Hanging in the balance. According to Fed-watchers, the Federal Reserve is nearing a crossroads in its thinking about the need for further reductions in the federal funds rate. On one hand, they say, the economy remains weak despite the 2½ percentage point reduction already made this year; on the other hand, there are some signs that inflation and inflation expectations may be stirring. Since the Fed is presumed to be sensitive to both inflation and the pace of economic growth, it is reasonable for Fed-watchers to assess carefully the balance between the risks that pertain to each. Indeed, the FOMC referred explicitly to the balance of risks between economic activity and inflation in its May 15 press release, which announced a reduction of ½ percentage point in the funds rate.

The economy grew slowly in the last two quarters and, judging by the little bit of hard data available plus many anecdotal accounts, it is still doing so. Employment, hours worked, and factory orders all reflect a decline in activity from just six months ago. Interest rates and credit terms reflect the tighter standards lenders are applying to borrowers in a broad array of financial markets. Cash—not equity—is king. Earlier this year, analysts looked for a quick inventory correction and some thinning out of high-tech firms, but expected little extended damage. Now that personal consumption spending has slowed from last year’s torrid pace, observers have stretched out their forecasts of stronger overall economic growth. Those who spoke of a V-shaped recovery have grudgingly begun to substitute the letter ‘U’.

The FOMC was certainly aware of current conditions—and the possibility of continuing sluggishness—when it met on May 15. Although some aspects of the economy appeared to be positive, its published statement indicated that “[t]he Committee continues to believe that…the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future.”

In arriving at this balance of risks, the Committee also discussed inflation and the potential for it to accelerate in the period ahead. Its published statement concluded that “[w]ith pressures on labor and product markets easing, inflation is expected to remain contained. Although measured productivity growth stalled in the first quarter, the impressive underlying rate of increase that developed in recent years appears to be largely intact, supporting longer-term prospects.”

Inflation should be thought of not as the monthly or even yearly change in a price index, but as a persistent decline in the purchasing power of money. Price indexes fluctuate at different rates from year to year, and only by considering their movements over several years can we form a clear picture of inflation. In an environment characterized by complete price-level stability, people would expect their money’s purchasing power to be constant over long time horizons and would not be terribly concerned about short periods of inflation and deflation.

Until recently, price stability in the United States seemed a quaint notion; people’s only question about inflation was how much of it there would be. The FOMC has repeatedly stated its intention to achieve price stability over time, although it has not provided a precise numerical definition of that goal. However, noting that the rate of increase in the Consumer Price Index fell below 2% in 1997 and again in 1998—and recognizing possible upward biases in the index—many people believed that price stability finally had arrived. Since that time, price indexes generally have been rising at greater rates, and inflation expectations have picked up as well. Has price stability slipped away?

In reality, price stability may not truly have been reached. A more accurate assessment of inflation in the 1990s may be that not much progress toward price stability was made at all. Between 1990 and the present, the CPI, the CPI excluding food and energy, and the median CPI each increased about 3% annually on average, making a cumulative gain of 40%. The bountiful years of 1997 and 1998 must be balanced against some of the leaner years. The current performance of the CPI and the median CPI, in the range of a 3.5% annual rate, looks less aberrant when compared to the decade-long trend than when measured against the experience of 1997–98 alone.

As the economy regains some of its lost momentum and the effects of oil price shocks dissipate, we will have additional opportunities to evaluate our money’s purchasing power. Price stability remains a laudable goal, and the FOMC has the ability to achieve it over time. It appears, however, as though its time has not yet come. Nevertheless, we understand that for now, inflationary pressures are expected to remain contained.