Minutes of the Economic Advisory Panel Meeting

October 16, 2015

Present: William Dudley, Michael Strine. Panelists (external advisors): Julia Coronado, Michael Feroli, Marvin Goodfriend, Austan Goolsbee, Jan Hatzius, Peter Hooper, Glenn Hubbard, N. Gregory Mankiw, Frederic Mishkin, Kenneth Rogoff. FRBNY staff: Tobias Adrian, Gerard Dages, Bianca De Paoli, Linda Goldberg, Jan Groen, Beverly Hirtle, Thomas Klitgaard, Meg McConnell, Alberto Musalem, Sandra Lee, Jamie McAndrews, Jonathan McCarthy, Richard Peach, Paolo Pesenti, Simon Potter, Aysegul Sahin, Argia Sbordone, Ernst Schaumburg, Angela Sun, Andrea Tambalotti.

The meeting began with a discussion on China and other emerging market economies, introduced by a dialogue between Marvin Goodfriend and Peter Hooper, followed by a discussion of the outlook of the U.S. economy.

Discussion on China and other emerging market economies

The discussion started with Marvin Goodfriend providing his thoughts on China's macroeconomic adjustment, which he defined as the need for China to reduce its dependence on investment as the main source of aggregate demand. According to his remarks, China's main challenge is the low share of private consumption. Mr. Goodfriend noted that uncertainty on the path of economic reforms in China affects households' confidence in their future income prospects, decreasing their willingness to spend more of their current income on consumption goods, hence delaying the adjustment process. He concluded that "to consume more out of current income the Chinese public must believe that China will transition smoothly to a self-sustaining balanced growth path in which household incomes continue to rise."

Peter Hooper then presented what he described as "The China Bull View." Focusing on near-term growth prospects, he first cited a number of higher-frequency indicators, such as electricity consumption, that seem to suggest only a gradual slowdown in Chinese growth. Mr. Hooper then discussed a number of factors that supported a more benign near-term outlook for the Chinese economy: increasing levels of government expenditures, a pick-up in residential property markets as well as improved housing affordability, and debt-to-GDP and non-performing loan ratios that are not unusually high when compared to the U.S. Also over the medium term he saw a number of developments that should support a positive growth outlook for China. Firstly, he noted that another twenty years will be needed for China to reach urbanization rates comparable to those of the advanced economies, which will guarantee ongoing labor supply growth in the non-agricultural sector of its economy. Also, the gap in real per-capita income relative to the

U.S. is still wide and lags compared to other East Asian economies, which suggests a lot of scope for high rates of productivity growth in China. Finally, Mr. Hooper also commented on the growth slowdown in emerging market economies as a whole, and noted that this slowdown mostly reflected developments in the market for industrial commodities. He attributed the observed industrial commodity price declines not only to China's growth slowdown but also to overinvestment in production capacity by major commodity producers; the latter will exert downward pressure on growth in those economies for the foreseeable future.

In the ensuing general discussion, one panel member noted that while the Chinese debt-to-GDP ratio is comparable to that in the U.S., it is higher compared to that of other Countries with similar levels of GDP per capita. Several panel members agreed that debt could act as a drag on future Chinese economic growth. Another participant suggested that while the Chinese economy seems heavily reliant on investment spending, the bulk of this spending is aimed at infrastructure projects that could lay the foundation for strong future growth.

A number of panelists also noted that while China has vast amounts of currency reserves, it is not clear how these could be mobilized to confront a potential banking crisis. In this context, some panel members referred to the Japanese banking crisis in the 1990s, when Japan's large currency reserves remained virtually untouched.

Several panel members also pointed to the difficulty in fully assessing the state of the Chinese economy due to some doubts on the reliability of official data releases. In this context, one panel member noted that survey data for the Chinese economy, which are largely produced by private parties, have fallen at a faster pace than most government-sponsored data.

On the outlook for emerging market economies as a whole, many panelists adhered to the notion that industrial commodity-producing nations have built up an excess production capacity of these commodities. As a consequence, these panelists held the view that there would be downward pressure in industrial commodity prices over the medium run. The necessary downward correction of this overcapacity was seen by a number of panelists as a drag on growth in commodity producers for the foreseeable future and as posing a substantial downside risk to the overall outlook for emerging market economies.

Discussion of the outlook for the U.S. economy

The general discussion continued, moving on to the U.S. economy and outlook. Most panelists agreed that the U.S. economy is currently operating at or close to its trend growth rate. A number of panelists believed that trend growth in the U.S. economy is lower than it was in the past, due to a downward shift in productivity growth. One of these panelists suggested that based on this development, a slower rate of improvement in employment conditions than seen in the past would suffice to see upward wage pressures build up. There was also some discussion of whether the U.S. could experience the same rapid increase in inflation observed in the mid-1960s. Most panelists downplayed such a possibility, mentioning that fiscal policy is now more restrictive and that the Federal Reserve's commitment to stable inflation is now stronger.

One panelist pointed out that if the FOMC were to follow a standard interest rate rule calibrated on historical data, it should have already started raising the federal funds rate target. Another panel member countered that such an interest rate rule should be centered on a lower equilibrium interest rate level than in the past, partly because of lower trend growth. Nonetheless, this panelist did agree that such an adapted rule suggests that the FOMC could begin to move towards lift-off soon. Some panelists also discussed the merits of how rent inflation is measured in the personal consumption expenditures price deflator, as opposed to the CPI, as this has led to diverging developments in the two inflation measures. Other members of the panel pointed out that financial conditions had tightened since the summer, making the stance of U.S. monetary policy less accommodative than it was earlier in the year. Multiple panelists said that the recent economic and financial developments in the rest of the world raise uncertainty on the U.S. economic outlook, and that it is likely that net exports will continue to be a drag on growth well into 2016.

Part of the discussion centered on the guiding principles for an increase in the fed funds rate target. A number of panelists discussed the trade-off between moving interest rates early, so as to assure a gradual normalization path thereafter, as opposed to waiting longer to move, with the risk of having to normalize more aggressively if the economic data turns out to be stronger than expected. In the context of this discussion, many downplayed the benefits of early liftoff.

Other members of the panel said that their base case included a fed funds rate target range increase in December, but also suggested that the FOMC use the December meeting to firmly re-establish more data-dependent guidance for policy normalization. Others thought that a lift-off in December would be problematic, as the data in their view worsened since the September meeting. Many of these panel members would prefer that the FOMC delay action and wait for more evidence of inflation acceleration, as well as of continued labor market improvement. Related to this, a number of panelists pointed out that it is riskier to raise rates too early than too late, as a more aggressive, restrictive monetary policy is less costly when economic data are strong. Several panel members suggested that the FOMC should communicate what policy options it has at its disposal if U.S. economic conditions were to deteriorate, with some panelists arguing for more explicit communication that the FOMC's long-term inflation objective is symmetric around 2%.