Minutes of the Economic Advisory Panel Meeting

May 15, 2015

Present: William Dudley, Chris Cumming. External Panelists: Alan Blinder, Julia Coronado, Michael Feroli, Jeffrey Frankel, Mark Gertler, Marvin Goodfriend, Austan Goolsbee, Jan Hatzius, Peter Hooper, Anil Kashyap, N. Gregory Mankiw, Frederic Mishkin, Kenneth Rogoff, Carmen Reinhart. FRBNY staff: Tobias Adrian, Beverly Hirtle, Thomas Klitgaard, Sandra Lee, Jamie McAndrews, Jonathan McCarthy, Alberto Musalem, Richard Peach, Paolo Pesenti, Simon Potter, Aysegul Sahin, Argia Sbordone, Michael Strine, Andrea Tambalotti. Other FRBNY staff, including counsel, observed the meeting.

The meeting began with a discussion of the outlook for the US economy, including feedback on the Federal Reserve Bank of New York (FRBNY) staff forecast. The meeting then moved to a discussion of developments in both emerging and advanced economies.

Discussion of the economic outlook

The discussion started with a presentation on the FRBNY staff forecast. Recognizing that the U.S. economy probably shrank slightly in the first quarter of 2015, the staff saw this weakness as due partly to transitory factors, principally the severe winter weather in parts of the country and the labor disputes at the West Coast ports. Looking ahead, the staff forecast anticipated that growth would rebound to around 2½ percent (annual rate) over the remainder of 2015 and 2016. As support for this rebound, the staff pointed to a number of positive economic fundamentals, including solid household wealth and real income growth, slightly stimulative fiscal policy, and still-accommodative monetary policy.

Nonetheless, the real GDP growth rate in this forecast was below what the staff anticipated at this time last year. Households and businesses had shown more restraint in their spending than expected, leading to lower projections for future spending growth from those sectors. In addition, lower oil prices had reduced investment in domestic oil exploration, which was projected to have a negative effect on business investment over the short run. Finally, the appreciation of the dollar over the past year and subdued global growth were expected to lead to a negative growth contribution from net exports.

This forecast projected the economy to grow somewhat above its potential rate, which the staff estimates to be around 2 percent. But with later-stage expansion dynamics taking hold, the forecast anticipated that the unemployment rate would decline gradually to about 5 percent—around the staff assumption for the natural rate of unemployment—by the end of 2016. The staff view was also that the labor force participation rate and average weekly hours worked would remain near current levels with productivity growth increasing back up toward its longer-term trend.

Inflation remained low over the past year, in part due to the decline in energy prices. The staff forecast anticipated that, once the short-run effects of energy prices and past dollar appreciation subside, and as the amount of slack in the U.S. economy dissipates and puts less downward pressure on inflation, the gravitational pull of well-anchored longer-term inflation expectations would slowly pull the inflation rate toward the Federal Open Market Committee's (FOMC) longer-run goal for inflation of 2 percent by 2017.

Julia Coronado next provided her views on the staff forecast, focusing on some of the downside risks for the U.S. economy. She pointed out that it was likely, because of the temporary nature of fiscal adjustments in recent years, that current fiscal multipliers may be quite low, and thus any fiscal expansion would not lead to a sustained increase in aggregate demand. She also noted that consumer spending had not responded significantly to lower gasoline prices, which might indicate continued household caution resulting from the debt overhang following the financial crisis. Ms. Coronado also noted that the Chinese economy may accumulate fewer foreign exchange reserves as a result of slowing exports, which may affect U.S. financial conditions, and she expressed concerns whether the combined effects of Japanese and European Quantitative Easing policies would be sufficient to maintain favorable financial conditions. Regarding inflation, she noted that in some U.S. states, wage growth was not accelerating notwithstanding low state-level unemployment rates, which suggested wage growth and, thereafter, inflation, may not pick up in line with the FOMC's expectations as the national unemployment rate falls.

Jan Hatzius then discussed the staff forecast, focusing especially on the upside risks for the U.S. economy. He first reviewed analysis suggesting that first quarter GDP figures might be distorted downward by residual seasonality, with the implication that the low growth in the first quarter of 2015 should be discounted. In addition, his analysis suggested that the especially low temperatures and heavy snowfall experienced in the first quarter of 2015 accounted for about 1.5 percentage points of the growth shortfall (at an annual pace), which he expected to reverse in the next couple of quarters. Turning to consumption, Mr. Hatzius noted that consumer sentiment was relatively strong. Regarding overall growth he pointed out that higher-frequency economic indicators generally suggested a stronger pace of economic growth than measured GDP growth. Mr. Hatzius also noted that the significant reduction in capital spending observed in Q1, much of it related to the earlier fall in oil prices, is already abating. Finally, he noted that manufacturing may be stabilizing after a period of softness following the rise in the exchange value of the U.S. dollar, whose effects on trade appear to have been front-loaded with respect to historical experience, and hence likely to be less of a factor going forward.

In the general discussion of the economic outlook, some members of the panel indicated that growth in the 2 to 2.5 percent range would be a favorable outcome for the U.S., as its working age population is growing at about a 0.5 percent annual rate, much more slowly than in recent decades. Further, one participant noted that PCE healthcare inflation is running at a rate of about 0.7 percent, defying a long-standing trend of higher rates of price increases in this sector, which suggested that overall inflation might remain subdued. Another participant also questioned the forecast of inflation returning to 2 percent over the forecast horizon, pointing to continued very low long-term nominal bond yields. Another noted that the U.S. trade balance had worsened in the first quarter, and that trade typically has not been highly sensitive to the exchange value of the U.S. dollar, but it has been more sensitive to the strength of emerging markets; consequently, that participant expressed concern over emerging market growth, and the implications for the U.S. economy.

Discussion of international developments

Carmen M. Reinhart presented a wide-ranging discussion of international developments. She noted that only the U.S. and Germany have recovered their pre-crisis levels of per-capita GDP from among 12 countries that experienced a systemic financial crisis in 2008-2010 (France, Germany, Greece, Iceland, Ireland, Italy, Netherlands, Portugal, Spain, Ukraine, the U.K, and the U.S.). According to her analysis, a number of factors may have impeded faster recovery, including the synchronous nature of the crisis, the absence of greater exchange rate movements, fiscal austerity, the lack of credit growth, and the limited amount of deleveraging so far. She observed that the incidence of deflation in the aftermath of this crisis was above the post-World War II experience and may also have been another impeding factor, since deflation limits how low the real interest rate can fall. Ms. Reinhart also noted that negative real interest rates have been fairly common, worldwide, since 1870.

Ms. Reinhart, drawing on the history of many debt reductions around the world, pointed out that the high levels of debt accumulated in various countries were likely to be reduced through a few ways. These ways included high economic growth, fiscal austerity, default or restructuring of debt, surprise inflation, or a combination of financial repression and inflation.

She then turned to the risks in the global economy and pointed to recent research she had published together with Kenneth Rogoff, which suggested that emerging markets were experiencing greater risks of crises than advanced economies. In particular, many emerging markets are running current account deficits, in part fueled by a credit boom many of the countries have experienced. In addition, many of their currencies may be overvalued in the current environment of slowing global growth, even as inflation is increasing in some of them. Finally, the recent slump in commodity prices may be long-lasting and may negatively affect exports for many emerging countries, and the potential policy divergence among advanced economies may cause financial vulnerabilities to emerge.

General discussion

After completing the formal agenda, panel members discussed related topics. On the domestic economy, a discussion ensued regarding the strength of spending in technology. One panelist noted that nominal spending on technology is much weaker now than in 2000. Another pointed out that many businesses are replacing computers with other, generally less expensive, connected devices, such as smartphones. One panelist noted that capital spending was growing at about 2 percent, which, if the economy grows at 2 percent as well, would leave the capital to output ratio constant. It was noted that the measure of capital used in that calculation included intellectual capital.

On the global economy, one panelist noted that there was significant risk of current debt negotiations in Greece resulting in an impasse, which could have significant political effects. Two panelists gave differing views on whether there was a significant risk of a “lift-off tantrum” in financial markets when the Federal Reserve begins to raise the federal funds rate target from its current range of 0 to 25 basis points. One panelist stated that the large degree of policy divergence in the world could lead to a significant reaction, while the other said that the extensive Federal Reserve communication about the potential for lift-off would mitigate that risk. One panelist expressed concern that recent Chinese policy actions were not addressing fundamental issues in that economy and that if an economic pullback occurred, the country could be faced with a significant debt overhang that would slow its growth for an extended period. Finally, a panelist noted that much of the global “savings glut” had shifted from Asia to Europe over recent years, reflecting rising current account surpluses in many European countries; moreover, this shift in location was associated with more reserve accumulation by the private, rather than by the official sector.