

The Economy in Perspective

Dead reckoning ... The beginning of a new year always brings increased attention to the economic outlook, as though the prospect of another lap around the sun endows economists with fresh insights about more earthly navigation. This is the time of year when we dismal scientists are conscripted for forecasting speeches, panels, and polls. So—whar' does she blow?

Surveys indicate that, on average, private forecasters expect real output to increase at a 2% pace in 1997, extending an already long expansion by another year. Inflation forecasts are clustering around a 3% rate, which, if attained, would represent no acceleration from the 1991–96 trend. Unemployment is predicted to remain at or below 5.5%, and the employment/population ratio should hover around record-high levels. Although investment spending is likely to slow, as is spending on consumer durable goods, no serious imbalances except high levels of credit card debt are thought to threaten continued economic growth. The pros say that the U.S.S. *Economy* is shipshape and blessed with favorable winds.

With smooth sailing ahead, monetary policy would seem to enjoy an enviable position. Shouldn't the Federal Reserve just chart a neutral course, leaving the federal funds rate unchanged and thereby promoting steady economic conditions? The answer to this question depends on the definition of "neutral course." During the past six years, the Federal Open Market Committee (FOMC) has raised and lowered the federal funds rate and left it unchanged over prolonged periods (it has not been altered since January 1996). Likewise, the various money-stock measures have fluctuated considerably. The expansion got under way slowly, but strong winds eventually filled her sails; inflation, seeming to defy Neptune, has not surged along in her wake.

The orientation of post-1979 monetary policy bears closer scrutiny. Unquestionably, the events of the 1970s—when a progrowth, proinflation course was charted—powerfully influenced subsequent monetary policy. As we know, the ship, lured by the Sirens of faster economic growth, went aground on the rocks of rising inflation. One interpretation of monetary policy in the mid-1980s is that the FOMC set a course for credibility with one objective—to preserve the disinflation it had achieved by 1983. By showing its willingness to curtail liquidity at critical junctures, the FOMC not only earned credibility, but also enabled households and businesses to coordinate their plans and actions more easily, which prevented serious disruptions of overall economic progress. Credibility strengthened economic stability. By the end

of the 1980s, in the midst of a long expansion, the FOMC could talk convincingly about its intention to change its bearings and set sail for price stability.

What are the map coordinates of price stability, and what instrument settings will hold the economy on course? Should the primary emphasis be on stating more clearly the longitude and latitude by which price stability shall be known and by announcing the journey's intended length? Or should the FOMC heed warnings that it is now sailing into heavy swells that threaten to swamp the ship? Perhaps a meandering cruise would be more comfortable. And, as a practical matter, can the FOMC successfully control inflation by managing aggregate demand?

Accurate estimates of "potential output" or "full employment" underlie the aggregate demand management framework. To avoid the shoals, the helmsman must know what limits of real economic activity are consistent with no change in inflation. How reliable is the NAIRU compass, an instrument that purports to inform us of the nonaccelerating inflation rate of unemployment? And how reliable are the cables that set the federal funds rate sails to catch the winds of aggregate demand?

Conventional NAIRU compasses operate through labor market demographics. The old captains thought they could tell what unemployment rates would mark "full employment" for different age and sex subgroups. The NAIRU is a weighted average of the subgroup-specific "full employment" unemployment rates; the weights change over time as the subgroups' shares of the labor force change. For example, teenagers have larger unemployment rates than adults, and as they become a smaller fraction of the labor force, the NAIRU declines.

Unfortunately, the NAIRU compass needle appears confused. When the U.S.S. *Economy* left port in 1991, old salts estimated NAIRU at 6% to 6.5%. During the voyage, as the ship plowed the waves with greater speed than seemed possible without generating more inflation, NAIRU estimates have been continuously revised downward. Some hands judge it to be as low as 5%. Then again, the NAIRU compass may be broken. Relying on old relationships between unemployment rates and inflation could be like using an old map in territory where the land masses have shifted and water channels have altered through the years.

One thing that has not changed is the desire of passengers and crew to know where they are bound. Is it better to define monetary policy by its instrument settings, or by a course plotted, declared, and steadfastly pursued?