

The Economy in Perspective

Monetary policy in a box....The Federal Open Market Committee has reduced its policy-controlled interest rates—the federal funds rate target and the discount rate—three times already this year, and if the majority of Fedwatchers are right, more rate cuts are in the offing. Why are commentators so convinced? There are at least two reasons.

Judging from the way they discuss monetary policy, many journalists, talking heads, and ordinary citizens believe that the Federal Reserve should keep cutting the federal funds rate until continued economic expansion is demonstrably assured. News of weak economic conditions, like the March labor report of further layoffs in manufacturing industries, convinces this audience that additional monetary stimulus makes sense. Many economists adopt a different framework but still reach the same conclusion.

Experienced economists recognize that during a period when excess inventory needs to be worked down, manufacturing output and employment will be curtailed temporarily. Since monetary policy begins to affect economic conditions only after a lag, experts know that at some point an aggressive reaction to current economic conditions may turn out to be an over-reaction in the broader scheme of things. With 150 basis points of policy-induced declines in short-term interest rates only recently initiated, one could argue that a wait-and-see approach is just as valid as another cut in the funds rate. Why, then, are some of the pros still impatient?

Those advocating hurried additional action cite signals that, in their opinion, suggest continuing weakness. Many business firms have been reporting lower-than-expected earnings. Corporate profits in high-tech sectors have been particularly disappointing, and these industries were so important during the economy's long expansion phase that it is sensible to question how vigorous the future can be unless they get back on their feet. Investors have not yet shown confidence in these industries, fearing that it may take a while for demand to firm up and stabilize at higher levels.

Finally, the stock market itself continues to be an important factor. The "wealth effect" on consumption is not always reliable, but the size of the market's decline obliges us to take it into account. Many people lost a significant share of their wealth in the past year, so households might cut back on purchases they otherwise would have made. Firms, for their part, no longer have such liberal access to funds, so capital investment is more costly and difficult to support. Arithmetic tells the story: Economic growth

will remain feeble as long as consumption and investment spending are below par.

The focus on immediate prospects for growth is what preoccupies many Fedwatchers, leading them to advocate further quick policy actions. They evaluate the case for funds rate movements in terms of the "Taylor rule," a deceptively simple relationship between the funds rate, inflation, and real growth. A central bank that followed the Taylor rule would pay attention to two gaps: the gap between inflation and the bank's inflation target, and the gap between actual output and the economy's growth capacity. Conventional wisdom places the inflation target for the PCE price index at 2%, fairly close to inflation's actual performance for the past year.

Estimates of the economy's growth potential are more problematic and contentious, but most economists consider its current growth rate to be far below reasonable estimates. For example, if potential growth falls in the 3%–4% range, the current shortfall is somewhere between two and three percentage points. Since the Taylor rule suggests that the funds rate should decline in response to significant output gaps, many analysts call for further reductions.

Rules offer several advantages over pure discretion. In particular, the Taylor approach to monetary policy is attractive because it limits the number of variables to be considered, it offers a simple method for balancing inflation concerns with concerns about economic growth, and it yields a numerical setting for the funds rate. Some analysts seem to regard such rules of thumb as "monetary policy in a box" and use them as a do-it-yourself kit. But the old warning still applies: "Don't try this at home!"

Output gaps may be illusory because potential output cannot be estimated with confidence. Instead of gauging gaps in output, they may merely betray gaps in our knowledge. If the economy is currently growing more slowly than someone's idea of potential, it might well be because certain sectors are undergoing adjustments that simply need more time to work through. In some previous business cycles, policymakers exacerbated inflation by mistakenly responding to output gaps that subsequently proved insubstantial.

As for inflation, although several core measures have been escalating steadily during the last six months, few analysts seem worried. After all, when output grows slowly, inflation is not supposed to be a threat. That combination of outcomes just doesn't fit into a handy box.