

# The Economy in Perspective

*Matters of interest...* The September 11 terrorist attacks have dramatically altered the economic landscape. Before that date, many analysts had conjectured that economic conditions were stabilizing, but the attacks sapped the economy's momentum and dealt a staggering blow to several industries.

Many financial markets seized up on September 11 and the following days. Some banks did not receive payments due to them, some could not send payments owed, and some could do neither. Stock exchanges, futures markets, and commodities markets were closed for a time. Financial markets were in disarray, with buyers and sellers frequently unable to find one another and complete transactions. In these circumstances, the Federal Reserve did exactly what central banks are designed to do: provide the banking system with the capacity to absorb a surge in demand for cash and near-cash assets. Immediately after the attacks, the Federal Reserve System injected massive quantities of reserves into the banking system through open market operations and by lending against collateral. The financial system regained its footing quickly, enabling the Federal Reserve to withdraw the extra reserves it had provided. Market conditions, however, had changed.

The terrorist attacks caused people to re-evaluate U.S. economic conditions. Some industries, such as air travel and lodging, now seem likely to be less profitable in the future, while industries selling security products and teleconferencing services promise to be more profitable. Netting out the pluses and minuses, though, forecasters and market analysts expect people and business firms in the economy as a whole to curtail their purchases until the future is clearer. This retrenchment, in an already lackluster business environment, could make the difference between economic expansion and contraction.

While most people have an intuitive grasp of these "real economy" dynamics, the financial market consequences are less well appreciated. In times of great uncertainty, households and business firms express strong preferences for reducing their exposures to risk. Their efforts to mitigate risk can play out in many ways and cross many markets. Companies thought to be riskier in the post-attack environment will find it harder to issue debt and equity. Stocks will sell at lower prices. Those who purchase risky debt will demand an extra interest rate premium. The longer a financial asset's maturity, other things being equal, the less valuable the asset will be. A surge in demand for short-term

U.S. Treasury securities will drive up their prices and lower their yields. The larger the dollar volume of asset restructuring in a short period of time, the greater will be the financial market response. When the rebalancing is complete, we would expect to see short-term interest rates fall relative to long-term rates. In addition, with household and business spending reductions translating into lower borrowing needs, the overall structure of interest rates will fall as well.

Responding to these developments, the Federal Open Market Committee reduced its federal funds rate target to 2.5% in two steps of 50 basis points each, one on September 17 and another on October 2. Moreover, the FOMC's October 2 press release stated that the balance of risks in the economic outlook is weighted toward conditions that may generate economic weakness in the foreseeable future. Press accounts routinely explain that these actions are expected to stimulate economic growth. One school of thought teaches that monetary policy can regulate the pace of economic growth. The causal chain runs from the funds rate through other interest rates, the stock market, the foreign exchange market, and so on, in ways that induce people to spend more and save less. Experience demonstrates that these linkages are considerably looser in practice than in textbooks.

In the current circumstances, it should be clear that the decline in interest rates generally, and in short-term interest rates particularly, reflects the public's changed actions and expectations. The federal funds rate is not a market-determined rate. If the FOMC had left the funds rate pegged at 3.5% while the one-year Treasury yield fell below 2.5%, monetary policy would arguably be tighter than it is today. Allowing the funds rate to fall along with market rates, however, need not be described as stimulative; "accommodative" might be more appropriate.

The distinction is more than semantic. The level of interest rates in itself tells us little about the economy's health. A year ago, interest rates were rising because society wanted to spend more than it was saving. Today's economic circumstances require a lower structure of interest rates as a result of events that are depressing spending. When the pace of spending picks up, it will not be a result of monetary stimulus so much as a consequence of greater certainty. For once, the prospect of higher interest rates might seem downright attractive.