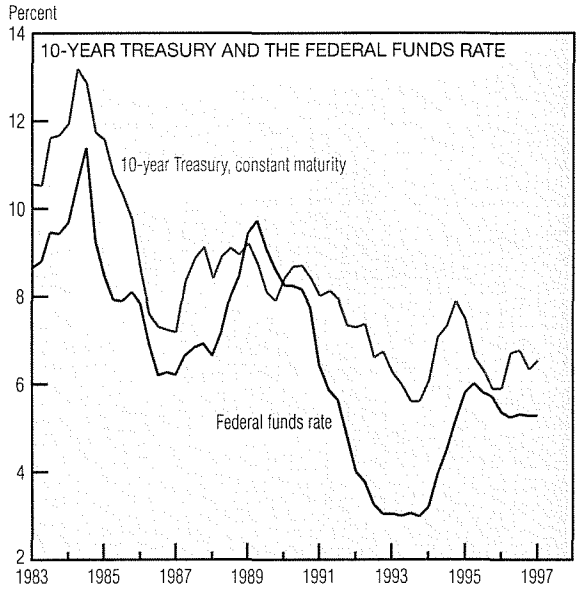
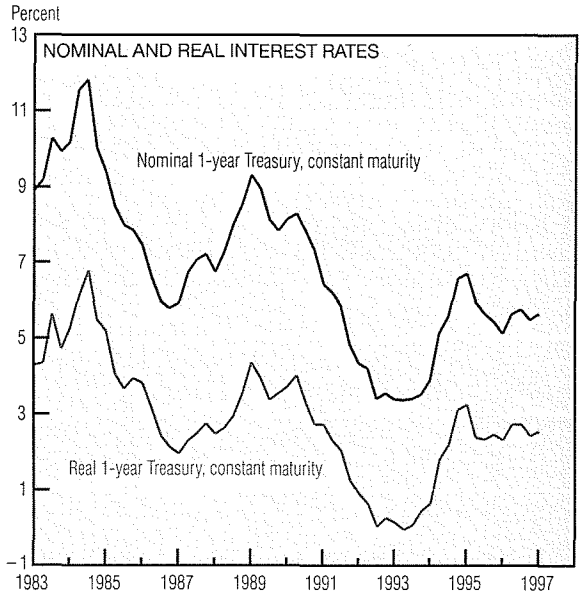
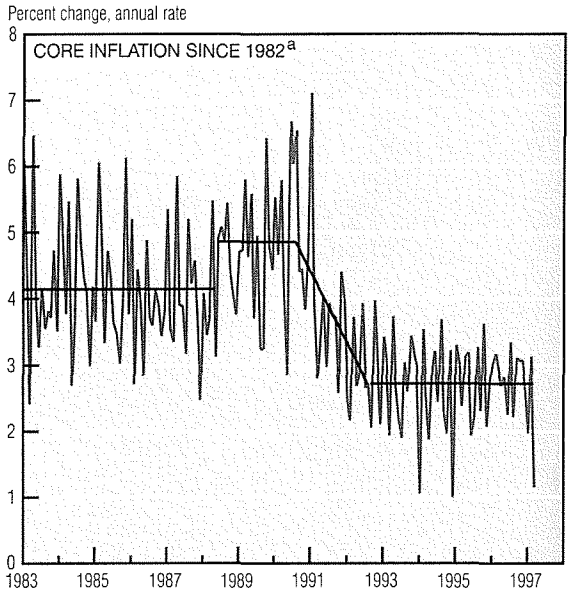
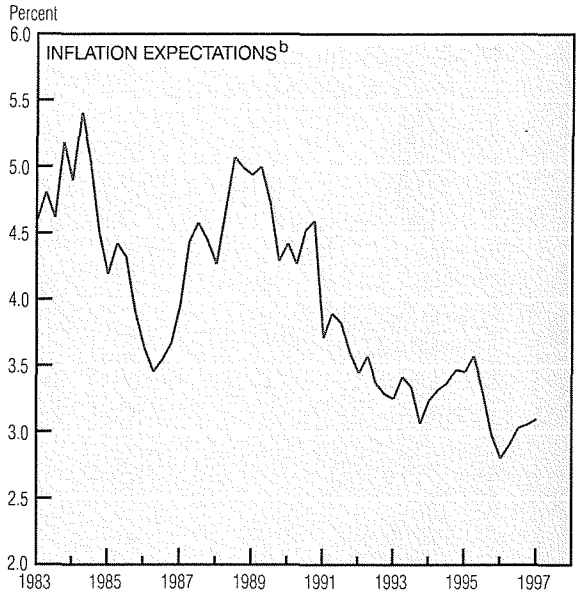
Monetary Policy: A Long-Term Perspective









a. Core inflation is measured as the 15% trimmed mean of the Consumer Price Index. Green lines represent trends.
b. Data are from the Federal Reserve Bank of Philadelphia's Survey of Professional Forecasters and reflect year-ahead expectations.
SOURCES: Board of Governors of the Federal Reserve System; the Federal Reserve Bank of Philadelphia; and the Federal Reserve Bank of Cleveland.

The financial press has given much attention to the 25-basis-point increase in the federal funds rate on March 25. The reports have tended to concentrate on how near-term economic growth might be affected by the latest rise and by possible future increases. It is constructive, however, to consider the Fed's recent action in a longer-run context.

Since 1982, there have been three episodes when the funds rate was increased over sustained periods: 1983:IQ to 1985:IIIQ, 1988:IIQ to 1989:IIQ, and 1994:IQ to 1995:IQ. Between April 29 and October 8, 1987, the rate was pushed from 6% to 7-3/8%. However, this course was reversed sharply in October in the face of dramatically declining stock prices. A series of increases resumed in April 1988, but not in time to head off a somewhat discrete jump in the trend of core inflation. Thus, the policy increases that occurred over the course of the following year were largely directed at reversing an acceleration in the price level.

A recession (beginning in 1990) followed the 1988–89 funds rate increases, suggesting that once inflationary imbalances are in place, their elimination may entail a risk of output declines. Moreover, a series of funds rate decreases just months prior to the recession could not head it off.

Neither the first nor the third episode was associated with output declines; thus, both are examples of preemptive disinflation policies. Indeed, the last episode has been followed by robust economic conditions. Since 1983, preemptive policy actions have been associated with a decline in inflation expectations and hence a lower level of interest rates.