

The Economy in Perspective

The real thing?...At this writing, we have just finished preparations for the May 7 meeting of the Federal Open Market Committee. If you are a Fed watcher, you know that your peers do not expect to see any change in the federal funds rate target at this meeting and perhaps not at the June meeting either. Sentiment about the funds rate waxes and wanes with news about the economy's strength, and lately the news has been interpreted more as mixed than bullish. Professional forecasters generally scoff at the notion that the recovery is in jeopardy, but they now expect a more attenuated expansion path this year than they envisioned a month or two ago.

Seasoned observers of business cycles and economic policymaking realize that several factors make forecasts of the federal funds rate especially volatile in times like these. Data are subject to revision, of course. And since some industries and regions are at different stages in their own cycles, it can take time for aggregated national statistics to reveal an overall pattern of economic activity. Consequently, forecasts of the real economy—and the funds rate—may be unusually sensitive near business cycle peaks and troughs, when the pace and direction of economic growth are shifting.

Just how important to the economy is the federal funds rate's path over the next six to nine months? Financial market traders may care; but for the nation as a whole, economic welfare depends hardly at all on near-term movements in the funds rate. Other factors have so much more effect on economic welfare that it is often difficult to understand why the funds rate attracts such abundant attention. True, the funds rate reflects liquidity conditions in the interbank lending market at a particular moment; over the course of a business cycle, however, we would expect it merely to oscillate around the trend in the real rate of interest.

The real rate of interest reflects the return to capital, which itself reflects the rate of productivity growth that investors expect. An economy characterized by 2 percent productivity growth will double its standard of living every 36 years; a productivity growth rate of 4 percent will cut the doubling time in half. So factors that affect the rate of productivity growth deserve close attention. What might they be?

Innovation to be sure, but more than that: innovation yielding goods and services that can be sold at a profit. Scientific advances might fuel the process, but competitive markets, enforceable

property rights, and a legal system for settling disputes are necessary to nurture and sustain innovations that can raise living standards. Current developments in accounting standards, intellectual property rights, antitrust enforcement, and privacy laws all will affect the way scientific discoveries are transformed into goods and services that benefit people.

International trade has the potential to contribute greatly to economic welfare in the long run, but it gets a bad rap in some quarters because imports are thought to eliminate domestic jobs. But the same logic works here as in the case of purely domestic innovation: The whole point of productivity improvements, from the invention of the wheel to today's computers, is to create more effective ways of combining labor and capital. Over time, people who learn how to work with the newest capital goods become more valuable and earn higher incomes. International trade simply expands the arena in which this process of innovation and resource reallocation takes place.

Trade barriers can protect domestic producers in the short run but not the long run. For example, raising the cost of importing foreign steel or sugar simply encourages U.S. companies to import finished steel products and candy, undercutting the value of steel tariffs and sugar quotas. The volume of imports and exports has been growing much faster than total GDP in this country for quite some time, and trade patterns have been an important determinant of what is—and is not—produced here.

Population aging continues to have far-reaching consequences for the nation's economy, including its impact on health care outlays, which now account for more than 13 percent of GDP, and on Social Security, which is projected to show a cash-flow deficit in 2016. It is widely recognized that the federal government faces significant immediate challenges in reforming both the medical care marketplace and the Social Security system. How we meet—or fail to meet—these challenges could have profound consequences for key aspects of U.S. economic performance over the next several decades.

Speculation about the next change in the federal funds rate sometimes seems a bit like a soft drink: It might satisfy a momentary craving but it doesn't contain the protein needed to sustain and improve life.