Minutes of the MONETARY POLICY ADVISORY PANEL[1]

Meeting of March 6, 2015

Present - Panelists: Markus Brunnermeier, Peter Diamond, Gauti Eggertsson, Mark Gertler, Nobuhiro Kiyotaki, Christopher Sims, Michael Woodford. Internal Staff: Richard Crump, Bianca DePaoli, William Dudley, Stefano Eusepi, Domenico Giannone, Marc Giannoni, Tom Klitgaard, David Lucca, Jonathan McCarthy, Richard Peach, Paolo Pesenti, Simon Potter, Benjamin Pugsley, Robert Rich, Argia Sbordone, Andrea Tambalotti, Joseph Tracy.

The roundtable discussion focused on four issues: the economic outlook and risks to the outlook, low inflation and the timing of lift-off of the federal funds rate (FFR), forward guidance about FFR lift-off and the subsequent policy path, and policy implications of longer-term developments.

The economic outlook and risks to the outlook

Regarding the economic outlook, the initial focus of the discussion was the February labor market release that was released that morning. Panelists agreed that the release pointed to a further improvement in labor market conditions; however, many saw continued sluggish wage growth as consistent with a significant amount of labor market slack remaining despite the unemployment rate falling to near many estimates of its “natural” rate. Panelists pointed to a number of other labor market indicators to support this view: the low participation rate, the still large number of involuntary part-time workers and a quit rate that is still somewhat below pre-recession levels. The latter development was seen indicating a ‘fragile’ labor supply: workers seemingly reluctant to search or accept new job offers because of the higher uncertainty over the path of future earnings at a new job.

The broad consensus among panelists was that monetary policy should remain accommodative at least until wage growth and other measures of labor market health move more significantly closer to their pre-recession levels. One panelist also noted that if there is hysteresis in unemployment, then a lower path for unemployment would tend to reduce the natural rate of unemployment, which is another reason for maintaining an accommodative policy stance.

[1] The views presented in these minutes are solely those of the panelists, not of the FRBNY staff.

Low inflation and the timing of lift-off

There was a discussion on the timing of lift-off of the FFR with some debate on the relative risks from an earlier lift-off versus those of a later lift-off. Several panelists discussed previous episodes of what proved to be premature tightening, including the recent experiences in Japan and Sweden as well as the United States in 1937-38. The panelists were unanimous in their concern that the risks from removing accommodation too soon—slower progress toward the FOMC's objectives and a higher probability of a forced return to the effective lower bound—outweighed those from a later lift-off—primarily, a higher probability of overshooting the inflation objective. They indeed saw the higher probability of a temporary inflation overshoot as consistent with trying to keep inflation on average near its 2 percent longer-run goal. Several panelists recommended that the FOMC communicate clearly that it would not lift off until it observes clear evidence of a sustained recovery in wage growth and inflation. Echoing a recent statement of Larry Summers, some panelists recommended that the FOMC wait to raise the FFR until it sees "the white of the eyes of inflation," rather than basing a lift-off on a projected increase in inflation. This recommendation assumed that the FOMC would act forcefully if inflation and/or inflation expectations were to rise substantially. Finally, some panelists noted that in an environment where many countries struggle with low inflation or deflation, generating inflation should be seen as a badge of honor for a central bank.

The sequencing of policy normalization was also discussed. Some panelists expressed the view that the balance sheet could begin to be normalized before the FFR lift-off. It was observed, though, that adjusting the balance sheet and the FFR target simultaneously in the early part of normalization could lead to confusion for market participants. Furthermore, the Fed arguably has a better understanding of the effects of an FFR lift-off than of those of shrinking the balance sheet, suggesting that it would be easier to calibrate the appropriate changes in the FFR target. In addition, it was not clear to the panelist that having a large balance sheet entails significant costs.

Forward guidance about lift-off and afterwards

There was some discussion about policy communications, in particular whether it would be appropriate to remove the 'patient' language from the FOMC statement. Some panelists expressed concern that such a removal might pose some significant risks, but argued that the Committee should clearly communicate that the lift-off would be state-contingent; in particular, stating its desire to see inflation closer to its objective before lift-off, because a lack of reaction to the current low inflation could be seen as a shift in the FOMC's longer-run inflation objective.

Then the issue of which form of forward guidance (if at all) is appropriate after exiting the zero lower bound was raised. Some panelists argued that the time-dependence implicit in the current forward guidance should be removed, since it probably has contributed to an excessive compression of term premia, and thus may be inducing over-investment in long-term financial assets. In general panelists thought that guidance after lift-off should be a clearer representation of the FOMC's reaction function and the way in which policy will respond to different configurations of the outlook.

The panelists then discussed to what extent the conduct of policy after lift-off should depend on the possible scenarios of financial conditions: if these tighten more than expected—as in the 'taper tantrum' episode of 2013—then a less steep path of the FFR would be appropriate to provide more accommodation. Conversely, if term premia do not react much to a policy rate increase, then it would be appropriate to raise the FFR more quickly to avoid excess accommodation and economic overheating. Panelists generally noted that the need to adjust the policy rate to changes in financial conditions points to an inadequacy of mechanical rules, such as the standard Taylor rule, as policy guides. Such rules also do not account for external factors affecting financial conditions, like the current dollar appreciation.

On communication more generally, there was some discussion on how to improve the presentation of the FOMC's outlook and policy stance in the Summary of Economic Projections (SEP). Many panelists agreed that significant gains could be obtained through presentation of each participant's joint projections of the economic variables and policy rates. There was a brief reference to the opportunity of presenting forecasts in the context of a monetary policy report as other central banks do, but the panelists also noted that the FOMC faces greater logistical difficulties than these other central banks because of the large size of the Committee and its geographical dispersion.

Policy implications of longer-term developments

Finally, there was some discussion about whether the economic environment has shifted towards one with a permanently lower equilibrium rate of interest, and if so whether there were additional risks in maintaining a 2 percent long-term inflation objective. Panelists noted that the recent SEP submissions showed that FOMC participants have shifted down somewhat their longer-run projections of the short-term rate. In the discussion of the desirability of an increase in the longer-run inflation objective, several panelists voiced a concern that even if 2 percent leaves only a small buffer to accommodate shifts in the equilibrium real short-term interest rate, communicating a change in the inflation objective would likely be difficult and would risk jeopardizing the FOMC's credibility.