GOLDMAN'S JAN HATZIUS ON FED POLICY AND THE PRODUCTIVITY PARADOX

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Last week, Professor Jeremy Siegel and I chatted with Jan Hatzius, Chief Economist at Goldman Sachs, to discuss his thoughts on the state of the U.S. economy, Fed policy action and long-term growth forecasts. **Highlights from the Fed Policy Meeting** The Federal Reserve (Fed) conducted its policy meeting last week and held a press conference shortly after. Both Professor Siegel and Hatzius noted that the members of the Federal Open Market Committee (FOMC) brought down their estimates for what the most appropriate monetary policy rates should be—commonly known as the "dot plots." They both believe these downgrades were particularly meaningful. Hatzius noted that in March 2015 three people penciled in zero or one hike this year, and that number has now increased to seven. Hatzius believes—somewhat speculatively but also critically—that one of these seven was Fed chairman Janet Yellen. As a result, Hatzius' team at Goldman pushed back its call for the first Fed rate hike to December 2015 (from September). Siegel pointed out that Hatzius' forecast is counter to the majority of the committee. Yes, there were seven dots indicating one hike as most appropriate policy—up from three dots in March—but there were also 10 members indicating two to three rate hikes as the appropriate policy. **Position on the Long Run, New Neutral 2% Not 4%?** While the Fed prescribes a long-run tendency for a neutral Federal Funds Rate to be closer to 4%, a number of analysts, including Bill Gross, expect a new neutral Fed Funds Rate to be 2%. The lower neutral policy rate coincides with slower growth potential in the economy. Hatzius disagrees with the new normal theory and sides with the Fed in having higher expectations for the neutral target rate. While slower population and productivity growth can lead to generally lower economic growth, Hatzius does not believe it should slash 1.5% off of nominal growth figures. He expects longer-term growth to be closer to historical averages, disagreeing with predictions for growth of just 2%. **Productivity Paradox and Potential Growth** Within the last decade, we have experienced a disappointing productivity environment—similar to that witnessed in both the mid-1970s and mid-'90s, when the measure of productivity growth trended around 1.5%. Hatzius believes the current environment does not look like one where productivity has slowed as much as the gross domestic product (GDP) numbers imply. He has difficulty believing that "true" productivity has slowed materially considering that profit margins, inflation, equity valuations and the performance of the Information Technology sector have all been stellar. Instead, poor productivity growth may just be a function of mismeasuring productivity and other economic numbers. It has become increasingly difficult to quantify technological progress. For perspective, in late the '90s, the center of gravity for productivity growth was faster processors and greater memory capacity in computer hardware. Statisticians translated that into large quality adjustments through widespread price declines and thus large increases in technology output. The tech sector, including both hardware and software sectors, experienced a price drop of 7% to 8% in both the late '80s and '90s. In contrast, today, it is much tougher to measure software and digital output, and the price declines have barely budged, despite likely increases in the quality of software. **Tech Price Declines' Impact on Productivity**

Price declines that were apparent in the tech sector in the late '80s through '90s would have added 0.3% to 0.4% back to productivity growth. The questions today remain: How do you value free applications? How does that value find its way into national income accounts? Siegel adds that the productivity slowdown in the '70s was partly due to a spike in oil prices, but today's low oil prices only deepen this productivity puzzle. **Looking Ahead: U.S. GDP Growth and Euro at Parity with U.S. Dollar** According to Hatzius, Goldman expects GDP growth in the second quarter of 2015 to hit 3.1%. This comes on the heels of dismal growth in the first quarter of -0.7%. In this coming week, there is a possibility that GDP in the first quarter of 2015 might be revised up to -0.1%. Hatzius believes that the U.S. dollar thus far has trimmed 0.5% from GDP growth in 2015. In the first quarter alone, trade contribution was adversely impacted by -1.9%. Considering how volatile trade data is, he believes the drag on overall GDP later this year might not be as significant. But Hatzius thinks the stage is set for continued U.S. dollar appreciation. Interest rates in the U.S. are still higher compared to Europe, and his team believes the euro is apt to fall to parity and potentially below. *Read the Conversations with Professor Siegel Series here.*

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Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Monetary easing policies : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.

Dot Plot : a chart based on the economic projections of the Federal Reserve board members that illustrates their views on the appropriate pace of policy firming and provides a target range or target level for the federal funds rat.

Federal Funds Rate : The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the “policy rate” of the U.S. Federal Reserve.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Inflation : Characterized by rising price levels.

Interest rates : The rate at which interest is paid by a borrower for the use of money.