Worst-case scenarios... Most people pondering worst-case scenarios for the U.S. economy this year are likely to be concerned that the slowdown we have been experiencing will be unusually steep and protracted. We cannot know the future with certainty, and some U.S. contractions have indeed been marked by large declines in output and employment. A related concern is the possibility that economic growth could remain sluggish for a period, entailing not an absolute loss of output, but a loss relative to the economy’s imagined growth potential.

Many hypothetical business cycle contours are plausible because the economy has generated a number of patterns during its history. The magnitude, duration, and composition of business cycle fluctuations have proven extremely difficult to forecast reliably. In fact, there is compelling evidence that even economic policymakers, who arguably have access to the best data and forecasting tools available, may not always recognize an economic contraction until after its onset. By then, of course, it is too late for any actions that might have prevented a downturn.

Whether policymakers can prevent economic contractions is debatable. Economists remain divided over how many of our past business cycles can be attributed to monetary and fiscal policy mistakes rather than exogenous disruptive events. They also debate how aggressively policymakers should respond to business cycles, by trying either to speed up or slow down the economy. Some prominent economists have concluded that once business cycle dynamics are set in motion by outside forces, a meaningful part of the subsequent volatility results from people responding rationally to changes in their environment.

Macroeconomists have also learned that when policymakers presume to know too much, they may unintentionally exacerbate business cycle fluctuations. During the 1970s, policymakers thought the economy was capable of expanding faster, and they repeatedly tried using monetary and fiscal policies to spur growth. Higher inflation was initially regarded as an acceptable price to pay, but as it kept accelerating, the government resorted to wage and price controls for a solution. So many poor economic decisions were made in those years by households and businesses trying to shield themselves from runaway inflation that it took nearly a decade for the economy to regain its health.

It is not surprising, therefore, that policymakers took a cautious view of the economy’s growth potential in the 1990s. By then, they finally had learned that if there is any relationship at all between inflation and economic growth, it is that price stability promotes a strong economy. So it is probably fair to characterize the 1990s’ stabilization policy as one that primarily tried to do no harm, and only attempted to “fine-tune” as a secondary matter. In practice, that meant containing inflation expectations and relying on the economy to expand, rather than assuming that policy actions were required to boost the economy to a preconceived pace.

With a suddenly emerging softness in the demand for durable consumer and investment goods, short-term interest rates have naturally declined. The Federal Open Market Committee responded by quickly reducing the federal funds rate target by 100 basis points. What comes next? It is not clear how soon and with what intensity economic growth will resume. Some analysts, claiming the economy’s underlying growth potential has been exaggerated for several years, declare that unemployment has a long way to rise before reaching its new equilibrium rate. From this perspective, significant further easing in monetary policy seems appropriate.

But a truly worst-case scenario is one in which core inflation indicators continue to accelerate—as they did last year—while the economy works its way through the adjustments ahead. In a worst-case scenario, people become so convinced of what they “know” and so preoccupied with overriding ordinary business cycle dynamics that economic policy stimulus eventually proves to be excessive. Periods of below-par economic growth bring difficult conditions, but these usually pale in comparison to the ultimate damage that cyclical fine-tuning can inflict. Though such damage may seem remote today, now is the time to be alert to the prospect.