The minutes of the Federal Open Market Committee’s (FOMC) January meeting acknowledged that economic activity has been expanding at a solid pace, and that even if growth had slowed relative to the third quarter, real GDP growth continued to exceed its potential GDP growth at the end of 2014/early 2015.

Risks to the outlook were seen as nearly balanced. With regards to the domestic economy, the underutilization of labor resources was seen as continuing to diminish, with consumer spending likely to remain supported by a number of factors over the coming months. However, the recovery in the housing sector was noted as being slow, while the tepid pace of wage growth, if continued, was mentioned as a potential constraining factor for household spending.

In terms of the foreign economic outlook, participants noted that a number of developments, including lower energy prices and accommodative monetary policy actions, had likely reduced the risks for U.S. growth. However, several participants pointed to heightened geopolitical and other risks, such as tensions in the Middle East and the Ukraine, financial uncertainty in Greece, as well as the slowdown in China weighing on other countries. The increase in the value of the dollar was viewed as a persistent constraint on U.S. exports, with the risk of further appreciation ahead.

Inflation was seen as having moved further below the committee’s objective, largely reflecting transitory factors, such as the decline in energy prices and the stronger dollar. A few participants noted that weakness in nominal wage growth suggested that inflation could take longer to return to target. However, there was also talk of pent-up wage deflation weighing on wage gains during the economic recovery, and that if this is the case, wage growth could be expected to pick up in coming quarters.

There appeared to be a healthy discussion concerning the sizeable decline in market-based inflation expectations. While a number of participants judged that the reduction reflected a decline in risk premiums rather than in inflation expectations, others suggested that the decline reflected a reduction in expected inflation. Of particular interest, these participants argued that the stability of survey-based measures of inflation expectations should not be viewed as providing reassurance, as even in Japan in the late 1990’s and early 2000’s, these measures had not recorded major declines.

In terms of a first lift-off in rates, many participants observed that a premature rise could dampen the recovery in real activity. Many participants also noted that their “assessment of the balance of risks associated with the timing of the beginning of policy normalization had inclined them toward keeping the federal funds rate at its effective lower bound for a longer time”. In contrast, several participants noted that a late departure could result in excessively accommodative policy, leading to undesirably high inflation.

Key Implications

The minutes struck a dovish note in that while the FOMC acknowledged recent strength in the economy, the balance of risks led many participants as appearing comfortable keeping the fed funds at its current rate for longer.

This appears to have been motivated by a plethora of issues, ranging from geopolitical risks to the sharp fall in market-based inflation expectations to the tepid pace in nominal wage growth. With regards to the latter issue, at its last meeting, the FOMC had yet to receive the employment report for January, showing robust job gains and a pickup in wage growth. As a result, these particular concerns have likely been somewhat assuaged.
Nonetheless, considerable uncertainty remains concerning the situation in Greece and global economic data continues to remain sluggish. While we do expect a modest rebound in the global economy this year, the external sector is set to continue to weigh on the U.S. economy. All of this suggests caution on a first rate hike. A number of FOMC participants have in the past pointed to a first rate hike sometime in mid-2015; their comfort with maintaining the fed funds at its current rate for longer is in line with our own view for a first lift-off in September 2015.

The bottom line is that the FOMC is keeping an eye on a wide range of factors, and that while data dependence remains the name of the game, geopolitical and financial market factors are also being closely observed.

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