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Less is more when it comes to Federal Reserve policy

Caution is the best response to recent US economic data

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Friday's US employment report was generally strong, with job growth of 211,000, declining unemployment and a drop in the number of workers involuntarily confined to part-time work.

The data, along with indications that growth in the second quarter is likely to come in above 3 per cent, suggest the economy is reasonably robust. But these economic data present difficult issues of interpretation and policy choice for the US Federal Reserve. Is the economy or the stock market enjoying a "sugar high" or is the current path sustainable? What weight should the Fed give strong employment figures relative to gross domestic product growth that remains modest by historical standards and relative to low rates of inflation and expected inflation? How should the Fed treat the tension between the great uncertainty that so many economic actors experience and near-record low levels of market volatility and expected volatility?

Given how little the administration has actually changed policy, recent economic performance was pre-determined before Donald Trump took office. Stock markets have boomed in recent months but it is less obvious that there is a sugar high element in their performance than it seemed around the turn of the year. Fundamentals unrelated to the new administration have strengthened, particularly as strong earnings reports for the first quarter have come in, growth abroad has strengthened and bond yields have declined. At the same time, the "Trump signature" in the market has attenuated: for example, high-tax stocks which outperformed after the election have given back their outperformance.

The greatest puzzle regarding the stock market is not its level but its lack of volatility. We have for months been in a period where volatility has been low by historic standards, despite what seems high policy uncertainty. Perhaps this reflects technical factors in the market. It may also be that uncertainty is a kind of self-denying prophecy as it causes investors to scale back their leverage, which in turn limits volatility. It is probably important to recognise also that much of market volatility reflects factors other than economic policy.

It is now very difficult to argue that there is a large amount of slack in US labour markets. Another year of employment performance like that we have seen during the past few months, would take the labour market into nearly uncharted territory. It has been surprising, in the face of the labour market tightening, that there has not been more evidence of accelerating wage inflation. A reasonable conjecture is that this reflects workers cowed by the possibility of being replaced by technology or foreigners. Indeed, given the tightness of the labour market, workers appear relatively reluctant to quit jobs.

What about slow GDP growth? There is little reason to think growth has moved out of the 2 per cent range in which it has been stuck for the last half a dozen years. If, as seems arithmetically almost inevitable, employment growth slows, GDP growth will as a matter of logic slow, unless productivity growth accelerates. There is little in the data to suggest this is likely in the near term.

So the next couple of years are likely to see slower GDP growth and possibly a tendency to rising inflation. What does this mean for monetary policy? The assumption manifest in the statements of the Fed and most commentary is that policy should be tightened over time through rising interest rates and a reversal of quantitative easing. Perhaps, but tightening involves real dangers and needs to be carried out with great care. The Fed has committed itself to a symmetric 2 per cent inflation target and inflation has been below 2 per cent for eight years. If a booming economy in the ninth year of recovery with this prelude is not the time for inflation above 2 per cent, when would such a time arise?

Moreover, economists should now have great humility regarding the inflation process. The Phillips curve relation on which they have relied has largely broken down over the past several decades and so relying on it to take pre-emptive action with respect to inflation seems problematic. It may be that the economy will surprise in its ability to run hot without accelerating inflation.

There is also the observation that price inflation remains very much under control and that some wage growth in excess of price growth would be desirable given the erosion of labour's position in the economy over the last period.

The Fed will have little room to respond if it overdoes things and the economy goes into recession. Sometimes the hardest and most important decisions in government involve doing less rather than more. This is one of those times for the Fed. Caution should be its watchword.

The writer is Charles W Eliot university professor at Harvard and a former US Treasury secretary.