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MonetaryTrends

THE FEDERAL RESERVE BANK of ST. LOUIS

# Getting “Real” About Monetary Policy

In response to weak U.S. economic activity, the Federal Open Market Committee lowered its target for the nominal federal funds rate by 450 basis points between January and November of 2001. The size and speed of this reduction represents one of the most aggressive policy actions ever undertaken by the Federal Reserve. However, some have suggested that monetary policy is still too tight, arguing that the *real* federal funds rate—the federal funds rate less the expected rate of inflation—is still relatively high.

Unfortunately, the real interest rate is difficult to measure because the public’s expected rate of inflation is not directly observable. A possible solution to this problem is to use information from surveys, of which there are several varieties. One type of survey simply asks the public what rate of inflation they expect. An example is the University of Michigan *Survey of Consumers*, a monthly sampling of consumers’ expectations for future economic conditions, including inflation. The University of Michigan survey does not ask about a specific measure of inflation, but instead asks how much the survey respondent expects prices in general to rise over a given period. Another type of survey queries professional forecasters. The quarterly *Survey of Professional Forecasters* (*SPF*) produced by the Federal Reserve Bank of Philadelphia is an example. Unlike the Michigan survey, the *SPF* requests forecasts of explicit measures of inflation, such as the consumer price index. Each type of survey has its own merits: although one might expect more accuracy from the *SPF*, the perception of actual consumers and investors is what matters for the economy.

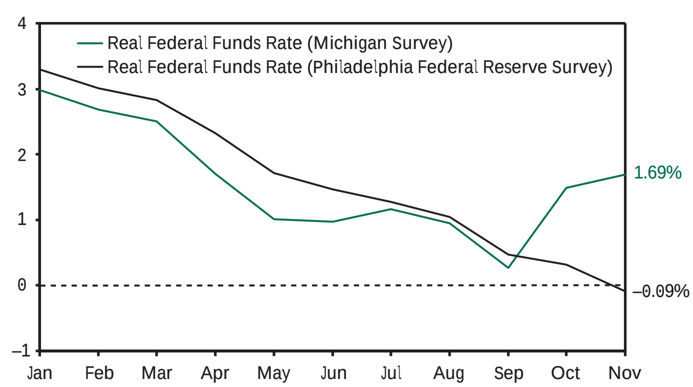
The accompanying Figure displays two measures of the real interest rate based on the surveys described above: (i) the nominal federal funds rate minus the expected rise in prices over the next year from the Michigan survey and (ii) the nominal federal funds rate minus the expected increase in the consumer price index over the next year from the *SPF*. For each survey, expected inflation is measured as the median survey response.

Recently, the real interest rates implied by the two surveys have differed markedly. While the measure of the real interest rate using the *SPF* was slightly below 0 percent in late November (a low value historically), the measure based on the Michigan survey was around 1.7 percent (well above levels seen in previous recessions). This disparity reflects differences in expected inflation from the two surveys. Professional forecasters expect consumer prices to rise by around 2 percent over the next 12 months, as reported in the November release of the *SPF*. However, the Michigan survey reported that consumers expect prices to rise by only 0.4 percent.

The large difference between these measures of expected inflation may reflect economic uncertainty in the aftermath of recent terrorist attacks; if so, this difference may disappear as the uncertainty dissipates. However, the discrepancies point out the difficulty in measuring the stance of monetary policy using the real interest rate when different measures of expected inflation send conflicting signals.

—Jeremy M. Piger

The Real Federal Funds Rate in 2001



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