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The FOMC in 1996: "Watchful Waiting"

ST. LOUIS — The Federal Open Market Committee (FOMC), the Federal Reserve's monetary policymaking arm, didn't tighten policy in 1996, but two economists found that it did engage in "watchful waiting," defined as "a policy mode in which policymakers (and probably financial markets) know the direction of the next sustained series of policy moves, but immediate action is not considered necessary."

Michael J. Dueker, a senior economist with the Federal Reserve Bank of St. Louis, and Andreas M. Fischer, an economic advisor with the Swiss National Bank in Zurich, studied the 1996 actions of the FOMC for the current issue of ***Review***, the St. Louis Fed's bimonthly publication of economic and policy issues.

Dueker and Fischer noted that the FOMC de-emphasized monetary targets as the anchor for monetary policy in 1993. The current period without an explicit policy anchor,

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they said, may go down in U.S. monetary history as an "interregnum." Thus, in 1996, the FOMC adopted a stance of watchful waiting, not only for inflationary imbalances in the current expansion, but also waiting to establish a new anchor for monetary policy, they said.

In addition, Dueker and Fischer found that monetary policy in 1996, on average, was "slightly accommodative" relative to an inflation target between 2 percent and 3 percent.

They also analyzed a number of issues that economists cited in 1996 as arguments against an immediate policy push past watchful waiting and towards price stability. These arguments, they said, may or may not have swayed FOMC policymakers, but were certainly widely discussed by both academics and business economists.

For example, the U.S. economy in the middle of 1996 was enjoying continued, robust growth, low unemployment and relatively stable inflation — advantages rarely seen in the sixth year of an expansion. Many pundits, however, thought it was "time" for the expansion to run out of steam, based on the historical average length of expansions. Yet empirical evidence from many contemporary economic studies indicated that expansions don't just inevitably wither and die. Mirroring Federal Reserve Board Chairman Alan Greenspan's testimony to Congress in February of 1996, Dueker and Fischer noted that "recessions do not occur simply because too much time has passed since the last one."

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That recessions are thought to be often the product of inflationary imbalances provides policymakers a strong impetus to prevent upticks in the inflation rate, Dueker and Fischer noted, but does little to supply a rationale for further disinflation in the near term.

Dueker and Fischer also analyzed other factors related to inflation that economists debated publicly that year, and which may have influenced the FOMC to continue a stance of watchful waiting and postpone adopting a new, long-term policy anchor:

• Possible bias in the Consumer Price Index (CPI) and its reliability as a measure of inflation. In the absence of any other, more accurate barometer of inflation, policymakers may have been reluctant to tie price stability to the CPI.

• The non-accelerating inflation rate of unemployment (NAIRU), a level of unemployment – historically between 5 percent and 6 percent – at which wage increases are generally thought to be consistent with stable inflation. Since unemployment has dipped below this figure and inflation has still been steady, some observers have questioned whether NAIRU is still valid as a predictor of inflation.

• "Opportunistic disinflation," a term describing a monetary policy that would have the FOMC concentrate on sustaining an expansion near the trend rate of output growth and switch its focus, if necessary, from shepherding real growth to controlling inflation.

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The FOMC has received widespread credit for helping to foster and sustain the low inflation rate the nation has enjoyed recently. Nevertheless, Dueker and Fischer maintain that the U.S. economy will probably not achieve long-term price stability until the Federal Reserve has a new policy anchor aimed at achieving it.

Subscriptions to ***Review*** are free and can be obtained by calling (314) 444-8809. The publication is also available on the Federal Reserve Bank of St. Louis' website: http://www.stls.frb.org.

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