

The Economy in Perspective

Color my world ... The possibilities for monetary-policy head games expanded with the June 2 release of new labor market statistics indicating that private-sector payroll employment declined by 116,000 in May. Combining this news with other recent data on housing markets and retail sales, financial market analysts have already begun to anticipate less monetary policy restraint from the Federal Reserve this year than they expected just after the Federal Open Market Committee's May 16 meeting. If history offers any insight into market assessments, we should expect several twists and turns before the economy's trajectory and the ultimate stance of monetary policy become clearer.

Although current economic data are all we have to work with, they can present a misleading picture of underlying conditions. Data-generating agencies rely on various sampling techniques to learn about the larger whole, and these samples do not always produce reliable estimates. In addition, many key indicators are seasonally adjusted, but unusual weather patterns or holiday schedules (both of which occurred this year) can create false impressions. It often takes several quarters of data to bring fundamental patterns into focus, and sizable data revisions commonly occur one or more years after the initial release. Consequently, despite every effort to adjust officially reported statistics for these potentially distorting factors, history shows that analysts—and policymakers—have made incorrect inferences and decisions as a result of blurred vision.

Market analysts and policymakers are subject to another bias, which receives less attention than it deserves. Psychologists know that people tend to interpret information in keeping with mental frames of reference; these reference frames color what they see. The May labor force data provide a handy example. The Bureau of Labor Statistics reported a total increase of 231,000 jobs in May, not the previously described decline of 116,000 in the private sector. The headline-grabber, however, was that temporary Census workers swelled the employment ranks by 357,000 in May, and that after discounting them, private sector employment actually fell by 116,000 people.

If one's reference frame has the economy slowing down over the year (as the conventional wisdom predicts), one would naturally interpret the May labor numbers as corroborating evidence. Skeptics would be told to consider the hike in the nation's unemployment rate from 3.9% in April to 4.1% in May. If, however, one's

reference frame featured continued strong growth, the overall May figures could be used to support that view; after all, the total May increase exceeds the monthly averages of both the entire expansion and 1999. Doubtters would be instructed to remember that workers who have completed temporary Census jobs will become available for other work, thus easing some pressure from tight labor markets.

The power of preconceived reference frames should be neither doubted nor ignored. Market analysts, policymakers, and the general public are well aware that the conventional wisdom expected the U.S. economy's growth rate to slow markedly in each of the past four years, only to be proven wrong. In every year since 1995, the reference frame was articulated and incoming information initially was bent to validate that perspective. And, despite each year's large forecasting errors, the reference frame was simply renewed and incoming information was viewed again through that lens.

This year, of course, the situation is supposed to be different. The Federal Reserve has been increasing its intended federal funds rate target and discount rates steadily since last summer. In announcing 50-basis-point increases in these rates on May 16, the Fed stated that increases in demand have continued to exceed gains in potential supply. Financial market participants, reacting to previous rate increases as well as this explanation for the Fed's most recent actions, are once again envisioning a notable slowing in economic conditions. Observers are convinced they are finally right because they are certain the Fed will do whatever it takes to reduce the economy's manifest economic growth rate to one that is compatible with gains in potential supply.

It is hard to quarrel with those who contend that a determined Fed is capable of slowing the growth in aggregate demand. But, once again, it is useful to recall the power of preconceived notions. How much faith should be placed in the need to slow real economic growth in order to restrain inflationary pressures? If the public knows that the Fed is committed to resisting inflation increases, price-setting behavior will be disciplined accordingly. History shows that along with the pitfalls associated with reliably manipulating total demand, accurate real-time estimates of potential supply also can be quite elusive. Those who see the world through the output-gap prism must be careful to recognize the ways in which incoming light can be distorted.