Fed Chair Janet Yellen will testify on monetary policy on Tuesday and Wednesday. These appearances are less traumatic for the financial markets than they used to be. The Fed releases minutes of the policy meetings on a timelier basis and the Fed chair holds press conferences after every other meeting. Hence, it’s unlikely that we’ll see Yellen signal a major change in the policy outlook. Still, the financial markets will pay attention.

The minutes of the January 27-28 policy meeting helped to clarify the outlook for monetary policy. Officials continued to prepare for policy normalization, as they worked on the technical details. The financial markets are more concerned about the timing of the lift-off – that is, when the Fed will begin to raise short-term interest rates. However, policymakers were briefed not just on possibilities for the timing, but also on the pace of rate increases. The minutes did not go into details on what the Fed staff presented or what conclusions may have been drawn, if any. Note that in her press conference in mid-December, Yellen cautioned against assuming that the Fed would raise rates at “a measured pace” (that is, 25 basis points per meeting) once tightening begins. She also emphasized that the FOMC could decide to begin raising rates at any meeting, not just the ones that have a post-meeting press conferences. So, the Fed could wait longer and raise rates more rapidly once it starts, or make larger moves on an irregular basis. Indeed, Yellen previously emphasized optimal control theory, which “calls for a later lift-off” of policy tightening.
Prior to each FOMC meeting, the Fed surveys the primary dealers, asking questions about the timing of policy firming and about the outlook for the economy and financial markets. In January, responses on the timing were all over the place, but with more than half between June and September. This is roughly consistent with the range of forecasts of the year-end federal funds rate made by senior Fed officials in December.

The FOMC minutes provided a concise picture of the Fed’s timing debate. “Several” Fed officials feared that waiting too long could lead to higher inflation. However, “many” participants (which is more than “several” in Fed lingo) worried that moving too soon could “damp the apparent solid recovery in real activity and labor market conditions.” An earlier lift-off would also leave the Fed with limited options should the economy slow (as it remains close to the zero lower bound). Many Fed officials wanted to see a pickup in wages growth or evidence that the recovery remained on solid footing, with inflation moving back toward the 2% goal “after the transitory effects of lower energy prices and other factors dissipate.”

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The low inflation does not mean that the Fed won’t hike. Yellen indicated that the Fed could still raise rates as long as there is a strong expectation that inflation will move toward the 2% goal. The Fed has described the impact of lower energy prices as “transitory.” However, lower energy prices are likely to help push core inflation down in the near term.
Low inflation is also a consequence of a soft global economy. Yet, lower energy prices should help the rest of the world to eventually recover. However, the timing isn’t clear. Estimates of European growth have picked up a bit recently, due to the drop in energy prices, but there are a lot more issues in the global economic outlook besides energy.

Note that the Fed does consider the impact of a stronger dollar on growth and inflation. However, the exchange rate of the dollar is not the Fed’s responsibility (that’s the Treasury’s call). The Fed is not going to refrain from raising short-term interest rates to weaken the dollar.

Does it really matter when the Fed begins to tighten? The timing has some minor implications for longer-term Treasury yields, but it’s much more important for the middle of the curve. Forecasting the pace of policy normalization ought to be just as important as getting the start date right.