MONETARY POLICY PANEL

Luncheon Meeting, September 25, 2015

AGENDA

U.S. policy normalization and international headwinds

Background

When this Panel last met in March, the U.S. economy was coming out of a strong second half of 2014, and the FOMC had provided the public with more information about eventual policy normalization by issuing the "Policy Normalization Principles and Plans" in September 2014. Market participants generally appeared to anticipate either a June or a September lift-off of the federal funds rate, even though inflation was low and global growth was fairly weak. We discussed the outlook and the risk factors to the outlook from the domestic and the global environment.

Today we convene in an economic landscape where the U.S. economy has continued to grow at a moderate pace, but one where global economic and financial developments may restrain economic activity somewhat. Financial markets have been turbulent, especially in the weeks following the devaluation of the Chinese currency, with continued declines in commodity prices and ongoing appreciation of the dollar. Financial conditions tightened and apparent greater vulnerability in emerging economies, particularly in Asia, increased uncertainty around the outlook for the U.S. economy. Recent economic developments are reviewed in our monthly 'Snapshot' of the U.S. economy (attached is the September issue).

At its September meeting, weighing the potential impact of these and other developments on the realized and expected progress towards its objectives, the FOMC maintained the 0 – 25 basis point target range for the federal funds rate.

At this meeting we would like to discuss the following interrelated topics:

- *Policy stance and communication*: How do you view the policy decision and communication around the September FOMC meeting?

- *Recent turbulence in financial markets*: How do you interpret recent financial market developments and their possible implications for U.S. monetary policy?

- *Divergent policy paths*: How do you view the risks that could stem from the potential divergence of policy paths across major central banks?

Questions for Discussion

On the FOMC policy stance and communication

According to the minutes of the July FOMC meeting, "results from the Desk's July Survey of Primary Dealers and Survey of Market Participants indicated that a majority of respondents to both surveys continued to view the September 2015 meeting as the most likely time for the first increase in the target range for the federal funds rate." Amid the turbulence in financial markets, the market-implied future path of the policy rate shifted downward. Communications from various FOMC participants were interpreted as giving somewhat divergent views about the near-term policy path. On the eve of the September FOMC meeting, it appeared that there was sizable uncertainty among market participants about a possible rate increase at the meeting.

In the September statement, the FOMC "reaffirmed its view that the current 0 to 1/4 percent target range for the federal funds rate remains appropriate," and indicated that it "expects that, with appropriate policy accommodation, economic activity will expand at a moderate pace." The Committee continued to state that it sees "the risks to the outlook for economic activity and the labor market as nearly balanced," but indicated that it is "monitoring developments abroad." It also stated that "recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term."

- What is your assessment of the Committee decision to hold steady on the policy rate?

- What is your view of the impact of the Committee's recent communications on market expectations of the policy path?

- The economic projections submitted by FOMC participants in conjunction with the September meeting show that a large majority of FOMC participants continues to assess that it would be appropriate to raise the policy rate by year-end (see Figure 1). How do you view these projections in concert with other FOMC communications?

On the sources and implications of recent turbulence in financial markets

Understanding the factors behind the volatility in financial markets is obviously important for assessing the extent to which it may impact the U.S. economy.

The recent developments in foreign exchange and commodity markets raise the issue of whether they may reflect the impact of structural changes that could lead to a more prolonged global economic slowdown. Our staff statistical models, for example, estimate that the recent declines in oil prices may have been driven to a large extent by global demand factors, suggesting more significant global deflationary pressures (see Figure 2).

Of significant interest is the market-perceived deterioration of China's growth prospects and its spillover to other emerging economies, particularly those that are commodity suppliers. The difficulties of these economies could also be aggravated by further dollar appreciation. Chair Yellen's comments at the post-meeting press conference touched on this topic.

Tightening of financial conditions can have a significant impact on the economy. Our staff DSGE model shows that a protracted period of tight financial conditions would lower substantially the path of the natural rate of interest and negatively affect the evolution of output and inflation (see Figure 3).

- Do you interpret recent financial market developments as transitory external 'headwinds', whose impact on the U.S. economy will be contained, or as signaling a deeper, more persistent slowdown in global growth, with larger consequences for the U.S. and the developed economies?

- Which implications do you think this uncertain global landscape, including developments in the EMEs, carries for U.S. monetary policy?

On the implications of diverging policy stances

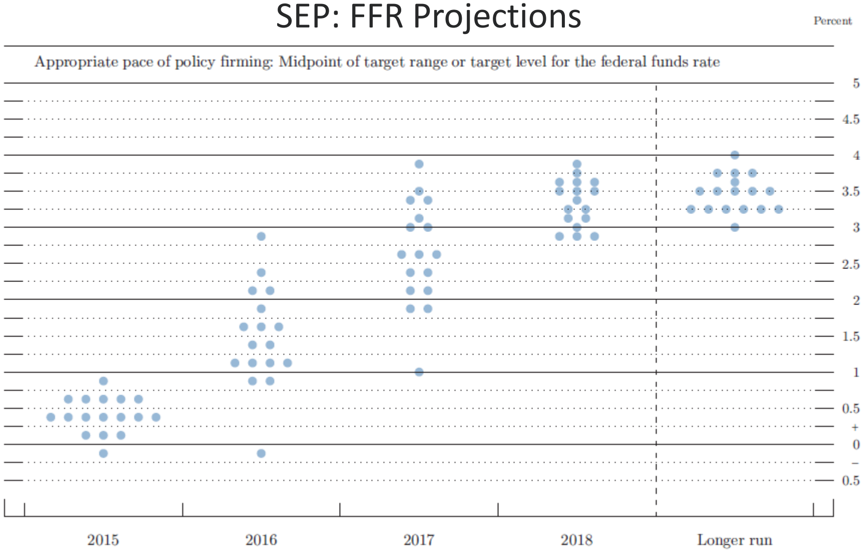
Another issue on the international front that has had some impact on financial markets is the configuration of monetary policy stances among developed economies. Notwithstanding the September decision, the Federal Reserve appears to be approaching conditions that could warrant the lift-off of the policy rate, but the ECB and the Bank of Japan are continuing to provide accommodation via asset purchase programs. This potential policy divergence is reflected in relatively large forward interest rate differentials, particularly between the U.S. and the euro area, which in turn has likely contributed to the appreciation of the U.S. dollar since mid-2014 relative to both the euro and the yen (see Figure 4).

- What is your view on the impact of the policies in Japan and the euro area? Do you think the pace of recovery in these areas will continue to lag that of the U.S. economy?

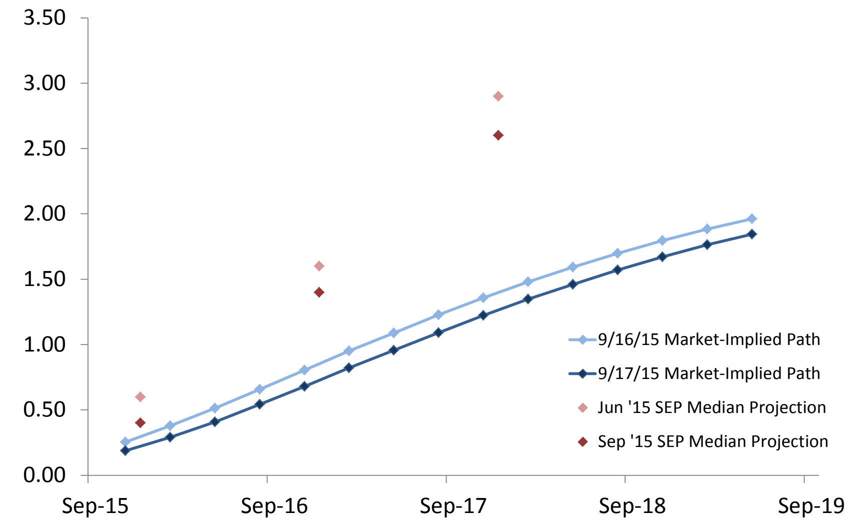
- Should the monetary policy stances continue to diverge, what is your view regarding the impact of a potential continued dollar appreciation on growth and inflation in the U.S.?

Figure 1 - Federal Funds Rate Projections: September 2015 SEP

SEP: FFR Projections



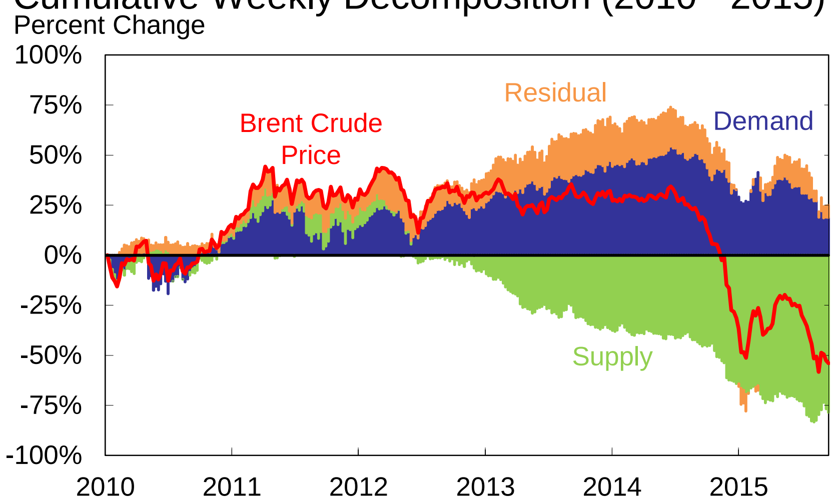
Median SEP vs. Current Market-Implied* FFR Paths



*Estimated from OIS Quotes

Figure 2 - Oil Price Decomposition

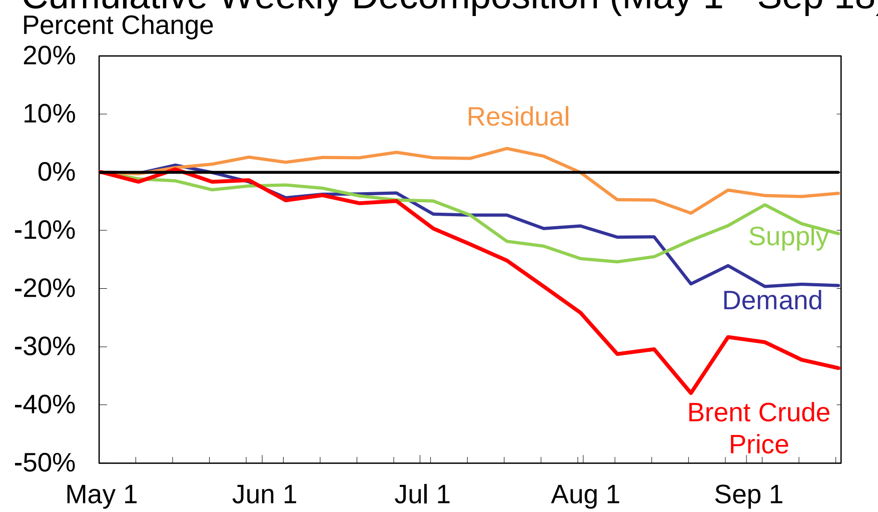
Cumulative Weekly Decomposition (2010 - 2015)



Sources: Author’s calculations; Haver Analytics; Thomson Reuters; Bloomberg.

Notes: Demand and supply shocks affecting oil prices are identified using correlations of oil price changes with a large number of financial variables. Residual reflects price movements unexplained by supply and demand factors. Decomposition uses the approach in Groen and Russo (2015).

Cumulative Weekly Decomposition (May 1 - Sep 18)

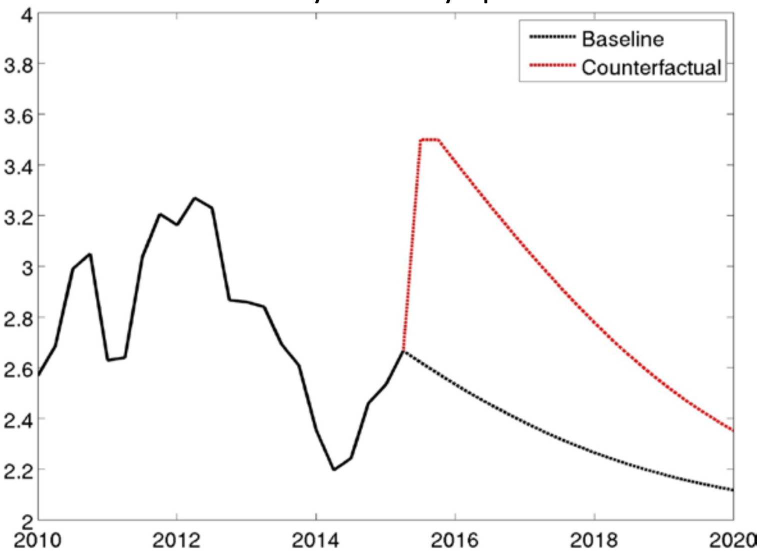


Sources: Author’s calculations; Haver Analytics; Thomson Reuters; Bloomberg.

Notes: Residual reflects price movements unexplained by supply and demand factors. Supply, Demand, and Residual sum to Brent Crude Price.

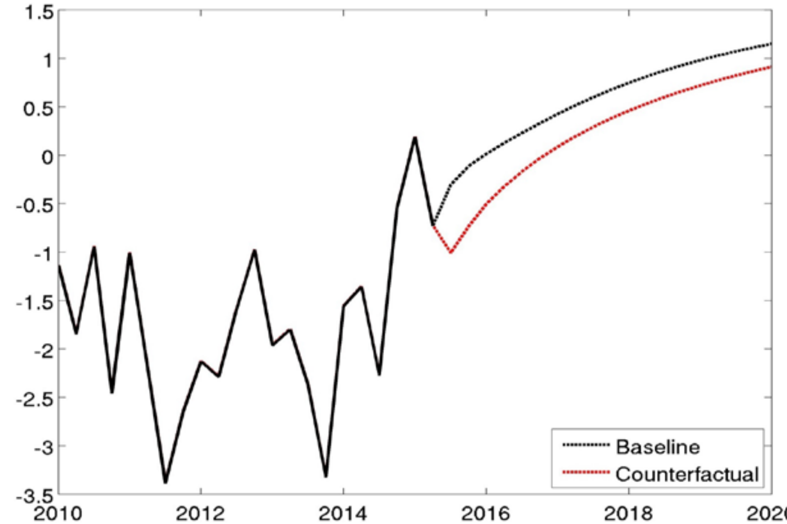
Figure 3 - FRBNY DSGE Scenario Analysis: Baseline vs Tighter Financial Conditions

Baa -10 y Treasury Spread



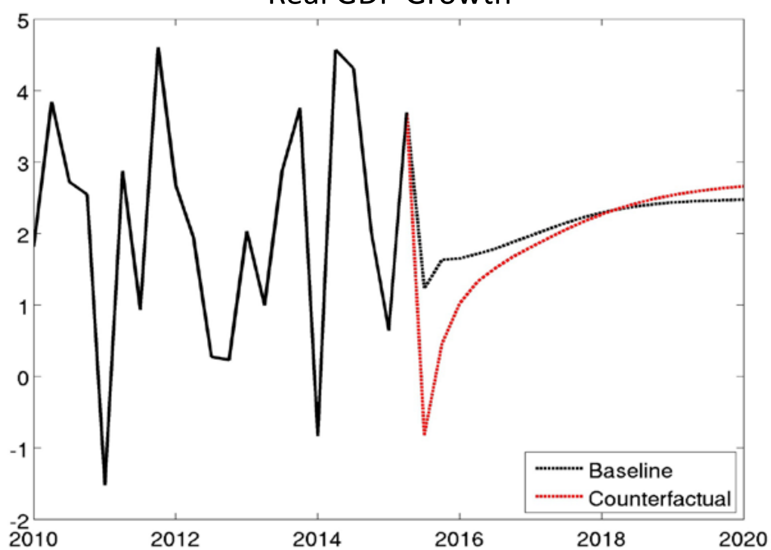
- Counterfactual scenario of tighter financial conditions defined by increase in spread to 3.5% for two upcoming forecast quarters

Estimated Real Natural Rate of Interest



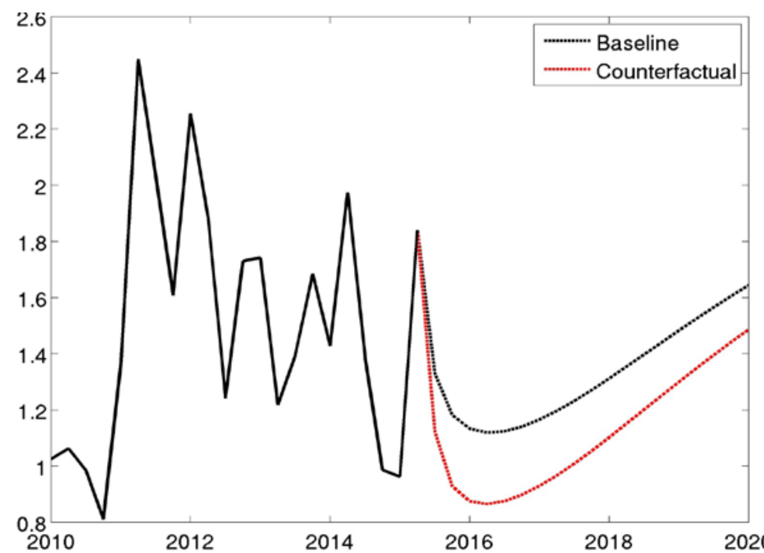
- In the counterfactual scenario the real natural rate drops in 2015 and remains negative through 2017, a full year longer than in the baseline projections

Real GDP Growth



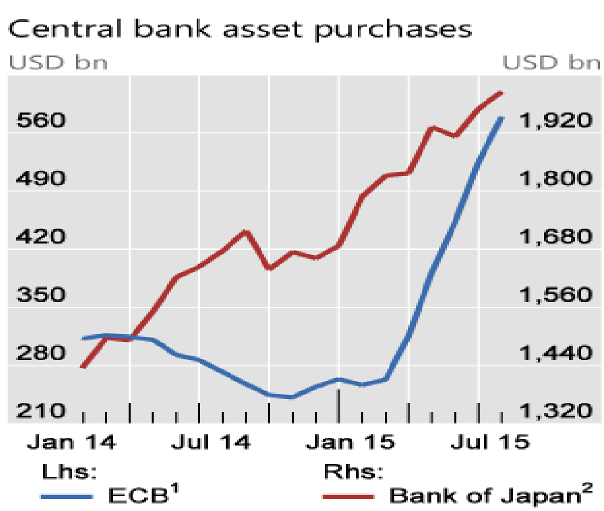
- Real GDP growth projections remain below baseline until 2018

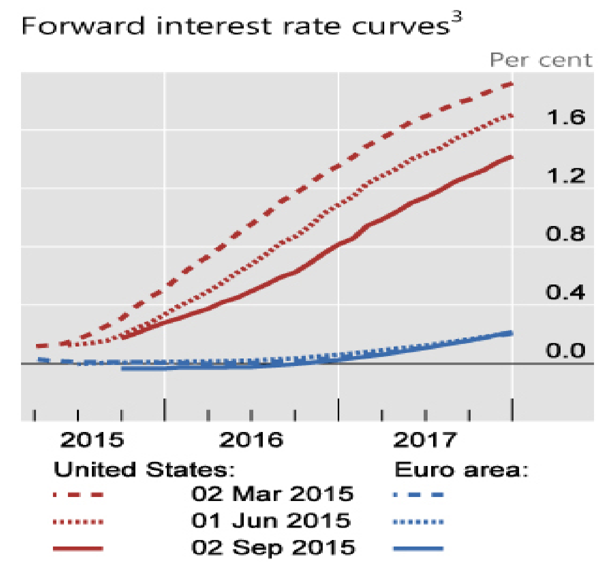
Core PCE Inflation



- The forecasted path of inflation in the counterfactual is more shallow.

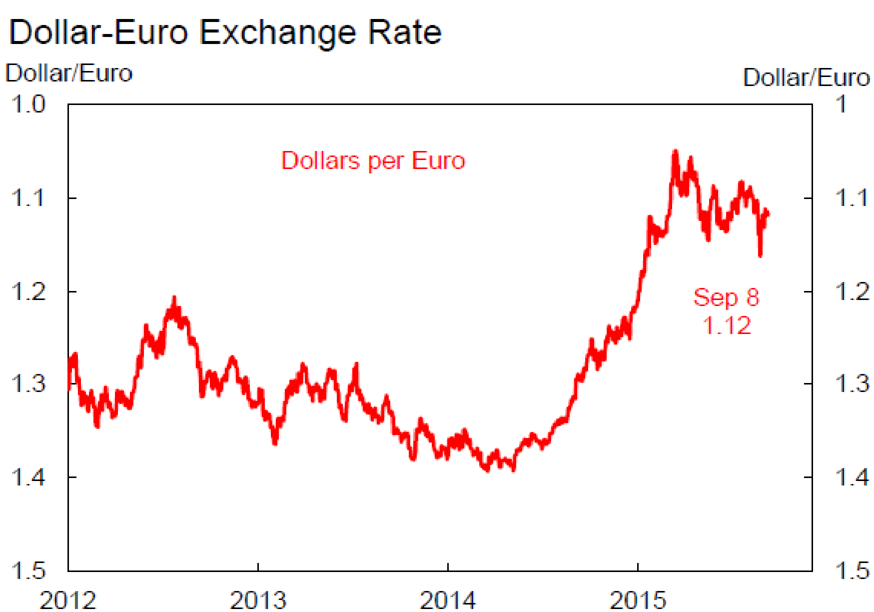
Figure 4 - Diverging Policy Stances





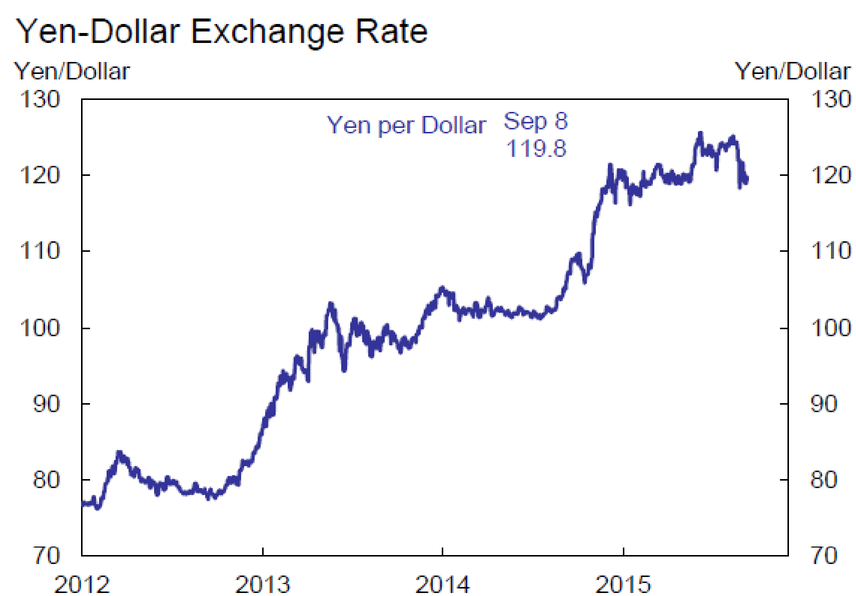
[1] Holdings under the Securities Market Programme, the Asset-Backed Securities Purchase Programme, Covered Bond Purchase Programmes 1, 2 and 3 and the Public Sector Purchase Programme. [2] Outright purchases of Japanese government bonds.
Source: BIS Quarterly Review, September 2015

[3] For the United States, 30-day federal funds rate futures; for the euro area, three-month Euribor futures.
Source: BIS Quarterly Review, September 2015



Source: Bloomberg

Note: Exchange rate scale is inverted.



Source: Bloomberg