Minutes of the Economic Advisory Panel Meeting

May 16, 2014

Present: External advisors: Alan Blinder, Julia Coronado, Michael Feroli, Mark Gertler, Marvin Goodfriend, Jan Hatzius, Peter Hooper, Glenn Hubbard, Anil Kashyap, Frederic Mishkin, Carmen Reinhart. Internal staff: Tobias Adrian, Christine Cumming, Peter Diamond (Resident Scholar), Marc Giannoni, William Dudley, Linda Goldberg, Beverly Hirtle, Thomas Klitgaard, Sandy Krieger, Jamie McAndrews, Jonathan McCarthy, Meg McConnell, Richard Peach, Paolo Pesenti, Simon Potter, Robert Rich, Argia Sbordone, Michael Strine, and Andrea Tambalotti**.**

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 using total or short-term unemployment to measure labor market slack. It then returned to a discussion on the economic outlook based on presentations from two panelists.

Discussion of the FRBNY staff economic outlook

This discussion started with a presentation on the FRBNY staff forecast by Richard Peach. Despite a weak first quarter, the staff anticipated solid real GDP growth over the rest of 2014 and somewhat stronger growth in 2015. A major factor in the staff's stronger growth outlook is the gradual abatement of the headwinds that have restrained growth through much of this expansion.

The staff forecast anticipated that consumer price inflation in 2014 and 2015 would rise gradually toward the Federal Open Market Committee's (FOMC) longer-run goal. This projection was predicated on well-anchored inflation expectations, a gradual reduction of slack, and a firming of global demand.

The staff expected the unemployment rate to decline moderately over the remainder of 2014 and 2015 to around 5½% in 2015Q4. Among the assumptions underlying this forecast was a small increase in the labor force participation rate and a gradual increase in average hours.

The staff noted that the degree of uncertainty around its forecasts remained substantial. It saw the risks to the forecast for growth as skewed modestly to the upside for 2014 and roughly balanced for 2015. The risks to the inflation forecast were roughly balanced for both years. Key risks identified by the staff included stronger business and household confidence from improving fundamentals, lower potential GDP than assumed by the staff, stronger global disinflationary pressures, and an unexpected rise in inflation expectations due to concerns about the degree of monetary accommodation.

In the discussion of the staff economic outlook, some panelists questioned the source of the stronger growth in the staff forecast for 2015, particularly in regard to business investment. There were also a number of questions concerning the staff assumptions for labor force growth and labor force participation, with panelists generally expecting that the outcomes would be weaker than the staff's anticipation. One panelist also expressed concern that trend productivity growth may have declined below the staff's assumption.

Discussion of using total or short-term unemployment to measure slack

Robert Rich of the FRBNY staff then gave a presentation summarizing recent studies on the question of whether the total unemployment rate or the short-term unemployment rate should be used as a measure of labor market slack. Although the total unemployment rate remains elevated, which typically would indicate that there is considerable slack, some analysts have questioned this assessment based on two considerations. First, standard Phillips curve models using the total unemployment rate predicted lower inflation and slower wage growth than were observed over recent years. Second, there was a persistent increase in the long-term unemployment rate: if the long-term unemployed are on the margins of the labor market, then the short-term unemployment rate, which has returned to its historical average, may be more appropriate to gauge labor market pressures.

The presentation reviewed various studies on the short-term/long-term unemployment distinction. Overall, the evidence using aggregate data is mixed for a variety of reasons that include little precedent for the current labor market environment and the high correlation between the short- and long-term unemployment rates prior to 2007. Because of these difficulties, several recent studies have used state- or metropolitan-level data to assess the relative impact of short- and long-term unemployment on prices and wages.

Several panelists commented that the behavior of prices and wages over recent years may have not been as puzzling as some have posited. Rather, the behavior could reflect the pull of well-anchored inflation expectations offsetting downward pressure from slack. It was also noted that the impact of the long-term unemployed may depend on whether such individuals becoming long-term unemployed was due more to the bad timing of losing jobs in a severe recession than a mismatch in skills. A number of panelists reiterated that the analysis of the short-term/long-term distinction is problematic because of sensitivity to model specification, to the measures of inflation and wage growth, and to the sample period.

Discussion of alternative economic outlooks

The meeting then turned to presentations of alternative views of the economic outlook from two panelists. First, Julia Coronado presented her outlook, which put a greater emphasis on the impact of credit developments on the aggregate real economy. In her view, excess credit build-up in the mid-2000s, relative to that justified by expected future income growth, was a significant factor behind the severity of the recession and the subsequent sluggish expansion. Although she saw the Federal Reserve's large scale asset purchase programs as providing a stabilizing force, the prospect that credit demand, particularly by households, would continue to rise only slowly indicated to her that the expansion would remain sluggish. One risk factor that she noted was the possible effects of developments in the Chinese economy on the credit cycle.

Michael Feroli then presented his view of the outlook. He noted that the sluggishness in capital spending was largely concentrated in information equipment, which in turn could be justified through the slower pace of price declines for such equipment. He saw tentative signs that the housing recovery was beginning to get back on track. He noted some of the contrasting labor market developments, which he saw as consistent with the difficulties of determining the impacts of cyclical and structural factors. Regarding inflation, he saw a modest buildup of pressures that could lead to some increases in goods prices. Feroli anticipated that growth would be somewhat weaker than in the FRBNY staff and Blue Chip consensus forecasts, especially in 2015. He expected that inflation would rise moderately, but still be fairly subdued.

In the general discussion that followed, panelists noted that the disagreement at the moment among forecasts seemed to be fairly small. There was also further discussion about the factors that might prompt stronger investment growth, the prospects for inflation, and the possible financial market reaction as market participants increasingly anticipate the start of policy normalization.

General discussion

After completing the formal agenda, panel members discussed U.S. monetary policy developments. Panel members noted that markets probably would remain sensitive to news about a prospective renormalization of policy. As such, panelists agreed that the FOMC faces a significant challenge in communicating the process of eventually renormalizing the policy stance. There was also discussion concerning whether the FOMC's longer-run inflation goal should be adjusted: panelists generally believed that such adjustments would be detrimental to the FOMC's mandated objectives.