

# *The Economy in Perspective*

by Mark Sniderman

*We may reason on to our heart's content, the fog won't lift.*

—Samuel Beckett, 1967

To better understand today's economic and policy environment, go back about 10 years. The stock market was running in high gear, but some market observers began to predict a major market correction, especially in the tech-sector-rich NASDAQ. In 1996, Alan Greenspan, then Federal Reserve Board chairman, made a widely quoted remark about irrational exuberance in the stock market. Eventually the market did collapse, the tech sector most spectacularly, but the years that elapsed between the initial warnings and the correction that began in April 2000 illustrate the difficulties of accurately predicting even seemingly obvious events.

Unlike the equity market crash, which was widely anticipated, the recession that began in March 2001 and lasted until November appeared to take nearly everyone by surprise, despite the now-obvious connection between these two developments. The Federal Reserve's industrial production index peaked in March 2000, coincident with the NASDAQ's zenith, but most forecasters expected the economy's growth rate to moderate to a pace that would be consistent with stable inflation.

For example, in the FOMC's mid-year Monetary Policy Report to the Congress of July 2000, most of the Federal Reserve governors and Reserve Bank presidents reported that they expected real GDP to expand in the range of 4 to 4½ percent in 2000; as it happened, real GDP advanced by 3.7 percent in 2000, short of the projection (but still within the confidence ranges of very good economic forecasters).

Seasoned forecasters continued struggling to keep up with the deterioration in economic conditions. Using the FOMC as an example again, in July 2000, the governors and presidents looked for growth to slow to a pace in the range of 3¼ to 3¾ percent in 2001. Six months later, in February 2001, they revised down their 2001 projection for real GDP to the range of 2 to 2½ percent. In July, the majority of the panel members downgraded their outlook once again, this time to the range of 1¼ to 2 percent. In hindsight, we know that the actual growth rate was 0.8 percent and that a recession was already underway at the time of the July report.

The Federal Reserve had been raising its federal funds rate target from mid-1999 to mid-2000 in the face of a strong economy and concerns about an intensification of inflationary pressures. The FOMC had maintained a 5 percent target from the start of 1999 until its June meeting, when it raised the target to 5¼ percent. The target gradually rose to 6 percent and, in May 2000, the Committee boosted it to 6½ percent. According to the minutes of that meeting, "[t]he members saw little risk in a relatively aggressive policy move, given the strong momentum of the expansion and widespread market expectations of such a move. The greater risk to the economic expansion at this point was for policy to be too sluggish in adjusting, thereby allowing inflationary disturbances and dislocations to build..." The funds rate target remained at 6½ percent until the FOMC conferred by telephone on January 3, 2001, and agreed to cut the rate by 50 basis points. A year later the rate stood at 1¾ percent; it would eventually bottom out at 1 percent and remain there for a considerable time.

The point is not to cast aspersions on the Federal Reserve's economic projections, for academic studies indicate that the FOMC has access to the best forecasts available. Moreover, the record clearly shows that the FOMC was right to regard inflation as a serious threat to the economy. Despite the FOMC's strenuous actions to contain inflation and inflation expectations, the CPI minus food and energy (the core CPI) increased by 2¾ percent in 2000 and 2001, even higher than the year-over-year readings of the core CPI that have been so disconcerting recently.

It would be easy today to say that the FOMC would not have followed as restrictive a course of action if it had known then what we know now, but it would also be vacuous to say so. The recession, which was relatively brief and shallow, might well have come anyway, and inflation might not have been subdued. There are no certainties when it comes to positing alternative futures. Our recent history reminds us, if we need reminding, that even as policymakers become more transparent, the world they contend with is still shrouded in fog.