

# *The Economy in Perspective*

by Mark Sniderman

*A journey of a thousand miles begins with a single step.*

—Chinese proverb

*On a journey of a hundred miles, ninety is but halfway.*

—Chinese proverb

Participants in the federal funds futures market expect the Federal Open Market Committee to raise the funds rate target by 25 basis points at each of the next two policy meetings. If this does happen, the funds rate will have steadfastly traversed a territory of 400 basis points in 16 equal steps over a two-year span. As of today, few believe that the FOMC will implement another rate increase at its June meeting—in fact, the futures market actually expects the funds rate to decline slightly next year from its anticipated June peak of 5 percent.

What is the logic behind this expected funds rate path? What does it imply about the market's view of the real economy, inflation, and the FOMC? First of all, the path's relative stability shows that financial market participants expect the FOMC will have to take very few actions to achieve its policy objectives. Most forecasters call for the economy to continue expanding for the next several years at a pace close to its potential growth rate, and for any existing inflationary pressures to gradually diminish as the expansion lengthens. Second, the level of rates along the path indicates market participants' belief that for the next few years, the FOMC will accept the market-expected inflation rate, that is, just a touch above 2 percent annually on a CPI basis.

A federal funds rate of 5 percent has a certain aesthetic appeal. Many forecasters follow the rule of thumb that potential GDP will grow at a rate near 3 percent, and that 2 percent inflation lies in the middle of the FOMC's comfort zone. With the unemployment rate between 4<sup>1</sup>/<sub>2</sub> and 5 percent, and the manufacturing capacity utilization rate near its long-term average, there is ample reason for analysts to suspect that the economy—and monetary policy—are tantalizingly close to equilibrium.

Arbitrage conditions across financial markets should guarantee that signals consistent with this vision will appear in a variety of other places, as they do. The Treasury yield curve has become nearly flat

from the three-month bill to the 10-year note, but exhibits a small hump (10 to 15 basis points) that peaks at the six-month maturity. Quality spreads in the corporate bond market have remained low and stable for several years, stock market volatility has all but disappeared, and inflation expectations derived from the market for Treasury inflation-protected securities seem well contained.

To dwell forever in policy nirvana requires fulfillment of the expectations that underpin these and many other financial markets. Though this is not impossible, the odds are slim. History is full of unforeseen events. In the economic context, when shocks happen, prices, interest rates, exchange rates, and expectations adjust, sometimes very quickly. Real and financial resources—people, commodities, equipment, and financial capital—are diverted from their original destinations toward places where they command greater economic value.

The FOMC cannot predict these unexpected events; even if it could anticipate some of them, it lacks the power to offset their full impact on the U.S. economy. But it is far from helpless: It has the ability to accomplish two very important things. First, it can return the U.S. inflation rate to the long-term path that represents price stability, even if shocks initially turn it from that path. For example, during the 1990s, we saw the FOMC push the inflation rate down until it reached a price stability path; we saw it act again in 2003 to raise an inflation rate that had gotten low enough to be potentially problematic.

Second, the FOMC can be clear about its objectives and its methods for achieving them. It can establish ongoing communications with the public about its own intentions and expectations, and it can endeavor to be as consistent as is practicable in its analytical framework, data assessment, and policy responses to incoming information. Assuming that it does what it says it will do, a central bank that abides by these principles can create an environment in which the informed decisions of others will reinforce the outcomes that policymakers seek to achieve. Well-informed financial markets will smooth the economy's journey along the best path, one step at a time.