Minutes of the Spring 2023 Economic Advisory Panel Meeting

Present: **Chair:** John Williams. **External Panelists:** Kathryn Dominguez, Kristin Forbes, Simon Gilchrist, Sebnem Kalemli-Ozcan, Lisa Lynch, Raghuram Rajan, Paula Campbell Roberts, James Stock, Linda Tesar, Laura Veldkamp, Mark Zandi, Gabriel Zucman. **New York Fed staff:** Jaison Abel, Ozge Akinci, Martin Almuzara, Mary Amiti, Augustin Belin, Kristian Blickle, Rajashri Chakrabarti, John Clark, Jeff Dawson, Richard Deitz, Marco Del Negro, Julian Di Giovanni, Keshav Dogra, Thomas Eisenbach, Michael Fleming, Christian Flores, Linda Goldberg, Tiffany Hewlin, Hyeyoon Jung, Tom Klitgaard, Gizem Kosar, Anna Kovner, Donggyu Lee, Deborah Leonard, Jonathan McCarthy, Rebecca McCaughrin, Meg McConnell, Davide Melcangi, Don Morgan, Timothy C. Nash, Jr., Michelle Neal, Paolo Pesenti, Maxim Pinkovskiy, Julie Remache, Argia Sbordone, Giorgio Topa and Wilbert Van Der Klaauw.

Timothy C. Nash, Jr., counsel for the New York Fed, provided a reminder to the panelists that their discussions are subject to the Antitrust Guidelines for Members of the Federal Reserve Bank of New York's Advisory and Sponsored Groups.

Following introductory remarks by John Williams, Sebnem Kalemli-Ozcan presented "Credit Conditions, Labor Markets and Economic Outlook". She noted that while recent data shows that credit is tightening, mostly for mid-sized banks, the consequences of this tightening depend on which firms are most exposed to tighter bank credit. While private firms and small and medium sized firms are more likely to be bank dependent, these smaller firms do borrow from larger banks. Overall, bank dependent firms account for more than 60 percent of aggregate employment. Typically, leveraged firms are most affected by monetary tightening; over the last decade, while small and medium sized firms' debt grew rapidly, they did not become more leveraged. Turning to inflation, she stressed the importance of sectoral heterogeneity: goods inflation has slowed in the United States, but service inflation has remained strong, here and in other advanced economies. She described a theoretical framework based on segmented labor markets to understand the recent drivers of inflation, which suggests that aggregate demand explained around two-thirds of the inflation over the 2019-2022 period, and sectoral supply shocks explained around one third.

The second presentation was delivered by Simon Gilchrist on "Bank Health and Local Economic Outcomes". He described his research using cross-sectional variation to study the effect of shocks to bank health on local credit supply and economic outcomes. The estimated effects of a shock to bank health are basically the same before and after the 2008-2009 global financial crisis, contradicting the view that banking conditions only matter in periods of stress. Overall, his results suggested that a 1 percent rise in bank charge-offs would decrease employment by around two-thirds of a percent, as a lower bound. He noted that, while in principle, tighter credit can increase inflation (since it increases marginal costs for bank-dependent firms), it is likely to be deflationary on net, especially since it has a strong contractionary effect on the service sector, where inflation is currently strongest. He closed by mentioning two potential risks: the commercial real estate sector, and the effect of the recent doubling of the bank prime rate on interest coverage ratios.

In the following discussion, panelists expressed a range of views on credit conditions, inflation, and the economic outlook. One panelist noted the good news in the labor market, with the unemployment rate being historically low and the participation rate largely recovered; they also argued that we should not worry too much about unionization increasing wages and inflation, since growth in unionization is proceeding very slowly from a low level, the average time to contract ratification is over 500 days, and employee-initiated decertifications have increased. One panelist noted that the real economy has been surprisingly resilient to monetary policy tightening even in the United Kingdom, where activity should be more sensitive to monetary policy tightening because of the prevalence of flexible rate mortgages. Another panelist noted that a new tool on real-time inequality continues to show growing real wages for low-wage workers, and argued that this data could also be used to study distributional consequences of banking stress and credit supply. Panelists broadly agreed that credit conditions have been tightening; one panelist noted that, while the focus has rightly been on banks, insurance firms (which also hold significant amounts of commercial real estate debt) should also be considered since they have also been tightening underwriting standards. One panelist noted that, while one would typically expect tighter credit to affect real activity via residential construction, housing starts still appeared on track compared to models based on historical data, while construction has plateaued, but not declined. Panelists discussed whether this might be explained in terms of single-family vs. multifamily construction, or might reflect the fact that many construction projects were already fully-funded and backlogged. Participants also discussed the time lag between credit tightening and its real effects, with one participant suggesting it usually takes one quarter before the effects of tightening become visible. One participant was surprised by the lack (so far) of much visible effects of recent banking stress on lending and economic activity. They noted that besides the direct effect of credit on economic activity, confidence was a key channel, and confidence surveys remain surprisingly sanguine. Some speculated that this might be because confidence is related to unemployment risk, which remains historically low. Another panelist noted that the demand for credit has a strongly countercyclical component, as banks draw down their credit lines in a slowdown; thus, it may take time for tighter credit conditions to show up in credit flows. One panelist cautioned that data is inherently backward looking, but this time might be different: for example, we have recently seen a weakening of the geographic link between banks and their local customers, who are now more willing to shop around for more favorable terms.