

Monetary Policy Stance: The View from Consumption Spending

The Federal Reserve has set the target range for the federal funds rate at 0 to 0.25 percent and intends to keep this rate near zero for an extended period. According to the policy statement issued after the September 23 Federal Open Market Committee (FOMC) meeting, the Committee will maintain this range and “continues to anticipate that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period.”

Generally, policymakers try to “lean against the wind”—that is, they keep the federal funds rate below a neutral interest rate when the economy is weak and above it when the economy is strong. There is no clear consensus about the appropriate definition of a “neutral interest rate” to be used to evaluate whether monetary policy is “easy” or “tight.” One method is to look at long-term interest rates. Another, used here, is to appeal to economic theory to gain from observations on consumption spending.

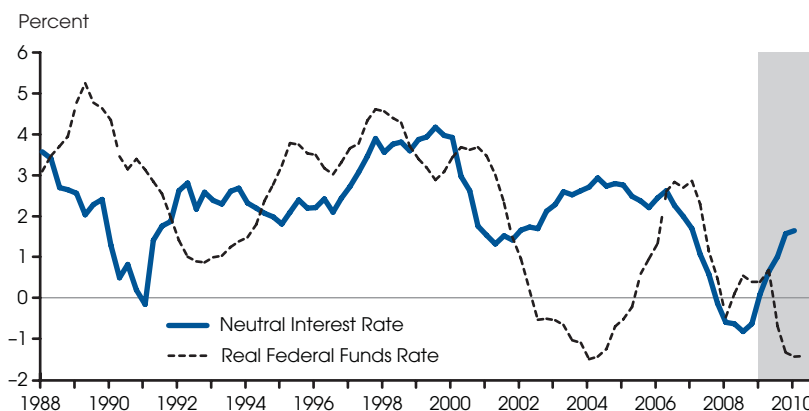
Models in economics and finance relate consumption growth to the interest rate. In the basic models, this is an asset pricing relationship that depends on the average household’s discount factor (a measure of their preference for consuming today rather than tomorrow) and degree of risk aversion. In calculating the implied market interest rate, we choose a discount factor and degree of risk aversion so that the series for the neutral interest rate would be, on average, equal to the real federal funds rate since 1988. For the period since 1958, with these assumptions the neutral rate is only 27 basis points below the average real federal funds rate.

The chart shows the real effective federal funds rate and the neutral interest rate implied by the consumption-based asset pricing formula. The federal funds rate is adjusted for inflation using the chain price index for personal consumption expenditures.¹ Different assumptions about the discount factor and people’s aversion to risk would shift the average level of the implied market rate up or down, but would have only a minor effect on the cyclical pattern of the difference between the series.

According to this standard for measuring the stance of policy, monetary policy was relatively tight during the late 1980s through 1991. Policy was easy from mid-1992 until early 1994 and then, except for a brief period following the Russian bond default, relatively tight through 2001. Policy was very easy from 2002 through 2005. To see the stance of policy going forward, the series on the chart are extended to the end of 2010 using forecasts of inflation and consumption growth from the Federal Reserve Bank of Philadelphia’s Survey of Professional Forecasters (SPF) and assuming that the extended period for the current Fed forecast goes to the end of 2010. If the forecast is accurate, consumption growth and the implied rate should both increase and become positive over the next quarters. With a positive inflation forecast and the FOMC promise to keep the federal funds rate target near zero for an “extended” period, we should expect a third business cycle in succession in which the real federal funds rate reaches its trough well after the economy begins to recover.

—William T. Gavin

¹ The data on the real federal funds rate and our measure of the neutral interest rate are quite volatile from one period to the next. Therefore, we smooth the data by taking a centered 5-quarter moving average for both variables. By centering the moving average, we smooth the series without distorting the timing of the peaks and troughs.



NOTE: Shaded area averages include data from SPF forecasts through 2010.