

A TALE OF TWO PRESS RELEASES

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*The change in the weather,
is known to be extreme.
But what's the sense in changing,
horses in mid-stream?*
Bob Dylan

Economists are continuously faced with the challenge of reconciling economic data with their theories of how the economy works. It can be a delicate balancing act for a couple of reasons. The first is that data are imperfect. It never comes out when we would like, it always gets changed through data revisions, numerous re-estimates, seasonal adjustments and re-benchmarking. Data also suffer from the shortcoming that they are often inconsistent with what economic theory suggests. An example is in the measurement of durable goods consumption. Theory suggests that we should be interested in the service flow that households receive from their stock of durable goods. However, reported data is for current spending on the flow of new durable goods. Data are simply hell.

Actually, hell would be a step up for theory. The critical issue in formulating an economic model is to separate and decompose all the independent pieces into a coherent paradigm. This involves sorting out causes and effects, as well as identifying shocks that affect the economy, as opposed to economic re-actions that spread shocks to other economic sectors, countries or throughout time. The process of identifying models starts early in an economist's career. For example, we begin the teaching of economic principles by asking students to sort out observed prices and quantities of a particular good into two relationships: one that represents demand for the good that implies that consumers want more of a good as its price gets lower, and a second relationship where the good's supply increases when the price gets higher. Economists have made painstaking progress in modeling macroeconomies, often taking two steps forward and one step back. Humility here is a virtue.

The dilemma of conducting monetary policy in an environment of poor data with simple economic models of limited range is a daunting task for the Federal Reserve Board.

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But act it must. The Fed's burden is to make timely decisions against the backdrop of a noisy economy. No simple task.¹

Despite the environment in which it makes decisions, however, the Fed must convey a principled explanation for its decisions to a broad audience in order to maintain the maximum credibility in pursuing its goals of "price stability and sustainable economic growth". To accomplish this, the Fed should inform and educate the public with regard to monetary policy. It should also delineate what it knows from what it does not. It should also provide evidence for its conclusions, fully evaluate its recent decisions, admit to past mistakes, and then learn from them.

In this regard, I believe that the Fed needs improving. Their over-emphasis on "story-driven" as opposed to "fact-based" explanations for what drives economic activity can be exceptionally misleading. Indeed, their current approach allows the Fed to continually escape criticism for its actions and to constantly set inconsistent guidelines from which it can never find itself wanting. Such "explanation hopping" is inconsistent with maintaining long run credibility.

In the following pages, I attempt to untangle the how the Federal Open Market Committee's (FOMC's) consensus view of U.S. economic activity abruptly changed over a period of just four months. This tale of two press releases points out how the FOMC's story evolved during this recent transition from the best of times to the not-so best of times. I believe that a careful reading of the press release and minutes of these FOMC meetings suggests that the FOMC did not have a coherent explanation or theory for analyzing or reacting to the changes in the economic environment. Rather, they appealed to a smorgasbord of anecdotes to justify their policy decisions.

The October 3rd, 2000 Press Release

In early October of 2000, the U.S. economy was still glowing from the red-hot growth of real GDP of the first half of the year, while somewhat puzzled by the drop-off in activity in the third quarter. The Fed had been on a tightening course as indicated by a succession of increases in the federal funds rate since ... While the FOMC was pleased that "aggregate demand has moderated closer to the enhanced rate of growth of the economy's potential to produce," the FOMC emphasized that it believed that the "risks continue to be weighted mainly toward conditions that may generate heightened inflation pressures in the future."

¹ Allan Greenspan has recently lamented similar shortcomings in theory and evidence. Allan Greenspan. 2001. "The Challenge of Measuring and Modeling a Dynamic Economy," Remarks at the Washington Economic Policy Conference of the National Association for Business Economics, Washington, D.C., March 27th, 2001.

This sounds pretty good. Growth would still make Goldilocks happy --neither too hot nor too cold-- and the FOMC was poised to do something about inflation in case it ever showed up. The problem is that even by the standards of the day, their explanations they provide are very thin.

First, let's look at why they felt the risks were weighted towards inflation. They list a couple of reasons. The first is that "the utilization of the pool of available resources remains at an unusually high level". That's codeword for "the rate of unemployment is too low". The reason why low unemployment is "bad" for some economists, is that firms will have to set higher wages independent of productivity growth, and that firms will have to pass along these higher costs as higher prices. Voila, inflation! This wage-price spiral usually enters most monetary policy considerations, sometimes as the NAIRU (i.e. the threshold non-accelerating inflation rate of unemployment) model. The problem is that the NAIRU is generally viewed as horrible for predicting inflation, though moderately interesting for economists who enjoy playing the role of Monday morning quarterback. It's inherent problem as a forecasting tool is that this critical level of unemployment is a free variable, whose changes are manipulated to make the model work better after the fact. As a case in point, when the unemployment rate fell below 6.5% in the mid-1990's, many economist recommended a monetary policy tightening for fear of future inflation ignited by nominal wage pressure from the labor market. That seems rather silly now. I believe that the best available evidence speaks rather poorly of this view of inflation². A more plausible story is that due to perceived improvements in productivity that resulted in more sales, firms found it profitable to expand employment. No upward price pressure in this story.

The second reason for inflationary concerns can be attributed to increased energy prices. However, the Board played this in an unbelievably subtle manner. They wrote that: "the increase in energy prices, though having limited effect on core measures of prices to date, poses a risk of raising inflation expectations." It's the word "expectations" that kind of sticks out. Now expectations, by definition, are supposed to weight possible future outcomes. In fact, if these inflation expectations are "rational", then they should already incorporate the chance that energy price increases will raise future inflation. The fact of the matter is that the FOMC must believe that the expectations of inflation that it observed at the time did not place enough weight on the fact that energy prices could trigger inflation (i.e. the current inflation expectations were not "rational"). Otherwise, the FOMC must be using inflation expectations in an unorthodox way. Regardless, the evidence that inflation, its expectation or possible revisions in future inflation expectations are caused by energy prices is wanting. Indeed, recent research, even by Federal Reserve economists, suggest that while

² Robert King, James Stock, and Mark W. Watson. 1995. "Temporal Instability of the Unemployment-Inflation Relationship." Economic Perspectives of the Federal Reserve Bank of Chicago, May-June, 2-12.

oil prices do affect inflation based on their share of overall expenditures, they have only a limited impact on core inflation measures.³

The Fed, as mentioned above, also felt that aggregate demand had moderated. The press release provides no explanation why. The minutes, distributed later, suggest that: “the moderation reflected lower growth in most major expenditure sectors. As a result of the deceleration in aggregate demand, expansion of employment and industrial production had slowed (p. 3).” The clear intention of this statement is that changes in aggregate demand drove output and employment downward during this time period. This view of business cycles used to be popular, though it is certainly controversial.

But we still have not figured out what made Aggregate Demand change? There are a few statements. One is that: “A flat and volatile stock market and the rise in energy costs appeared to be key factors currently tending to inhibit growth in consumer spending at least to some extent.” They also added “the tightening that had occurred in financial conditions through the spring and the rise in energy prices since the fall of 1998 had not yet had their full effects on aggregate demand, and members expected these to contribute to a more sustainable rate of growth in aggregate spending.

I think it is fair to say that in October of 2000, the FOMC believed that economic activity was slowing because of higher energy prices, a reduction in the wealth effect on consumer spending, and the course of monetary tightening they had applied based on their continued view that inflation was a concern. But now let’s fast forward a few months to the most recent evidence of FOMC decision making, when both the FOMC’s statement and minutes are currently available.

The January 31st, 2001 Press Release⁴

In a between-meeting move, the FOMC lowered the target Federal Funds rate on January 3rd, 2001 by 50 basis points. On January 31st, they eased again by another 50 basis points. This is pretty quick action by Federal Reserve standards. The press release cites declines in business and consumer confidence, “exacerbated by rising energy costs that continue to drain consumer purchasing power and press on business profit margins.” Moreover, capital spending and declines in manufacturing production and unintended

³ Mark Hooker. 1999. “Are Oil Shocks Inflationary? Asymmetries and Nonlinear Specifications Versus Changes in Regime,” Federal Reserve Board, FEDS Working Paper # 1999-65.

⁴ While there are Press Releases from more recent FOMC meetings, January 31st is the most recent meeting for which the minutes have been made public. Since more substantial discussions are potentially available in these minutes, I decided to analyze the January 31st date.

inventory build-ups responded in part to this erosion of confidence, further weakening the economy.⁵

The FOMC's January press release places a large burden of the slowdown on declines in business and consumer confidence that in turn slowed aggregate spending and demand. It is certainly a bold theory. But it's not a theory for which they or anyone else has provided much evidence. Though, it certainly makes a good story. We have all seen the releases from the University of Michigan and the Conference Board that show declines in confidence and sentiment. However, using changes in confidence as an independent source of aggregate demand fluctuations is troublesome. If the drop in confidence is truly independent of fundamentals, then it would also be unlikely to respond readily to monetary policy. Rather, it would recover when it's good and ready. Alternatively, if changes in confidence are linked to some economic fundamentals, then the FOMC should indicate what they believe these fundamentals to be. Indeed, recent research points to the fact that falling consumer confidence is linked to decreases in future consumer spending because it indicates that future income will be falling⁶. If this is the consensus view of the FOMC, then declines in confidence measures are simply symptoms and not the causes of economic slowdowns, and the FOMC should be pushed harder to clarify and provide evidence for what those causes are.

But even if confidence is falling, why did the FOMC rush to cut interest rates? Shouldn't the FOMC still be concerned about long run price-stability? Indeed, the FOMC argued in October of 2000 that inflation was a concern, despite the moderation of aggregate demand, because "the utilization of the pool of available resources remains at an unusually high level" and that higher energy prices could possibly affect future inflation expectations. But as the January statement clearly states, energy prices were still deemed "rising", so there would still seem to be a continued threat to future inflation expectations. In addition, the unemployment rate in December of 2000 and January of 2001 remained at 4.0 and 4.2, respectively, as compared to the unemployment rate of 3.9 in September and October of 2000. Certainly, by the FOMC's prior standards, this low unemployment rate would be an inflation threat (especially since they did not yet know of the January number). Nevertheless, they concluded that while "the labor market remained very tight and the unemployment rate held at 4 percent (p. 12 of the Minutes)," that "inflation was contained" (Press Release).

Of course, the FOMC could have come out and said that higher energy prices and low unemployment are not good indicators of inflation, but then they would have some

⁵ The FOMC's exact language in the press release is that household and business spending fell "partly as a consequence" of business and consumer confidence losses that were exacerbated by energy shocks. Subsequently, manufacturing production cut back sharply "in response".

⁶ Jason Bram and Sydney Ludvigson. 1998. "Does Consumer Confidence Forecast Household Expenditure? A Sentiment Index Horse Race," Federal Reserve Bank of New York, Economic Policy Review, June, Volume 4, Number 2.

explaining to do for their prior explanations and decisions. Alternatively, they could have argued that energy price and unemployment indicators were good indicators of inflation in October of 2000, but not in January of 2001. But that's not the monetary policy high ground either.

An Evaluation

I am not arguing that FOMC decisions should better satisfy academic economists (whom in my experience never seem satisfied). What I am arguing is that many recent FOMC justifications for their decisions are too reminiscent of ramblings on Squawk Box. The FOMC should explain and defend how the current data and its interpretation of economic activity are consistent with its primary principle of implementing a credible long-run, low inflation monetary policy that also provides for some (though perhaps limited) stabilization of real output growth.

In fact, I believe that the Shadow Open Market Committee (SOMC) had a better read on things at the end of last year than the FOMC's publicly released statements. We argued in our last meeting that in the face of declining real spending, the Fed's interest rate targeting regime would exacerbate this weakness and that an indicator of such a phenomenon would be sluggish growth in the monetary base.⁷ Indeed, this scenario unfolded as indicated by the decelerating growth of the monetary base. One can look at the recent St. Louis Fed publication Monetary Trends, for a graph of the growth of the monetary base that would be consistent with a nominal GDP growth target.⁸ This recommended rate of monetary base growth, based on the monetary policy rule advocated by Shadow member Bennett McCallum that targets nominal income growth at 4% per-year and modestly stabilizes fluctuations in spending, was well above the growth of the monetary base at that time. Indeed, we argued at the time that a lower federal funds rate would be consistent with achieving this faster money growth of the monetary base.

⁷ The President of the Federal Reserve Bank of St. Louis, and former Shadow member, William Poole, originally demonstrated this policy dictum. He published the paper while an economist at the Fed. William Poole. 1970. "Optimal Choice of Monetary Instruments in a Simple Stochastic Macro Model." Quarterly Journal of Economics 84 (May): 197-216. In contrast, Poole argues that if the fluctuations in the economy are due to financial shocks to the money market, then a nominal interest rate targeting approach would be more appropriate than a money growth targeting procedure.

⁸ The May 2001 version of Monetary Trends is available from the St. Louis Fed's web-site at <http://www.stls.frb.org/docs/publications/mt/mt.pdf> . Also see Bennett McCallum. 1988. "Robustness Properties of a Rule for Monetary Policy," Carnegie-Rochester Conference Series on Public Policy 29, Fall, 173-203.