

## *The Economy in Perspective*

*Matters of interest...*The Federal Open Market Committee reduced its federal funds rate target by 25 basis points at its June 25 meeting, and the Board of Governors reduced the discount rate on primary credit by an equal amount the same day. These two policy rates, which stand at 1 percent and 2 percent, respectively, have not been this low since the 1950s, yet some financial market participants anticipate even further reductions. In fact, yields have been falling all along the yield curve for several years. During the last three years, the FOMC has lowered the federal funds rate by 550 basis points in a series of 13 steps, while the market-determined 10-year U.S. Treasury note has fallen by 310 basis points.

Several factors account for interest rates' decline. Most obviously, and almost tautologically, the supply of savings has been expanding faster than the demand for credit. Despite the strength of the automotive and housing sectors, the overall pace of real economic growth remains far below the rates attained during the previous business cycle expansion. Capital spending has been especially weak for several years. Corporate executives evidently think that risk-adjusted returns to new investment projects are poor right now. Until and unless the demand for business credit revives, real interest rates will probably remain low.

Declining inflation and inflation expectations have also played a role in the downward drift of interest rates. In March 2000, the peak of the last business cycle, the core CPI registered a gain of 2½% in the prior year. Inflation expectations, as measured by the University of Michigan's Survey of Consumers, stood at 3¾%. Today's comparable figures are 1½% and 2½%. This decline in actual and expected inflation probably has contributed 100 basis points to the decline in nominal long-term interest rates. And the public seems convinced that inflation will remain at historically low rates for quite some time.

To the extent that inflation reduces economic welfare, lower inflation rates will confer public benefits. Consequently, the Federal Reserve System has been systematically pursuing a goal of price stability for several decades. Many observers might argue that this long-sought goal has finally been realized. Ironically, though, the public seems largely indifferent to the arrival of price stability, linked as it has

been to a troubled domestic economy and very low interest rates.

The Federal Reserve's actions have supported the decline of interest rates by making bank reserves available at ever-lower overnight rates and by fostering the expectation that reserves will continue to be available on easy terms. In effect, as households and business firms have signaled a desire for more liquidity and less risk, Federal Reserve actions have been accommodative of market forces pushing interest rates down.

Although business cycles resemble one another, each has its own idiosyncrasies. The current cycle has been so peculiar, especially in regard to poor labor market conditions, that its trough still has no official date. Output is expanding, but employment is not. Moreover, the composition of output growth remains unbalanced, being heavily tilted toward residential construction and automobile purchases. Households and corporations have significantly reduced their appetite for risk, leaving financial intermediaries with plenty of highly liquid liabilities and fewer opportunities to deploy them. To be sure, households and firms have taken advantage of this environment to refinance outstanding debt, but these actions themselves create no new wealth. For every borrower who finds cheaper refinancing, a lender encounters a premature principal repayment and faces reinvestment risk.

How should one regard the economy's present intransigence? Have policymakers systematically underestimated the need to stimulate demand for goods and services? If so, will recent monetary and fiscal policy actions give economic activity the desired boost? Or do the peculiarities of this business cycle suggest thinking about the U.S. economy from an additional perspective? Are we being affected by powerful external forces—including global competition and geopolitical tensions—that carry consequences for investment, risk taking, and resource utilization? Do these forces act as "headwinds" against the U.S. economy at the moment, preventing vigorous growth? How successful can monetary and fiscal policy actions be in the face of these forces, especially if economic growth continues to be unbalanced?

These are indeed matters of considerable interest.