Minutes of the Economic Advisory Panel Meeting[1]

October 21, 2016

Present: William Dudley, Michael Strine. External Panelists: Alan Blinder, Julia Coronado, Michael Feroli, Marvin Goodfriend, Austan Goolsbee, Gita Gopinath, Jan Hatzius, Peter Hooper, Glenn Hubbard, Rick Mishkin, Carmen Reinhart, Kenneth Rogoff. FRBNY staff: Sarah Bell, John Clark, Linda Goldberg, Beverly Hirtle, Tom Klitgaard, Sandra Lee, Jonathan McCarthy, Meg McConnell, Richard Peach, Paolo Pesenti, Simon Potter, Rob Rich, Aysegul Sahin, Argia Sbordone, Michael Schetzel, Kevin Stiroh, Andrea Tambalotti, Joe Tracy. Other FRBNY staff, including counsel, observed the meeting.

Discussion on the Causes and Consequences of Low Interest Rates

The meeting started with presentations by Kenneth Rogoff on the global factors behind low interest rates and by Alan Blinder on the implications of low interest rates for monetary policy.

Prof. Rogoff discussed the many theories that have been advanced in the economic literature to account for the currently low level of interest rates. He observed that whereas many secular factors had been driving real interest rates down before the financial crisis, the largest drops occurred as the crisis unfolded. From this evidence he concluded that giving the crisis second billing to longer-term secular factors in the decline of interest rates is hard to justify. In terms of policy implications, he suggested that the “simplest and most elegant” approach to address the constraints posed by low interest rates on monetary policy would be to pave the way for effective negative interest rate policy.

Prof. Blinder’s presentation focused on the consequences of low interest rates for monetary policy. His starting point was that the FOMC will no longer be able to cut the federal funds rate by 250-600 basis points to fight recession, as it has done historically. Therefore, he claimed that the FOMC will have to get more creative. One option he suggested would be to target a different interest rate than the federal funds rate, such as the interest rate on longer-term Treasuries, which he viewed as substituting prices for quantities as the objective of quantitative easing. He also discussed the extent to which low interest rates might foment asset price bubbles, the possibility that low interest rates might make the distributional effects of monetary policy more salient, and the extent to which policy rates near zero might diminish the effect of further rate cuts on the economy, beyond the problems posed by the effective lower bound.

Following the presentations on the agenda, the open discussion on the topic of low interest rates started with an intervention by Carmen Reinhart, based on a chart that she distributed to the participants. According to these data, the fraction of general government debt held by the official sector in 21 advanced economies has increased significantly between 2004 and 2015. Reinhart observed that

[1] The views presented in these minutes are solely those expressed by the panelists, not by FRBNY officials or staff.

this increased demand by the official sector is a factor contributing to the downward pressure on the interest rates on government bonds around the world.

After this intervention, the panelists went on to discuss further reasons why real interest rates might be low, such as low productivity growth, an increase in the demand for safe, bond-like assets, and the change in the risk characteristics of bonds in an environment in which deflation might be more likely than inflation. They also discussed the extent to which low interest rates on government bonds are representative of other rates of return, or rather the wedge between the return on safe assets and the return on capital has increased. They considered the implications of the low rate environment, and of the attendant risks of policy divergence between the US and the rest of the world, for the exchange rate of the dollar.

Outlook Discussion

The panelists' conversation then moved on to the outlook for the US economy and its implications for monetary policy. The consensus view among the panelists was that the economy is operating close to its potential and that inflation should continue to firm gradually. However, several panelists highlighted the fragility of this equilibrium and the extent to which it might be threatened by global developments. One camp expounded the view that as long as inflation expectations remain at the low historical levels seen recently, it would be desirable to run a "high pressure" economy and let unemployment fall further from its current levels. Following this path could help repair some of the supply-side damage caused by the Great Recession—a proposition that was questioned by some other panelists—and it could contribute to a reversal of the negative drift in inflation expectations observed over the past several years. Moreover, given the uncertainty surrounding any estimate of NAIRU, observing the response to a further fall in unemployment would be a way of learning more about the current level of NAIRU. Some panelists cautioned about the risks of this strategy, highlighting the difficulty inherent in guiding the economy to a soft landing with stable inflation and unemployment, since even modest increases in unemployment have historically been associated with recessions. However, several panelists stressed that the risks of undershooting the level of unemployment consistent with stable inflation are likely lower now than in the past, given the currently low level of inflation and of inflation expectations.