The Economy in Perspective

Sigmund Freud has said that every normal person, in fact, is only normal on the average. So it is with business cycles…

Sooner or later, something will throw the U.S. economy off the brisk growth trajectory it has followed since 1995. Reverberations from the collapse of East Asian economies might do it, despite the apparent durability of the U.S. until now. Or the financial sector might seize up, notwithstanding the as-yet-unshakable support of stock market investors. Perhaps it will be something more traditional, like tight monetary policy chasing after accelerating inflation. Whatever the cause, lately it seems that everyone on the planet is anxiously awaiting the economy's return to normal behavior. Human beings (especially the economists among them) can tolerate ambiguity only so long.

Recent statistical reports present an enviable picture: Output expanded at an annual rate of 5.6% in real terms last quarter, more than double the pace expected by many forecasters only a few months before. Job growth continues at a healthy clip, holding the unemployment rate at a 28-year low. Never before has such a large proportion of working-age Americans been employed. Because consumer prices are barely increasing, working people continue to enjoy strong gains in their standard of living. In fact, consumer sentiment remains so positive that economy-wide household spending now matches income, with saving coming only through increases in the value of assets. What's wrong with this picture? Everything! It's not undesirable, just unjustifiable.

Doubtless the exuberance expressed since 1995 has been unusual. But how many people recall that this beautiful swan of an economy began its life as an ugly duckling? In the first several years of the expansion, economic activity's pace was feeble in comparison with many previous expansions. Progress in new job creation was particularly slow. Federal Reserve Board Chairman Alan Greenspan acknowledged the presence of strong "headwinds" that seemed to be restraining the expansion.

Soon enough, the pace of activity quickened. Recognizing that the federal funds and discount rates were set at zero (inflation adjusted), the Federal Reserve boosted its policy rates about 300 basis points in 1994 and early 1995. By 1996, the unemployment rate had fallen to 5.5%, a point that mainstream economists believed was at or below the level where inflation would accelerate. Many urged that the Federal Reserve should raise policy rates to preempt further inflation. Others, expecting labor compensation's surge to precede inflation's swell, opposed any additional monetary tightening.

Needless to say, inflation did not accelerate. Indeed, deviating even further from the textbook script, inflation actually declined as labor markets strengthened. With each additional ¼% drop in the unemployment rate below 5½%,warnings were issued and then proven false. Today, with employment sitting near 4¼%, labor compensation rates finally have bestirred themselves, but only slightly. Yet those who preached labor markets' usefulness in predicting inflation have been so thoroughly discredited that few have strength left for wagging their fingers.

The seemingly inexplicable odyssey of equity prices has been chronicled many times by now. True, equity price movements can be explained through adjustments to standard equity-valuation models: Capital gains taxes have been lowered over time, and people accept risk more readily. But these adjustments are merely rationalizations after the fact. The reality is that the old norms no longer provide sufficient guidance.

Some observers regard the economy as surreal and dwell on its inevitable comeuppance, while others extoll the glories of a New Age. The first group, expecting familiar economic relationships to re-emerge, wants the Fed poised for restraint. The second, envisioning eternal, inflation-free expansion, desires a perennially accommodative monetary policy. Neither faction is likely to be satisfied.

Monetary policy is a blunt instrument; it cannot be used to manage the economy's short-term behavior precisely. Models based on previous experience are rough approximations of economic relationships and policy frameworks that change through time. Business cycle dynamics are simply tough to pin down and even harder to generalize. Attempts to smooth out all fluctuations might cause further instability. Appropriate interventions are those that keep price levels—and price expectations—stable. But not even a stable-price policy is an infallible guarantee against recession.

It stands to reason that monetary policy will be harder to conduct when established guideposts provide so little direction. Having fewer guideposts, however, is not the same as having no destination.