

## *The Economy in Perspective*

*Close calls ...* The Federal Reserve's Open Market Committee will meet on September 24 to review the state of the economy and to consider making changes in its chief monetary policy instrument, the federal funds rate. Financial market participants have been poised for a September rate increase for nearly six months, but their expectations continue to rise and fall with the tide of information about near-term economic activity. In August, for example, an upward revision of second-quarter real GDP, coupled with stronger-than-expected data about housing starts and durable-goods orders, persuaded investors to retract their prediction of an imminent economic slowdown.

Despite last month's vibrant economic news, financial market participants did not react similarly to August's labor market situation. The Bureau of Labor Statistics reported on Friday, September 6, that net new jobs increased by 250,000, hourly earnings jumped sharply, and the unemployment rate fell to 5.1 percent—its lowest point (on a comparable basis) since early 1973. What prevented a sharp sell-off in the nation's financial markets?

For one thing, the markets had already declined the previous day on expectations of a strong report. Just as important, perhaps, was analysts' recognition that the unemployment rate fell primarily because of a steep decline in the labor force, not because employment surged. Since many observers are convinced that the economy is operating at, or beyond, its ability to generate output without boosting inflation, such distinctions are regarded as highly relevant to the outlook.

Preoccupation with the ebb and flow of daily economic news tends to obscure policymakers' longer-term objectives and downplays the problems they face along the way. Some people expect the Federal Reserve to carefully control short-term movements in economic activity and, at the same time, to employ these fluctuations to regulate the pace of inflation. Although monetary policy may affect real economic activity in the short run, it has no ability to move real output systematically along a predetermined growth path. Over time, the average rate of real economic growth stems from productivity gains and from the amount and quality of labor and capital employed in production.

Similarly, monetary policy probably has little influence over short-run price-level fluctuations, but it plays the determinative role in establishing the inflation trend through control of the

money supply. The Federal Reserve did not establish a numerical objective or time path when it took strong actions in 1979 and 1980 to halt the prevailing inflation spiral. It was sufficient then to recognize that double-digit inflation was too high and had to be stemmed.

As it happened, the inflation rate fell more quickly and remained lower than the public initially expected. By the mid-1980s, the Consumer Price Index (CPI) was fluctuating around a trend rate of 4.5 percent. Once it became clear that inflation had stabilized, the Fed undertook a program of further disinflation. Again, there were no numerical goals or time frames, but there was a public commitment to achieve price stability (commonly defined as inflation so low that it does not affect economic decisions).

During the approximately 10 years that the Federal Reserve has been committed to this course, it has both tightened and eased its policy stance. It is not likely that every policy action has been perfect: At times steps may have been taken too quickly or too late, and some may have been either too large or too small. Nevertheless, both inflation and inflation expectations have moved onto a lower track. Since 1991, the CPI has been hovering around 3 percent, and real output has expanded in every year but one. Capital formation rates have strengthened notably, raising hopes of faster productivity growth.

Some economists consider a 3 percent inflation rate to be close enough for government work, while others think that 0 or 1 percent is more appropriate. Operating within the narrow range of 0 to 3 percent, and recognizing that some measurement biases are present in all inflation indexes, policymakers must proceed carefully. However, the experience of the last 10 years should leave little doubt about the Federal Reserve's ability to achieve a new, lower inflation trend over time. Perhaps more explicit inflation targets will prove useful in narrowing the price-stability range.

For the moment, financial markets do not appear to be focused on price stability per se. Instead, they seem more concerned about the prospect of inflation breaking out above its 3 percent trend. The federal funds futures markets and the degree of upward slope built into the U.S. Treasury yield curve clearly reflect the market's view that the Federal Reserve will tighten monetary policy at its September meeting. The truth is close at hand.