The Economy in Perspective

Behind the curve...Those who put their money where their mouths are speculate that next April, the federal funds rate will be nearly 50 basis points lower than today’s 6.5% rate. Moreover, with one-year Treasury bills trading at 5.75% and 10-year Treasury bonds at 5.35%, investors clearly are expecting short-term interest rates to continue declining and to stay in a lower range for much of 2001.

Before last May, financial market participants expected the federal funds rate to increase beyond 6.5%; they have been lowering their estimates steadily since then. Between May and September, rates seesawed in response to mixed economic news. Since September, however, analysts have interpreted incoming information as pointing in only one direction, that is, toward a slower-paced economy in 2001 than in the prior two years.

At its November 15 meeting, the Federal Open Market Committee elected not to alter either its target federal funds rate or its statement that the balance of risks was weighted toward “conditions that may generate heightened inflation pressures for the foreseeable future.” Hearing this news, some observers might have thought that the Fed was in danger of falling behind the curve, if it had not already done so. And if this was their opinion then, it must have intensified in the past weeks as government statistical agencies reported October’s sharp decline in durable goods, revised the third-quarter real GDP rate downward, and corroborated a slowdown in the rate of new hires in 2000 compared with the last several years of this long economic expansion.

Not surprisingly, then, many financial market participants consider the outcome of the FOMC’s December 19 meeting a foregone conclusion: In their view, the balance-of-risks statement will surely give equal weight to heightened inflation pressures and waning economic growth. To them, an outright reduction in the federal funds rate target would be a welcome and not entirely unexpected bonus. What could be more obvious, they would say, than the need for all interest rates to decline markedly in the presence of evidence that economic growth is weakening and inflation poses no threat?

Taken at face value, this is a reasonable question that can be answered simply. If inflationary pressures indeed are not threatening to escalate, and economic activity is slowing down, then the entire structure of market-driven interest rates should be falling of its own accord. If the central bank pegs its funds rates higher than what would be consistent with money demand under these conditions, monetary policy will be geared toward reducing the trend rate of inflation; and in the short run, this policy might temporarily amplify forces already slowing the economy’s growth. Setting the funds rate somewhat lower would remove these forces, at the expense of a further trend reduction in inflation.

Now let’s explore this question at a deeper level, examining the premise. Suppose that prior monetary policy had been permitting an upward drift in the inflation trend. For example, M2 growth accelerated from the 1%–2% range in 1993–95 into the 7%–8% range in 1998–99. Moreover, most inflation measures indicate acceleration since mid-1999. Indeed, the rebound of the Federal Reserve Bank of Cleveland’s median CPI since then has been strong enough to eliminate what progress had been made toward price stability since 1992. It is no secret that the FOMC’s decision to raise the funds rate from 4.75% to 6.5% in a series of steps between June 1999 and May 2000 was prompted by concerns about accumulating inflationary pressures.

It is also well known that real GDP growth fluctuates greatly from quarter to quarter and even year to year. During the present expansion, for example, real growth has averaged about 4%, but the quarterly standard deviation has been two percentage points. Moreover, forecasters incorrectly have been calling for a downshift in economic growth for the last four years. Policymakers have learned not to underestimate the economy’s ability to shake off a few slow quarters and continue to follow a pattern of strong growth.

The FOMC increased the federal funds rate 300 basis points in 1994 to head off an inflation upsurge, and economic growth slowed in 1995. That slowdown proved to be temporary, of course, as did the full amount of the funds rate hike. Whatever action, if any, the FOMC takes at its December meeting will incorporate a full appreciation of the leads and lags associated with the processes determining economic growth and inflation. Those who might appear to be behind the curve may actually be ahead of the game.