

The Economy in Perspective

The price of success... The Federal Open Market Committee voted on February 2 to increase the federal funds target $\frac{1}{4}$ percentage point, to $5\frac{3}{4}$ %. The federal funds target (the price of overnight Federal Reserve credit that depository institutions charge one another) now stands a full percentage point above its level last June.

Many financial market analysts have remarked on the number and timing of these policy actions: February's funds rate target increase was the latest in a series of four upward adjustments, made in quick succession. Fewer commentators note, however, that today's federal funds and discount rates are broadly similar to those prevailing from 1995 to mid-1998, a period when the funds rate ranged between $5\frac{1}{4}$ % and 6%, averaging $5\frac{1}{2}$ %. This stability was also evident in most other U.S. interest rates.

In market economies, prices equilibrate the interests of buyers and sellers. An interest rate balances the willingness of sellers, who consume less today in the expectation of enhanced future consumption, with buyers, who wish to shift some of their anticipated future consumption to the present. Ignoring the effects of inflation and inflation expectations, rising interest rates signify that people want to shift relatively more future consumption to the present—and that they must compensate savers more handsomely to get the wished-for resources immediately.

A number of factors affect borrowers' and lenders' behavior. If some people suddenly expect to be wealthier in the future, they may wish to begin consuming some of their anticipated wealth right away. In these circumstances, they will reduce their saving and perhaps even borrow against future income. If many of a country's people simultaneously try to alter the time patterns of their consumption in this way, the additional resources needed will have to come from abroad and the real interest rate will usually rise, encouraging lenders to defer their own consumption. But other circumstances can counteract these fundamental influences.

For instance, market-driven U.S. interest rates plunged in the latter half of 1998 as investors around the world, seeking refuge from turbulent international financial markets, rushed to purchase U.S. dollar-denominated financial instruments. As international economic prospects gradually improved in 1999, this extraordinary demand for dollar liquidity receded, causing market-driven interest rates to move back up toward their pre-panic levels. Federal Reserve-controlled interest rates matched these developments.

All this activity occurred against a backdrop of very large capital inflows to the United States for nonliquidity purposes. Seeing good prospects for continued strong economic growth, together with low inflation, foreign investors have joined their U.S. counterparts in financing a capital spending and stock market boom. The influx of foreign capital also is reflected in our foreign trade accounts. Foreigners acquire dollar-denominated assets by exporting goods and services to the United States and investing the sales receipts rather than spending them on U.S.-produced items (that is, they are lending us what would otherwise be their current consumption). Since increased demand for dollar-based assets strengthens the dollar's foreign exchange value, making imports more attractive to U.S. consumers, the capital inflow and merchandise import processes complement and reinforce one another.

The most dramatic divergence between domestic spending and domestically generated income in this expansion has taken place in the last several years, as foreign economic activity languished and demand for dollar assets surged. With international financial jitters calmed and activity in many large foreign economies reviving, it seems reasonable to expect that global investors will broaden their portfolios beyond dollar-denominated assets, and that foreign markets will come to absorb a larger fraction of global resources than they have for several years. Should these patterns emerge, it would also be reasonable to expect market-driven interest rates to firm, reflecting a more intense global pressure for additional investment and consumption spending.

Monetary policy affects economic activity through a variety of channels that are not completely understood or predictable. Movements in the overnight federal funds rate reflect changes in the supply and demand for account balances at the Federal Reserve. How funds rate fluctuations affect other interest rates depends on several factors, including inflation expectations. When savers expect inflation to rise, they add a premium to the rate they charge borrowers, because they believe that future dollars will purchase fewer goods and services.

If market participants think that the Federal Reserve will persistently oversupply liquidity to financial markets by keeping the funds rate too low, longer-term interest rates could rise even while the funds rate holds fixed. If the Fed has credible inflation goals, however, increases in the funds rate can actually reduce longer-term rates. So far during this expansion, funds rate movements have been followed by more prosperity.