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The Fed Got Policy Right, but not for the Right Reasons

By W. Michael Cox and Richard Alm

The U.S. economy just had a pretty good year—growth and job creation were strong, the unemployment rate fell to lows not seen in decades and inflation stayed relatively mild. For the Federal Reserve, it seemed a decade of highly unorthodox monetary policy had finally paid off with an economy in a "sweet spot."

Did the Fed get the chance to take a bow, the sound of applause ringing loudly? No such luck. The nation's central bank, almost always a favorite punching bag in Washington, entered 2019 hearing catcalls after it raised interest rates four times in 2018. Led by President Trump, critics warned that continuing the policy of gradually pushing up interest rates would damage the economy, just when things were going so well. "The only problem our economy has is the Fed," Trump said in December.

At its first meeting of the year in late January, the policy-making Federal Open Market Committee held the target federal funds rate at 2.25 percent to 2.5 percent, pausing a series of nine quarter-point hikes that dates back to early 2016. The Fed then suggested further rate increases might be delayed until the summer or even later, and the central bank indicated it would slow the pace of whittling down its balance sheet, if economic conditions warranted it.

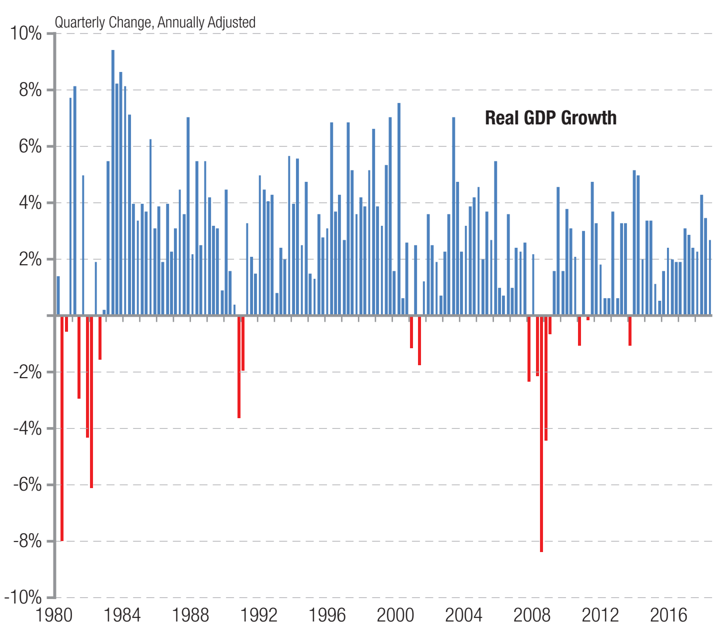
The January meeting changed the monetary policy outlook for 2019. Instead of moving forward with a series of rate hikes, the Fed now seems more likely to stand pat for months while weighing new dangers facing an expansion on the verge of becoming the longest on record *(see page 4)*. If the threats to growth pass, the Fed could resume its tightening. If the economy weakens further, the fed funds rate could be heading back down again.

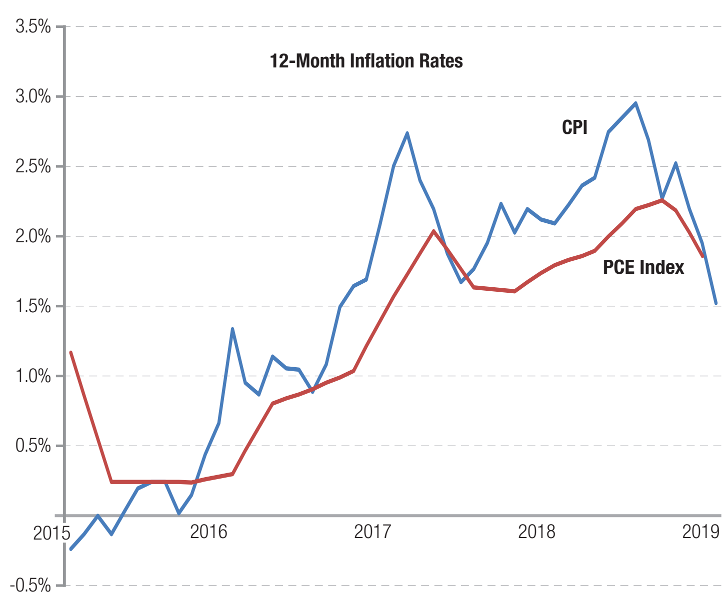
All of this follows the playbook of conventional monetary policy. Today's Fed continues to focus on yesterday's concerns and responses, even as technology-driven changes sweep through the economy and disrupt traditional links between growth, inflation and monetary policy. Conventional monetary policy called for caution in upcoming months—the right decision, fortunately. An outmoded view of the economy, however, won't always point the Fed in the right direction; someday, the conventional playbook will lead the Fed to big monetary policy mistakes.

FED'S RIGHT—THIS TIME

Conventional monetary policy centers on an easier-said-than-done balancing act that

What the Fed Faces: An Economy Growing Strongly with Tame Inflationary Pressures





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aims to keep the economy growing at the highest rate possible consistent with price stability. Too-fast growth ignites inflation; too-low inflation risks putting the economy into a downward spiral—the story's been told for decades and decades.

Recent data on inflation-adjusted GDP isn't setting off alarm bells about an economy overheating. Measured growth jumped to a 4.2 percent annual rate in last year's second quarter, but it slowed to 3.0 percent in the second half of the year *(see chart Page 1, left)*. Looking farther back in time, the GDP gains of today's nearly 10-year-old recovery haven't matched the expansions of the 1980s and 1990s.

The two main inflation measures confirm that price pressures haven't been building. The Consumer Price Index rose by nearly 3 percent in mid-2018, but more recent readings had inflation down to about 1.5 percent in early 2019 (see chart Page 1, right). The price index for personal consumption expenditures (PCE)—a gauge many economists prefer—rose just 1.8 percent in its latest quarterly reading, down from 2.25 percent in the last quarter of 2018.

What's more, interest rates suggest inflation expectations aren't building. Since the Fed began pushing up the fed funds rate, short-term Treasuries have risen right along with it—the expected result *(see chart below)*. However, longer-term Treasuries are up only slightly, suggesting investors aren't seeking a premium to offset expectations of higher inflation in the future.

Neither the GDP nor inflation data supports raising the fed funds rate at this time. From a conventional perspective, there should be no quarrel with January's decision to temporarily suspend increases in the fed funds rate. It follows that there should be no quarrel if later this year the Fed decides the dangers have faded or grown and it should begin to adjust the fed funds rate accordingly.

OUR EVOLVING ECONOMY

In early months of 2019, monetary policy was in a curious state—making the right moves but not for the right reasons. There's a non-conventional case to be made for keeping the fed funds rate low this year, but the Fed hasn't made it. The policy statements don't consider how new technologies have been changing production and pricing in the economy.

Previous issues of *The MPACT Report* have discussed the new economic realities that should be shaping the Fed's monetary policy deliberations. To start with, an increasing share of U.S. production now occurs under conditions of high fixed costs and low marginal costs *(MPACT, second quarter, 2017)*. Stripping away the economic jargon, it means many of today's products are expensive to develop but cheap to produce—due mostly to digital technologies. Cell phones stand out as a prime example: Nationwide networks require heavy investment in product design, transmission towers, satellites, switching software and more. Once it's all in place, AT&T, Verizon, T-Mobile and Sprint can sign up new users at little additional cost, spreading the fixed costs over more customers.

Extremely low marginal costs allow companies to entice new customers and retain old ones with free or almost free features—e-mail (Google), entertaining or educational videos (YouTube), prompt and cheap delivery (Grubhub). In today's busy world, relatively inexpensive products that save time and add convenience are improving daily life for millions of Americans.

In yesterday's world of high marginal costs, fast growth led to bottlenecks that raised average production costs, pushing up prices. Today, markets dominated by digital technologies mean that an expanding customer base will drive *down* average costs, so companies aren't compelled to raises prices. At the same time, the Internet allows shoppers to scour the world for the lowest prices without ever leaving home. Greater transparency, lower search costs and added competition all help hold prices in check.

A world of high fixed and low marginal costs creates a natural incentive for firms to grow bigger and more dominant—the tech giants Facebook, Google and Amazon should come immediately to mind. Bigger companies mean more concentrated markets, with just a few sellers doing the bulk of the business. The four carriers just mentioned control 99 percent of the wireless market. This kind of dominance isn't unusual. A growing number of other sectors show high concentration ratios, including package delivery, pharmaceuticals, smart phones, personal computers, cable television, car rentals, airlines and app sales. Greater size allows firms to capture the gains from network and scale economies, pushing average costs down.

The bias for bigness gets a push from the rise of the global middle class *(MPACT, third quarter, 2017)*. Three billion new consumers with rising incomes

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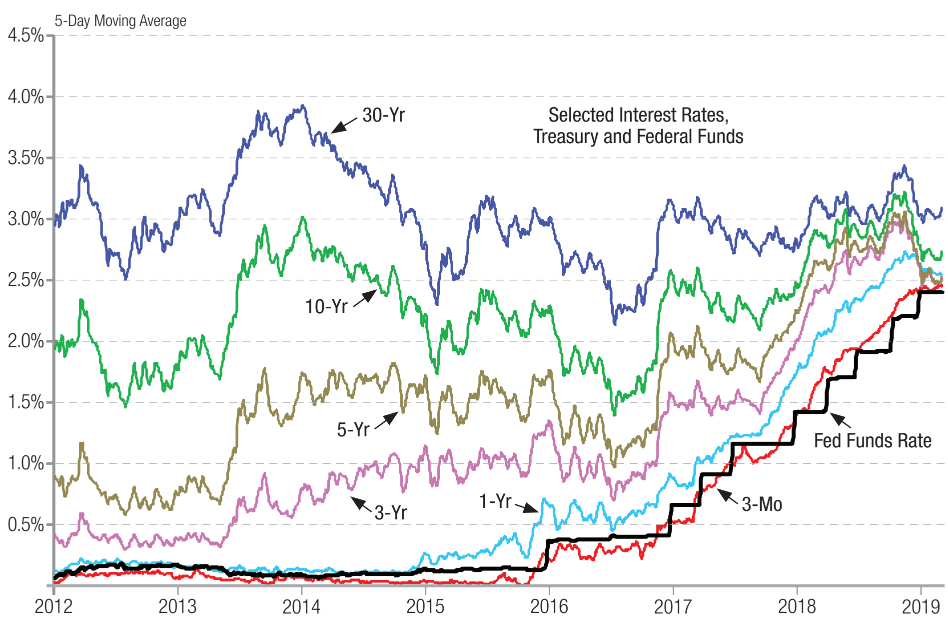
Tightening Interest-Rate Spreads Indicate Low Inflation Expectations



have enough money to afford things like smartphones and streamed entertainment. Bigger companies have the reach and resources needed to meet the global marketplace's growing demand. Increasing overseas sales mean average costs fall further, and U.S. customers don't bear the entire burden of paying the fixed cost of bringing new products to market.

Big U.S. companies don't just sell overseas. They source. Many of the world's 3 billion new consumers get the money to buy things working at companies integrated into corporate America's sprawling global supply chains. Plenty of Americans grumble about outsourcing and imports, but globalization pays dividends by helping U.S. companies keep production costs down and restraining inflation.

For companies and consumers, the combination of falling costs and expanding markets makes for the best of all worlds—plenty of cash for further growth and higher profits without raising prices. In addition, healthier profits give companies a financial cushion to absorb market shocks, so they're more stable during the ups and downs of the business cycle.

Widespread applause will greet free stuff, lower prices and financially fit companies. They're all positives, but some Americans might still see menace in a world with bigger companies operating in more concentrated markets and an open economy. Won't these quasi-monopolists just use their dominance to charge higher prices and pile up profits?

Some may try, a few may even succeed, but the inflation readings would be a lot higher if most big companies aggressively exploited their pricing power. They're held in check because highly concentrated markets can still be *contestable,* with enough freedom of entry to potentially allow new competitors to take on the entrenched firms making outsized profits. Today's technologies encourage a contestable market structure economists call *oligopolistic competition*—a few big and highly profitable players acquiring strong pricing power, with freedom of entry creating a discipline that keeps them from charging too much.

Even without newcomers, big companies face price competition. Joseph Schumpeter, an economist who incorporated business behavior into his analysis of capitalism, looked at markets with just a small number of rivals and saw competition as intense, even cutthroat, with companies using advertising, product redesign and pricing to gain an edge. Being first to raise prices risks lost sales and perhaps declining revenues. So companies will raise prices only cautiously, especially when they're not facing pressures from rising costs.

When companies produce more at lower cost, the economy grows faster, but conventional GDP statistics, calculated as price multiplied by quantity, don't capture all of what's really going on. The U.S. economy's actually doing better than we think—at least better than the GDP numbers are telling us *(MPACT, second quarter, 2018)*. On one hand, GDP's lapses might bias monetary policy toward a lower fed funds rates; on the other, realizing the economy's actually running hotter might create a justification for higher rates.

It's a bit of a conundrum, one with an important lesson. GDP and correlated measures aren't as reliable as they once were for making judgments about the danger thresholds for future inflation. When is GDP growing too fast? The unemployment rate too low? Inflation targets too binding? A particular fed funds rate stimulating, neutral or stifling? Many of the conventional rules of thumb may no longer serve as useful guides for Fed decision-making.

MONETARY POLICY'S NEW RULES

Taken together, the size imperative, concentrated markets and globalization are changing the fabric of the economy in ways that require new rules for monetary policy. The most important one presents a direct challenge to conventional monetary policy: The Fed can let the economy grow faster without causing an uptick in inflation.

In today's emerging economic order, the dangers of overheating abate because added output is less likely to trigger the supply-side bottlenecks that accelerate inflation. Volatility subsides because more companies are large, stable and profitable—i.e., capable of weathering a storm without cutting output and employment. Bigger company's steadier output and profits pump up price/earnings ratios and reduce financial market risks, often a source of macroeconomic instability. Expansions will last longer and recessions will come less frequently—unless policy-makers blunder. Overall, the economy has emerged more vibrant and stable as well as less fragile and inflation-prone.

In its reports and statements, the Fed rarely acknowledges how the economy has changed in recent decades, and how these changes disrupt traditional links between growth, inflation and monetary policy. The disconnect is confirmed by the bank's adherence to conventional monetary policy.

Old rules sometimes work out in the sense that they point us toward the appropriate policies—the right moves for the wrong reasons. Confidence in such coincidences should be shallow among investors and businesses—the wrong reasons can lead to policy mistakes, like the ones preceding the Great Recession of 2007-09.

The goal for monetary policy should be the right reasons as well as the right policies. The following new rules, better adapted for today's economic realities, would improve the Fed's chances of being doubly right:

- Recognize that the economy has changed and let it grow at a faster pace than central bankers would have been comfortable with

The Fed rarely acknowledges how the economy has changed in recent decades, and how these changes disrupt traditional links between growth, inflation and monetary policy.

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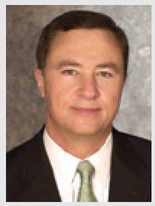
a few decades ago.

- Don't be so quick to leap from seeing faster growth to concluding higher inflation is just around the corner, requiring higher interest rates now to fight it.
- Be skeptical of old rules—GDP growth above a certain percent, the unemployment rate below a certain percent—in judging what's about to happen with inflation.
- Keep an eye on market interest rates—the spreads between long- and short-term yields—and what they reveal about inflationary expectations.
- Quit using past norms regarding the length of expansions to conclude that recession is imminent, or to decide the threshold at which the fed funds rate risks overheating the economy.
- Pay more attention to U.S. stock markets, a better guide than GDP for how well the economy's doing. Since January 1981, the Dow Jones Industrial Average is up 3,014 percent (not adjusted for inflation), far exceeding GDP's 176 percent.
- Never forget that inflation is still dangerous and a monetary phenomenon—the result of too much money chasing too few goods— so don't be complacent on prices and watch that money growth doesn't rise too fast.

The list isn't exhaustive. No doubt, the Fed would be well served by other ideas that embody the same spirit—a monetary policy in better alignment with the economy as it is today rather than how it was yesterday. It's the way to get monetary policy right, not for the wrong reasons but for the right ones.



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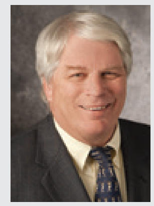

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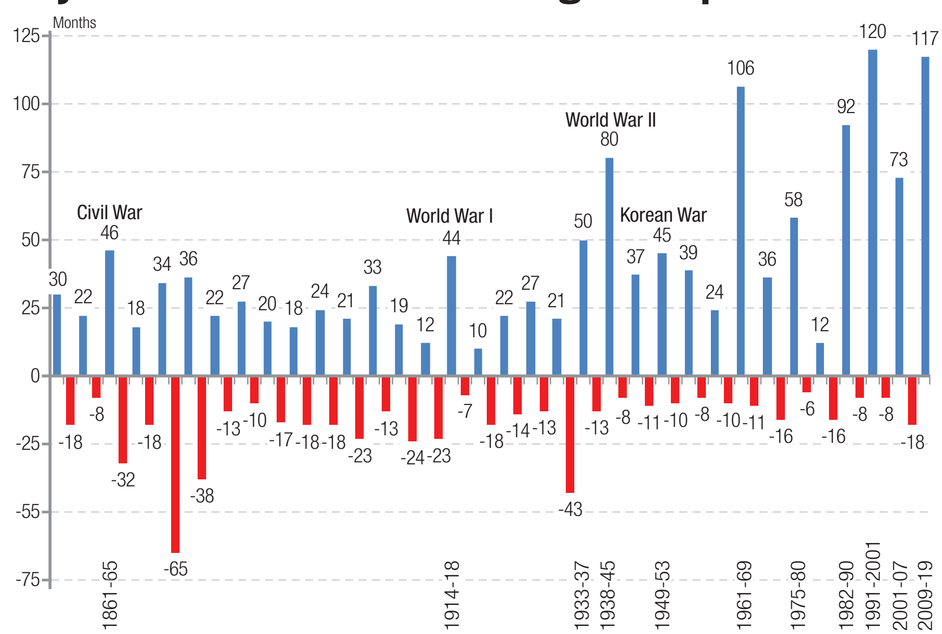
CHARTING THE ECONOMY

Good News! Economy's Ready to Break Record for Longest Expansion

The current expansion, which began in June 2009, already ranks as second longest on record, and it will soon set a new benchmark for endurance. In July, the U.S. economy will enter its 121st month of growth, surpassing the expansion from April 1991 to March 2001.

Today's longevity builds on historical trends. On average, recessions have become shorter—from 21.5 months from 1854-1919, to 18.2 months from 1919-1945, to 11.1 months from 1945-2009. Expansions have gotten longer—from 26.6 months from 1854-1919, to 35 months from 1945-2009, to 88.4 months from 1945-2009.

War accompanied some of the longest pre-1960 expansions. Long-term structural shifts gained importance more recently. As a share of the economy, highly cyclical industries like agriculture and manufacturing have become smaller; more stable sectors centered on services have become larger. The big companies producing under conditions of high fixed cost and low marginal costs have added stability in recent decades (*see main essay*).



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