Minutes of the MONETARY POLICY ADVISORY PANEL

Meeting of April 5, 2013

Present: External advisors: Markus Brunnermeier, Gauti Eggertsson, Mark Gertler, Francesco Giavazzi, Frederic Mishkin, Ricardo Reis, Christopher Sims. Internal Staff: Christine Cumming, Stefano Eusepi, Marco Del Negro, William Dudley, Marc Giannoni, Krishna Guha, Jamie McAndrews, Jonathan McCarthy, Paolo Pesenti, Simon Potter, Rania Perry, Aysegul Sahin, Argia Sbordone, Ernst Shaumburg, Andrea Tambalotti, Kei-Mu Yi (Minneapolis Fed).

The roundtable discussion largely centered on the items in the meeting agenda: the risks and costs associated with the current asset purchase program and the communication challenges for the FOMC associated with an eventual renormalization of policy. The panelists also discussed the implications of the recent change in policy strategy adopted by the Bank of Japan and offered their views on some other current economic issues.

Risks associated with extended accommodation

The panelists first discussed the risks associated with the current asset purchase program and the expansion of the Federal Reserve's balance sheet. The discussion focused on the possible impact of a rise in interest rates on realized and unrealized capital losses on the balance sheet as well as on Federal Reserve net income and remittances to the Treasury. The participants agreed that under most scenarios for the evolution of the US economy the capital losses associated with an increase in rates would not pose serious problems to the Federal Reserve's ability to fulfill its mandate. The panelists also commented on recent research focused on more adverse scenarios implying a sharper increase in interest rates. Some participants suggested that the Federal Reserve should retain a portion of its currently large positive returns against possible future losses associated with the policy renormalization process.

There was also discussion about the implications of current fiscal conditions for the effectiveness of the asset purchase program and for the policy renormalization process. Some panelists pointed out that if the beginning of renormalization coincided with a fiscal crisis, the potential losses for the Federal Reserve could be substantial. The panelists agreed that greater coordination between monetary and fiscal authorities would be desirable.

Federal Reserve communication

The panelists agreed that clear and effective communication will be important for an orderly process of renormalization of the current accommodative policy stance, particularly to avoid unduly sharp movements in financial markets. Some panelists recommended that the FOMC should maintain flexibility on both instruments of policy—the short-term interest rate and the balance sheet—and noted that such flexibility might require revising the “exit strategy principles” that the FOMC agreed to at the June 2011 meeting. They also suggested that during the renormalization process both the size and composition of the balance sheet could be adjusted in response to changing economic conditions and in order to foster the alignment of market expectations with the FOMC’s desired path for the policy rate.

Japan’s new monetary policy strategy

The panelists also addressed the recent policy initiatives adopted by the Bank of Japan. They noted their effects on the Japanese stock market valuations and on the exchange rate, but indicated that, besides these immediate reactions, the success of the new monetary strategy in the medium term will depend largely on the response of longer-term inflation expectations. If the new policy regime gains credibility, inflation and inflation expectations should increase over time.

A discussion followed about the possible risks of these new policy actions. Some panelists pointed out some long-term stability issues. They stressed that the extremely expansionary policy could succeed in increasing inflation, but at the cost of unanchoring longer-term inflation expectations. Furthermore, some panelists raised the possibility of a fiscal crisis, especially given the high level of government debt, which could lead to increased risk premia and possible adverse effects on the BoJ’s balance sheet.

Panelists also suggested that meeting the inflation target could not be considered a success if it were not accompanied by an increase in real economic activity. Finally, the participants agreed that the outcome of the new policy initiative will depend on the degree of coordination between the central bank and the fiscal authority in maintaining an expansionary stance of policy, and that the planned tax increases might hinder the effects of monetary accommodation.

Current economic conditions

The panelists agreed that in the first quarter the US economy showed signs of further recovery, notably in the housing and labor markets. There was some discussion about the apparent muted effects of the recent fiscal contraction. Some participants pointed out that the fiscal actions were small relative to the "fiscal cliff" that was avoided at the turn of the year, while others suggested that market participants and the public may not have fully incorporated these fiscal actions into their economic decisions. Some panelists also suggested that the planned cuts to fiscal expenditures might have boosted confidence.

The panel also discussed the European crisis, and in particular the challenges faced by the European banking sector. Participants agreed that tighter coordination of bank supervision across the euro area would be helpful and that European banks could need a substantial recapitalization in order to lead to a sustained economic recovery in the euro area.