TD Economics

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Data Release: Uncertainty regarding labor market slack is a key source of disagreement on the Committee

- Federal Open Market Committee participants generally agreed that the case for a rate hike has strengthened, according to the minutes from their September 20-21st meeting. Still, most felt comfortable with awaiting further evidence of continued progress given the still modest signs of inflationary pressures, but for several members the decision to wait was a close call. Many participants expressed the view that that economic slack remained. On the other hand, some viewed the economy as at or near full employment, arguing for an immediate rate hike given the risks of waiting too long: faster rate hikes down the road that could cause recession as well as eroding credibility of the Federal Reserve given growing divergence from policy benchmarks.

- The labor market was viewed as having improved appreciably, with payroll gains exceeding most participants' expectations. Participants were in less agreement as far as remaining slack however. Some believed that slower payroll growth and a pickup in wages recently indicated "little or no remaining slack." Others viewed wage growth as still-muted, and argued that the high level of involuntary part-time employment and rebounding labor force participation suggested that slack remained.

- Participants discussed the notion of undershooting the equilibrium rate of unemployment, which is expected by a number of members. Several argued that, given historical experience which suggested that such periods are often followed by recessions given rapid tightening episodes, waiting too long poses risks and monetary policy should instead be tightened earlier to pre-empt such outcomes. This view was countered by others who felt that current circumstances of only moderate growth, inflation below target, and low inflation expectations is markedly different and necessitates different policy, highlighting also that the estimates of equilibrium unemployment rate remain highly uncertain.

- Inflation dynamics remained as expected and participants continued to anticipate that inflation would rise towards target. However, several pointed to limited evidence of cost/price pressures, low responsiveness of inflation to unemployment, lower inflation expectations, and economic slack as possible factors that would restrain inflation. The Committee discussed the reasons for core CPI running well above core PCE inflation recently, but largely agreed that the divergence was related to different weights and methodology pertaining to medical services and rent.

- A "substantial majority" of the Committee viewed near-term risks as approximately balanced, with several of the opinion that Brexit risks receded. On the other hand, few saw risks as remaining skewed to the downside arguing that weaker global growth, Brexit, near zero interest rates, and economic headwinds remain key concerns.

- Participants discussed the implications of the apparent decline in the neutral real rate of interest, or r*, suggesting that lower productivity growth, demographic shifts, and an excess of saving around the world are to blame. One participant suggested that the r* is likely to remain low for a long time, arguing cross-country evidence suggests persistence, while several others viewed the duration of the lower level of r* with more uncertainty.

Key Implications

- The minutes from the September meeting suggest that FOMC members are generally in agreement that the economy has made significant progress in recent months, but are far more at odds as far as the amount of slack that still remains in the labor force.
- The hawks view slack as largely nonexistent and argue that historical precedent, whereby past undershooting of the natural unemployment rate necessitated rapid rate hikes and often tipped the economy into recession, calls for action in normalizing policy sooner but more gradually. On the other hand, the doves argue that slack still remains and history is not a good guide given the very different circumstances currently facing the economy. Their call for delay is further underscored by a less sanguine view of the global economy and the potential downside risks that may lurk around the corner.
- All in all, the minutes do not alter our view that the Fed is likely to tighten policy in December if the data continues to come in relatively constructive and global financial markets remain calm in the coming months. Having said that, any hike is likely to come with strong messaging whereby the Fed telegraphs a very gradual, or gentle, tightening cycle ahead.

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