

Minutes of the Economic Advisory Panel

Meeting of May 11, 2012

Present: External advisors: Alan Blinder, Martin Feldstein, Jacob Frenkel, Marvin Goodfriend, Jan Hatzius, Peter Hooper, Anil Kashyap, Greg Mankiw, Catherine Mann, Frederic Mishkin, Michael Woodford. Internal Staff: Tobias Adrian, James Bergin, Terrence Checki, Christine Cumming, Vasco Cúrdia, Sarah Dahlgren, William Dudley (conference call), Linda Goldberg, Krishna Guha, Andrew Levin (Board of Governors), Tom Klitgaard, Sandy Krieger, Jamie McAndrews, Jonathan McCarthy, Margaret McConnell, Patricia Mosser, Richard Peach, Paolo Pesenti, Simon Potter, Brian Sack, Ayşegül Şahin, Argia Sbordone, Roseann Stichnoth (conference call), Kevin Stiroh, Joseph Tracy.

The meeting started with an overview of the FRBNY staff's economic outlook followed by feedback from the panel. The meeting then proceeded to a discussion focusing on the items laid out in the meeting agenda: the economic outlook, monetary policy and communication, and fiscal policy.

Feedback on the staff's economic outlook

In their feedback on the staff outlook, panel members discussed the greater uncertainty implied by the staff's forecast distribution compared to the uncertainty implied by the corresponding distribution from the Survey of Professional Forecasters. It was noted that the staff forecast distribution had notable probabilities of real GDP growth above 6% and of negative growth, although the risks were skewed to the downside. Concerning the probability of high growth, the staff said that this reflected the possibility of a substantial reduction in headwinds that would allow currently underutilized resources to be employed.

There was also discussion about the possibility of the unemployment rate declining further without robust output growth. The staff mentioned that Okun's law has not been a good predictor of the unemployment rate at similar stages in the last three expansions and also noted the impact of declining labor force participation on the unemployment rate, as did several panel members. There was discussion about whether the natural rate of unemployment has changed.

Panel members asked about the recent increase in core (excluding food and energy) consumer price inflation, which has occurred even though there appears to be considerable slack in the economy. Staff responded that it was still investigating possible factors behind this rise. There was some discussion of the role of inflation expectations in the inflation process.

Some panel members suggested that the staff's forecast of net exports was too optimistic given the weakness in Europe. There was also some discussion of inventory behavior, start-up creation, and credit constraints on small businesses.

Panel discussion of the economic outlook

Inflation

Several panel members said that they expect inflation would run near levels consistent with the price stability objective as stated in the FOMC's January statement on longer run goals and policy strategy. However, some members expressed concerns about the impact of high energy prices on inflation and the potential upward pressure from low rental vacancy rates on rents. Some panelists also said that the upside risks to inflation might be greater than commonly thought.

Real Activity

There was some agreement among panel members that there were still significant headwinds affecting the real activity outlook and thus that the recovery would continue to be gradual. In addition, the general view was that there are few significant upside risks, but substantial risks on the downside. The two main risks to real activity cited were the potential for a large fiscal policy drag and spillover associated with external factors, especially the European situation. Panel members also discussed the continued weak confidence of households and businesses, the condition of household balance sheets, and the impact of long-duration unemployment on participation and on structural unemployment.

External Risks

Panel members expressed concern regarding the situation in Europe. Many viewed the main risks as stemming from the impact on financial markets. There was some discussion of the possible impact on the exchange value of the US dollar and its implication for the US trade balance. Many members noted the problems in Spain associated with its banking sector as well as fiscal pressures. Several panelists were pessimistic about the situation in Greece. However, some said that they saw European leaders as becoming more receptive of taking more decisive actions to address the issues. Some members said their outlook for economic growth in China was below most forecasts including the staff's.

Panel discussion of monetary policy and communication

Monetary policy

There was some agreement among panel members that further quantitative easing probably was not appropriate under the current outlook. Some panelists noted that the benefits of additional purchases appeared fairly small at the moment, based in part on their reading of the evidence about the effect of the previous LSAP programs on economic activity. They also pointed out that there were notable costs associated with additional asset purchases.

Some members were concerned that the apparent improvement in economic conditions could lead to a premature reduction in monetary policy accommodation. In their view, any such action would be problematic if a lower unemployment rate was driven by lower participation, suggesting that such a fall in

the unemployment rate was not an indicator of stronger economic conditions. In contrast, some other members mentioned that the costs of maintaining the federal funds rate target at the zero lower bound for too long may be quite significant.

Communication

Panel members also discussed some of the recent communications initiatives of the FOMC, including the longer run goals and policy strategy statement released in January. Regarding this statement, some panelists stated that with significant uncertainty about the course of economic policy, it was helpful for the Federal Reserve to provide direction and thus releasing this statement was an important step. They noted that, although the inflation goal was not a surprise to market participants, its announcement still provides discipline for policy and may reduce uncertainty.

Regarding the release of FOMC participants' FFR projections, several panel members stated that the release a single FOMC interest rate projection path would have been preferable to the current practice of providing all individual forecasts. In contrast, other members mentioned that the individual approach extends the tradition of showing the diversity of opinions at the FOMC. Some panelists noted that too much information may be detrimental to open discussion. There was discussion about the relationship between projections, the voter/non-voter distinction, and the forward guidance in the FOMC statement.

The discussion then turned more directly to the views on the FOMC's forward guidance. Panel members generally believed that such guidance should be stated in terms of economic conditions (state-contingent) rather than a calendar date (time-contingent). Members stated that there should be more discussion of the conditions that would trigger an earlier or later lift-off from the zero lower bound. Panelists also discussed whether the forward guidance was motivated strictly by the outlook or by research pointing to the desirability of keeping the policy rate low for longer than indicated by economic conditions.

Panel discussion of fiscal policy

In their discussion about fiscal policy issues, panel members noted that the political environment has the potential to lead to considerably larger fiscal drag than assumed in most forecasts, and thus it poses a significant downside risk to the outlook. In addition, some members said that uncertainty about fiscal policy could reduce investment over the course of this year.