

The Economy in Perspective

Second guessing ... With all the buzz about U.S. economic statistics in recent public discourse, one might almost believe that the ocean's tides are now governed by the waxing and waning of the business cycle. Every statistic is analyzed not only for revelations about economic performance, but also for its likely effect on the Federal Reserve's *attitude* about economic performance, partly because many people think the economy is at a turning point. Greater interest in economic life is certainly heartening, but this frenzy seems unwarranted.

The current economic expansion has just entered its eighth year and shows every sign of continuing. Production of goods and services increased at roughly a 4 percent annual rate in real terms last quarter, and domestic purchases excluding inventory adjustments rose at a 6 percent clip. Second-quarter data show that the U.S. manufacturing sector may finally be getting some fallout from Southeast Asia, but these effects do not yet seem overwhelming. Moreover, as we anticipated, the weakness in tradable goods is being countered by added buoyancy from interest-sensitive sectors like housing and automobiles. Consumers, confident that the expansion will continue, are picking up the pace of their retail spending. The unemployment rate hit a 28-year low in April, and earnings are climbing.

Inflation? What inflation? Wholesale prices, on average, have been steady for a few years now, and consumer prices advanced less than 2 percent during the last 12 months. Even making allowances for large, temporary declines in food, energy, and other items, consumer price inflation has not accelerated for several years. The median CPI, for example, has been recording 12-month changes within a narrow range (around 3 percent) for about five years. Since the 1950s, inflation has accelerated over the course of business expansions, often peaking at a higher rate than it reached at the previous cycle's peak. In the current cycle, the core inflation rate has been nearly constant or on a slightly downward trajectory.

There are, of course, risks to consider. Continuing economic problems in Japan could combine with Southeast Asia's travails to weaken exports even further. An inventory correction could depress manufacturing activity. Labor shortages could lead to compensation increases large

enough to reduce corporate profits. Lending by financial institutions may overreach the bounds of good judgment, causing a retrenchment in credit extensions that impairs economic activity. Any number of possible events *could* reverse the economy's forward momentum. And then there is the Federal Reserve.

Throughout this expansion, the Federal Open Market Committee (FOMC) has been willing to supply whatever reserves the banking system has demanded, at a predetermined federal funds rate. Nevertheless, using the funds rate to judge the stance of monetary policy can be misleading. The intended funds rate, which the FOMC can achieve almost precisely, may lie either above or below the unobservable noninflationary equilibrium rate. If the demand for bank credit shifts with economic circumstances, an unchanged funds rate would alter the degree of pressure on bank reserves and would consequently affect the growth rates of money, credit, and output.

Early in the expansion, the FOMC pushed the funds rate down to 3 percent (where it stood for nearly two years), to provide the liquidity needed to spark a pickup in economic activity. Though successful, when this policy stance threatened to rekindle inflation, the FOMC decisively raised the funds rate a total of 300 basis points (to 6 percent) between January 1994 and February 1995. The FOMC has since lowered the funds rate to 5¼ percent for a year, then raised it to 5½ percent last March.

Unless substantial shocks hit the economy, real interest rates are unlikely to make sudden jumps. Consequently, it would be unusual for small changes in the federal funds rate—amounting to less than 100 basis points within a 12-month period—to represent a significant change in the thrust of monetary policy. Indeed, small movements may occasionally be necessary to prevent the funds rate from drifting too far from market-determined rates and fostering undesirable money and credit conditions.

In January, market sentiment favored a funds rate cut; today, the balance of opinion has shifted to the opposite side. Since the expansion has already withstood a 300-basis-point increase in the funds rate, the small rise anticipated by financial markets should not be as electrifying as some commentators would have it.