Minutes of the Economic Advisory Panel Meeting

May 23, 2013

Present: External advisors: Alan Blinder, Martin Feldstein, Jeffrey Frankel, Mark Gertler, Marvin Goodfriend, Austan Goolsbee, Jan Hatzius, Peter Hooper, Glenn Hubbard, Catherine Mann, Frederic Mishkin, Michael Woodford. Internal staff: David Altig (Atlanta Fed), Terrence Checki, William Dudley, Linda Goldberg, Krishna Guha, Beverly Hirtle, Thomas Klitgaard, Sandy Krieger, Lorie Logan, Benjamin Mandel, Jamie McAndrews, Jonathan McCarthy, Richard Peach, Paolo Pesenti, Simon Potter, Argia Sbordone, Christopher Sims (Resident Scholar).

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 on the international dimensions of quantitative easing (QE) policies that have been implemented by a number of central banks including the Federal Reserve.

Discussion of the economic outlook

This discussion started with a presentation on the FRBNY staff forecast. The staff anticipated moderate real GDP growth in 2013, as improving underlying economic fundamentals of the economy were expected to be offset by restrictive federal fiscal policy. For 2014, the staff expected stronger growth, as fiscal restraint subsides, monetary policy remains highly accommodative, global economic growth begins to recover, and the fundamentals underlying private demand continue to improve.

The staff forecast anticipated that consumer price inflation in 2013 would be low and below the Federal Open Market Committee's (FOMC) longer-run goal. In part, this forecast reflected the recent steep decline of energy prices, but the staff noted that measures of underlying inflation also had slowed over the past year, particularly for nonfood, non-energy goods. For 2014, the staff projected that inflation would move up toward the FOMC's longer-run goal as economic slack diminishes and well-anchored inflation expectations exert a pull on inflation.

The staff expected the unemployment rate to decline only modestly over the remainder of 2013 and then decrease somewhat more quickly in 2014. It was noted that there is substantial uncertainty around the projected path of the unemployment rate, reflecting the uncertainty about GDP growth, productivity growth, and the labor force participation rate, among other variables.

The staff noted that the risks to the forecast for growth and inflation were roughly balanced but the degree of uncertainty was substantial. Possible risks noted by the staff included stronger economic effects from fiscal consolidation, greater-than-expected improvement in the fundamentals of private demand, stronger global disinflationary pressures, and an unexpected rise in inflation expectations.

Jan Hatzius then discussed the staff forecast and reviewed his outlook for the U.S. economy. His forecast for real GDP growth was similar to the staff's, but his inflation forecast was somewhat below that of the staff's. The lower inflation forecast was partly based on analysis indicating that the amount of resource slack was greater than that implied by the unemployment rate. In particular, he found that much of the decline in the labor force participation rate since 2008 was due to cyclical weakness in labor demand. As a result, he anticipated the participation rate would likely rise as economic growth increased, limiting the decline of the unemployment rate and keeping labor compensation growth relatively sluggish.

In the general discussion of the economic outlook, some members of the panel stated that the staff forecast for growth in 2013 and 2014 was too optimistic. A few members noted that actual growth over the past few years had turned out to be lower than the staff forecast. A number of members also pointed out that, after declining substantially in 2013Q1, the personal saving rate remained quite low, and thus consumer spending growth could be lower than in the staff forecast as households adjust behavior to save more. Finally, it was noted that the Affordable Care Act may start to have more significant effects on the labor market; for example, some employers may seek to reduce workers hours to below 30 hours per week to avoid having to provide health insurance to employees or face a penalty. If such practices become widespread, they could result in a lower unemployment rate without a corresponding increase in income.

Discussion of the international dimensions of quantitative easing

In this part of the meeting, two members of the panel gave presentations on the possible repercussions of recent asset purchase programs for exchange rates and cross-border capital flows.

Catherine Mann noted that movements in the exchange rates of emerging market economies since 2009 have been heterogeneous across countries and currency pairs. This observation suggests that it is not straightforward to ascertain the generic response of currency values to QE. She then discussed potential QE effects on capital flows. She first examined U.S. purchases of foreign assets to gauge the types of assets, purchasers, and geographic locations that have contributed most to their volatility. She noted that claims by U.S. banks and securities brokers contributed more to the volatility of capital outflows than direct purchases of foreign securities or foreign direct investment. Of the claims by banks and securities brokers, the geographic locations accounting for much of their volatility were Caribbean financial centers and the U.K. She then turned to the extent to which US treasury securities are held by foreign public and private entities. She pointed out that roughly half of the stock of U.S. Treasury securities is held by foreigners, but that foreigners have been purchasing a declining share of the flows of those securities, reflecting in part Fed purchases of Treasury securities as well as changes in the composition of investor allocation at U.S. Treasury auctions.

Peter Hooper also discussed the implications of QE for the dollar exchange rate as well as other financial variables such as equity prices and government bond yields. He evaluated the effects of QE in two exercises. The first was an event study around the dates September 13, 2012 (the FOMC statement announcing the new outcome-based purchase program of agency mortgage-backed securities ["QE3"]) and January 3, 2013 (the release of the December FOMC meeting minutes). The second exercise used an econometric technique to compute a variable that summarizes common movements in global financial variables and then related changes in this variable to the timing of QE policy. His conclusions were: (i) the QE3 announcement effects were a general rise in global equity markets, a depreciation of the dollar against most currencies, and only small movements in foreign government bond yields; (ii) the correlation of returns across global asset classes rose during periods of Fed balance sheet expansion and declined during periods of balance sheet stability; (iii) the sensitivity of these correlations seems to have diminished across successive episodes of QE; and (iv) the Fed's QE seems to have been more influential in affecting the correlation of global financial variables than quantitative easing by other central banks.

In response to the presentations, one panel member commented that the implications of QE, in and of itself, for financial variables should not be substantially different from those associated with conventional monetary policy. Another member noted the difficulty in identifying and isolating the specific effects of policy changes on financial variables, even within the context of daily market fluctuations around specific announcement dates.

General discussion

After completing the formal agenda, panel members discussed two additional topics: the recent shift in Japanese monetary policy and U.S. monetary policy developments. Regarding Japanese monetary policy, panel members generally agreed that such a shift in policy was appropriate and believed that it could potentially reflate the economy. Participants noted that equity prices and indicators of consumption had responded favorably so far.

In the discussion of U.S. monetary policy, panel members noted the sensitivity of markets to news about potential changes in the rate of asset purchases. Members generally agreed that the FOMC faces a significant challenge in communicating possible changes in the rate of asset purchases as well as the process of eventually renormalizing the policy stance in a way that minimizes financial market disruptions.