Musings: Minutes of 29-30 July FOMC meeting

Let's start with the FOMC's discussions on market pricing and expectations for federal reserve changes to policy rate:

The Open Market Desk's Survey of Market Expectations "*continued to indicate expectations of two 25 basis point rate cuts in the second half of this year. Market-based measures of policy rate expectations were also little changed and indicated expectations of one to two 25 basis point rate cuts by the end of the year*."

The charts highlight market pricing for Fed rate cuts ahead of, and soon after, the late July FOMC meeting. Prior to the FOMC meeting, as noted in the minutes, the market was priced for at least one 25bp rate cut by year end. The probability of such a move in September was just over 60%, but that jumped to 80% for the October meeting, and it was over 90% for December. So at least one 25bp rate cut was baked in, possibly in September, but more likely later in the year. The probability of at least 50bp in rate cuts by year end was nearly zero for September, roughly 30% for October, but just over 60% for December. Hence, one to two rate cuts were priced in before the end of the year.

After the FOMC meeting, however, things got crazy. The first development was Fed Chair Powell's press conference that was taken as "hawkish," given concerns about elevated inflation readings and upside risks due to tariffs. The probability of multiple rate cuts before year end tumbled, with the probability of at least one 25 bp rate cut in September falling below 40%.

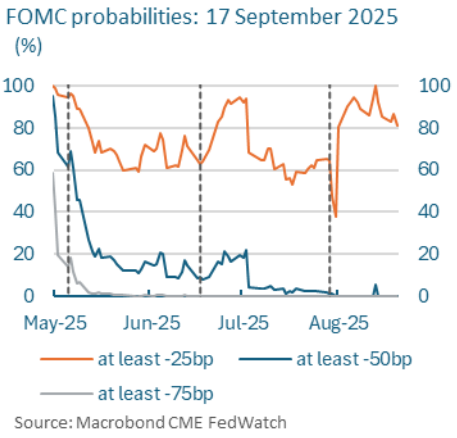
Then the July nonfarm payrolls report was released on 1 August. The report was weak, with job creation well below expectations. This highlighted a key concern about the economic outlook aired by the two dissenters to the FOMC meeting, who favoured lowering the policy rate by 25bp. Post nonfarm payrolls, the probability of rate cuts moved sharply higher. The probability of a rate cut in September leapt over 90%. The probability of at least 50bp in rate cuts by year end also rose above 90% at one point.

The probability of at least 50bp of rate cuts by year end remains elevated at around 80%.

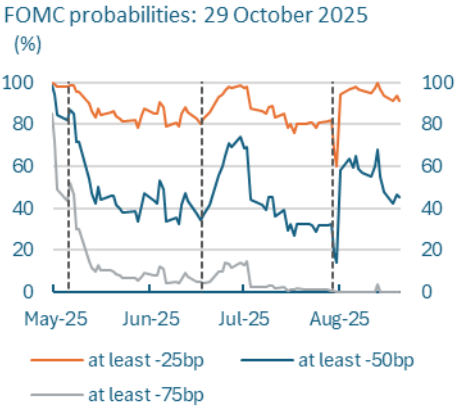
Vulnerabilities

The minutes described the financial situation of households and nonfinancial firms: "*Vulnerabilities associated with nonfinancial business and household debt were characterized as moderate. Household debt to GDP was at its lowest level in the past 20 years, and household balance sheets remained strong*."

We show that, for the first time since the early 00s, the ratio of household debt to GDP in the US fell below 70% in Q4 2024. By comparison, in Canada,



Source: Macrobond CME FedWatch



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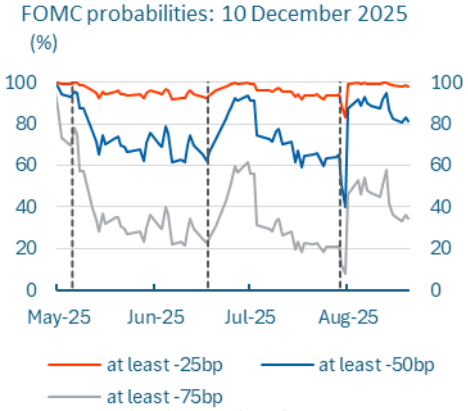

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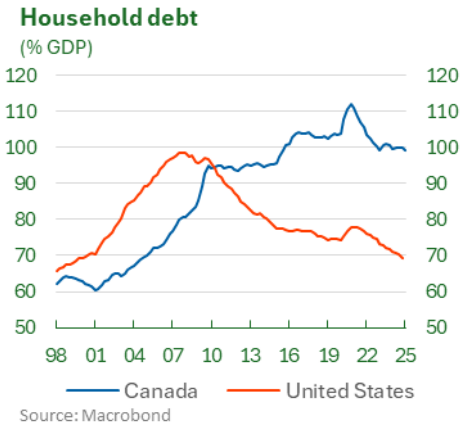
the ratio of household debt to GDP was right around 100% in Q1 2025. Unlike the steady decline in the US household debt to GDP ratio from its peak of just below 100% in 2009, in Canada, the ratio has been has remained in the range of between 95% and 100% since 2010.



The Fed could thus have a relaxed discussion over the household debt to GDP ratio falling to 20-year lows and feel confident in saying that household balance sheets "*remained strong*." The Bank of Canada (BOC) cannot make similar statements with a straight face.

In its recent Financial Stability report released in May 2025, the best the BOC could do was to say that, with interest rates having declined, it is "*less concerned than it was*" about the impact of high interest rates on the ability of households to service elevated debt levels. The BOC had also noted that in past reports, it had *"regularly highlighted the vulnerability in the financial system created by high household indebtedness*."

Hence, household debt continues to linger as a potential challenge facing the Canadian economy.

Tariffs

Now, let's talk about tariffs. To summarize, the minutes noted that tariff effects were becoming more apparent; that it might be difficult to disentangle tariff-related changes to inflation from underlying trend inflation; that the full effects of tariffs have not yet been observed as pass-through has been slow; and discussed how firms are managing the cost pressures arising from tariffs.

On tariffs, the minutes said: "*Participants noted that tariff effects were becoming more apparent in the data, as indicated by recent increases in goods price inflation*." In addition, "*a few participants remarked that tariff-related factors, including supply chain disruptions, could lead to stubbornly elevated inflation and that it may be difficult to disentangle tariff-related price increases from changes in underlying trend inflation*."

These developments left "*several participants*" concerned that after an extended period of above 2% inflation, a drawn-out effect of tariffs on inflation might unmoor longer-term inflation expectations. This was a key reason behind a majority of participants judging that the upside risks to inflation were greater than the downside risks to employment.

That said, as noted "*a couple of participants considered downside risk to employment the more salient risk*." These participants also had a different take on the tariff effects suggesting that they were "*masking the underlying trend of inflation and, setting aside the tariff effects, inflation was close to target*." It is important to note that this might be a minority view on the FOMC, but there are adherents outside of the Fed. It is thus not necessarily a fringe view.

Tariff pass-through? Its complicated …

While the FOMC note that tariff effects were "*more apparent*," it also noted that "*considerable uncertainty remained about the timing, magnitude, and persistence of the effects of this year's increase in tariffs*," and that the pass-through of tariff effects to customers was "*slow*."

Several factors were identified as contributing to a lagged pass-through of tariff effects including "*the stockpiling of inventories in anticipation of higher tariffs; slow pass-through of input cost increases into final goods and services prices; gradual updating of contract prices; maintenance of firm–customer relationships; issues related to tariff collection; and still-ongoing trade negotiations.*" Watch for news on these issues in coming months.

… but the effects are likely delayed not denied

Though pass-through has been slow, several FOMC participants "*expected that many companies would increasingly have to pass through tariff costs to end-customers over time*." Tariff effects have been delayed, but they cannot necessarily be denied.

However, there are still some issues to consider. For example, one of the FOMC dissenters, Governor Christopher Waller said in mid July that "*tariffs are one-off increases in the price level and do not cause inflation beyond a temporary surge. Standard central banking practice is to 'look though' such price level effects as long as inflation expectations are anchored, which they are*."

So are tariffs "one-off" increases or not? Given the slow pass-trough of tariff effects, the effects of tariffs will be spread across time as firms adjust their prices at different paces. There is thus the potential for a sequence of tariff related price increases, which, though INDIVIDUALLY one-offs, might be misconstrued as more persistent upward pressure on underlying trend inflation and become embedded in inflation expectations.

The minutes also described a "*mix of strategies*" firms were using to "*avoid fully passing on tariff costs to customers. Such strategies included negotiating with or switching suppliers, changing production processes, lowering profit margins, exerting more wage discipline, or exploiting cost-saving efficiency measures such as automation and new technologies.*

Firms also *"stressed that current demand conditions*" were limiting firms' ability to pass through tariff effects on costs to customers. This comment highlights broader range of economic effects of tariffs beyond and the potentially drawn-out nature of "one off" price increases. This leads to the question of who is paying for the tariffs.

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Who is paying?

This simple, and correct answer, is US importers.

From the minutes: "*As for the magnitude of tariff effects on prices, a few participants observed that evidence so far suggested that foreign exporters were paying at most a modest part of the increased tariffs, implying that domestic businesses and consumers were predominantly bearing the tariff costs*."

That is, US importers are paying the bulk of the tariffs. This seemingly puts paid to the idea that foreign firms or foreign countries are paying the tariffs.

One way to demonstrate that the effects have been largely on US firms is to examine recent reports on import prices and producer prices.

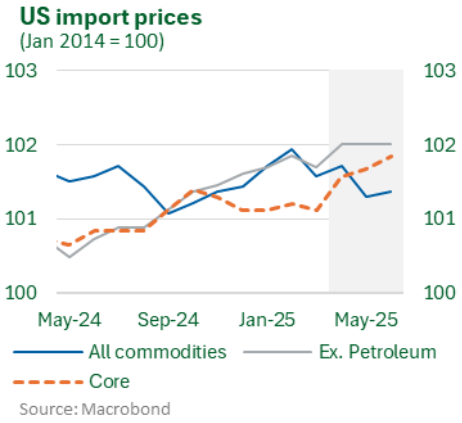
Firstly, note that import prices exclude the direct effect of tariffs. Nonetheless, import prices might be indirectly affected. For example, firms selling into the US might absorb the full costs of tariffs by reducing the price they charge US importers. They might do this if a firm faced with a tariff-induced competitive disadvantage and/or if their currency depreciated against USD. Thus, a foreign firm might lower their USD price to maintain market share, particularly if USD weakened and the firms USD revenues remained stable even with a lower price charged. In such circumstance, the exporting firm might "eat" the tariff. This would show up in a decline in the US import price index to reflect the amount of the tariff.

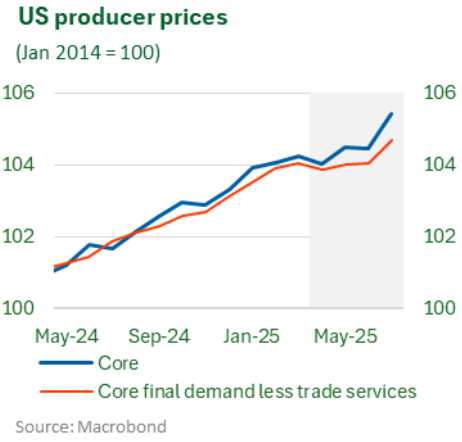
That is not what import prices show. True import prices are down, but when you strip out petroleum (which is not subject to tariffs), import prices are flat from April through June. Core import prices have increased. As well, an important story all year has been the decline in USD. Meanwhile, US producer prices rose by a greater than expected 0.9% MoM in July. Price increases were broad with goods prices up by 0.7% MoM with services prices up 1.1% MoM.

Overall, apparently firms selling to US companies.”

Hence, tariffs do not seem to be pushing down import prices, so foreign suppliers are not eating the tariffs. Instead, as noted by the FOMC, “*domestic businesses and consumers were predominantly bearing the tariff costs*” with domestic price pressures building as firms try to manage tariffs.

This gives some important context to the surge in tariff revenues flowing into the US Treasury. For example, the Committee for a Responsible Federal Budget, recently reported that tariffs are bringing "*meaningful new revenue*" into the US Treasury, and that tariff revenues are "*on course to rise substantially in the coming months*." These revenues will come from US importers and might eventually be passed through to customers.





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Tariff trade-offs

This brings up the issue of trade-offs. "*Participants noted that the Committee might face difficult trade-offs if elevated inflation proved to be more persistent while the outlook for the labor market weakened. Participants agreed that, if that situation were to occur, they would consider each variable's distance from the Committee's goal and the potentially different time horizons over which those respective gaps would be anticipated to close. Participants noted that, in this context, it was especially important to ensure that longer-term inflation expectations remained well anchored*."

While Governor Waller is convinced that inflation expectations are anchored, others are seemingly less confident.

It is interesting to consider the "*distance from the Committee's goal*" for inflation and employment in the current context. Looking at labour, there are some challenges reading labour market developments

Judging how far employment is from the goal of full employment — difficult at the best of times — might be even more challenging now: "*Some participants remarked, however, that slower output or employment growth was not necessarily indicative of emerging economic slack because a decline in immigration was lowering both actual and potential output growth as well as reducing both actual payroll growth and the number of new jobs needed to keep the unemployment rate stable*." Hence, key measures of momentum and slack in the labour market might not be giving a true characterization of the state of the labour market.

The tariffs also do seem to have affected the efficiency of the labour market: "*Several participants noted that the low and stable unemployment rate reflected a combination of low hiring and low layoffs. Some participants observed that their contacts and business survey respondents had reported being reluctant to hire or fire amid elevated uncertainty*."

As a result, labour market indicators might be less reliable in the past. It would be a shame for something else to further erode confidence in the reliability of the jobs data. On that note, we remind that it remains to be seen if the changes at top of the BLS will bolster or erode the reliability of key US data releases.

The Fed might find itself flying blind and facing intense political pressures.

Payment systems and stablecoins

Lastly, let's talk about payment systems and stablecoins. There is a lot packed into this paragraph from the FOMC minutes.

"*Many participants discussed recent and prospective developments related to payment stablecoins and possible implications for the financial system. These participants noted that use of payment stablecoins might grow following the*

recent passage of the GENIUS Act (Guiding and Establishing National Innovation for U.S. Stablecoins Act). They remarked that payment stablecoins could help improve the efficiency of the payment system. They also observed that such stablecoins could increase the demand for the assets needed to back them, including Treasury securities. In addition, participants who commented raised concerns that stablecoins could have broader implications for the banking and financial systems as well as monetary policy implementation, and thus warranted close attention, including monitoring of the various assets used to back stablecoins."

This in mind, we note that Goldman Sachs recently released a report on a "stablecoin gold rush." The Bank for International Settlements also released a research report in May on Stablecoins and safe asset prices. The BIS report found that the growth of stablecoins "*blurs the lines between cryptocurrency and traditional finance and carries implications for monetary policy, transparency of stablecoin reserves and financial stability – particularly during periods of market stress*." This discussion is for another time.

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