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ECONOMIC TALKING POINTS

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What to make of the latest Federal Reserve minutes?

The October 28 - 29th FOMC meeting marked the end of quantitative easing. Public attention would now shift focus to when the Fed will begin to lift short-term interest rates --- and on how fast they will rise over time. With that in mind, we look to latest FOMC minutes to clarify four key issues.

1. Will we get more clarity on how Fed bank presidents and governors view the sustainability of the US expansion ---- and of its vulnerability should foreign economic conditions continue to deteriorate?

The US economy has been growing at an average pace of 3% over the last five quarters. At the same time, payrolls have increased at their fastest since 1999. And based on some leading indicators, it appears firms are inclined to further ramp up employment and capital spending. Globally, there is now universal recognition the US economy is the bright spot in the world, fueled largely by strong domestic demand.

So we have to ask the first question. Did the Fed concentrate largely on the U.S. resurgence in business activity, which would suggest they might lift short term rates around mid-year? Or, was their more discussion than usual about the deepening economic crisis outside the U.S. and how that could undermine the expansion here. If so, it would indicate the Fed might view a tightening in monetary policy next year as so destabilizing to the international economy, it could ricochet and damage the U.S. too.

WHAT DID THE MINUTES SAY? Fed officials did comment quite a lot on the economic difficulties abroad, but see little risk that weakness would endanger the US expansion. Bottom line: Monetary policy will continue to be based solely on the strength of the domestic economy.

"In discussing economic developments abroad, participants pointed to a somewhat weaker economic outlook and increased downside risks in Europe, China, and Japan, *as well as to the strengthening of the dollar over the period.* ***It was observed that if foreign economic or financial conditions deteriorated further, U.S. economic growth over the medium term might be slower than currently expected. However, many participants saw the effects of recent developments on the domestic economy as likely to be quite limited."***

2. What about the Fed's assessment of labor market conditions?

With the unemployment rate now at 5.8%, the lowest in six years, it is inching closer to the 5.0% to 5.5% level generally considered to be full employment. This raises certain questions: Which metric does the Fed see as a more important determinant of tight labor market conditions? Will it be once the jobless rate approaches full employment equilibrium, or is the Fed going to give much more weight to the lack of wage growth? The former would favor higher rates by mid-year, if not sooner. The latter would likely postpone ending the zero bound interest rate policy to perhaps much later in 2015 or 2016.

WHAT DID THE MINUTES SAY?: The minutes dealt with this issue indirectly, hinting that the declining unemployment rate does not, in and of itself, accurately reflect tightness in the job market. This means that even as the jobless rate gets to nominal "full employment," the Fed will still not feel compelled to raise rates if it is accompanied by anemic wage gains.

"Labor market conditions improved somewhat further, with solid job gains and a lower unemployment rate; on balance, participants judged that the underutilization of labor resources was gradually diminishing……. ***A couple of participants judged that the large number of individuals working part time for economic reasons and the continued drift down in the labor force participation rate suggested that the unemployment rate was understating the degree of labor market underutilization."***

"Business contacts reported employment gains in several parts of the country, with relatively few pointing to emerging wage pressures, *although one participant indicated that larger wage gains had been accruing to some individuals who switched jobs".*

3. How does the Fed view inflation?

Did concerns about disinflation still dominate the meeting, which would mean the Fed is in no hurry to raise rates? Or will there be a more substantive discussion of other costs that are beginning to pinch consumers, like food and shelter.

There is no question lower oil prices slashed the cost of gasoline and helped dampen CPI inflation (to just 1.7% over the year). But Americans have lately complained more loudly that their real cost of living has been marching higher on essentials, like food and shelter (both up 3%). The argument consumers are making is a genuine one: Everyone relies on food and shelter, but not everyone owns a car or drives daily. If the Fed takes more seriously the latter argument, rates could move up sooner to lessen the chance of cost-push inflation, where employee demand for higher wages puts pressure on firms to raise retail prices and protect margins.

WHAT DID THE MINUTES SAY?: While briefly acknowledging the jump in food prices, the Fed still looks at inflation at the aggregate level, which continues to to remain below the central bank's 2% target. Moreover, policymakers expect inflation will ease further in coming months. In other words, escalating food and shelter prices alone will not be a significant driving force in setting monetary policy.

"The staff's forecast for inflation this quarter and early next year was reduced in response to further declines in crude oil prices, but the forecast for inflation over the medium term was only a touch lower. ***Consumer price inflation was projected to be lower in the second half of this year than in the first half and to remain below the Committee's longer-run objective of 2 percent over the next few years.*** *With resource slack projected to diminish slowly and changes in commodity and import prices anticipated to be subdued, inflation was projected to rise gradually and to reach the Committee's objective in the longer run.* ***Consumer energy prices declined further in September, largely reflecting continued declines in retail gasoline prices, and survey data suggested gasoline prices fell further over the first few weeks of October. Consumer food prices rose solidly in recent months."***

4. Among the most important issues facing the Fed next year will be how they plan to actually tighten monetary policy, especially with banks sitting on a record $2.7 trillion in excess reserves.

With an economy growing at a robust 3% and joblessness falling rapidly, the danger increases that such massive excess could end up igniting inflation. True, banks seem content for now to earn a risk-free 25 basis points on those idle reserves. But as the economy shows more durable growth and loan demand picks up, a lot more of those reserves may get converted into credit. After all, will lenders be satisfied earning a mere 25 basis, or even a 50, basis points on those reserves if they see more lucrative opportunities to lend in the private sector? If so, how will the Fed prevent an explosion in the money supply?

WHAT DID THE MINUTES SAY?: Unfortunately, little mention was made in these minutes how the Fed would avert such a danger. But it will have to be addressed in the very near future. **The biggest challenge they face next year is how to control the inflationary firepower these excess reserves pose as demand for loans accelerates.**

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