Macro Views

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A column devoted to understanding monetary policy issues for the long run.

The Fed’s Panic Attack

The Fed panicked in late 2002 to mid-2003, thinking that deflation might rear its ugly head. At the time, the Fed was looking at sharp drops in its core inflation measures and became concerned about “an unwelcome substantial fall in inflation.” As Figure 1 shows, core inflation was indeed declining, and deflation was a potential threat. This led the Fed to cut the fed funds rate further, even though it was already very low.

The problem is, the recession had ended in November 2001, and although growth of the labor force was mediocre, there was really no reason for the Fed to panic. The recession had been mild, the economy was gradually strengthening, and forecasters called for the economy to continue to grow with stabilizing inflation. But policymakers at the Fed read the data differently than most forecasters did, and they began to fear that inflation would decline further. Slow growth of employment no doubt contributed to that fear, but the Fed did not yet understand how much the labor force participation rate had declined, and thus how slow growth in labor supply was affecting the labor market.

As the Fed eased policy further, interest rates throughout the economy reached very low levels. Car makers used zero percent financing to entice buyers and produced millions of new cars. The low rates stimulated a home building boom. Essentially, the economy was moving resources from the capital goods sector, as business investment was very low, to the durable goods and housing sectors.

So, we built many cars and houses in the first half of the 2000s. But now that the economy has strengthened sufficiently, what happens next? Inflation began to rise in 2003, stabilized a bit in 2004, and has begun to rise again. The Fed has been undoing its incredibly accommodative position since June 2004, but can it undo the shift in resources that the private sector undertook when interest rates were so low? That is not clear, but is the key question to focus on in thinking about the economy’s future.

What will the Fed do? For now, it is waiting and hoping that the slowing growth in the housing sector will keep the economy from growing too fast. Falling oil prices will help keep inflation from rising further. But the readjustment of resources, out of housing and autos and into other sectors, could take some time and there is nothing the Fed can do to help out.
Sources for figure: All data from FRED databank, Federal Reserve Bank of St. Louis, research.stlouisfed.org/fred2. Fed Funds Rate = quarterly average fed funds interest rate, from monthly series FEDFUNDS; Core Inflation Rate = inflation rate from 4 quarters earlier in CPI excluding food and energy prices, quarterly average of monthly series PCILFENS.

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