

The Economy in Perspective

Behind the curve... Despite the Federal Open Market Committee's June 30 decision to increase its federal funds rate target by 25 basis points, some people still wonder whether or not the Committee is "behind the curve." What might they be thinking? Used one way, this idiom implies a lower-than-average score or performance, in the sense of falling below the mean on a test that is graded on the curve. Alternatively, the expression implies lagging behind the expected pace of action, in the sense of following a trajectory that falls below an idealized curve plotted on graph paper. Neither usage is flattering—both connote suboptimal performance.

Although many Fed watchers, informed or otherwise, enjoy grading the Fed's performance and issuing periodic report cards, it's unlikely that they intend to conjure up images of failing grades. More likely, pundits are suggesting that the FOMC has been too slow to raise the federal funds rate. What is their case?

Their main point is that inflation has increased during the past year and appears to be accelerating, even after accounting for the influences of food and energy commodities. For example, the Consumer Price Index increased by 1.9 percent in 2003 and by 1.1 percent if food and energy are excluded (the core CPI). In the 12 months ending in May 2004, the total CPI rose by 3 percent and the core CPI by 1.8 percent. Most recently, taking the three months ending in May 2004, the CPI increased at an annualized rate of 5.5 percent and the core CPI at a 3.3 percent rate.

Some Fed watchers appear to regard accelerating core inflation as *prima facie* evidence of a lax monetary policy in an expanding economy that is operating close to its capacity constraints. Overall economic activity advanced at a pace near 5 percent during the four quarters ending in March; many private forecasters expect real GDP growth in the 4 percent range during the next four quarters. Clearly then, whatever excess capacity has existed in the U.S. economy is being whittled away as the expansion matures. How much remains is hard to discern because potential output—despite its conceptual appeal—has proven quite difficult to estimate with precision. Moreover, measures of potential output, taken alone, tend to explain only a small fraction of the variation in inflation.

Finally, some observers note that monetary policy affects the economy only after a lag of a year

or more. At 1.25 percent, the federal funds rate remains very low in both nominal and real terms. If a central bank wants to avoid falling behind the curve, it must take these lags into account.

What is the opposing view, the case for policy being "on the money"? For starters, the recent inflation run-up might just be the result of temporary factors. Prices for a broad range of commodities increased at very rapid rates last winter and this spring, but in many markets prices have recently backed off those highs. Although it once was commonplace to hear business people say that they could pass along price increases to their customers, such circumstances now seem somewhat more limited than initially was feared. Inflation expectations, as estimated by opinion surveys and financial market instruments, do not appear to be pricing in a higher-inflation environment once the temporary effects of the current situation dissipate.

As to excess capacity, one must recognize that the economy's productive capacity grows over time along with its actual output. If the strong productivity growth trend continues, the gap between potential and actual output may close very slowly during the next several years. Moreover, while potential output is difficult to estimate, it seems likely that labor markets—at a 5.6 percent unemployment rate—and industrial capacity—at a 78 percent utilization rate—still have room to grow. Finally, although employment gains were vigorous this spring, the June report was lackluster. Responding to that report, financial markets reduced the odds of a 50 basis point hike in the federal funds rate in August—effectively "lowering the curve."

This last development should make us more aware of how the curve is constructed, that is, what is behind the curve itself. Apart from the parochial views of individual Fed watchers, the curve represents the market's view of what the Fed will be doing at each point in time from now into the future. That view, of course, is conditional on what the market knows (or expects) today. By definition, that trajectory of policy actions—that curve—will change in response to current and anticipated events, so it is a moving reference line. What today might appear to some as being behind might later appear as being ahead of the game. The trick is to know when one is being thrown a curve.