Conversation with Laurence Meyer

This conversation was held through an exchange of e-mails between J. J. Senna and Dr. Laurence Meyer in the final days of March 2016. Laurence Meyer is a Chief Research Officer and co-founder of LH Meyer, Inc. Dr. Meyer served as a Governor on the Federal Reserve Board from June 1996 through January 2002. Prior to his appointment, he was a professor of economics and a former Chairman of the economics department at Washington University, where he taught for 27 years. During that period, he spent a year as a visiting scholar at both the Federal Reserve Bank of New York and the Federal Reserve Bank of St. Louis. He is a fellow of the National Association of Business Economics and a member of the Board of Directors of the National Bureau of Economic Research, and has served on the advisory panel to the Congressional Budget Office. He is the author of *A Term at the Fed: An Insider's View*, published by HarperBusiness in July 2004.

The Fed's dilemma

You became a member of the Federal Reserve Board of Governors in mid1996, a very challenging time for those in charge of monetary policy in the US. In your book *A Term at the Fed* you recall the discussions prevailing within the FOMC at that time. Greenspan, for example, sustained that "the unemployment rate is low and remained low for quite a while. Anecdotal evidence continues to indicate tight labor markets, but … broader measures of price inflation are, if anything, still declining". You also say the Chairman figured out the beginning of the new economy "before the rest of us". Under those circumstances, it would have been a mistake to embark into a tightening cycle. Today, the unemployment rate is close to what FOMC members believe the long-run level to be, inflation runs below "target", and inflationary expectations have moved slightly downward. FOMC members keep saying that the next policy movements will be "gradual". In your opinion, how gradual should that policy be? Before moving the basic rate up, would it not be wiser to wait for clearer signs that inflation is really heading toward the target?

There are definitely similarities today to the period when I was on the FOMC. In the latter case, the shock was the unexpected acceleration in productivity, a shock that is inherently disinflationary. Today's unexpected shock is believed by some to be labor market dislocations that arose from the Great Recession and, while diminishing, have proved persistent—the decline in the participation rate, higher percent of discouraged, marginally, and involuntary part time workers. Some believe these developments mean there is more slack than signaled by the "official" unemployment rate, U3, resulting in lower inflation today at the prevailing U3 than otherwise. But, it's really not clear that a traditional U3 based Phillips curve is over-predicting inflation. A lot of research disputes that. In addition, in both cases, the shocks only temporarily suppress inflation. When the dust settles, inflation will be back in line with the traditional Phillips curve, and, if the unemployment rate at that time is well below the NAIRU, inflation may be unacceptably high. Message: Be careful not to exploit too aggressively the ability to lower the unemployment rate without short-run adverse consequences for inflation. In addition, the more important force holding down inflation in the last couple of years has been the decline in the oil prices and appreciation of the dollar. But here too the effects holding back inflation are temporary. When those shocks dissipate, as is already the case today, inflation will rise toward its "underlying" rate, which even Yellen has said might be as high as 1¾%. At the same time, the unemployment rate is falling below the estimated NAIRU. The case for raising rates today is that it is not prudent to wait to raise rates until inflation is closer to 2% and the unemployment rate is well below the NAIRU! That would require rapid rather than gradual increases in rates later and such a rapid rise in policy rates has been a source of recessions in the past.

Negative interest rates

Since the adoption of a policy of negative interest rates by the central banks of several advanced economies, I have not seen any profound discussion of such policy within the central banking world. In general, central bankers seem to

support it. The argument is that the new strategy works just like conventional monetary policy, forward guidance and quantitative easing. In the end, all of them act to reduce the long-term interest rates, which would stimulate aggregate demand. In appraising the new policy, should we not be concerned with the impact of it on consumption savings decisions as well? What do you think of the possibility that, faced with negative rates for ten years, as we see in Switzerland and Japan, for example, households will prefer to save more, rather than consume more, a situation which arises if the income effect of the rate reduction is greater than the price effect?

The possibility that lower rates would discourage saving and therefore reduce rather than increase demand has surfaced many times, and, indeed, economic theory does not pin down the sign of the effect on consumer spending and hence aggregate demand. Most research however estimates that the effect of lower rates on consumer spending comes principally from its effect on equity and housing prices, that is, via an interest induced wealth effect. I know of no evidence that suggests the effect of lower rates is to reduce household spending. But negative rates have an adverse effect on bank profitability and potentially on bank lending, more serious in Europe and most other areas where credit intermediation is so bank centric. The adverse effect reflects, in part, that banks are reluctant to pass on the negative rates on reserves to retail deposit rates. At this point, many of the other adverse effects (increase in currency holding) have not occurred, while the effect longer-term rates, equities and the exchange rate have mostly in line with what would be expected for an easing through lowering rates. For the U.S., circumstances are seen as different and the uncertainty and potential costs higher, principally because of the size of the money market mutual funds industry in the U.S. and the risk of disruptive outflows of investor funds.

Oil and the world economy

Since the early 1970s, and at irregular intervals, the international price of oil becomes an issue for macroeconomists and policy makers, particularly monetary

policy makers. This time, we face a dramatic decline in the price of oil, to quite low levels. The situation is especially interesting because it comes in the wake of a fantastic phenomenon, the so-called shale revolution in the US. As it is widely known, firms in the shale business are highly indebted and have difficulties in surviving at something like US$ 40 dollars a barrel. This means that the price decline raises frictions in the US labor market, causes investments in the important energy sector to shrink and tends to worsen financial conditions, through increases in junk bond spreads. Do you think these indirect effects might be stronger than the direct effects, according to which a significant fall in the price of oil stimulates households to spend more on non-energy related goods and services, meaning that the net effect of the price decline could be harmful to the world economy?

The positive effect of lower oil prices on aggregate demand at least is now lower than earlier as a result of the shale revolution, and, as a result, the adverse effect on investment spending in that sector. This shale industry has been a rising share of overall business investment and GDP. As a result, the decline in investment in this industry offsets, at least in part, the traditional boost to consumer spending. Second, the firms in the shale industry are smaller firms whose investment is often financed out of revenue or by borrowing in the high yield market. A decline in oil prices increases default risk and leads to a rise in borrowing costs, as seen today in the high yield market. Third, lower oil prices have hit commodity-exporting countries especially hard, many of which are EMs that were already struggling. This has made the effect of lower oil prices less of a plus globally. Given the still small proportion of nonresidential investment accounted for by shale drilling, the traditionally positive effect on consumer spending through the associated rise in real disposable income appears to dominate the decline in investment in the shale industry, leaving the net effect of a decline in oil prices on aggregate demand in the U.S. still positive, but smaller than earlier.

Productivity slowdown

In *A Term at the Fed* you looked at productivity growth in the US since 1889 through the year 2000. You noticed that in periods of low productivity growth the average rate of expansion of output per hour worked is about 1.5% per annum, and that in periods of high productivity growth the average rate of growth of labor productivity is about 3.0%. More recently, though, namely between 2011 and 2015, we observe that the average yearly rate fell dramatically to 0.5%, a level which is three times lower than the historically registered "floor". In your opinion, how can we best explain this phenomenon? Is this recent period too short to allow a meaningful interpretation of the data?

The rate of potential output growth has been falling since the late 1990s and the early 2000s, from about 3 ½% then to about 1.5% 2% today. There is an active debate as to whether this low rate of growth will prevail going forward. But the consensus today is that growth in the U.S. will average about 2% over the next couple of decades. One source of the decline is clear and ongoing, a slower rate of growth of the population and a declining participation rate as a result of the aging population. But the surprise is the sharp decline in productivity growth. Some of this could reflect the scars of the Great Recession, but it appears it has deeper roots. In an accounting sense, the decline in labor productivity is some combination of less capital deepening (less capital per worker) and less technological progress, slower growth in total factor productivity (TPP). With respect to the former, that reflects the disappointing pace of investment for some time. The latter is the mystery and the source of the active debate. Their decline is dramatic, from near 2% during the mid-1990s to the middle of the next decade to just ½ % per year after. We estimate productive capacity is rising at just a 1½% rate in 2016. This is so low historically, that most forecasters assume it will edge upward to something more normal relative to previous decades, to about 1% per year, bring potential growth to about 2%.