

The Economy in Perspective

by Mark Sniderman

The road not traveled... In the Monetary Policy Report the Federal Reserve submitted to Congress in February 2005, the FOMC projected that real GDP would increase at a rate of about $3\frac{1}{2}$ percent, inflation as measured by the core PCE would increase at a rate of roughly $1\frac{1}{2}$ to $1\frac{3}{4}$ percent, and the unemployment rate would register between 5 and $5\frac{1}{4}$ percent in the fourth quarter of this year. When the FOMC updated its 2006 projections in July 2005, it shaded down its judgment for real output to the range of $3\frac{1}{4}$ to $3\frac{1}{2}$ percent, edged up its estimate for core inflation into a range of $1\frac{3}{4}$ to 2 percent, and put the fourth quarter unemployment rate at 5 percent. The FOMC last revised its 2006 projections in the Monetary Policy Report of February 15, 2006. In this most recent view, the Committee widened its central tendency range for real GDP at the low end to 3 to $3\frac{1}{2}$ percent, kept its estimate of core PCE inflation at $1\frac{3}{4}$ to 2 percent, and lowered its range for the unemployment rate even further to $4\frac{3}{4}$ to 5 percent.

The picture that emerges from this sequence of projections is that the Committee has consistently expected the economy to grow at a rate close to $3\frac{1}{4}$ percent this year, has expected core PCE inflation to register roughly $1\frac{3}{4}$ percent, and has gradually lowered the unemployment rate thought to be consistent with its GDP projection by as much as half a percentage point during this period.

What the projections themselves fail to reveal is the extent to which they maintained their consistency in the face of extremely large increases in energy prices. In the 12 months ending in February 2006, the energy price component of the Consumer Price Index soared by 20 percent; in the 12 months before that, the energy component rose by 10 percent. In earlier periods that saw energy price increases of this magnitude, the U.S. economy proved vulnerable to slowdown and even recession. Yet, during the past two years, our economy has demonstrated a remarkable resilience.

What the FOMC's economic projections also do not reveal is the extent to which the federal funds rate path they ultimately traveled is similar to, or different from, the path they might have anticipated after the initial projections for 2006 were made. Nevertheless, even without this information, it seems fruitful to think less of a particular path for

the funds rate than a set of paths, each with a different probability of being chosen. Even when it gives some words of guidance about future policy actions, the Committee is always careful to note in its press releases that there are risks to the outlook and that it reserves the right to be flexible in responding to incoming economic information.

To the extent that the FOMC was surprised by economic conditions as they emerged during the past year, it would have had to adjust its policy settings to keep the economy on a path of maximum sustainable employment and price stability. We cannot assess how much the economy's evolution differed from what the FOMC expected, but we do know that the magnitude of the energy price shocks was unanticipated. We also know, from the most recent Monetary Policy Report, that the combination of rising valuations for stocks and housing in the past few years is thought to have provided important support for consumer spending in 2005, a period of comparatively weak growth in real income. Capital spending was robust as well. Similar conditions have prevailed so far this year.

The energy price shocks certainly exerted a drag on economic activity but other factors emerged that not only offset the drag, but also supported enough additional activity to use a considerable amount available productive capacity. Last month, the nation's unemployment rate stood at 4.7 percent, already at the low end of the FOMC's projection for the year.

The most recent Monetary Policy Report, while noting that the FOMC gradually increased its federal funds rate target by 2 percentage points over the course of 2005, stated that this cumulative firming substantially exceeded what market participants expected at the start of the year. Financial market participants are now almost evenly divided in expecting the federal funds rate target to be set at either 5 or $5\frac{1}{4}$ percent after the FOMC's June meeting. Importantly, however, most professional forecasters expect the economy to turn in numbers this year that are similar to the FOMC's most recent projections.

Monetary policy should be judged on its ability to achieve price stability and maximum sustainable economic growth, not by where the funds rate might need to go to get us there.