

The Economy in Perspective

Wear sunscreen ... The Federal Reserve raised the target federal funds rate one-quarter of a point to 5% at its June policy meeting. This action, however widely expected, was not universally endorsed. Immediately before the Federal Open Market Committee meeting, some observers questioned the need for a rate hike. After all, inflation has been fairly stable during the past year, and has actually declined on average over the past several years. The April CPI report flashed caution, but May's release restored a sense of calm. And some analysts claimed that the combination of vigorous economic growth and low unemployment—which was associated with accelerating inflation during some earlier expansions—no longer posed a clear and present danger.

What, then, accounts for the precaution? The FOMC's press release stated that last fall the Committee "...reduced interest rates to counter a significant seizing-up of financial markets in the United States. Since then, much of the financial strain has eased, foreign economies have firmed, and economic activity in the United States has moved forward at a brisk pace. Accordingly, the full degree of adjustment is judged no longer necessary." The "full degree of adjustment" refers to last fall's 75-basis-point cut, which also went against the grain of the Committee's then-established bias toward raising the funds rate.

The current economic climate in the United States still shows the same torrid conditions that prevailed when the FOMC met in March and May of 1998. At that time, virtually all sectors of the economy were expanding rapidly, especially sales to domestic purchasers. Imports were streaming into the country to satisfy demand that was not met through domestic production. Credit availability in all sectors was judged ample. As it does now, the unemployment rate stood at 4.3% in May 1998. Moreover, according to the Committee's minutes, "The staff forecast prepared for this meeting indicated that the expansion of economic activity would slow considerably during the next few quarters and remain moderate in 1999." We know now that the shift to a more temperate climate did not occur.

These considerations, and others like them, led the Committee last year to adopt asymmetric directives in favor of a higher funds rate, both in March and in May, when the funds rate stood at IPF (Inflation Protection Factor) 5½%. In fact, two FOMC members dissented at the May meeting, seeking the shade of a funds rate hike immediately. That meeting's minutes make it clear that the Committee was entirely comfortable at the time with a more restrictive policy stance than prevails today, even after the recent funds rate hike of 25 basis points.

Critics of last week's rate hike argue that now is not the time to block the rays of our economic sun even slightly, for either of two reasons. Some allege that a higher IPF monetary policy will necessarily diminish the pace of economic activity. One response to such a contention is to agree with it. Just as a body can be exposed to too much sun, an economy may not be able to absorb too much activity without suffering side effects like inflation, poor credit decisions, and inflated asset prices. The more layers of skin are burned, the riskier the corrective treatment. Monetary policymakers have learned that it is better to act early than to rely on aggressive therapy later on. The success of this reasoning should be self-evident to observers of this long and prosperous expansion.

Others accept the FOMC's logic, but still consider its most recent action premature. Those who fault the Committee for raising the funds rate at its last meeting point to all of its previous decisions to forbear at seemingly similar times. They remind us that this willingness to apply a low-grade IPF has supported strong economic performance thus far. That may well be so, but monetary policy always requires a balancing of risks. As its actions last fall indicated, the FOMC is willing and able to adjust tactics in cloudy weather. When the clouds recede and the hot rays return, restraint always seems more objectionable because it is equated with the end of the expansion. The fallacy of this logic too should be self-evident.

But trust me on the sunscreen.