MONETARY POLICY PANEL

Luncheon Meeting, March 6, 2015

AGENDA

Near-term policy and longer-run views

Background

Since this Panel last met in September 2014, the U.S. economy has strengthened further, with progress particularly evident in the labor market. In the second half of 2014 payroll employment increased at an average of 280,000 per month, unemployment continued to decline, and other labor market indicators improved, while real GDP grew at an average annual rate of about 3.5%. At the same time, inflation has continued to run below the FOMC objective. We review these developments in our monthly 'Snapshot' of the U.S. economy (attached is the February issue).

Meanwhile, global growth outside the U.S. has been relatively weak and inflation in most major economies has run below central bank objectives. Responding to these developments, many foreign central banks moved to provide additional accommodation over the past six months. Significant uncertainty surrounds the foreign outlook: while there are sizable downside risks to the outlook in the euro area and China, the decline in energy prices and the impact of accommodative monetary policies are notable upside risks.

Against this backdrop, the FOMC concluded its latest asset purchase program in October and has maintained the 0 – 25 basis point target range for the federal funds rate. Based on its assessment of progress toward its objectives, the FOMC has judged that it can be "patient" in starting the normalization process. Regarding an eventual normalization of policy, the FOMC issued its Policy Normalization Principles and Plans in September, and has discussed further various aspects of its plans as well as conducted further testing of the tools that could be used in policy normalization process.

At this meeting we would like to hear your views on three interrelated issues:

- The extent of improvement in the economic outlook and the risk factors to the outlook from the domestic and the global environment

- The apparent disconnect between market-implied expectations and FOMC participants' projections of the policy path and any implication that such a disparity may have for the attainment of the FOMC's objectives

- Interpretations and implications of sustained below-target inflation in developed economies.

We would also like to elicit your views more broadly on the challenges that fundamental technological and demographic changes, as well as the increase in income inequality, may pose to the conduct of monetary policy in the coming years.

Questions for Discussion

On the extent of improvement in the economic outlook

In her recent testimony to Congress, Chair Yellen underscored the Committee's increased confidence about progress toward its objectives, but pointed out that there is more room for improvement in the labor market, particularly with respect to the sluggish wage growth. She did point out that longer-term rates "have moved down significantly since the middle of last year," but judged those declines as reflecting at least in part external factors, namely "weak foreign growth and changes in monetary policy abroad."

In fact, the recent decline in U.S. longer-term yields has occurred as part of a general trend of lower yields in most major economies, as documented in figure1a, which shows 5-10 year forward rates for several countries. FRBNY Research staff analysis attributes this decline largely to a widespread decline in term premia [figures 1b-c].

- What is your view on the current outlook of the U.S. economy? Where do you see major risks that could impede further progress toward the FOMC objectives?

- Do you think the low level of long forward rates reflects a pessimistic view of the fundamentals of the U.S. or global economy, and as such it embeds expectations of a protracted accommodative policy stance?

On the disconnect between market-implied expectations and SEP projections

Looking further at financial market signals, there has been for quite some time a discrepancy between market-implied expectations and FOMC participants' projections of the federal funds rate. This discrepancy occurs both in the near-term projections as well as further out on the policy path. The SEP policy projections also have been above those of the Primary Dealers' Survey, although to a lesser extent [figure 2b].

In addition, comparing the SEP longer-run projections of the federal funds rate with the 5-10 year risk neutral forward rate (calculated using the Adrian, Crump, and Moench methodology) shows a significant gap. This gap remains sizable even though it has narrowed in the past year, as the market-implied risk neutral rate has risen and the SEP assessment has declined [figure 3b]. A critical issue is how the remaining discrepancy will be resolved.

- Which kind of risks do you think this discrepancy, if it were to persist, is presenting?

- What adjustments in its communications do you think the Committee could make in order to help resolve this discrepancy appropriately?

On missing the inflation objective

The plunge in oil prices has been one of the most notable developments in the second half of 2014 and early 2015. While this development has accelerated the decline in overall measures of U.S. inflation, core inflation measures have generally declined since 2012. Furthermore, rather than being specific to the U.S., the decline in inflation measures appears to be widespread. In particular, inflation has undershot many central banks' official targets; as a consequence, a number of central banks have increased policy accommodation with some deciding to set the policy rate at negative levels [figures 3a-e].

- Do you view these developments as indicating that monetary policy has become less effective, or do you think that central banks may not have been sufficiently aggressive in pursuing their inflation objectives?

- In your view, should very low inflation levels be considered a 'new normal'? Do you think that central banks should reconsider their inflation targets?

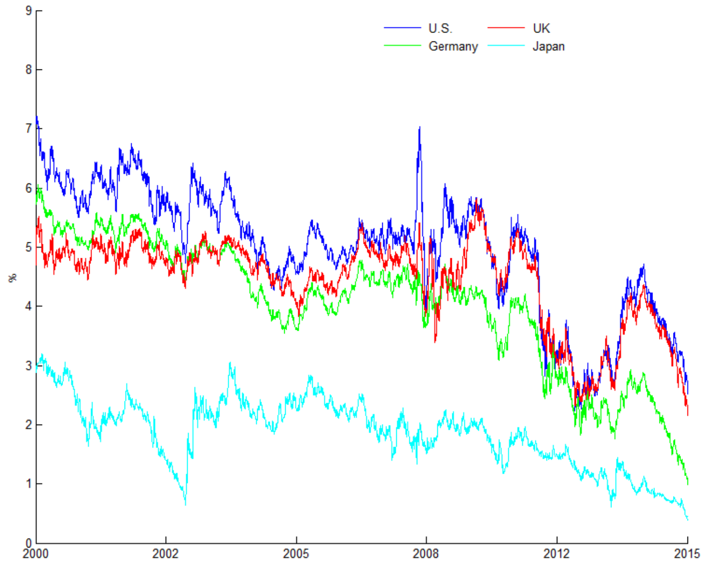
- More broadly, what do you think these new developments imply for the future of inflation targeting regimes?

On the challenges posed by structural changes

Demographic shifts, an apparent downshift in structural productivity growth, and an increase in income inequality have received wide attention in policy and academic circles. These structural developments could have significant impact on a number of variables that influence the appropriate stance and conduct of monetary policy over the longer term: these include possible downward pressure on the 'natural rate of interest', lower potential output, changes in the natural rate of unemployment, and possibly even changes in the assessment of the appropriate level of inflation. Furthermore, these developments could exacerbate the risk of 'secular stagnation'.

- To what extent, in your view, should monetary policy react to these trends in the short and long run?

Figure 1a. Global 5-10Y Forward Yields



Source: Bloomberg, Federal Reserve Bank of New York Calculations

Figure 1b. Global 5-10Y Forward Risk Neutral Yields

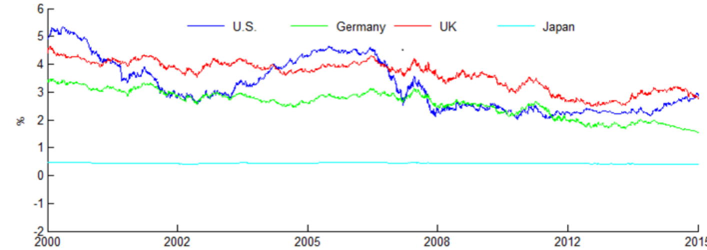
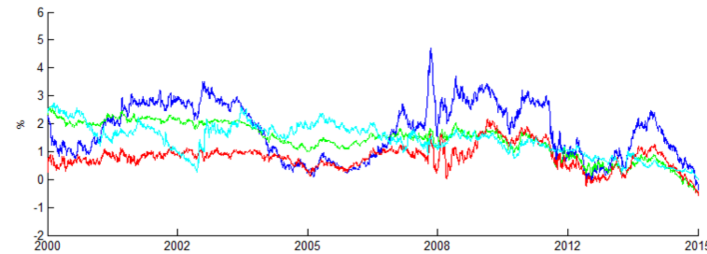
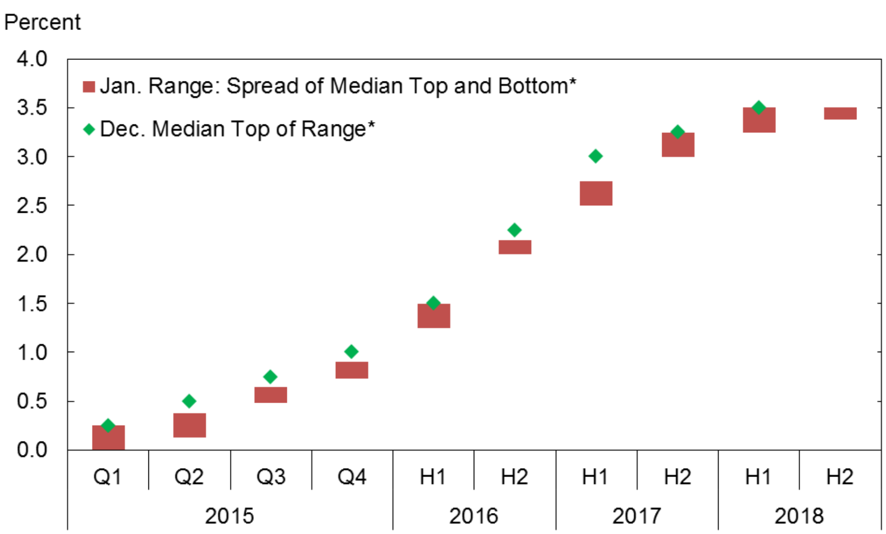


Figure 1c. Global 5-10Y Forward Term Premiums



Source: Bloomberg, Federal Reserve Bank of New York Calculations

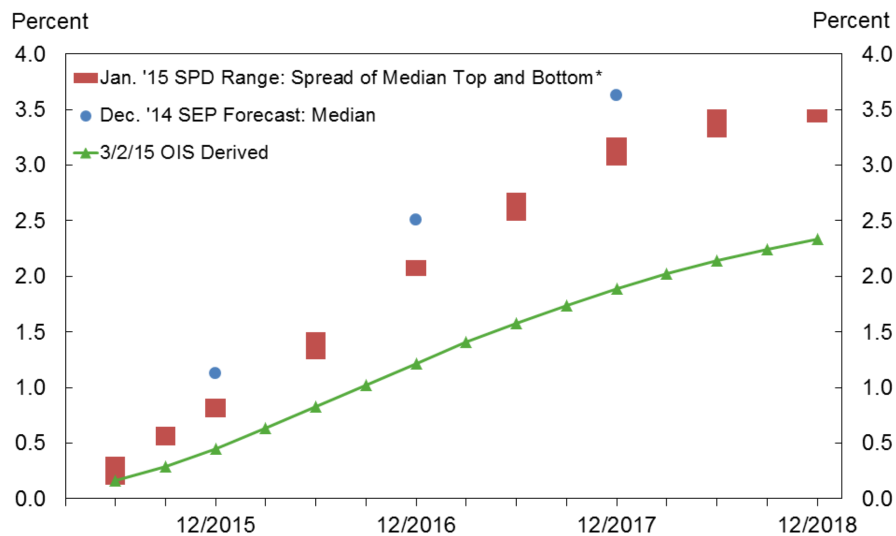
Figure 2a. Survey of Primary Dealers, January 2015



* If target rate included in top of range

Source: Federal Reserve Board of Governors

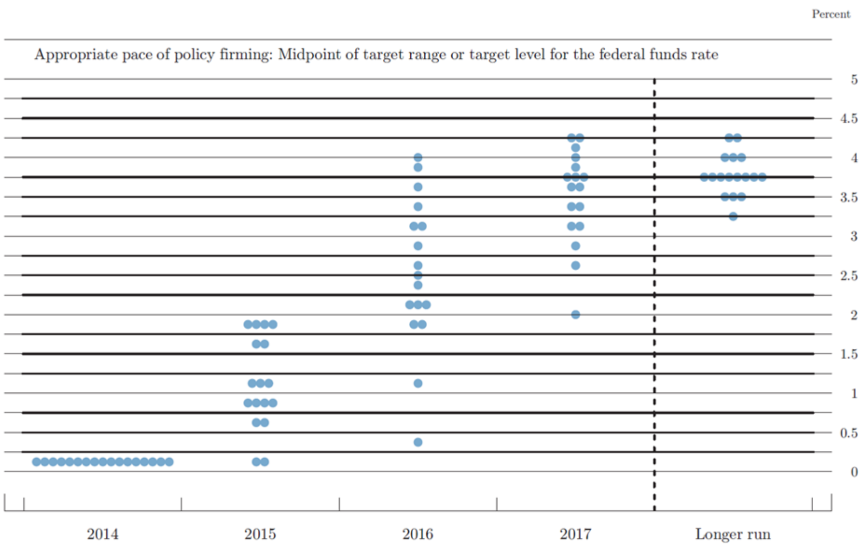
Figure 2b. SEP vs. Current Market Implied and SPD FFR Paths



* If target rate included in top of range

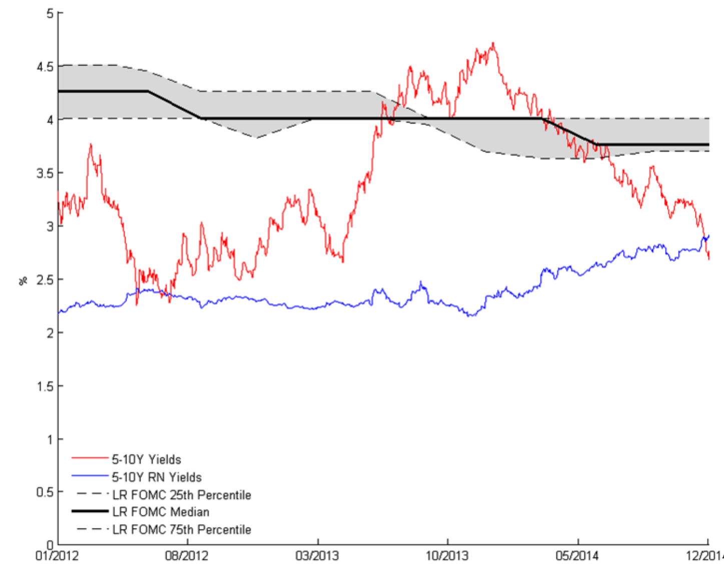
Source: Bloomberg, Federal Reserve Bank of New York, Federal Reserve Board of Governors

Figure 3a. Federal Funds Rate Projections - December 2014 SEP



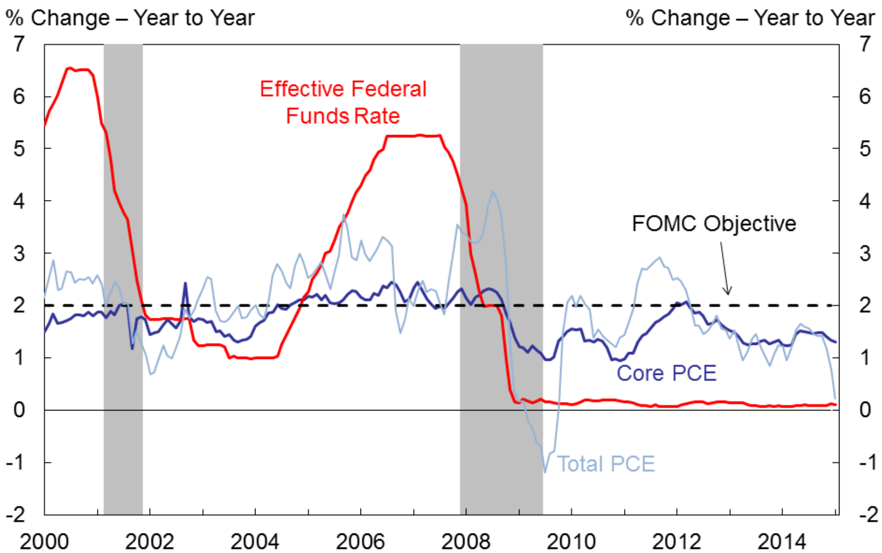
Source: Federal Reserve Board of Governors

Figure 3b. FOMC Long-run Projections and 5-10Y U.S. Forward Yields



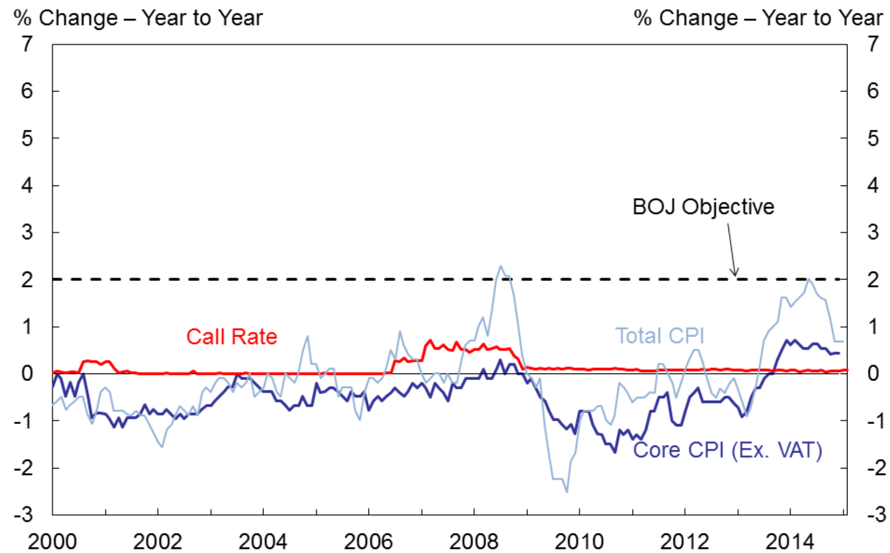
Source: Bloomberg, Federal Reserve Bank of New York Calculations

Figure 4a. Inflation vs. Target – United States



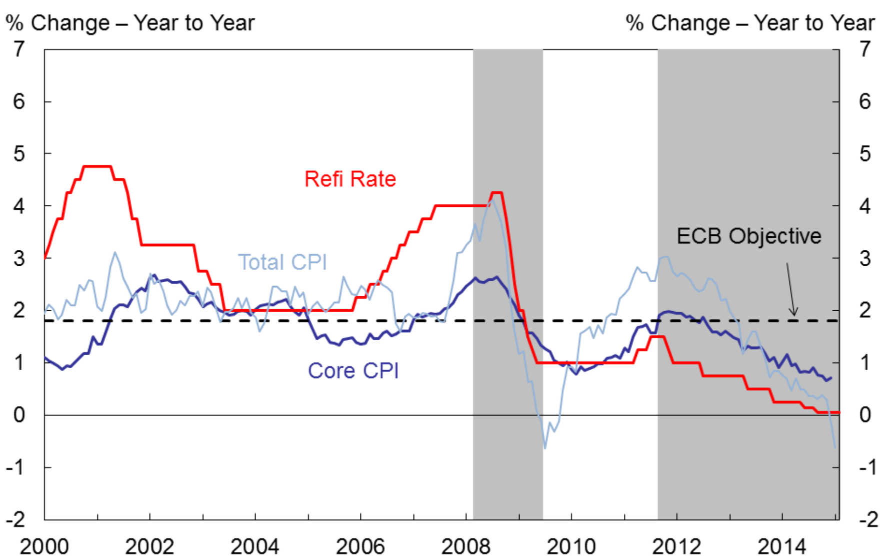
Note: Grey shading shows NBER recessions
Source: Bureau of Economic Analysis, Federal Reserve Board of Governors

Figure 4b. Inflation vs. Target – Japan



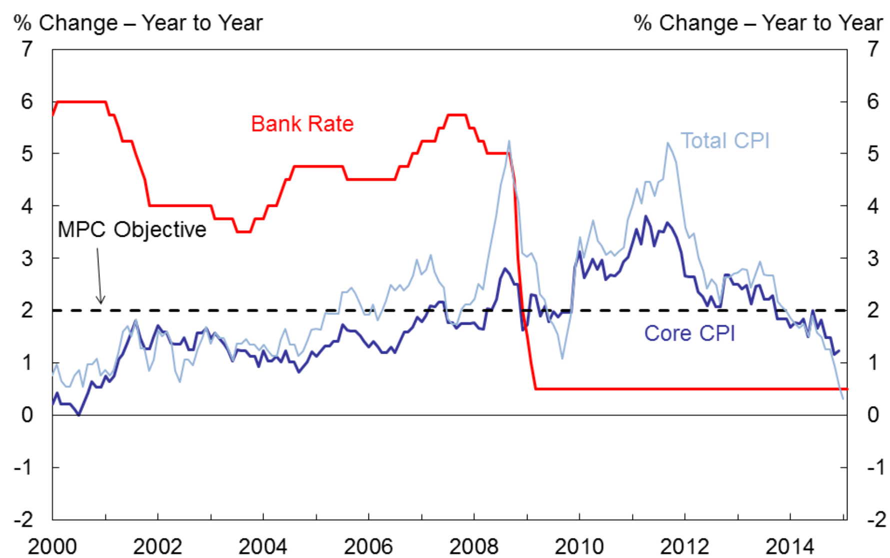
Note: Inflation excludes VAT tax
Source: Ministry of Internal Affairs and Communications, Bank of Japan

Figure 4c. Inflation vs. Target – Euro Area



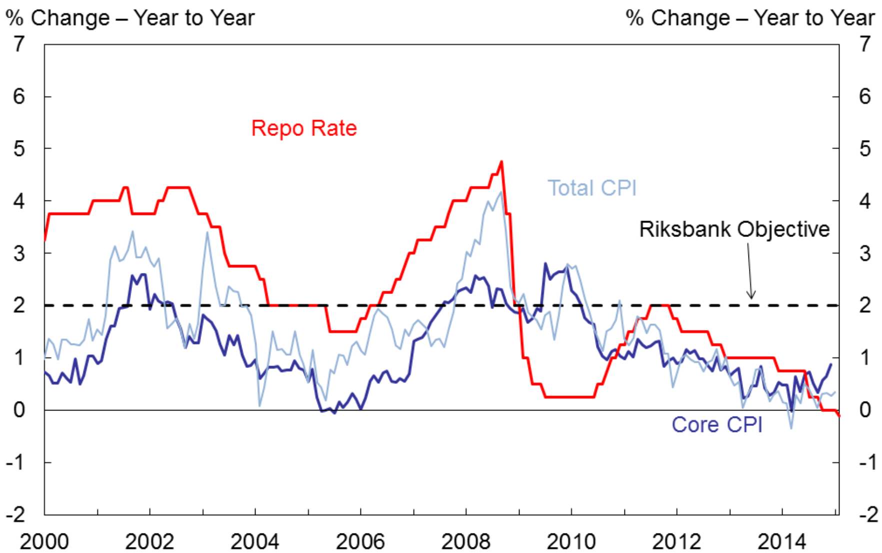
Note: Grey shading shows CEPR recessions
Source: Statistical Office of the European Communities, European Central Bank

Figure 4d. Inflation vs. Target – U.K.



Source: Statistical Office of the European Communities, Bank of England

Figure 4e. Inflation vs. Target – Sweden



Source: Sveriges Riksbank