

The gravity of the situation...This morning the Bureau of Labor Statistics reported that payroll employment declined by more than 200,000 people in April, a much larger number than private analysts had expected. Not only had employment weakened further in the already beleaguered manufacturing sector, but it had also softened in the service sector. The unemployment rate drifted up from 4.3% to 4.5%. Market opinion cheered this development, sensing that it would spur the Federal Reserve to reduce the federal funds rate another 50 basis points at its May 15 meeting. Market sentiment had already anticipated a funds rate cut because the FOMC had reduced the funds rate 50 basis points in a surprise intermeeting move on April 18, and market participants reckoned that such an action signaled a predisposition to move again if economic data continued to be weak. The employment report was the coup de grace.

We’ve gotten used to talking heads and do not begrudge them their pulpit. Someone, after all, has to supply “content” to an industry awash in bandwidth and column inches. Nor does the business public seem to mind the inaccuracy of economic forecasts. In fact, listening to some analysts is like watching WWF wrestling: You sense that the performers are winking at you as they launch a body slam against their opponent. Many analysts—though often wrong—are never in doubt. Humility doesn’t sell.

We’ve also grown accustomed to analysts who base their policy recommendations on the difference between the economy’s actual and “potential” output. During the 1996–2000 period, most analysts confidently intoned that the U.S. economy was exceeding its potential and would generate inflation; this afternoon a radio show sound bite delivered the equally confident message that the economy was now operating far below its potential and carried no inflation threat. Terminology can get even more sophisticated in the major media markets. When the level of output is below potential but expanding rapidly, the Fed is asked to engineer a “soft landing”; when the level of output is above potential but its growth rate is slower than that of potential, the Fed is urged to perform a “reverse soft landing.” Close your eyes and you will see Alan Greenspan out on the ice, with Scott Hamilton commenting on his triple Lutz/double toe loop combination.

We’ve even become inured to the market’s apparently perverse response to macroeconomic news, in which investors buy claims to earnings streams (stocks) after they find that earnings are likely to be poorer than they had thought. The attraction seems to arise from their belief that weakness begets easier monetary policy, which begets lower interest rates, which begets a smaller discount rate applied to the earnings stream, which begets greater willingness to pay for the stock. Hence, bad news is good news. Never mind that bad news may be the beginning of more bad news, including bankruptcy of the firm itself.

What we can’t get used to, however, is people’s inability—or unwillingness—to differentiate between easier monetary conditions and inflationary monetary policy. The U.S. economy has sustained two shocks: an energy supply shock and a capital-goods demand shock. Firms are slowing production and employment; inventories must be financed until they are liquidated. Firms and households still want credit, but many now are finding it more expensive if they can get it at all. The FOMC has provided the financial system with more liquidity, but markets are channeling these funds into short-term credit instruments because creditors have become more cautious about making loans with more than a few years’ maturity. Not surprisingly, then, the Fed’s actions have had little effect on long-term interest rates.

Easier monetary conditions play the very positive role of aiding the financial restructuring of households and firms as they adjust to new circumstances. Creditworthy individuals and firms benefit from access to short-term loans as they pare current expenses and realign their spending with their income. But easier monetary conditions can neither correct nonviable business plans nor revive nonviable businesses. People who based their plans on the continuing value of those businesses must now make new plans. Monetary policy can facilitate this restructuring but not prevent it. History suggests that attempting to do otherwise could eventually promote inflation. One might as well try to defy gravity.

It’s uncertain how much lower the FOMC will take the federal funds rate before it pauses or stops. This afternoon one analyst told a financial newscaster that the Fed is prepared to ease monetary conditions until all risks of a recession disappear. Policymakers who recognize the lags between actions and effects won’t wait that long; those who do not may press too hard. One thing seems certain: Performing the triple Lutz/double toe loop combination is much more difficult while weightless and in a vacuum.

The Economy in Perspective