



Monetary Policy & The Fed

Money Talks Monthly Seminar
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National Economic Education Delegation
May 20, 2024



Submitting Questions

- There will be a Q&A once the material has been presented.
- Slides will be posted at https://needecon.org/delivered_presentations.php.
- Access to my Google site:
<https://sites.google.com/view/macro-current-issues/monetary-policy>



Outline

- **Facts about the Fed; and its historical performance.**
- **The short-run determinants of inflation and unemployment.**
- **The Fed's policy tools.**
- **Monetary policy during the recession and the subsequent rise in inflation.**
- **Where does the Fed go from here?**



The Evolution of the Fed's Role in the Macro Economy

- **Federal Reserve Act of 1913 – “furnish an elastic currency”**
- **Employment Act of 1946**
 1. “Full employment” is a Executive Government Responsibility.
 2. Council of Economic Advisors.
 3. Economic Report of the President.
- **Humphrey Hawkins Act 1978 & the Fed's “Dual” mandate**
 - Full employment
 - Price stability
- **Division of Labor between Monetary and Fiscal Policies.**



Stabilizer in Chief: the Fed

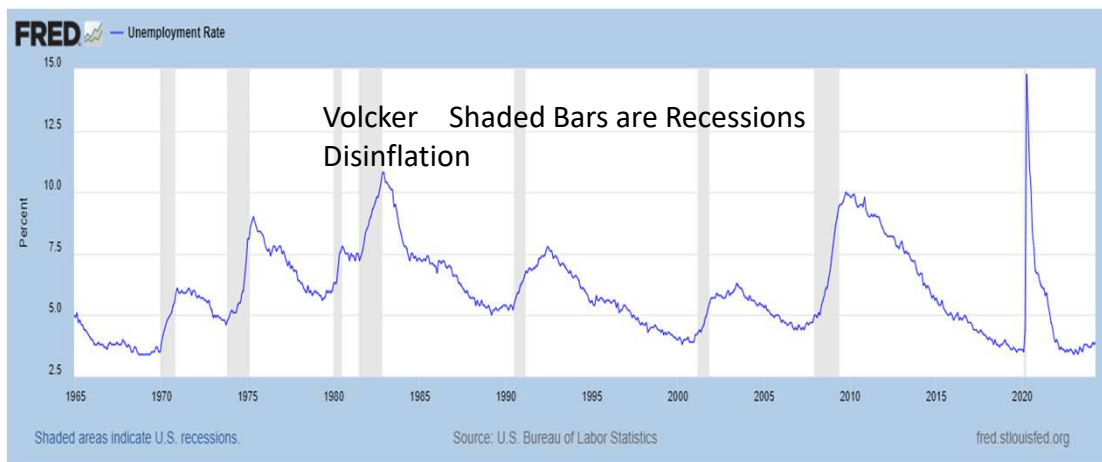


Jerome Powell
February 2018

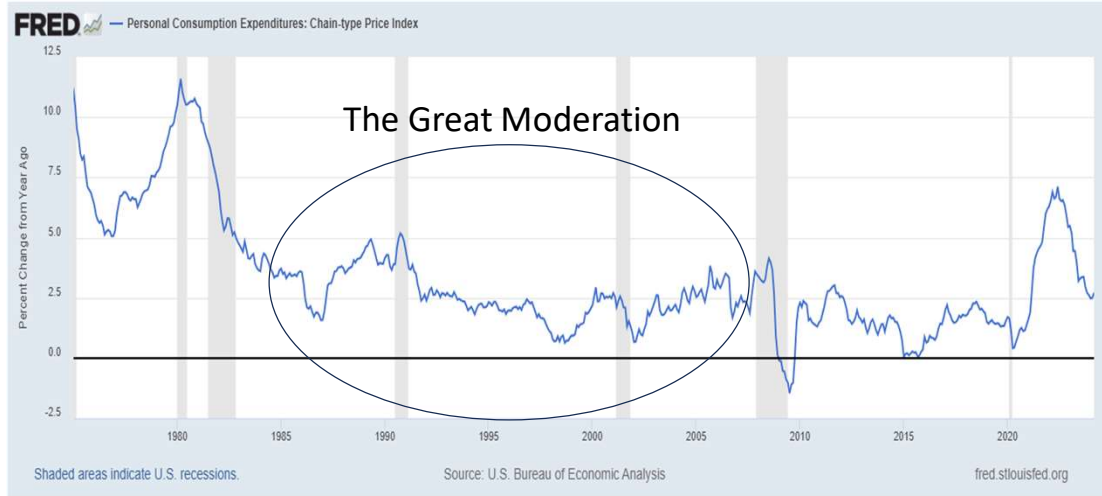
on Price Index

- **The Fed’s Dual Mandate:**
 1. “Stable prices” which means 2% rate of inflation in the long run (which corresponds to about 2.5% inflation in the medium run)
 2. “Maximum employment” which means the highest level of employment (lowest unemployment rate) consistent with mandate 1.
- **Monetary policy is made by the Federal Open Market Committee (FOMC), comprised of the 7 Fed Governors and 5 of the 12 Presidents of the Regional Federal Reserve Banks on a rotating basis.**
- **The FOMC has scheduled meetings 8 times a year, but can hold unscheduled meetings at a moments notice (e.g., March of 2020)**

Track Record on Unemployment



Track Record on “Price Stability”



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Determinants of Unemployment & Inflation

Short run:

- **Unemployment:** The higher the level of total spending the lower the unemployment rate.
- **Inflation:**
 1. “Too much Spending:” Total spending **above** the economy’s normal capacity (“potential output”) tends to **increase** inflation (Vietnam War) .
 2. Increase in production costs (e.g., “supply chain bottlenecks;” stagflation of the 70s)
 3. Expectations of high inflation can cause inflation to be high (persistence of high inflation in early 80s).
- **The Fed can affect 1, influence 3., but has no effect on 2.**



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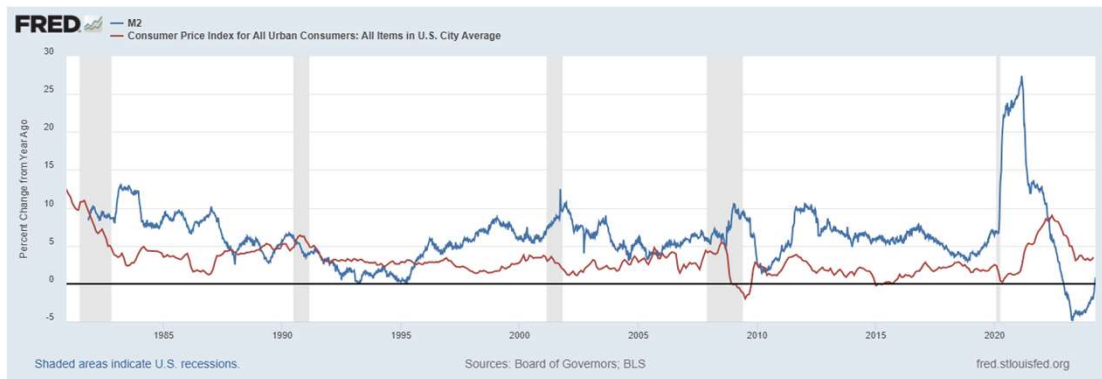
What about the Money Supply?

Notice the absence of the money supply. The Fed does not believe there is a reliable, short-run link between the money supply and total spending or inflation.

The Minutes of the 3/19-20 FOMC Meeting mentions:

- Money Supply, M1, M2 – 0 times
- Federal funds rate – 18 times

Do You See a Relationship?



The Fed's Affects the Economy via Interest Rates

- Higher Interest rates discourage firms from buying new plant and equipment, households from buying new homes, and tend to lower stock and housing prices (!).
- Lower spending tends to raise unemployment and eventually lowers inflation.



Become a Central Banker in One Slide!

- If you are more concerned that inflation is too high, raise interest rates to lower total spending below potential output.
- If you are more concerned that unemployment is too high, lower interest rates to raise total spending.
- Inflation and unemployment just right: keep rates the same.

Sounds Easy! But...



One Big Complication: Lags

- **Milton Friedman: Monetary Policy affects GDP and Inflation with Long and Variable (Unpredictable) Lags.**
- **Raising interest rates today does nothing to spending today nor to inflation.**
- **But over time spending slows and eventually inflation falls.**
- **Friedman believed that lags led the Fed to “oversteer” the economy consistently.**

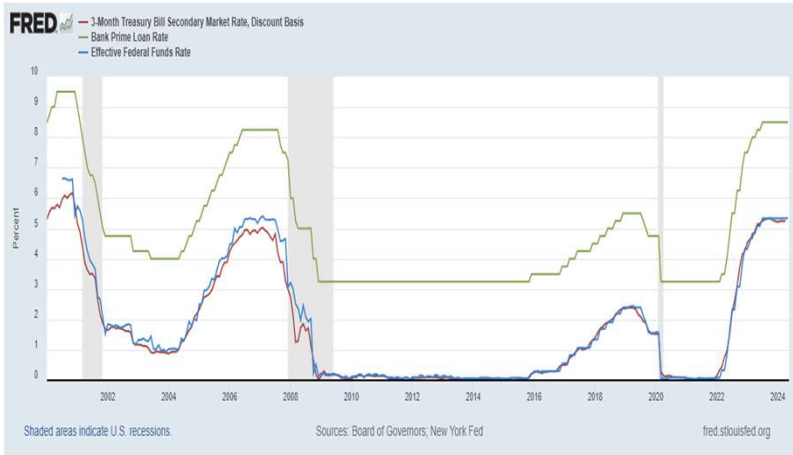


A Closer Look at Interest Rate Control

- ***Primary Tool*: the Fed targets the *federal funds rate* (or fed funds rate for short), the interest rate on overnight loans between banks.**
- **The Fed adjusts bank reserves so that the federal funds rate is within a target range 25 basis points wide; e.g., 5.5-5.25%**
- **From the bank’s perspective these loans are very close substitutes to other short-term, safe assets such as Treasury Bills.**
- **Therefore, controlling the fed funds rate gives the Fed close control over all safe, *short-term* interest rates.**



The Fed and Short-term Interest Rates



Blue is the fed funds rate.
 Red is the rate on 3 month Treasuries.
 Green is the prime bank lending rate

The Importance of Long-Term Interest Rates

- Nobody buys a house because of the level overnight interest rates.



Long-Term Interest Rates

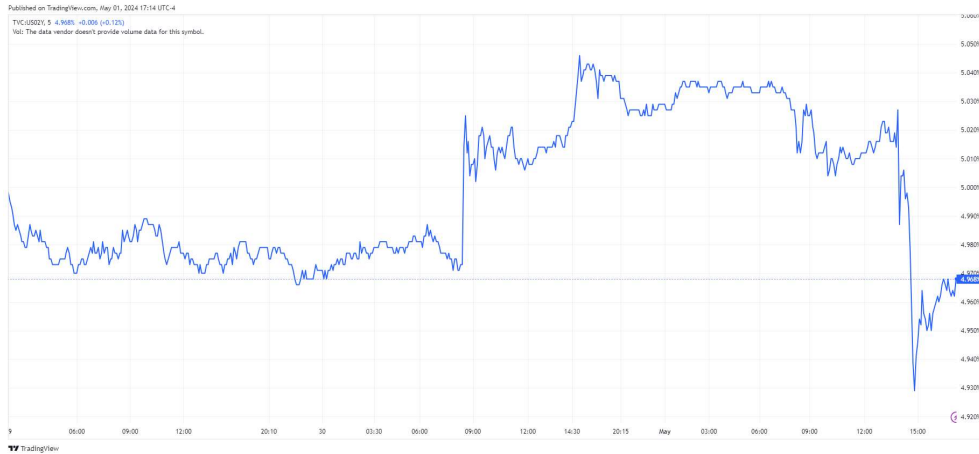
- Unfortunately, the current fed funds rate has much less influence on long term interest rates.
- Instead, long-term interest rates depend on two factors
 1. The average of expected, future short-term rates over the life of the long-term bond. Friday, US Treasuries: 1-Yr 5.14; 2-Yr 4.83. Why?
 2. “Risk” premia that reflect the possibility of unexpected changes in interest rates and the possibility of default.
- The Secondary Tools are aimed at affecting these factors.

Two Secondary Tools to Affect Interest Rates

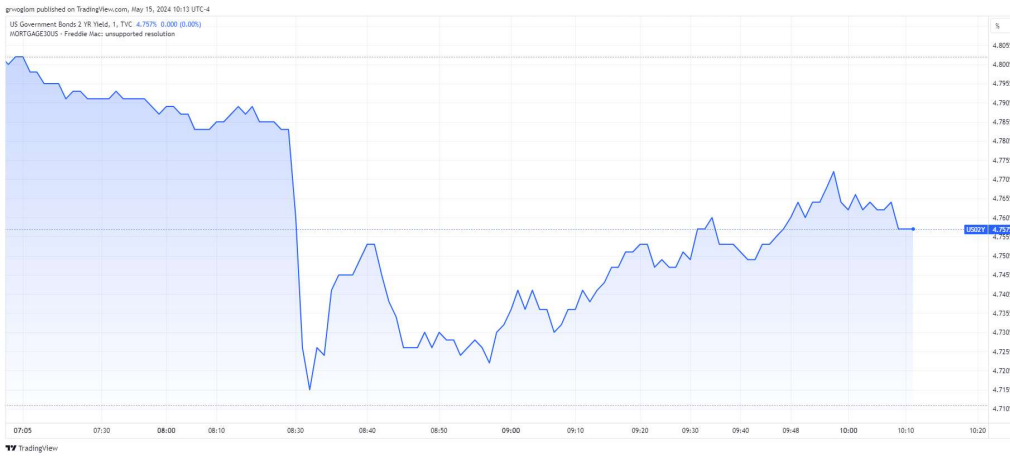
1. **Forward Guidance: Communicating the Fed’s intentions for the *future path of short-term interest rates.***
2. **Long-term Asset Purchases better known as quantitative easing or QE.**

Both of these tools also affect interest rates, and thereby aggregate demand. But their effect is on interest rates for longer-term and riskier assets.

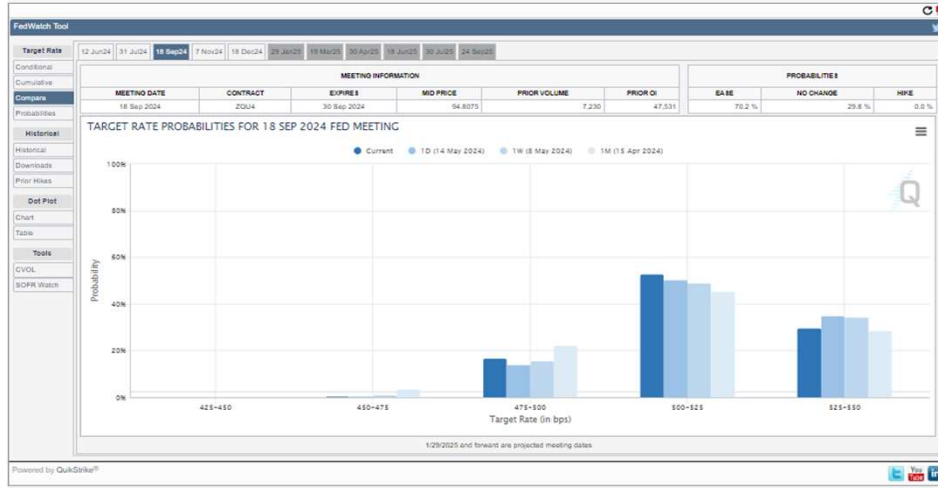
When Jay Powell Talks, People Listen!



People also Listen to the BLS!



Predicting Future Fed Actions



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<https://sites.google.com/view/macro-current-issues/monetary-policy>

QE And Long-term, Risky Rates

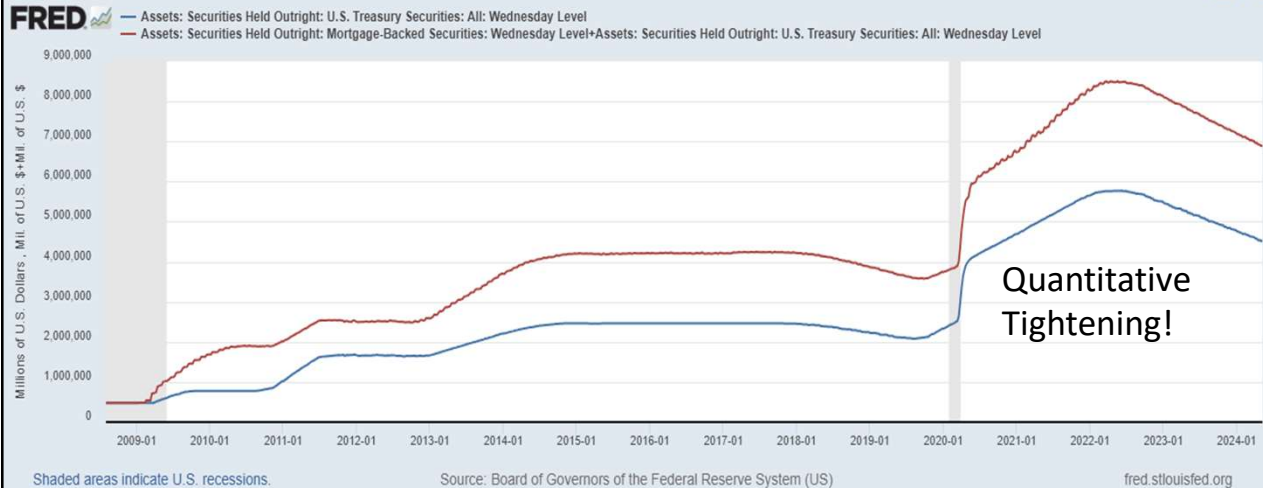
- Financial investors require a higher interest rate on risky bonds, than on safe short-term Treasuries.
- The lower the supply of risky bonds, the lower the required risk premia needed to get enough private investors to buy them.
- QE lowers the supply of long-term bonds held by private investors and thereby lowers to required risk premia and the interest rate on these bonds.



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QE Had Been a Big Deal



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Source: Federal Reserve Board

A Policy Strategy: Stabilize Expectations of Inflation

- Monetary Policy is much easier if the people believe that the Fed will achieve its inflation target.

Ben Bernanke (2007):

”...if inflation expectations respond less than previously to variations in economic activity, then inflation itself will become relatively more insensitive to the level of activity...”

- In central bank jargon, stable expectations are “well anchored.”



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Anchoring Requires Credibility

Credibility, the public believes that the Fed will achieve its goals.

- **Requirements for Credibility**

1. Transparency (Communication)
2. Accountability (Performance) BOE Letter?
3. Political Independence



The Great Moderation

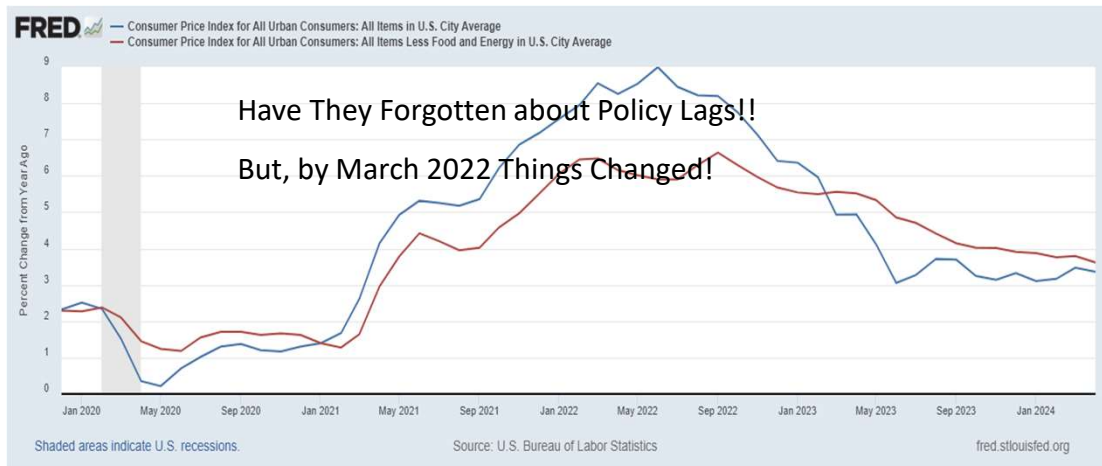
- **Volcker paid a price in the early 1980s, but the price paid dividends from 1990 through 2008.**
- **During that period the performance of the US economy was extraordinary and even Milton Friedman gave kudos to the Alan Greenspan.**
- **Has Powell jeopardized Volcker's legacy?**



Policy Changes under Powell

- In the Fed’s dual mandate FOMC put more emphasis on the employment goal relative to the inflation goal.
- Inflation goal switched from targeting forecasted *future* inflation to: “In order to anchor longer-term inflation expectations at this [2 percent], the Committee seeks to achieve inflation that averages 2 percent over time, and therefore judges that, following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time.”

Why Didn't the Fed Act by April 2021?



Has Powell Learned His Lesson

- Letting inflation exceed the target causes lots of problems.
- Because of lags you must act in advance of a potential problem.
- But, in January of this year the Fed reaffirmed that it was targeting average realized inflation!
- But where does the economy go from here?

Fed Economic Projections

3/20/2024

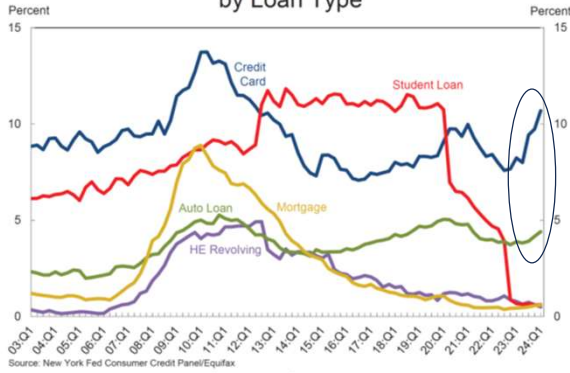
Percent

Variable	Median ¹			
	2024	2025	2026	Longer run
Change in real GDP	2.1	2.0	2.0	1.8
December projection	1.4	1.8	1.9	1.8
Unemployment rate	4.0	4.1	4.0	4.1
December projection	4.1	4.1	4.1	4.1
PCE inflation	2.4	2.2	2.0	2.0
December projection	2.4	2.1	2.0	2.0
Core PCE inflation ⁴	2.6	2.2	2.0	
December projection	2.4	2.2	2.0	
Memo: Projected appropriate policy path				
Federal funds rate	4.6	3.9	3.1	2.6
December projection	4.6	3.6	2.9	2.5

Austin Goolsbee, President of the Chicago Fed. The economy is on a “golden path” and will achieve the “mother of all soft landings.”

Maybe Not!

Percent of Balance 90+ Days Delinquent by Loan Type



Change in Spending

Median change in monthly household spending compared with a year ago



Inflation Expectations: Heating Up?



Above My Pay Grade

- To Cut or Not To Cut.
- Don't Forget about Lags.
- Political Reaction once Rates Start Coming Down (Unemployment Up)?
- Stay Tuned: 5/31, April PCE Inflation (BEA); 7/7 May Employment Report (BLS), 7/12, May CPI Inflation (BLS); 7/12 FOMC Mtg.!

The 2024 election may hinge on what the Fed does and when.



Let's Hear from You!

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<https://sites.google.com/view/macro-current-issues/monetary-policy>

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