Upcoming Challenges to Monetary Policy

Background

Since this Panel last met in October, the U.S. economy has continued to expand at a healthy pace with overall labor market conditions strengthening. Inflation also showed some firming even though the 12-month change in the PCE price index remains below the Federal Reserve’s longer-run objective.

As documented in the most recent NY Fed Research Staff’s “U.S. Economy in a Snapshot,” growth was solid in the second half of 2017 (The third estimate of 2018Q4 GDP growth will be released on March 28th). The recent data suggest a solid outlook for the first half of this year: The most recent NY Fed Staff Nowcast projects real GDP growth of 2.9 percent for Q1 and 3.0 percent for Q2 (see Figure 1). As of March 10, the Blue Chip Economic Indicators, the consensus of private forecasts, has economic growth in the first half of this year averaging about 2.8 percent. The medians of the GDP growth projections of FOMC participants in the March Summary of Economic Projections (SEP) for 2018 and 2019 were 2.7 and 2.4 percent, respectively, above those in the December SEP and well above the median projection for longer-run growth of 1.8 percent (see Figure 2).

Measures of consumers’ and businesses’ confidence have remained high (see Figure 3). Financial conditions have tightened somewhat this year, but still remain broadly accommodative. Equity market indexes continued to trend upward through the beginning of this year, but have been more volatile in the last two months. Longer-term Treasury yields have increased, credit spreads have widened modestly, and the trade-weighted dollar has appreciated somewhat (see Figure 4).

Fiscal policy has become more stimulative, with the passage of the Tax Cuts and Jobs Act in 2017 and the Bipartisan Budget Act earlier this year, likely contributing to the near term upgrade of the growth outlook.

Meanwhile the gradual process of policy normalization has continued. The FOMC raised the target range for the federal funds rate at the December and March meetings and it now stands at 1½ to 1¾ percent. The implementation of the plan for reducing the Federal Reserve’s security holdings, which
began in October,\(^1\) continues and the reaction of financial markets appears to have been subdued so far. Figure 5a displays a July 2017 projected evolution of the size of the Fed’s securities portfolio; the different projected paths use alternative scenarios for the composition of key liabilities based on responses in the June 2017 Surveys of Primary Dealers and Market Participants (figure 5b).

At this meeting we would like you to share your views on two broad issues facing policymakers in the current environment.

**Discussion Issues**

- **A large fiscal stimulus is being implemented at a time when the economy appears close, if not beyond, full employment, and monetary policy is on a course of gradual tightening. What do you see as the key risks to the outlook in this environment?**

- **Thinking past the “normalization” phase, what lies ahead for monetary policy? In your opinion, what features are most important for the long-run monetary policy framework, both in terms of strategy as well as implementation?**

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\(^1\) The plan is described in the June 2017 Addendum to the Policy Normalization Principles and Plans. Details of the implementation decisions for the balance sheet are in the Implementation Note issued at the same time of the FOMC Statement following each FOMC meeting. See the March 21, 2018 Implementation Note for the latest version.
Figure 1 - New York Fed Staff Nowcast*

2018:Q1 GDP Growth

- Housing and construction
- Manufacturing
- Surveys
- Retail and consumption
- Income
- Labor
- International trade
- Others

Percent (annual rate)

2018:Q1 GDP Growth

Nowcast: 2.9
Latest: March 23

2018:Q2 GDP Growth

Nowcast: 3.0
Latest: March 23

*updated every Friday at 11:15 a.m. [here](#)
Figure 2 – March 2018 Summary of Economic Projections (SEP)

<table>
<thead>
<tr>
<th>Variable</th>
<th>Median</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>2018</td>
</tr>
<tr>
<td>Change in real GDP, March</td>
<td>2.7</td>
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<tr>
<td>December projection</td>
<td>2.5</td>
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<tr>
<td>September projection</td>
<td>2.1</td>
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<tr>
<td>Unemployment rate, March</td>
<td>3.8</td>
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<tr>
<td>December projection</td>
<td>3.9</td>
</tr>
<tr>
<td>September projection</td>
<td>4.1</td>
</tr>
<tr>
<td>PCE inflation, March</td>
<td>1.9</td>
</tr>
<tr>
<td>December projection</td>
<td>1.9</td>
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<tr>
<td>September projection</td>
<td>1.9</td>
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<tr>
<td>Core PCE inflation, March</td>
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</tbody>
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Source: Summary of Economic Projections, March 2018
Figure 3 – Consumer and Business Confidence Measures

(a) Consumer Confidence Measures

- Conference Board Consumer Confidence
- University of Michigan Consumer Sentiment

(b) Business Confidence Measures

- ISM Manufacturing PMI Composite Index (Left Axis)
- NFIB Small Business Optimism Index (Right Axis)

Source: University of Michigan, Conference Board

Figure 4 – Indicators of Financial Conditions

(a) Chicago Fed National Financial Conditions Indexes

- Federal Funds Target Rate
- NFCI [National Financial Conditions Index]
- ANFCI [Adjusted NFCI]

Source: Federal Reserve Bank of Chicago

*midpoint of target range
Figure 4 (cont.)

(b) US Equity Market Index and Volatility

(c) Long-Term Treasury Yields

(d) Corporate Spreads

(e) Exchange Rate

† data are monthly averages as of Mar 23, 2018
Figure 5

(a) Projected Paths for Fed’s Securities Portfolio

![Projected SOMA Domestic Securities Holdings](image)

Figures are as of year-end and reported on a System basis. Shaded area represents historical settled holdings. Scenarios are based on the 25th, 50th, and 75th percentile responses to a question about the size and composition of the Fed’s long-run balance sheet in the FRBNY’s June 2017 Surveys of Primary Dealers and Market Participants.

Source: FRBNY (Projections for the SOMA Portfolio and Net Income, July 2017 data file)

(b) Expectations for Key Liabilities

![Expectations for Liabilities and Capital (on average in 2025) and Current Levels](image)

Sources: Survey of Primary Dealers and Survey of Market Participants, June 2017; Board of Governors of the Federal Reserve System