

The Economy in Perspective

On the policy trail... The Federal Open Market Committee has maintained its federal funds rate target at 1% for almost a full year, by most reckonings a considerable length of time. With inflation close to 1% and inflation expectations also very low, the real federal funds rate has stayed in the neighborhood of zero during that period. This situation is unusual but not unprecedented—the FOMC set the real funds rate near zero for a period in the aftermath of the 1990–91 recession.

As of May, nonfarm payroll employment is still 1.6 million below its level at the peak of the last business cycle in March 2001. The nation's 5.6% unemployment rate is above the 2000 peak of roughly 4.0%. Similarly, many industries' capacity utilization rates lie well below their pre-recession peaks. So, despite recent reports of accelerating economic activity, it is not surprising that many analysts think the economy is operating below its full-employment potential.

Although the theoretical concept of full employment potential and its cousins—potential output, the nonaccelerating inflation rate of unemployment (NAIRU), and the natural rate of interest—variously describe ideal economic conditions, policymakers face challenges in determining how to implement the concepts empirically and use them in real-time situations. Theoretically, each of these concepts can be thought of as indicating the output level, the rate of unemployment, or the interest rate that would prevail in an economy where supply and demand are balanced in all markets. Generally, no more resources could be employed without reducing overall social welfare.

How can policymakers constructively contribute to the attainment of ideal conditions? A central bank could attempt, in effect, to keep its policy rate on a path consistent with an economy evolving toward full resource utilization with price stability. Unfortunately, even the wisest and best-intentioned central banks are not omniscient. While trying to remain on this so-called neutral policy path, policymakers necessarily must rely on a constellation of judgments about economic structure and forecasts.

Why are policy rates not always characterized as neutral? Why are they sometimes described as “accommodating”? This terminology could mean

that policymakers are simply accommodating an increased demand for liquidity by lowering the price of bank reserves as the economy evolves along its equilibrium path. Alternatively, the term could connote a desire to foster a greater expansion in real economic activity than would occur if the policy rate were set higher, especially if a higher rate were called for by the neutral policy path.

Policymakers might choose to be accommodating if they were uncertain about particular aspects of their forecasts or were risk-averse regarding sluggish economic performance. However, if a central bank underestimated its economy's inflationary potential by putting too much faith in its estimates of economic slack, it could unwittingly “accommodate” an unwelcome acceleration in inflation.

Central bankers have learned that they can promote social welfare not only by achieving their goals, but also by avoiding policy surprises along the way. Consequently, central banks try to give the public information about their goals, economic frameworks, and policy reaction functions (that is, how they tend to respond to incoming data). People move in markets as soon as relevant information becomes available. When people are very well informed about policymakers' intentions and methods, they initiate transactions that make sense if the central bank subsequently acts in ways that are consistent. By the time the central bank actually takes the conforming action, it will have been anticipated and “priced into” the financial markets. A central bank can prevent some market turbulence by providing information about what it does and does not know.

Fortunately, just as people tend not to persist in systematic errors, many central banks also have proved to be quick learners. For if a central bank continues too far down a policy trail that would have undesirable consequences, chances are high that the markets would provide cautionary signposts along the way. Like policymakers, markets are not omniscient—they can make incorrect assumptions and judgements, and anticipate economic conditions that never arise. Consequently, one of the arts of central banking is knowing when to educate markets, and when to let markets educate you.