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National**Economic***Trends*

THE FEDERAL RESERVE BANK of ST. LOUIS

Ahead of the Curve

Many analysts have concluded that the U.S. economy entered a recession in the last few months. The historical pattern is that the Federal Reserve reacts to a weakening economy with a lower target for its monetary policy instrument, the federal funds rate. This suggests that if a typical recession does unfold in the coming months, short-term interest rates will move considerably lower. But there is an important difference this time compared with the last recession, which ended more than a decade ago. The difference is that this time the Fed began lowering its target aggressively in January 2001, well before the onset of recession, whereas in the 1990-91 episode, the Fed was essentially on hold as the recession began and, indeed, until it was well underway.

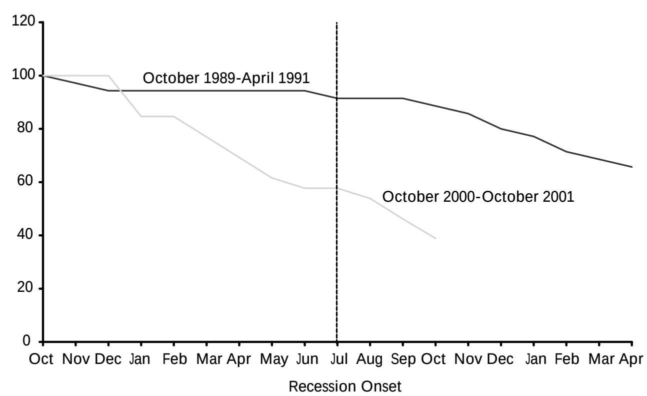
The Figure shows the Federal Open Market Committee's (FOMC's) target level for the federal funds rate, as a percentage of its initial level, nine months before and after July 1990, the official date for the beginning of the 1990-91 recession. (For example, 70 percent means that the target rate had fallen 30 percent from the level that prevailed nine months before the onset of recession.) For the current episode, no official beginning date has been established—and indeed there is still at least some possibility that no part of 2001 will be classified as a recession. But, for the purposes of discussion, let us suppose that a recession will eventually be dated as beginning in July 2001.

The Figure indicates that the Fed was essentially on hold during the first six months of 1990 and remained committed to a pre-recession level of the target federal funds rate until October of that year, four months after the recession began. At that point, as it became clearer that a recession was underway, the Fed began lowering its target more aggressively. The target federal funds rate eventually reached a cyclical low of 3 percent by September 1992—27 months after the recession onset. In contrast, during the current episode, the Fed began an aggressive lowering of the federal funds rate target in January of this year, well before any likely beginning recession date and six months before the provisional date we have adopted for purposes of discussion. The Fed thus has taken a far more preemptive stance during the current period as compared with the 1990-91 period.

What accounts for the difference in the two episodes? Probably the main difference is that inflation was kept under better control during the expansion of the late 1990s, whereas inflation had crept to unacceptably high levels during the late 1980s. The chain-type personal consumption expenditures price index rose at rates between 4 and 5 percent from the previous year during most of 1989 and 1990. The same index has risen at an annual rate of less than 1 percent during the first eight months of 2001. Low and relatively stable inflation has given the FOMC more room to lower its federal funds target than it had in 1990, when inflation was relatively high and rising.

—James B. Bullard

Federal Funds Rate Target (as a percentage of initial level)



NOTE: End of month federal funds rate target set by the FOMC. Upper line represents rate relative to October 1989. Lower line represents rate relative to October 2000.
SOURCE: Federal Reserve Board.