MONETARY POLICY ADVISORY PANEL

Luncheon Meeting, September 9, 2016

AGENDA

Monetary Policy in a Low Interest Rate Environment

Background

When this Panel last met in March, we discussed the post-liftoff landscape, and tried to put in perspective how the tightening in financial conditions at the beginning of 2016, global economic developments, and heightened uncertainty around the outlook had flattened the paths of market-implied expectations and of SEP projections for the policy rate from those in December.

At this juncture, even though real GDP growth was sluggish in the first half of the year, the U.S. economy appears to be on firmer ground and a number of FOMC participants have stated publicly that recent developments have strengthened the case for an increase in the policy rate. In parallel, the declines in estimates of potential growth and real equilibrium rates raise the issue of how constrained monetary policy has become to respond appropriately to adverse shocks.

Against this backdrop, as stated in the July FOMC meeting minutes, the Federal Reserve is engaged in "an ongoing long-term effort begun in July 2015 to evaluate potential long-run frameworks for monetary policy *implementation*." [Emphasis added.] Chair Yellen dedicated her remarks at Jackson Hole to a discussion of the post-crisis monetary policy toolkit. At the same time, there has been considerable commentary about whether the monetary policy *strategy* needs to be rethought in light of fundamental changes in the economic environment.

At this meeting we would like to hear your view on the following interrelated topics:

- **Implications of the low interest rate environment**
- **The effectiveness of the Fed's current toolkit**
- **Possible adjustments to the FOMC's policy strategy**
- **Monetary and fiscal policy interaction**

Questions for Discussion

On the low interest rate environment

- What are your views on the implications of longer-term shifts in the global economy, including the widespread fall in equilibrium real rates, for U.S. monetary policy?
- How should U.S. monetary policy address the possibility of transmission of "secular stagnation" across economies?

On the effectiveness of the policy framework

- Is the Fed's toolkit discussed in Chair Yellen's Jackson Hole speech sufficient in your view to provide appropriate countercyclical support in an environment with a greater likelihood of zero lower bound episodes?
- Given the changes in the economic and financial environment over the past several years, what do you see as an appropriate configuration of the balance sheet in the long-run operating framework?

On possible adjustments to the monetary policy strategy

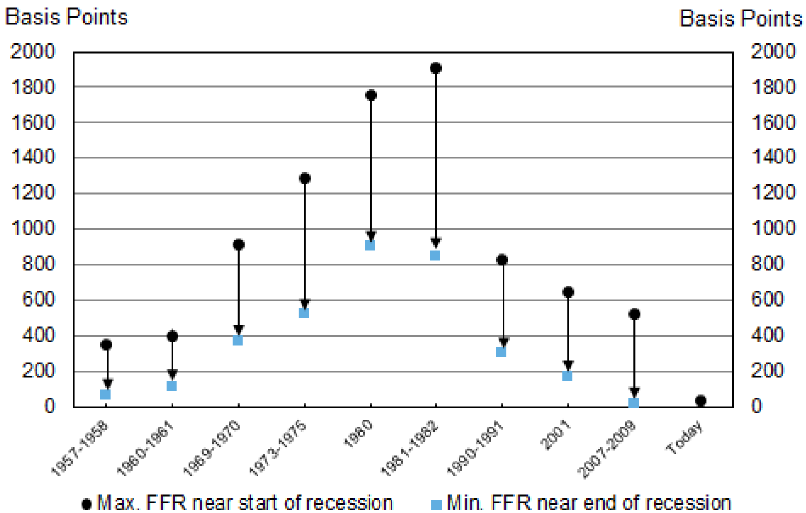
- Do you believe that any of the following would be a more effective way to reformulate the objectives from the dual mandate: expressing the Federal Reserve's longer-run inflation objective in a way that more explicitly allows short-term overshoots, targeting a price level trajectory, or targeting a nominal GDP path?
- Would a more explicit explanation of how policymakers would respond to alternative outlook scenarios help to clarify the FOMC policy reaction function?

On fiscal and monetary policy interaction

- The fiscal theory of the price level implies that, given the constraints of the consolidated government balance sheet, fiscal and monetary policies are interdependent. In your view, how important in the current environment is coordination between monetary and fiscal policy to achieve the FOMC's longer-term objectives?
- Are there specific fiscal actions that would support the increase of inflation to the FOMC objective and also be consistent with the medium- and longer-term objectives for fiscal policy?

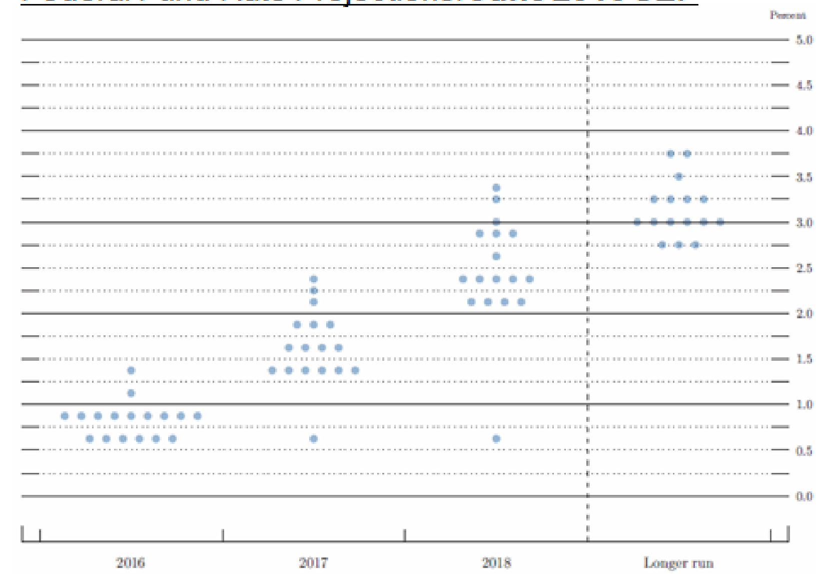
Figure 1 – FFR Target Reduction in Recession and Current Projected Paths

Reduction in Federal Funds Rate During Recessions

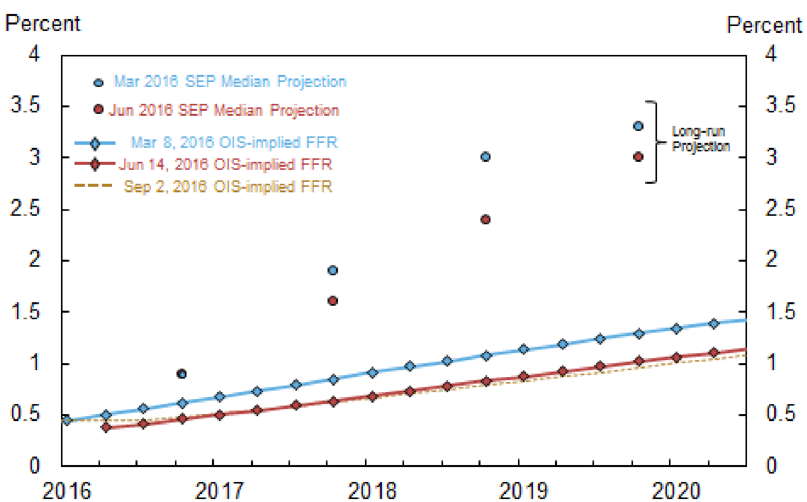


Source: FRED, Reifschneider (2016)

Federal Fund Rate Projections: **June 2016 SEP**

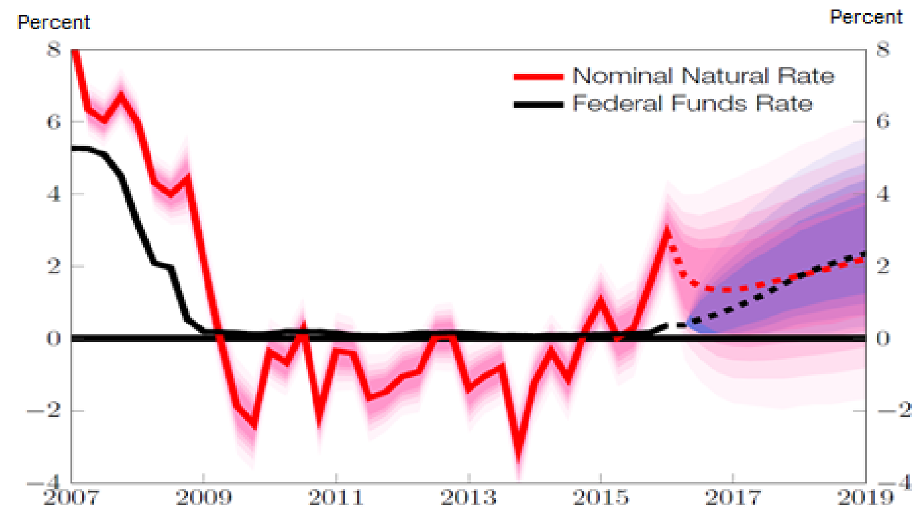


Market-Implied Path of FFR vs. SEP Dots



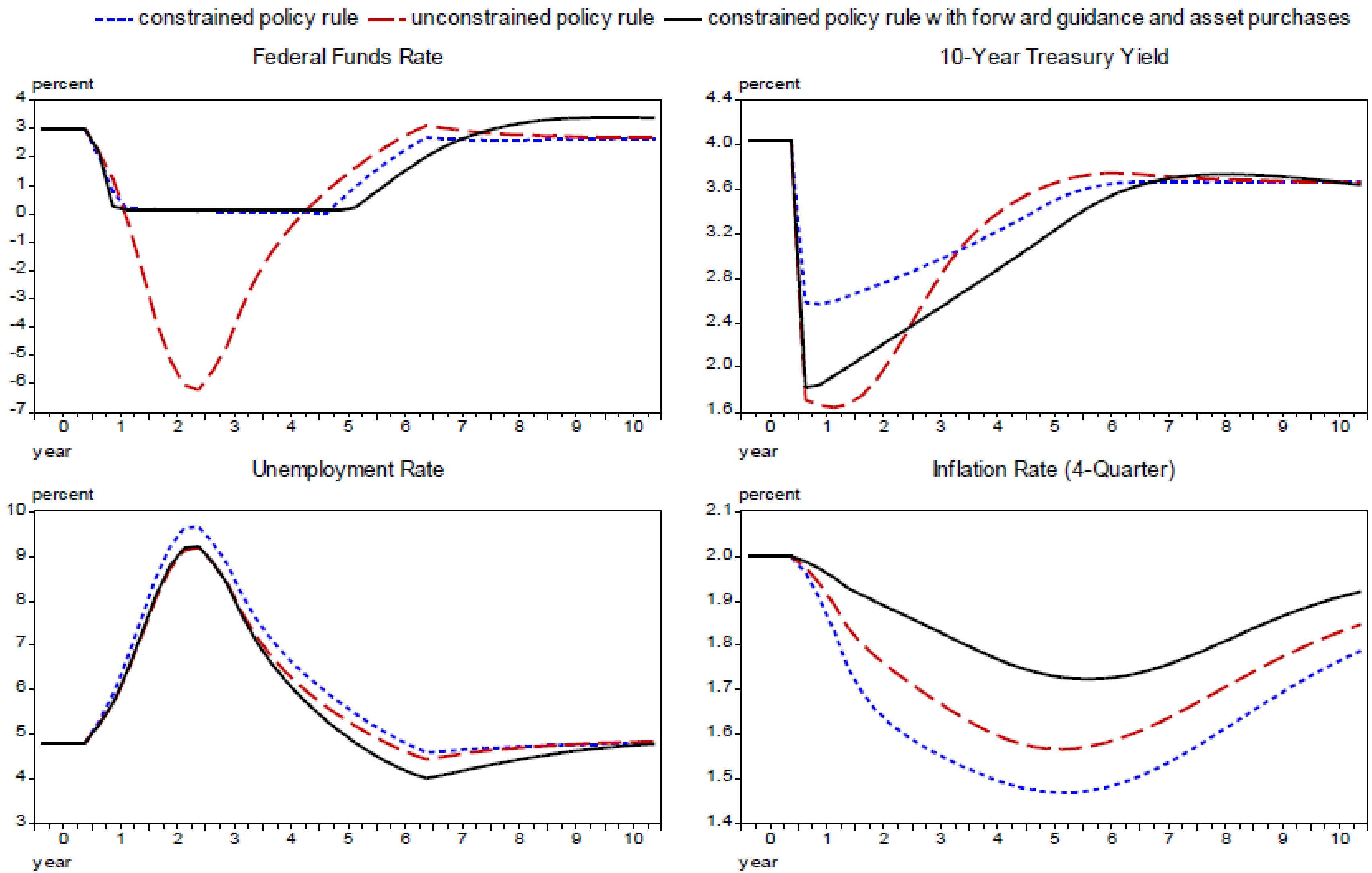
Source: FRBNY and Federal Reserve Board

DSGE Model FFR and 'Natural' FFR Paths



Source: FRBNY, DSGE team

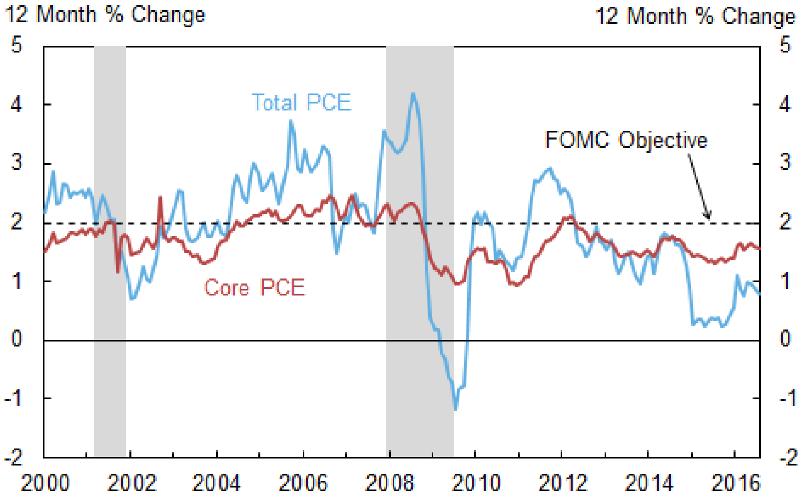
Figure 2 – An assessment of FOMC's ability to respond to future shocks



Source: David Reifschneider (2016), "Gauging the Ability of the FOMC to Respond to Future Recessions," Finance and Economics Discussion Series 2016-068 (Washington: Board of Governors of the Federal Reserve System, August), www.federalreserve.gov/econresdata/feds/2016/files/2016068pap.pdf

Figure 3 – Inflation Indicators

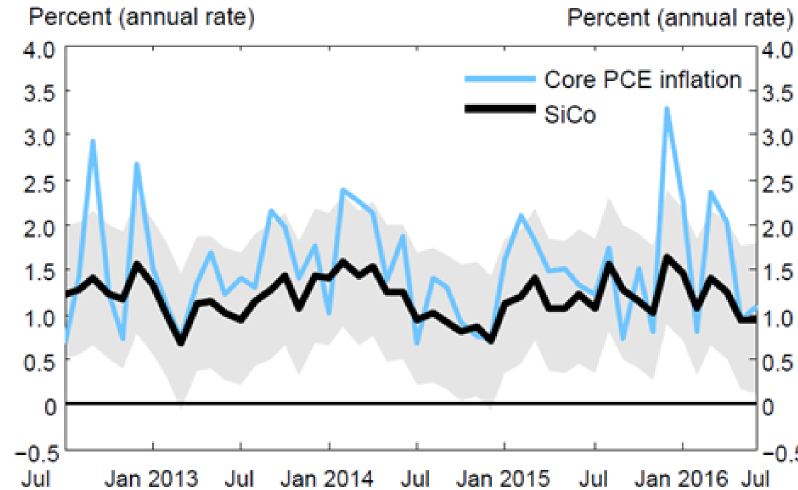
PCE Deflator



Source: Bureau of Economic Analysis, via Haver Analytics

Note: Shading shows NBER recessions.

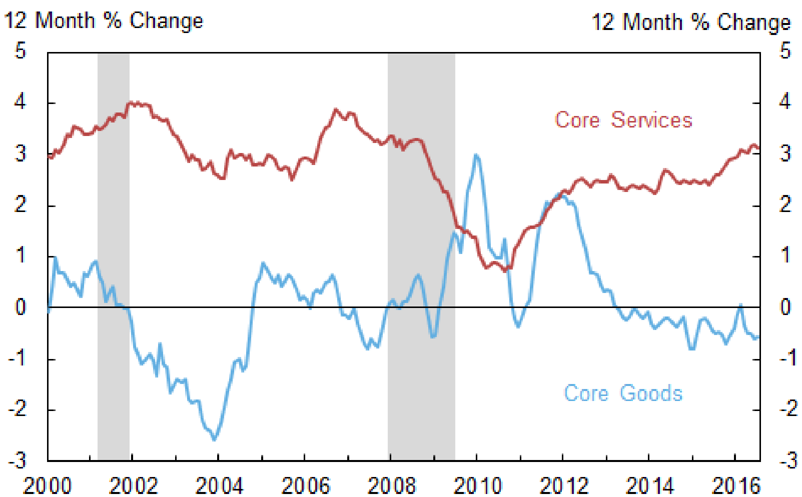
Signal Component (SiCo) model for core PCE



Source: FRBNY

Note: The gray area represents 90% bands for SiCo.

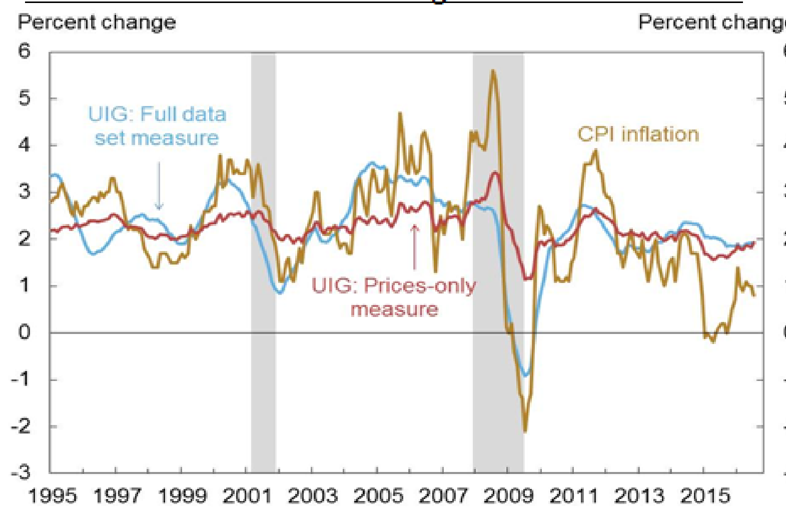
CPI Inflation: Core Goods and Core Services



Source: Bureau of Labor Statistics, via Haver Analytics

Note: Shading shows NBER recessions.

CPI Inflation: 12-Month Change and UIG Measures

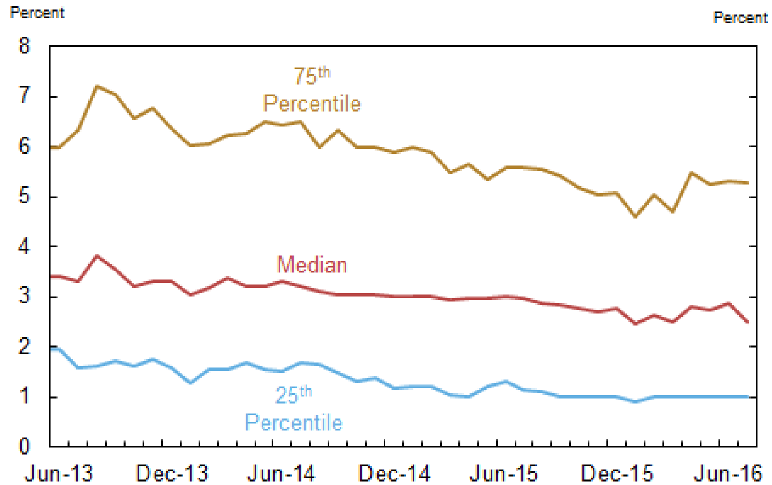


Source: Bureau of Labor Statistics, via Haver Analytics and FRBNY.

Note: Shading shows NBER recessions.

Figure 4 – Inflation Expectations

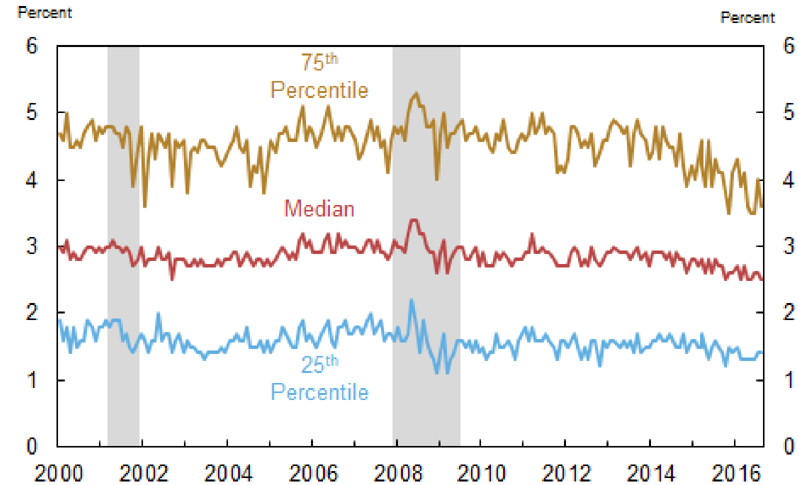
FRBNY SCE: 3-Year-Ahead Inflation Expectations



Source: Survey of Consumer Expectations, FRBNY

Note: Shading shows NBER recessions.

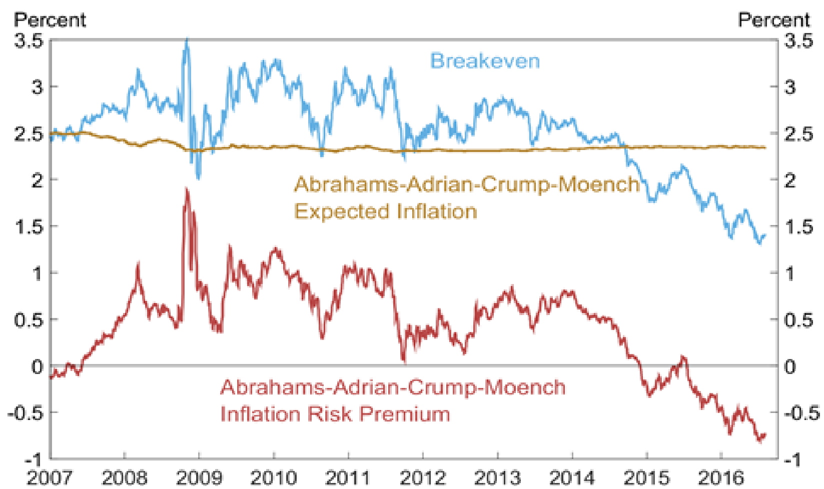
Michigan Survey: Inflation Expectations 5 to 10 Years



Source: University of Michigan

Note: Shading shows NBER recessions.

5-10 Year Inflation Compensation Decomposition



Source: NY Fed Calculations, Federal Reserve Board.

Note: 5-day moving average, Zero-coupon yield.