Connecting the dots…Economic policymakers can sympathize with the national security analysts who are criticized for not putting together the pieces that seem—after the fact—to have formed an unmistakable picture. After all, critics ask, if an intelligence agency can’t see the whole picture, who can? And if policymakers can’t fill in the blanks, then what?

But predicting the future is just plain difficult, so many professional analysts don’t look only at the single most likely event, they construct several scenarios and weigh the probability of each. Financial corporations rely heavily on risk management techniques to estimate their exposures from various events and design strategies to mitigate their losses in any eventuality. So do national security and economic policy analysts. To use risk management techniques successfully, they need the imagination to envision many possible outcomes, the willingness to incur costs to cover the undesirable ones, and the flexibility to adjust strategy when conditions change.

Now consider current economic conditions in the U.S. Some observers consider them far weaker than expected, and abandon hope of even a moderate recovery. Others think conditions are reasonably sound and gradually brightening. Everyone recognizes that future economic growth would be compromised by a war with Iraq, renewed terrorist attacks, or both. How does the U.S. economy accommodate these diverse opinions, and how do policymakers set their course?

The disappointed camp points to weak corporate profits, dismal stock market performance, moribund capital spending, declining goods prices, rising oil prices, stagnant labor markets, and dormant export sales. Because of these conditions and the prospect of military action, many unhappy campers advocate tax cuts and/or easier monetary policy to stimulate the economy.

The upbeat camp emphasizes record auto sales, a buoyant housing market, and strong productivity growth. Just as important are labor markets’ restabilization—a lagging cyclical indicator—and signs that spending on capital equipment and software is picking up. They expect the mix of activity to shift away from consumers and toward business investment as the economy consolidates its gains in the year ahead. These happier campers regard fiscal policy as stimulating and monetary policy as accommodative to economic expansion.

Financial markets digest these disparate viewpoints and reflect their net effect through prices, volume, quality spreads, and write-offs. Demand for U.S. Treasury instruments—especially short-term securities—has strengthened in the past six months as sagging confidence boosted the premium investors were willing to pay for claims in the world’s safest and most liquid financial markets. Private debt issuers have been forced to offer higher yields to float their paper; even so, the reception has often been tepid. Bond defaults are rising, as are loan-loss charge-offs at commercial banks. The volatility index of the S&P 500 stocks stands at record levels, showing wide swings of opinion about corporate valuations, and new issuance remains dormant. Cash is king.

For economic policymakers, the key issue is the likelihood that expansion can continue under these circumstances. Fortunately, policymakers who wish to see the big picture are aided powerfully by the markets, which have an enormous, gyroscopic capacity to rebalance economic activity after turbulence. By absorbing and retransmitting millions of individual corporate and household decisions, market economies channel resources toward their highest-valued use. So the fixed-investment famine has become the consumers’ feast. Liquidity sloshing around in financial markets, looking for safe harbors, has been washing up on households’ shores, financing homes and cars.

The Federal Open Market Committee’s self-described accommodative monetary policy stance has been supporting the public’s demand for cash and liquid assets at near-zero real interest rates. The question now is whether even lower nominal rates would be salutary. As the debate ensues, policymakers should draw comfort from knowing that while they are busy connecting the dots, market forces are hard at work piecing together the bigger picture.