Looking beyond conventional approaches

Early in 2006 the range of possible economic paths widened as rising energy costs and weakness in housing raised concerns about the sustainability of economic growth. Amid this uncertainty, the Federal Open Market Committee (FOMC) increased the fed funds rate during the first half of the year from 4.25 percent to 5.25 percent, continuing a process that began in June 2004.

As monetary accommodation was removed, Fed policymakers carefully weighed their options. Was the housing sector slowdown likely to place a heavy drag on economic growth? Were more rate hikes necessary to keep inflation and inflation expectations contained? Opinions were and remain mixed. But in August 2006 the Atlanta Fed voted with the majority to pause the Fed policy of steadily increasing rates in 25 basis point increments.

Price stability is a top priority across the Federal Reserve System. Inflation rates drifted upward perceptibly in 2006, and the Atlanta Fed's team of twenty-six Ph.D. economists filtered the data through innovative models to gain insights. Bank economists investigated not only the various headline inflation measures that include food and energy costs but also the core measures that exclude those volatile items, devoting considerable attention to specific inflation components and interpreting the often volatile and conflicting movements characteristic of inflation data.

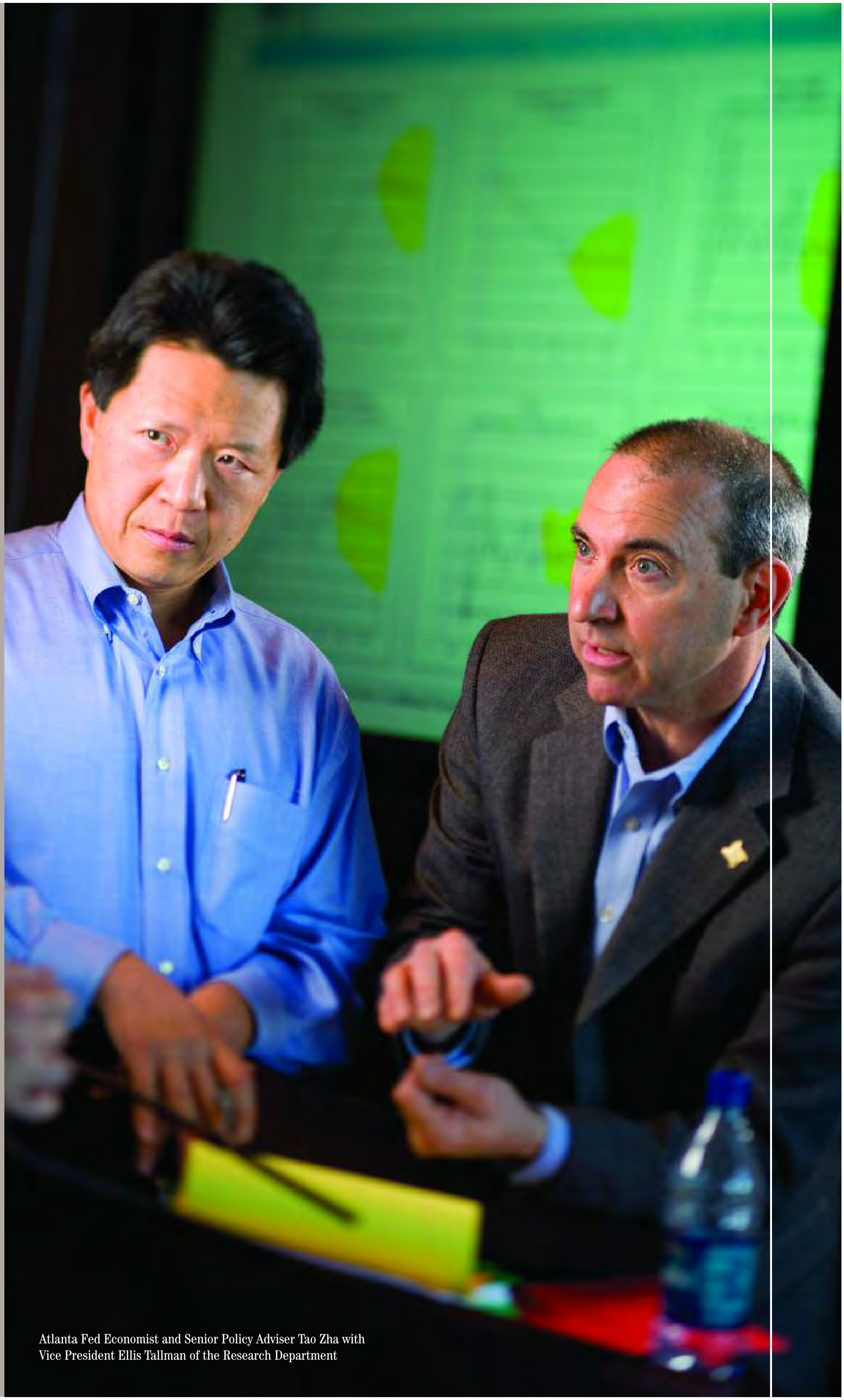
Amid the fluctuations, the economists began to notice patterns and informative signals. For instance, services inflation was rising rapidly, but prices for manufactured goods were relatively flat. And, given the weakening market for new and existing home purchases, it was not surprising that rental costs were increasing.

Effective monetary policy requires taking stock of the current economic situation not only by analyzing data but also by making forecasts. One such approach to forecasting was described in a 2006 paper titled "Were There Regime Switches in U.S. Monetary Policy?" by Atlanta Fed Senior Policy Adviser Tao Zha and Princeton University economist Christopher A. Sims. This paper outlines a technically innovative model used for forecasting inflation in 2006. Said Zha, "Monetary policy needs time to affect the economy. Our model signaled to us that we should wait for the lagged effects of monetary policy to play out on inflation."

This new approach, along with other evidence, indicated that past rate increases had not been given adequate time to take full effect and that past policy actions might have been sufficient to contain rising inflation and inflation expectations. This interpretation of the forecasts was a key input into the Atlanta Fed's recommendation and vote at FOMC meetings throughout 2006 and surfaced during intense debates about the proper time for a pause.

During the second half of 2006, the FOMC decided to keep the funds rate at 5.25 percent. For all of 2006, gross domestic product in the United States, the mostly widely used measure of economic growth, grew an estimated 3.3 percent—a slight decline from the previous year. An average of 187,000 new jobs were created per month in 2006, and the unemployment rate declined to very low levels. Although inflation measures in December were elevated, they were drifting downward moving into 2007.

For much of 2006 this favorable economic outcome was uncertain. But the Fed's work is never done. Economists remain vigilant about a wide range of risks. A willingness to look at nonconventional approaches such as Zha's dynamic forecasting techniques helps the Atlanta Fed to be a leader in the ever-changing business of monetary policy.



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