MONETARY POLICY PANEL

Luncheon Meeting, April 5, 2013

AGENDA

Monetary Policy in a Low Interest Rate Environment:

Balancing Economic Objectives with Financial Stability and Fiscal Risks

With the September 2012 decision to start a new, outcome-based, asset purchase program as well as the adoption in December of an economic threshold-based forward guidance on the federal funds rate target, the FOMC has now a more explicit state-contingent policy stance in place.

> *"[T]he Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the asset purchase program ends and the economic recovery strengthens. In particular, the Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored."*[1]

From the recent statements as well as other FOMC communications, the public should better understand that the future adjustment of policy will depend importantly upon the evolution of the economic outlook. The FOMC also gave additional guidance on how it will employ its balance-sheet tools:

> *"In determining the size, pace, and composition of its asset purchases, the Committee will continue to take appropriate account of the likely efficacy and costs of such purchases as well as the extent of progress toward its economic objectives."*

As for the interest rate policy tool, in addition to the numerical thresholds for unemployment and inflation, the FOMC provided the following guidance:

> *"In determining how long to maintain a highly accommodative stance of monetary policy, the Committee will also consider other information, including additional measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments."*

[1] FOMC Statement, March 20, 2013.

Background

The Economic Outlook[2]

- Since September, financial conditions have improved and a number of positive economic developments are taking place: the housing market appears to be in a gradual but more solid recovery, interest-sensitive categories of spending are picking up, and the households deleveraging process is well advanced (Figure 1 shows some recent data).
- However, the labor market is not yet 'healthy': while employment appears to be growing at a somewhat faster pace recently, unemployment remains elevated and many labor market flow measures have barely improved (see Figure 2).
- Most importantly, the recovery remains fragile, as increased fiscal drag and the euro area situation represent significant downside risks to the outlook.

Risks associated with extended accommodation

- Research at the Federal Reserve Board[3] has analyzed the evolution of the Fed's balance sheet under different assumptions about the size and composition of asset purchases, examining the implications of further balance sheet expansion for Federal Reserve remittances to the Treasury (Figure 3 reproduces some of these projections). Other research[4] has put forward some of the potential risks associated with the current stance of monetary policy, raising in particular the issue of the interaction between monetary and fiscal policy in this environment.
- Another concern that has been raised about the current policy stance is its implications for financial stability. In a recent speech, Governor Stein[5] discussed the implications of a "reaching-for-yield" behavior encouraged by long periods of very low interest rates, and their potential destabilizing effects on financial markets. These concerns are related to the recent literature on the 'risk-taking channel' of monetary policy, which emphasizes the risk that an overly accommodative policy may encourage excessive risk taking by financial intermediaries, and increase the vulnerability of the financial system to adverse shocks. Governor Stein discussed the need to monitor the build-up of excessive maturity

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[2] See the recent discussion of the outlook by William Dudley, "The Economic Outlook and Monetary Policy," remarks at the Economic Club of New York, New York City, March 25, 2013.

[3] Carpenter, Seth B., Jane R. Irhig, Elizabeth Klee, Daniel W. Quinn and Alexander Boote, "The Federal Reserve's Balance Sheet and Earnings: A primer and projections", FEDS 2013-01;

[4] Greenlaw, David, James D. Hamilton, Peter Hooper and Frederic S. Mishkin: "Crunch Time: Fiscal Crises and the Role of Monetary Policy", manuscript, 2013; Hall, Robert and Ricardo Reis, "Maintaining Central Bank Solvency Under New-Style Central Banking, manuscript, 2013.

[5] Jeremy Stein, "Overheating in Credit Markets: Origins, Measurement, and Policy Responses", speech at the 'Restoring Household Financial Stability after the Great Recession: Why Household Balance Sheets Matter,' research symposium sponsored by the Federal Reserve Bank of St. Louis, St. Louis, Missouri, February 7, 2013.

transformation and presented some evidence on emerging imbalances (see figure 4 for excerpts from the exhibits accompanying his speech[6]). He suggested that because of limitations of supervisory and regulatory tools, policymakers should maintain an open mind about the use of monetary policy tools to address some forms of credit markets overheating.

Questions for Discussion

How to shape the future course of monetary policy?

Future monetary policy thus may have to take into account both the effects of accommodation on achieving conventional economic objectives of price stability and full employment, and the potential risks of accommodation for fiscal outcomes and financial stability.

In the scenario in which the recovery weakens and further accommodation might be appropriate:

- How should the risks associated with a further expansion of the Fed's balance sheet be mitigated?
- What alternative policy tools would be appropriate to employ? Should the FOMC consider alternative interest rate policy strategies?
- How should the risks associated with maintaining very low interest rates for even longer time be addressed?
- To what extent should the economic stabilization objectives be traded-off with a financial stability objective?

Conversely, if the economy improves and a downward adjustment of the pace of purchases might be appropriate:

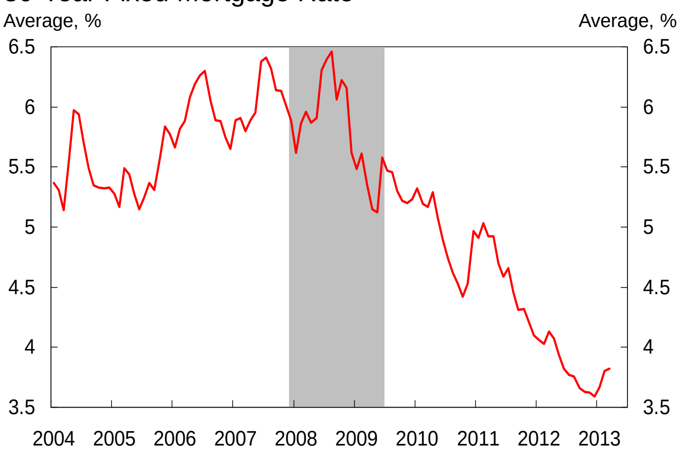
- How should the Fed's balance sheet be managed to prevent sharp adjustments in financial conditions?
- How should the policy stance be renormalized eventually?

Finally, how can FOMC communication be improved to help the public to better understand the Committee's intentions regarding the future path of monetary policy?

[6] The top half of the figure (inflow into mutual funds and ETFs that hold high-yield bonds) shows an example of increase in maturity transformation. The bottom half suggests a potential rapid development in the so-called collateral transformation: according to Governor Stein, while a small fraction of the dealer firms surveyed by the Federal Reserve report that they were engaged in collateral transformation, "a much larger share reported that they had been involved in discussions of prospective transactions with their clients."

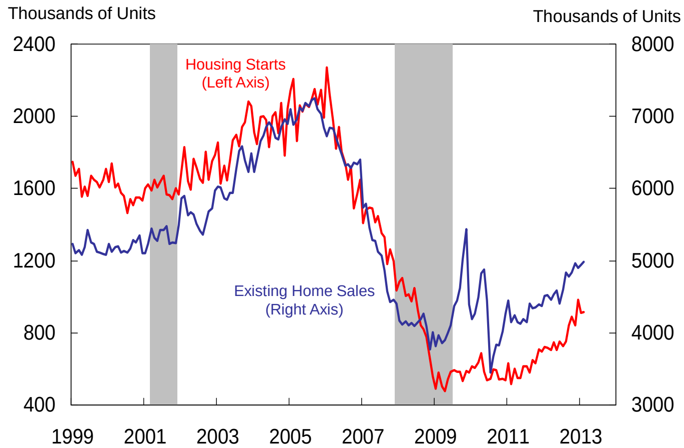
Figure 1: Recent Economic Indicators

30-Year Fixed Mortgage Rate



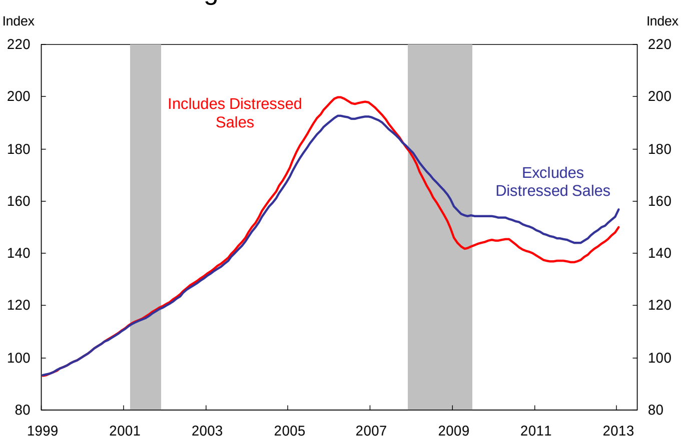
Source: Wall Street Journal

Housing Starts and Existing Home Sales



Source: US Bureau of the Census, National Association of Realtors

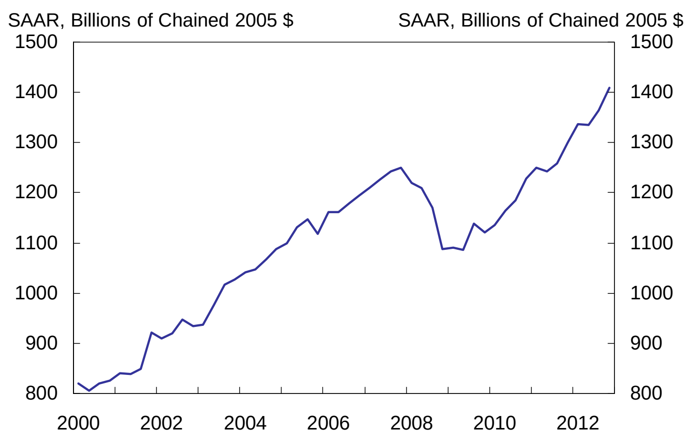
CoreLogic National Home Price Index



Source: CoreLogic/Haver Analytics

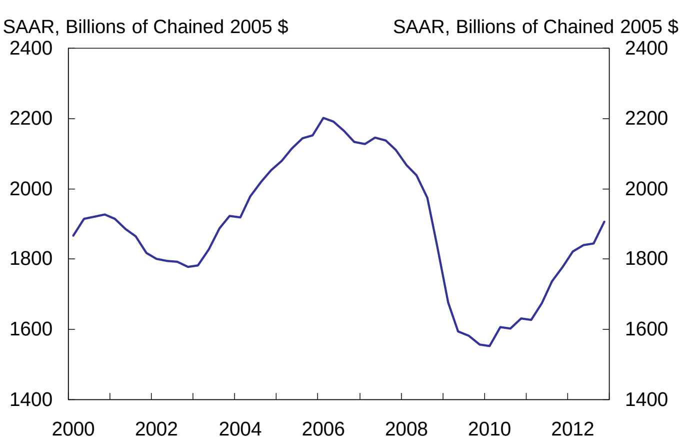
Note: Shading represents NBER recessions.

Real Personal Consumption Expenditures: Durable Goods



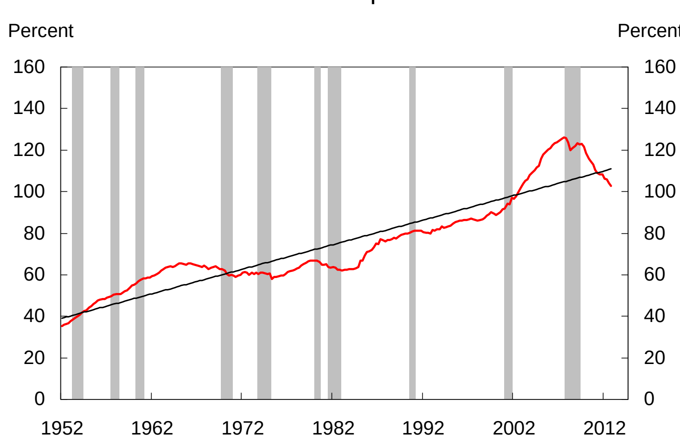
Source: Bureau of Economic Analysis

Real Private Fixed Investment



Source: Bureau of Economic Analysis

Household Liabilities over Disposable Personal Income



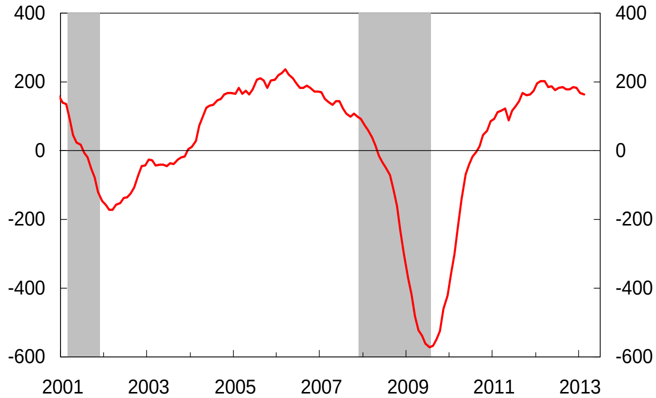
Note: Shading represents NBER recessions.

Source: Federal Reserve Board, Bureau of Economic Analysis

Figure 2: Recent Labor Market Indicators

Payroll Employment

12-month moving average of monthly change

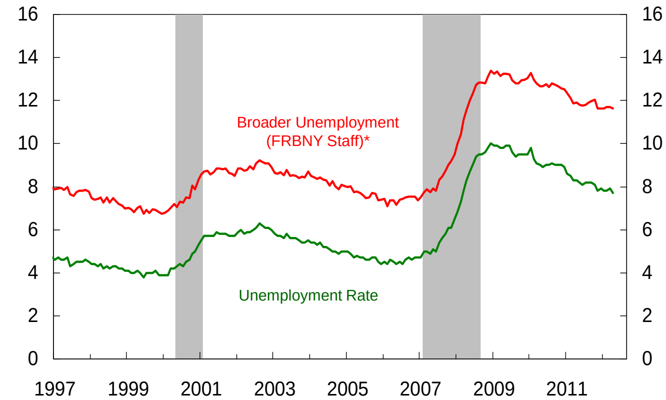


Source: Bureau of Labor Statistics/Haver Analytics

Unemployment

Percent

Percent



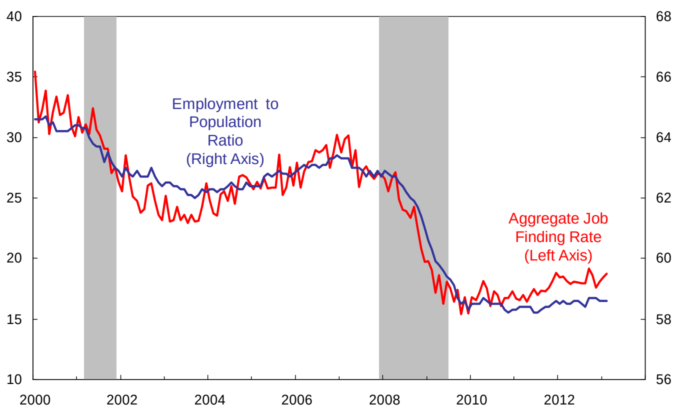
* Adds those who want a job but not currently searching.

Source: Bureau of Labor Statistics/Haver Analytics/FRBNY Staff

Measures of the Employment Situation

Percent

Percent



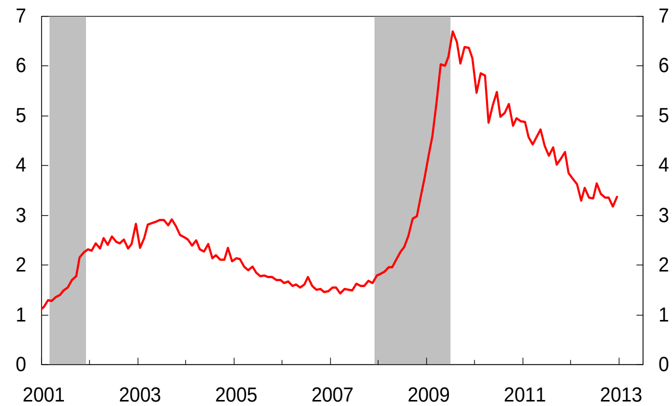
Source: Bureau of Labor Statistics

Note: Shading represents NBER recessions.

Measure of Job Availability

Unemployed-to-Vacancy Ratio

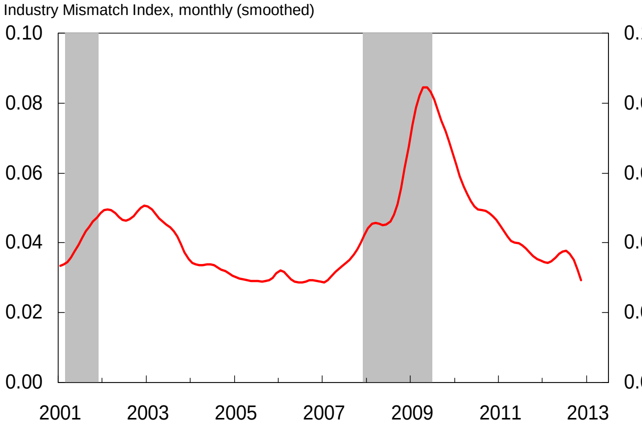
Unemployed-to-Vacancy Ratio



Source: Bureau of Labor Statistics/Haver Analytics

Labor Market Mismatch

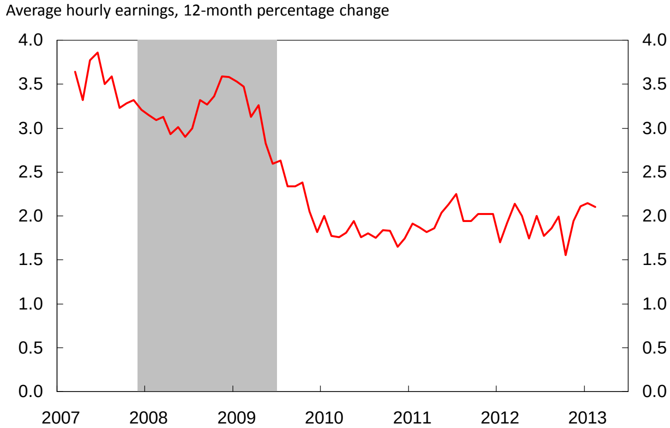
Industry Mismatch Index, monthly (smoothed)



Source: Sahin et al (2012), CPS, JOLTS

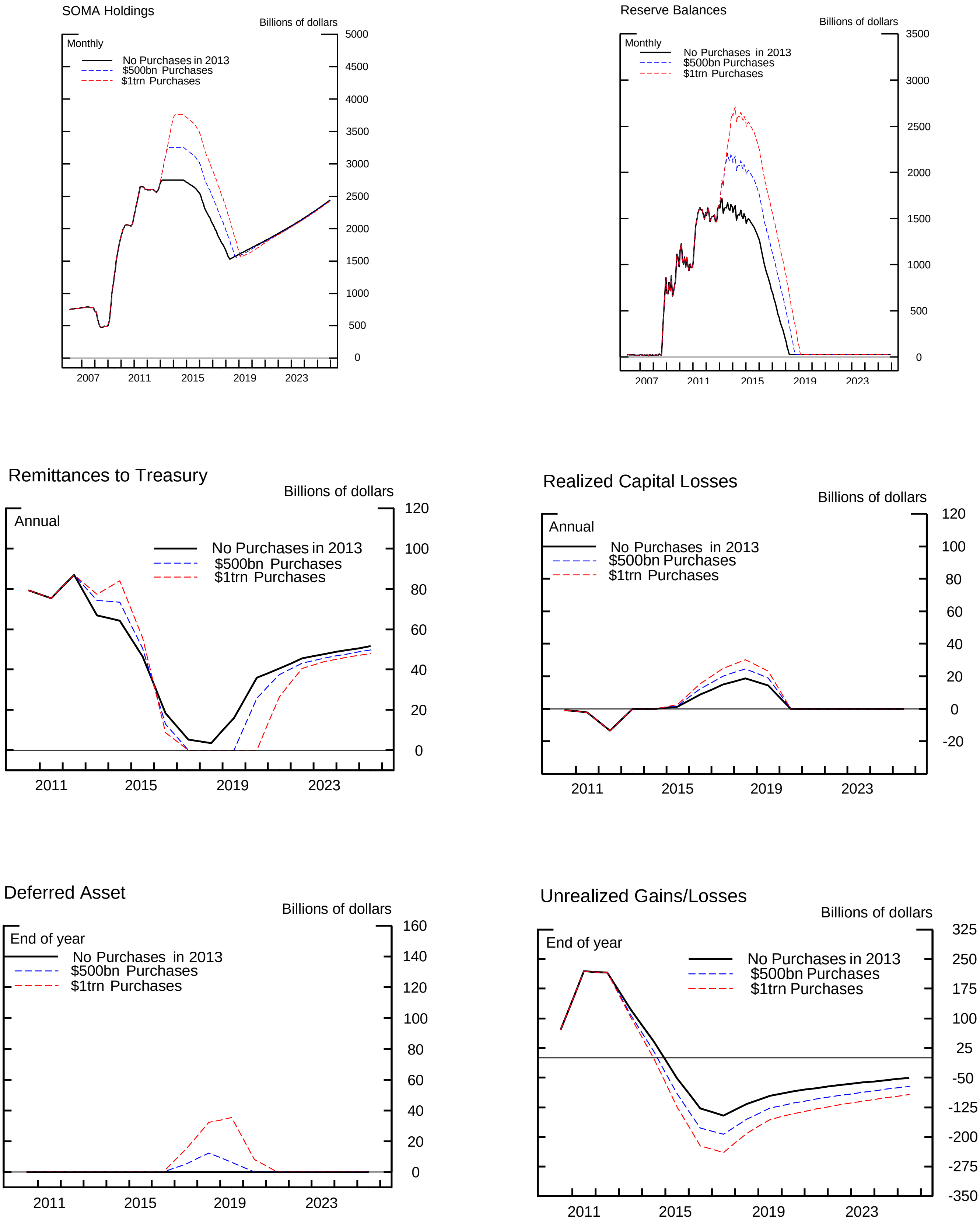
Labor Compensation

Average hourly earnings, 12-month percentage change



Source: Bureau of Labor Statistics/Haver Analytics

Figure 3*

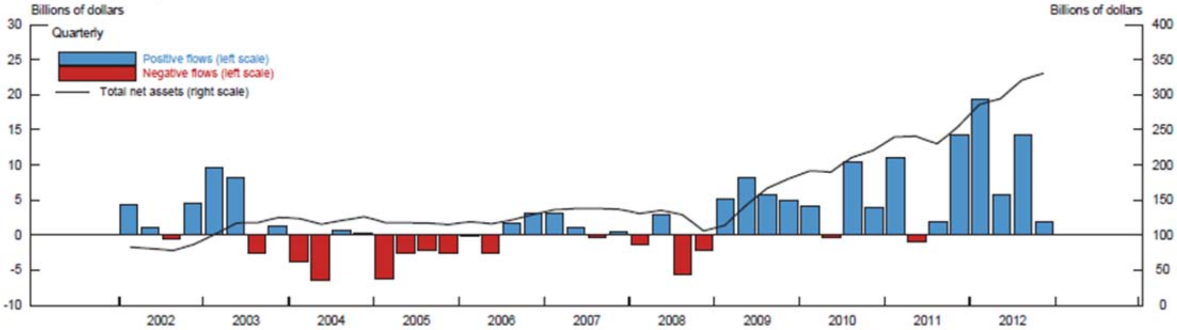


Source: Authors' Projections

*These exhibits are from Carpenter et al. (2013).

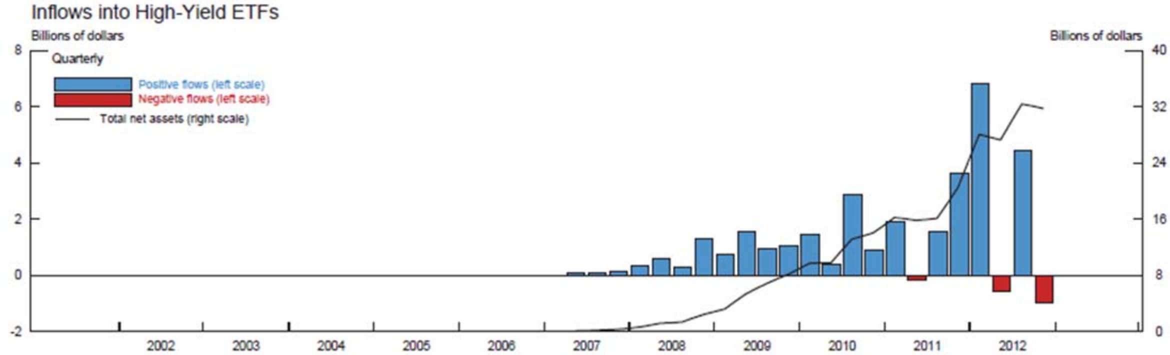
Figure 4*

Inflows into High-Yield Mutual Funds



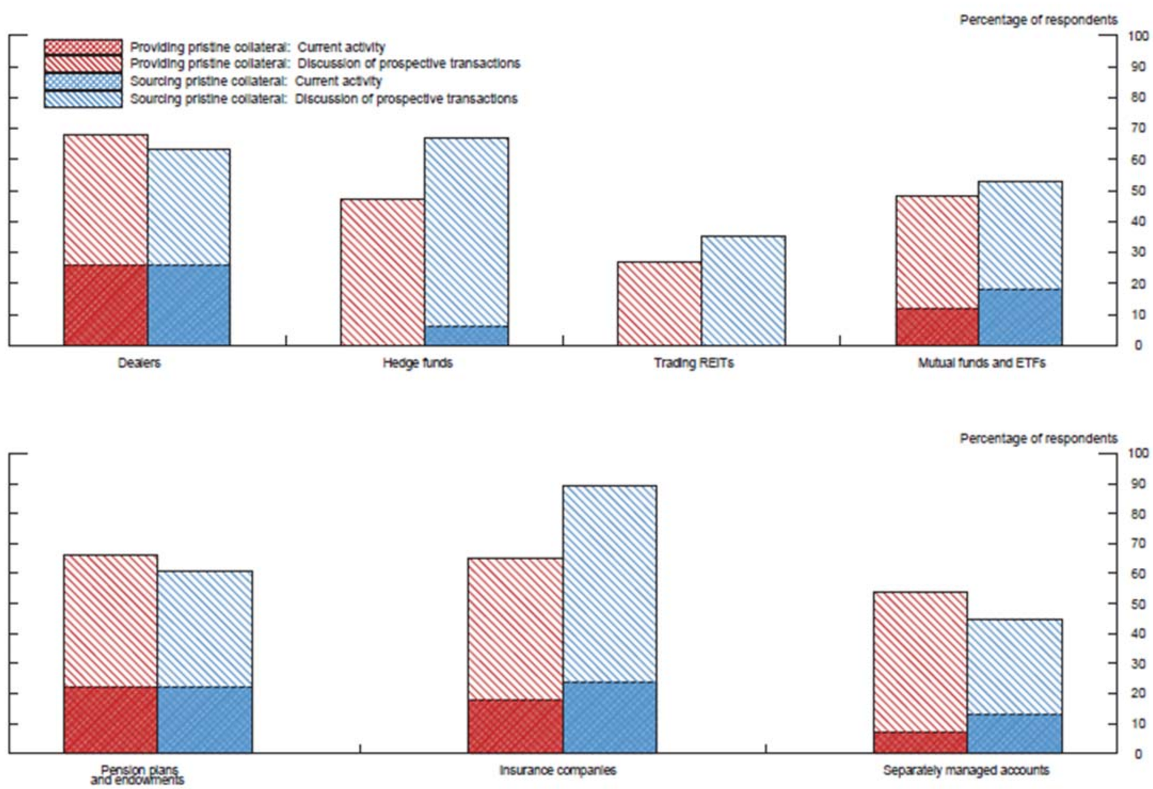
Source: Morningstar.

Inflows into High-Yield ETFs



Source: Morningstar.

Collateral Transformation Transactions



Source: Dec. 2012 Senior Credit Officer Opinion Survey on Dealer Financing Terms.

*These exhibits are from Stein (2013).