Challenges Facing the Next FOMC Chair

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Economic Advisory Panel
Federal Reserve Bank of New York
November 13, 2013

Managing the Transition from Current Policy

- Not just an issue for when it becomes time to “normalize”:
    - FOMC must decide now about what to communicate about the path to normalization
    - speculation about that process is already affecting financial conditions

- Can further guidance be provided about
    - interest-rate policy?
    - balance-sheet policy?

Guidance on Interest-Rate Policy?

- FOMC has already stated (since 12/12) that ffr will remain low until unemployment falls at least to 6.5 % (subject to expected inflation remaining below 2.5%)

  — isn't that enough?

- Remaining questions:

  1. when 6.5% is reached, will ffr actually be raised?

     — "a threshold, not a trigger"

     — if decline in u largely due to decreased labor force participation, may not indicate degree of improvement in labor market desired

Guidance on Interest-Rate Policy?

2. what policy will be followed after "liftoff"?

   — presumably, not immediate return to pre-crisis reaction function

   — announced thresholds not derived from that reaction function

   — and projections in 9/13 SEP don't seem to conform to simple "Taylor rule"

A Consideration

- There would be important advantages to guidance about the timing of "liftoff" that is consistent with what one wishes people to expect about post-liftoff policy

- This would have been an advantage to forward guidance based on a nominal GDP target path, in my view; but FOMC has not taken that route

  — evidently prefer guidance formulated in terms of outcomes for the variables that correspond to their "dual mandate" stabilization objectives (unemployment and inflation)

A Possible Approach

- Describe the intention to keep the ff rate "lower for longer" not by specifying an unemployment threshold that is much lower than the one that would justify such low rates under long-run policy

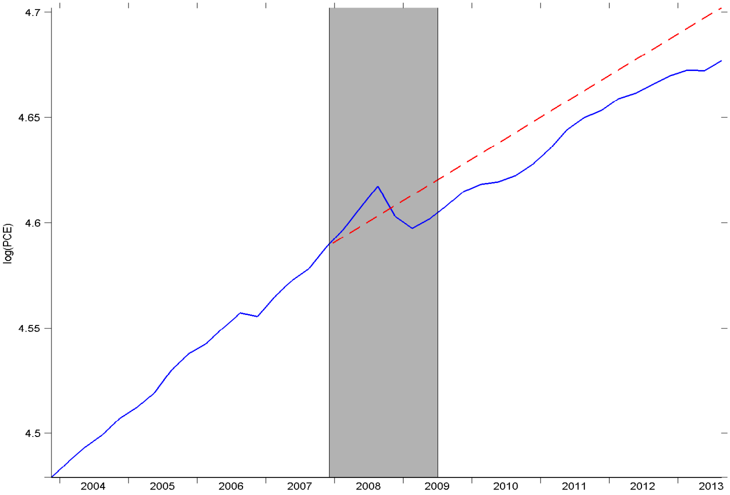
  — nor by specifying a temporarily higher inflation target than one expects to aim at over the longer run

  — but in terms of an intention to close a price-level gap

- Such a "gap" currently exists, if one looks, for example, at growth of PCE deflator since start of the recession

  — similar conclusion if one looks at period since reaching ZLB

The Price-Level Gap



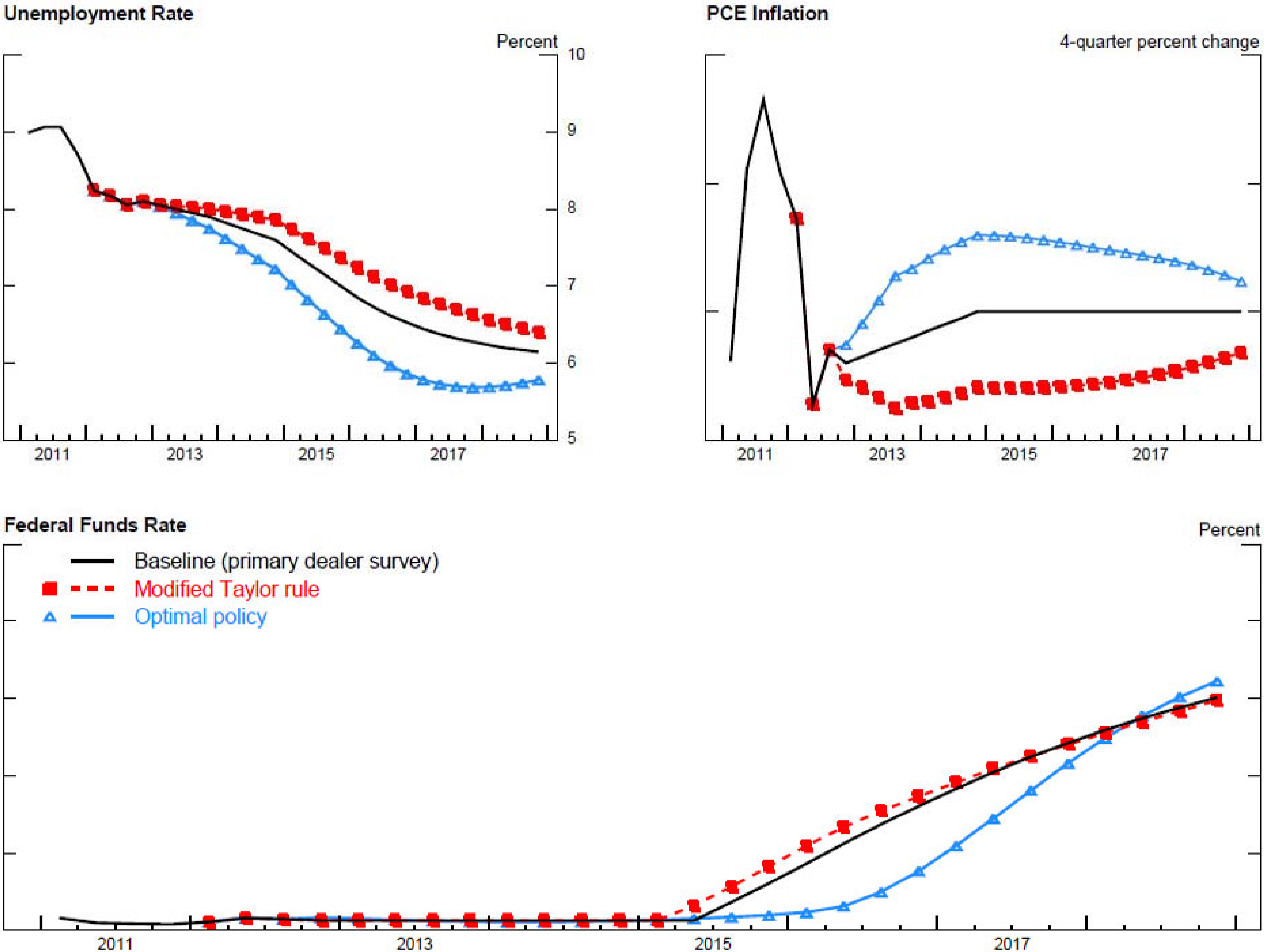
PCE deflator compared to 2 percent trend.

A Possible Approach

- Inflation "floor" would be another way of strengthening current interest-rate guidance, without lowering unemployment threshold

- But this, unlike a commitment based on the PCE gap, would not imply keeping rates as low for as long as an optimal policy commitment would involve

  — according, for example, to the "optimal control" exercise reported by VC Yellen in 11/12 speech



Source: Federal Reserve Bank of New York, Survey of Primary Dealers, September 2012.

Guidance on Balance-Sheet Policy?

- Is it necessary?
    - a similar case as with interest-rate policy: if Fed's balance sheet affects asset prices, its expected future path should affect financial conditions now, not just current purchases
    - made clear by market reaction last summer to hints about "tapering"
- Has enough already been said?
    - FOMC laid out fairly detailed picture of how policy normalization (including balance sheet) should proceed, in minutes of 6/11 meeting
    - but much has changed since then: little reason to think this plan still operational, even if FOMC has not updated it

Guidance on Balance-Sheet Policy?

- Hasn't the market reaction to discussion of "tapering" shown that it is best to say as little as possible about future policy?

  - Two possible interpretations of the reaction:

    — some really hadn't thought that purchases could end anytime soon

    — preparation to slow rate of asset purchases was misinterpreted as implying preparation to raise ff rate soon as well

  - In either case, an indication of inadequacy of previous FOMC communication

    — but not a reason to think it would have been better to allow mis-conceptions to persist

A Crucial Issue

- Need to further clarify why and how the criteria that will determine asset purchases or sales differ from the criteria that will determine interest-rate policy

- Guidance thus far creates impression of some similarity:
  - low ff rate and asset purchases: two tools, both used to ease financial conditions
  - currently doing about as much as judged feasible of both
  - have made commitments to maintain each at current level until sufficient improvement in labor market

- A problem if one doesn't want talk of "tapering" to be interpreted as meaning that interest rate increases are coming

A Crucial Issue

- Shouldn't the two tools be used in the same way?

- No: no close analogy between level of short-term interest rate and rate of asset purchases

  1. theory suggests a closer analogy between stock of CB asset holdings and level of short-term rate
  2. continued purchases change a stock variable, which constrains future policy options in a way that continued low ff rate does not

- A sensible criterion for determining if further asset purchases are appropriate must depend on size of balance sheet reached, and not simply on macro conditions