve.

Chart 3

Fed's Balance Sheet Only Filling In Behind Broad Money Destruction



Source: Federal Reserve, The Center For Financial Stability, Scotiabank Economics.