

## *The Economy in Perspective*

*A moment's notice* ... Those of us in the monetary policy business are used to being questioned almost daily about the meaning of a data release, a Fed official's speech, or a financial market swing. Does a depreciation in the Malaysian ringgit mean that the Federal Open Market Committee (FOMC) will hesitate to change the federal funds rate at its next meeting? If a jump in food prices can be traced to a freight car shortage in Nebraska, will the Fed look the other way? If short-order cooks now earn \$9.00 per hour in Poughkeepsie, will the Fed regard this as a cause for concern?

In an era when the news media provide continuous coverage of global happenings, the demand for instant commentary is intense. Unfortunately, there is a tendency for people to get caught up in the moment, as if one piece of information could crystallize all of the preceding pieces into a defining event. Policymakers must also guard against getting pulled into this short-term mind set: Their actions at each point in time should form a continuum with their past and future decisions. Consistency with the past enables people to anticipate how policymakers will respond to incoming information, thus avoiding costly surprises. Consistency with the future forces policymakers to anticipate the consequences of their choices, thereby avoiding the need for costly corrections to cumulative mistakes.

Time frames highlight the difference between actions and policies. A policy is not just a decision; it is a high-level plan that guides the course of future decisions. Achieving maximum sustainable economic growth through price stability is the FOMC's current monetary policy. Decisions to alter the federal funds rate are the FOMC's choices made in specific circumstances in order to achieve policy success.

Economic policymakers do not always articulate their goals. In fact, there may be strong political incentives to avoid doing so. Policy changes can make certain groups worse off immediately, even though the changes gradually improve national welfare. In these instances, policymakers may avoid adopting welfare-enhancing policies because the constituency for change cannot mobilize enough supporters. During the 1960s and 1970s, most Americans thought that inflation did not inhibit economic growth. Only when it became clear that this

premise was false did popular sentiment shift toward pushing the inflation rate down. By then, unfortunately, the damage proved costly to unwind.

Since those high-inflation years, the FOMC not only has publicly committed itself to a price stability policy, but has displayed a deliberateness in taking actions thought to be consistent with its success. Committee members have been engaged in a series of skirmishes with inflation since the mid-1980s, always preventing the trend rate from reverting back to its 1970s trajectory and sometimes nudging the trend rate lower. With the exception of a brief and shallow economic downturn in 1990, this strategy has been highly successful. Currently, the unemployment rate is at a 24-year low, and real economic growth has been both balanced and strong.

As business cycle dynamics and unexpected shocks have caused market-determined interest rates to swing widely and repeatedly over the last dozen years, the FOMC has been maneuvering the federal funds rate both up and down to regulate the supply of reserves available to the banking system. No economic variable—not the unemployment rate, the pace of economic growth, or any variety of monetary indicator—has proved to be a consistently reliable signal of inflation or a guidepost for FOMC decisions. So why has inflation moderated?

The principal difference between today's monetary policy and that of the preceding era may well be the FOMC's willingness to be realistic about what is economically feasible and to risk occasional periods of temporarily slower economic growth for the benefit of a longer-lived economic expansion. No one should think that the FOMC's previous decisions have all been perfect. In hindsight, it is possible to pinpoint times when liquidity injections appeared too generous or unduly stingy, and when actions might have been taken too quickly or too late. At various times, the Committee erred on the side of ease and at other times on the side of restraint.

What seems to matter most is not the precise timing of funds rate moves or their exact magnitude, but the FOMC's capacity to stay with a course of action and to be patient until the desired results are obtained. To paraphrase former President Dwight Eisenhower, plans are useless, but planning is indispensable.