

The Economy in Perspective

I am extraordinarily patient provided I get my own way in the end.

—Margaret Thatcher

At the conclusion of its January 28 meeting, the Federal Open Market Committee issued a press release stating that it “could be patient in removing its accommodative policy stance.” Stock and bond markets, which had placed heavy odds against such a message, immediately sold off.

Not surprisingly, certain talking heads initially pronounced some harsh words about the Fed on the evening news, but quickly enough, other voices pointed out that the FOMC had not, in fact, increased interest rates. The real news lay in the change of tone regarding how much time the FOMC expects to elapse before it acts. Instead of repeating its earlier language that it would be “accommodative for a considerable period of time,” the FOMC said that “with inflation quite low and resource use slack, the Committee believes it can be patient in removing its policy accommodation.”

That the FOMC eventually must hike the federal funds rate seems obvious. At 1 percent, the rate is likely to be several hundred basis points below its natural rate—the rate consistent with price stability in an expanding economy whose productive resources are fully employed. By holding the funds rate very low for a long period of time, the FOMC has been accommodating liquidity requirements, stimulative fiscal policies, and natural market forces working to repair imbalances and propel the economy forward. As these forces increasingly take hold, the need for monetary and fiscal policy “scaffolding” should lessen. Indeed, in the case of monetary policy, maintaining an easy stance too long could ultimately accelerate inflation.

Although market participants and policymakers recognize that extremely accommodative monetary policy cannot be maintained indefinitely, judging when and how to throttle back involves elements of the unknowable. Central bank actions affect inflation most importantly several years into the future. In the shorter run, the inflation process is governed by millions of decentralized wage and price decisions that themselves depend heavily on inflation expectations.

With actual and expected inflation very low, businesses facing slack labor markets and idle industrial capacity might find that price increases will not stick—in fact, expectations of such failures might keep businesses from even trying.

Inflation expectations are poised on a balance point today. Some analysts, looking ahead, anticipate that the rapidly expanding economy will quickly lose whatever slack remains. They surmise that inflation could easily accelerate somewhat next year and beyond, unless the Fed prepares to act against it. Other analysts, judging the amount of slack to be considerable and the FOMC’s surveillance to be vigilant, are less animated. Consequently, even though it seems unlikely that inflation in the United States will decline further from this point, it could be quite some time before the expansion’s dynamics translate into significant overall inflationary pressures.

The FOMC’s statement about being patient before removing its policy accommodation seems intended to respond to the concerns of one camp without alarming the other. Market participants expect the FOMC to sift through the incoming economic data, revise its thinking about policy, and remain prepared to respond flexibly to developing circumstances. In the short term, markets can be highly sensitive to incoming information of all kinds, including the FOMC’s assessment of further disinflation and the degree to which it might be regarded as unwelcome.

How the economy will evolve remains, as always, to be seen. It is often tempting and usually a mistake to think either that the economy is charting entirely new territory or that it follows a predictable cyclical course. Two of the earliest students of U.S. business cycles, Wesley Mitchell and Arthur Burns, observed that although business cycles displayed some common patterns, each cycle also had its idiosyncratic components. We tacitly acknowledge this insight when we give a particular episode a name, such as “the jobless recovery.” The irony, of course, is that the original “jobless recovery” (1990–92) has already been replaced by another, more pronounced one. We are still too close to this episode to know by what name it will ultimately be remembered.

To learn that, we must be patient—at least for a period of time.