Sovereign Macro- FED Minutes and commentary-Locked and loaded

January 5, 2022

Bottom line: the tone of the minutes was more hawkish than I anticipated because, in addition to the expected doubling of the tapering, the board went deep into the details of balance sheet reduction, not just an introductory discussion as Powell noted in the press conference, the staff made detailed presentations on many important issues. To be sure, it is the first topic outlined in the minutes before the review of the economic and financial situation and the description of the members' views. The discussion about BS normalization can be understood in two ways: one is a tactical decision to throw all the "bad news" to the market preemptively while the economy is doing well; they could always dial down the rhetoric from this point if economic conditions justify it. Two, that their reading of inflation dynamics is indeed much worse than they thought -thus admitting that they are a bit behind the curve- since by their own admission supply chain disruptions are more serious and widespread than anticipated and unlikely to improve until at least late 2023, the labor market is very tight, housing costs are rising, and companies appear confident in their ability to pass through costs to the consumer. The board, however, still believes that wage increases have not yet been reflected in higher prices. Believe me, they will, especially with a US president that is overtly pro-unions and with a heavy regulatory agenda. Going back to the timing and sequencing of policy normalization, it was clear that after tapering is done, rates will lead the process followed by balance sheet reduction through setting caps to reinvestments. It was noteworthy that the minutes established twice that tapering would be done by mid-March which coincides with the FOMC decision on March 16. So, in principle the FED is ready to hike in that meeting if necessary. The minutes also noted that the board is ready to start shrinking its balance sheet "shortly thereafter", or in the following one or two meetings, sooner and certainly at a much faster pace than in the prior experience. I don't buy the argument that the FED will skip what I believe will be its baseline quarterly rate hikes to announce the start of balance sheet reduction. The FED will try to keep balance sheet reduction in the background with a view to reaching the -yet unknown- optimal size possibly beyond 2024. What does this mean for EM central banks? Quite simply get the normalization done as quickly as possible, the FED is not going to procrastinate -it could hike in March and four times during the year and start shrinking its balance sheet by June-, and then be ready to do more if idiosyncratic conditions so warrant, be it due to fiscal pressures, currency pressures, weakening of balance of payments, including capital outflows or political noise or instability. Hunker down and do the right thing. I am now changing my call from 3 to 4 FED rate hikes in 2022 and a start of balance sheet normalization in June.

- In their discussion of BS normalization, "The topics included the lessons learned from the Committee's previous experience with policy normalization, alternative approaches for removing policy accommodation, the timing and sequencing of policy normalization actions, and the appropriate size and composition of the Federal Reserve's balance sheet in the longer run." This was far from just an introductory discussion. The minutes noted twice that tapering will end in mid-March.
- When discussing balance sheet normalization, they discussed the impact on the yield curve of different combinations of policy settings including interest rates and balance sheet reduction. That said, the primary instrument for the implementation of monetary policy is the setting of interest rates.
- In their discussion of the previous experience with balance sheet run off, they noted that conditions today were quite different because the outlook was stronger, inflation

was higher, the labor market was tighter, and the balance sheet was much larger in absolute terms and in relation to GDP. Also, they noted that the average maturity of the current portfolio was shorter and, all things equal, the runoff could be faster. Some noted that given the abundant liquidity in money markets and the elevated use of the repo facility, the size of the contraction of the BS could be significant.

- Almost all agreed that it would be appropriate to start the runoff at some point after the first hike and should be closer to it than in the previous episode that took more than a year.
- Some participants noted that relying more on BS reduction than on interest rate hikes would limit flattening of yield curve.
- In any case, the appropriate pace of normalization of BS would likely be faster than in the previous episode and using monthly caps for reinvestment should again be adequate especially due to the relatively short average maturity of the FED's portfolio.
- Inflation remained high and broadening. The staff said that risks to the baseline were to the downside for growth and to the upside for inflation.
- Participants thought that supply chain disruptions were more widespread and take longer to abate and likely to last well into next year. Progress on the employment side of their mandate was strong even if some indicators had stalled for instance the increase in LFP which is now likely to be exacerbated by the mobility restrictions imposed by Omicron.
- The labor market is quite tight by a number of measures including record rates of quits and vacancies and a notable pick up in wage growth. ECI is picking up faster and many employers are considering larger wage increases to keep or attract workers. They were short of accepting that wages are already pressuring prices to the upside. They were cautious to say that the maximum level of employment, as cited by their mandate, may evolve over time.
- In their revisions to the inflation outlook, the main factors at play were rising housing costs and rents, more widespread wage growth and more prolonged supply side frictions, all of which are now exacerbated by the appearance of Omicron. At the same time the board's contacts in the business community were confident of their ability to pass through these cost increases onto consumers. The board is paying attention to the public's concern about the increases in their cost of living.
- Several members judged that the employment side of the FED's mandate had already been achieved. Most thought it would be met soon. Nonetheless some also argued that even if they hadn't met their goal of maximum employment there are circumstance that may warrant policy tightening. The message is clear, they are ready to pull the trigger.
- "Participants generally noted that given their individual outlooks it may be warranted to increase the FF sooner or at a faster pace than they had *earlier* anticipated". It is not clear to me that this is in reference to their previous DOT plot which had one hike in 2022 or whether it refers to the latest DOT plot which has already 3 hikes. I am holding the view that it referred to the previous DOT plot, not to the most recent.

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