Osher Lifelong Learning Institute, Spring 2023

Contemporary Economic Policy

University of Arizona
May-June, 2023

Jon Haveman, Ph.D.
National Economic Education Delegation

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1

1

National Economic Education Delegation

- **Vision**
  - One day, the public discussion of policy issues will be grounded in an accurate perception of the underlying economic principles and data.
- **Mission**
  - NEED unites the skills and knowledge of a vast network of professional economists to promote understanding of the economics of policy issues in the United States.
- **NEED Presentations**
  - Are nonpartisan and intended to reflect the consensus of the economics profession.

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2

2

Who Are We?

- **Honorary Board: 54 members**
  - 2 Fed Chairs: Janet Yellen, Ben Bernanke
  - 6 Chairs Council of Economic Advisers
    - Furman (D), Rosen (R), Bernanke (R), Yellen (D), Tyson (D), Goolsbee (D)
  - 3 Nobel Prize Winners
    - Akerlof, Smith, Maskin
- **Delegates: 652+ members**
  - At all levels of academia and some in government service
  - All have a Ph.D. in economics
  - Crowdsource slide decks
  - Give presentations
- **Global Partners: 48 Ph.D. Economists**
  - Aid in slide deck development

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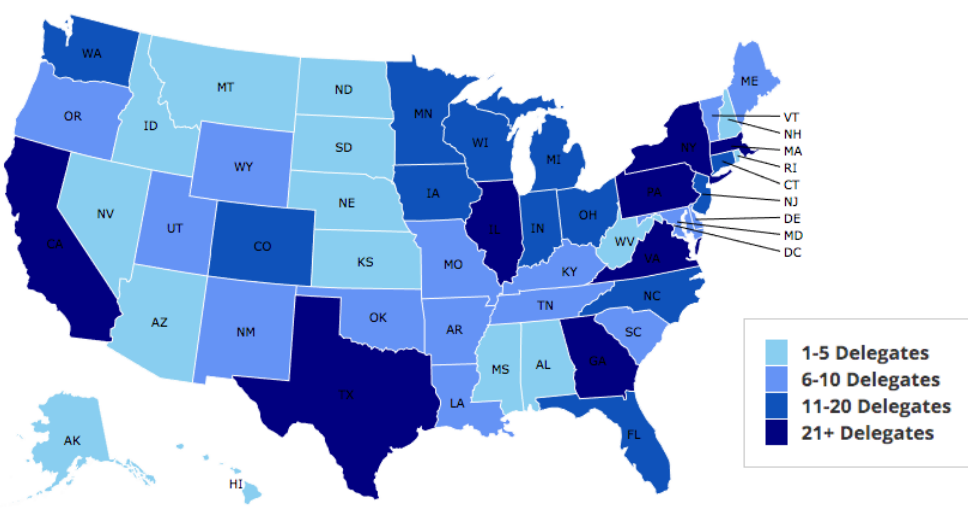
3

3

Where Are We?



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4

4

Available NEED Topics Include:

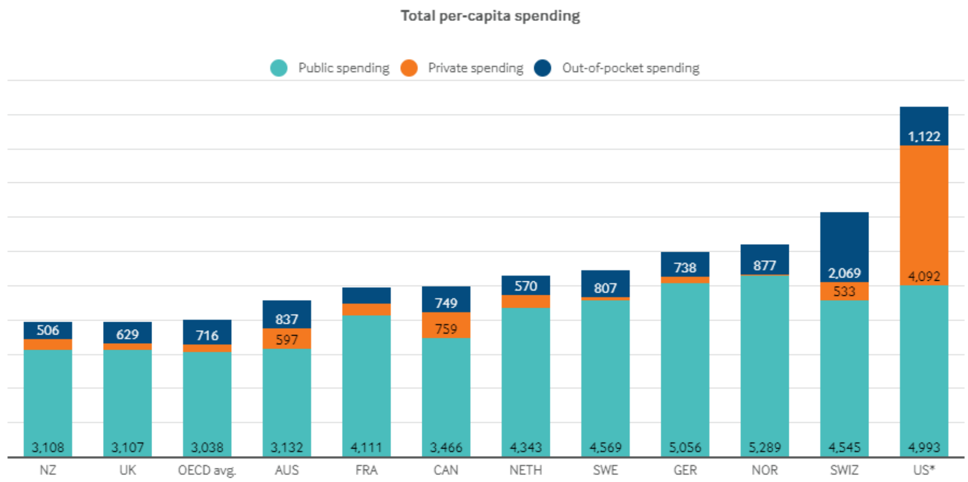
- US Economy
- Healthcare Economics
- Climate Change
- Economic Inequality
- Economic Mobility
- Trade and Globalization
- Minimum Wages
- Immigration Economics
- Housing Policy
- Federal Budgets
- Federal Debt
- Black-White Wealth Gap
- Autonomous Vehicles
- US Social Policy

Course Outline

- Contemporary Economic Policy
  - **Week 2 (5/23): Monetary Policy (Geoffrey Woglom)**
  - Week 3 (5/30): Health Care Economics (Kelley Cullen, E. Washington University)
  - Week 4 (6/6): Trade and Globalization (Alan Deardorff, University of Michigan)
  - Week 5 (6/13): Trade Deficits and Exchange Rates (Alan Deardorff)
  - Week 6 (6/20): Cryptocurrencies (Jon Haveman, NEED)

International Comparison: Health Spending

Dollars (US$), adjusted for differences in cost of living



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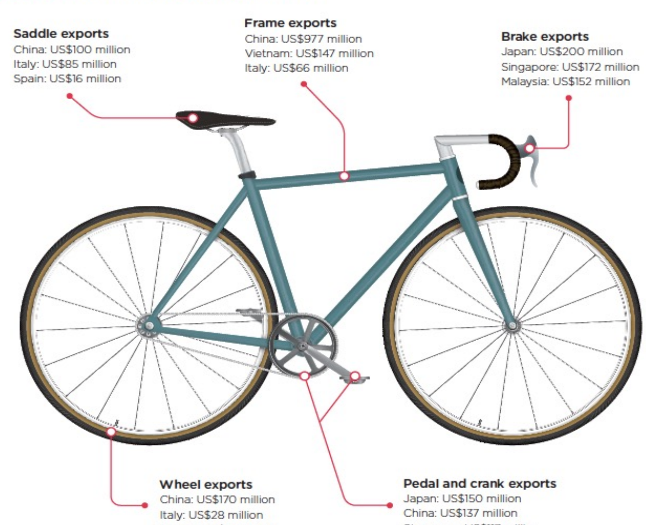
7

Trade: Bicycle Supply Chain

Figure 1.1 Where do bicycles come from?



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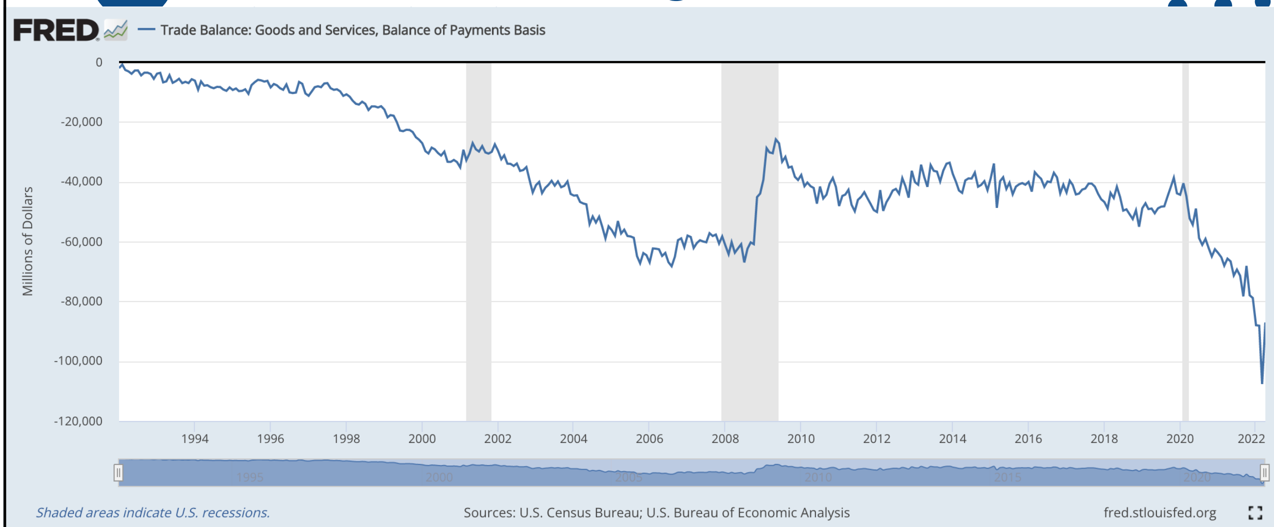
Source: World Development Report 2020

8

Trade Deficits and Exchange Rates



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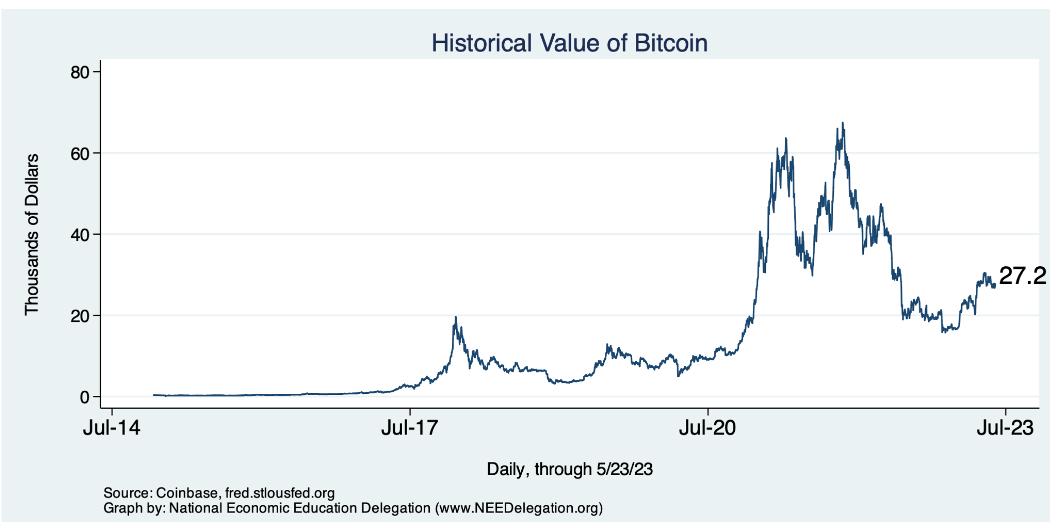
9

9

Bitcoins: What Was All the Excitement About?



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10

10

Monetary Policy & The Fed

Geoffrey Woglom
Professor of Economics (emeritus)
Amherst College

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11

11

Credits and Disclaimer

- **This slide deck was authored by:**
  - Geoffrey Woglom, Amherst College (Emeritus)
- **Disclaimer**
  - NEED presentations are designed to be nonpartisan.
  - It is, however, inevitable that the presenter will be asked for and will provide their own views.
  - Such views are those of the presenter and not necessarily those of the National Economic Education Delegation (NEED).

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12

12

Submitting Questions

- **Please submit questions of clarification in the chat.**
  - I will try to handle them as they come up, but may take them in a bunch as time permits.
- **We will do a verbal Q&A once the material has been presented.**
  - And the questions in the chat have been addressed.
- **OLLI allowing, we can stay beyond the end of class to have further discussion.**

13

Outline for the Talk

1. **What is the Fed.**
2. **The economic determinants of inflation and unemployment.**
3. **The Fed's policy tools for influencing interest rates and thereby affecting aggregate demand and the economy.**
4. **A closer look at changes that Chair Powell made in Fed policy that contributed to the run up in inflation.**
5. **What's at stake if we don't get inflation under control.**

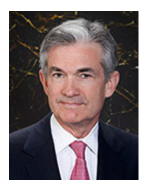
14

What Is a Central Bank?

1. **Government's Bank.**
   a. Regulate currency and manage the payment system.
   b. Help with government finance.
2. **"Lender of Last Resort" (LOL) in financial crises.**
3. **Responsible for stabilizing the macro economy: i.e., low, stable inflation and full employment**

15

Stabilizer in Chief: the Fed

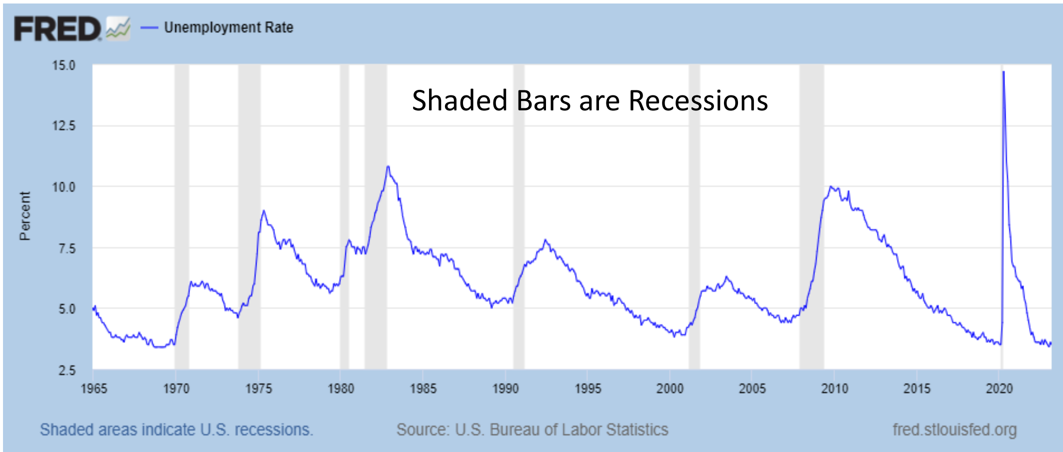


Jerome Powell
February 2018

- **The Fed's Dual Mandate:**
  1. "Stable prices" which means 2% rate of inflation in tl on Expenditure Price Index (which corresponds to about ıore well-known CPI).
  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)**

16

Track Record on Unemployment



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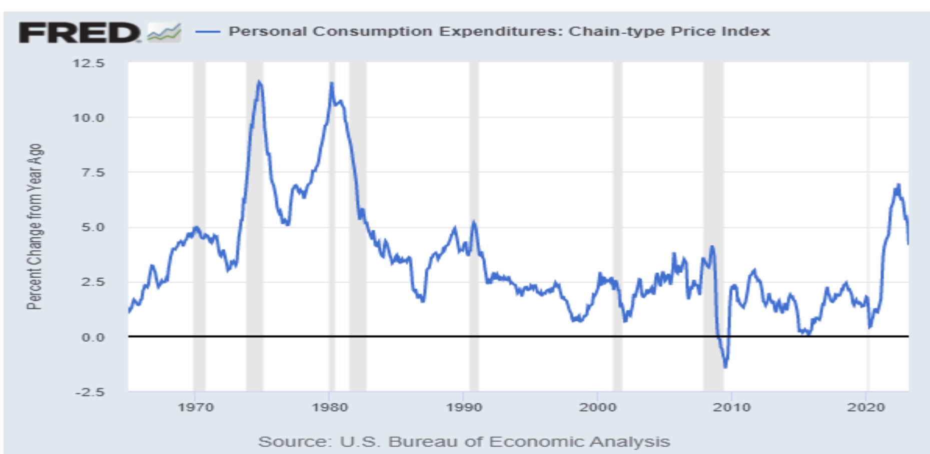
17

17

Track Record on "Price Stability"



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18

18

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.
  2. Increase in production costs (e.g., "supply chain bottlenecks.")
  3. Expectations of high inflation can cause inflation to be high.

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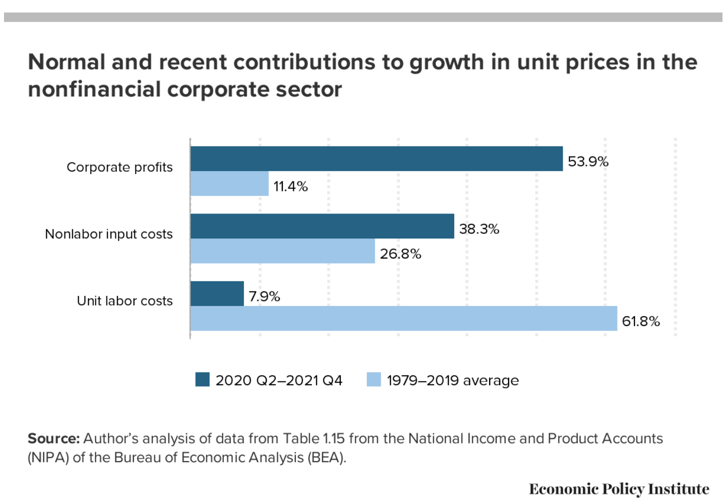
19

19

Corporate Profits and Inflation?



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20

20

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.

21

Become a Central Banker in One Slide!

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

Note: in deciding on appropriate interest rates you must take account of what fiscal policy is doing that affects total spending

22

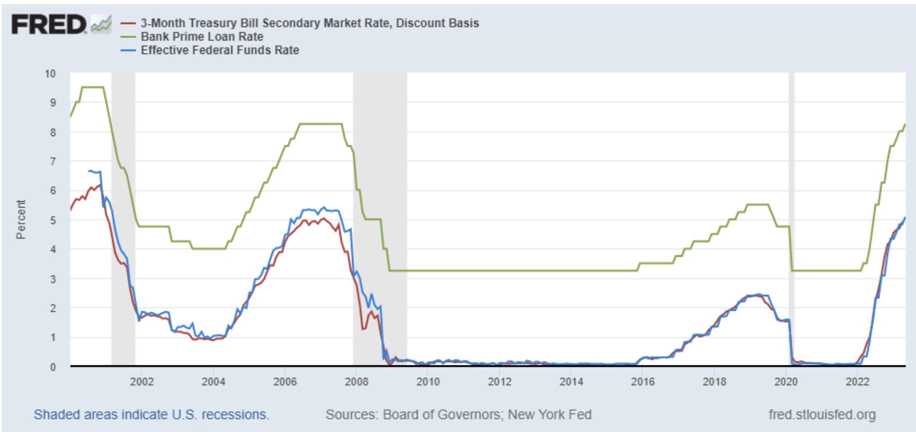
One Big Complication: Lags

- 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 to the Fed to "oversteering" 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.
- 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.
Green is the prime bank lending rate.
Red is the rate on 3 month Treasuries.

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25

25

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 3/21-3/22/2023 FOMC Meeting mentions:

- Money Supply, M1, M2 – 0 times
- Federal funds rate – 15 times

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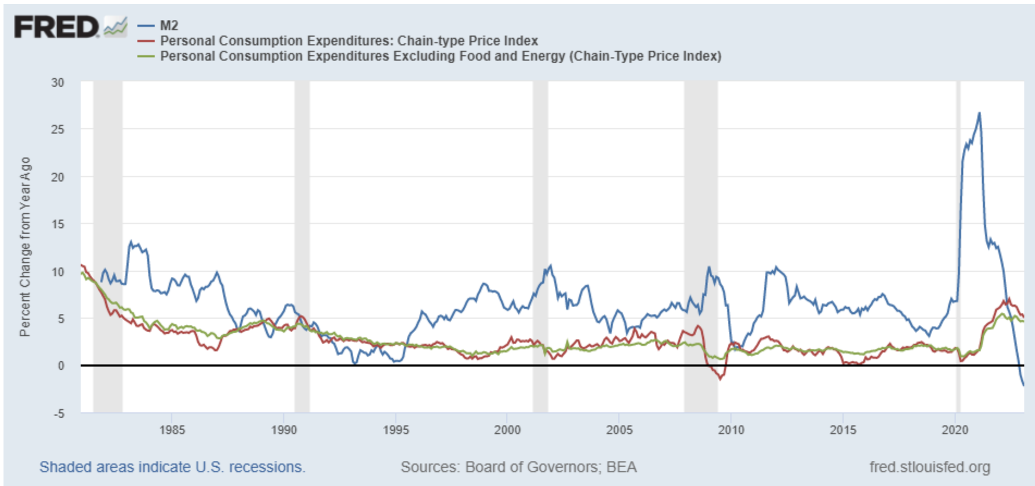
26

26

Do You See a Relationship?



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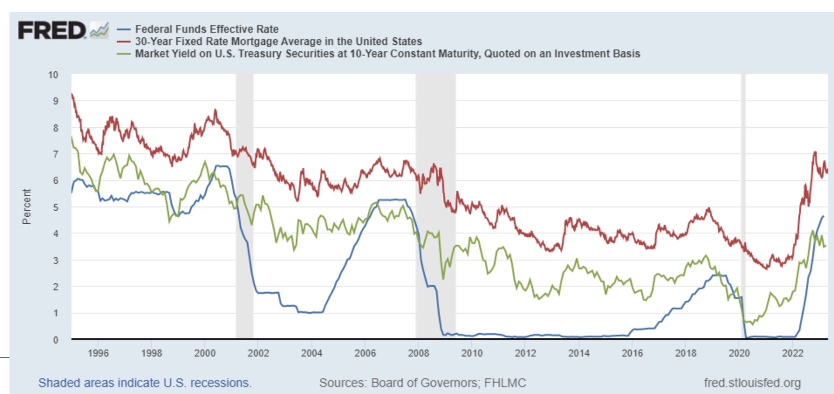
27

27

The Importance of Long-Term Interest Rates

- Nobody buys a house because of the level of 1-yr interest rates, and unfortunately, the current federal funds rate has much less influence on the rates that matter.



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Long-Term Interest Rates

- **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.
  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.**

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29

29

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 the interest rates of longer-term and riskier assets.

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30

30

Changes to the Policy Statement in May

The U.S. banking system is sound and resilient. ~~Recent developments are likely to result in t~~Tighter credit conditions for households and businesses and are likely to weigh on economic activity, hiring, and inflation. The extent of these effects ~~is~~ remains uncertain. The Committee remains highly attentive to inflation risks.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. In support of these goals, the Committee decided to raise the target range for the federal funds rate to ~~4-3/4 to 5~~5 to 5-1/4 percent. The Committee will closely monitor incoming information and assess the implications for monetary policy. In determining the extent to which additional policy may be appropriate to return inflation to 2 percent over time, ~~The Committee anticipates that some additional policy firming may be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time. In determining the extent of future increases in the target range,~~ the

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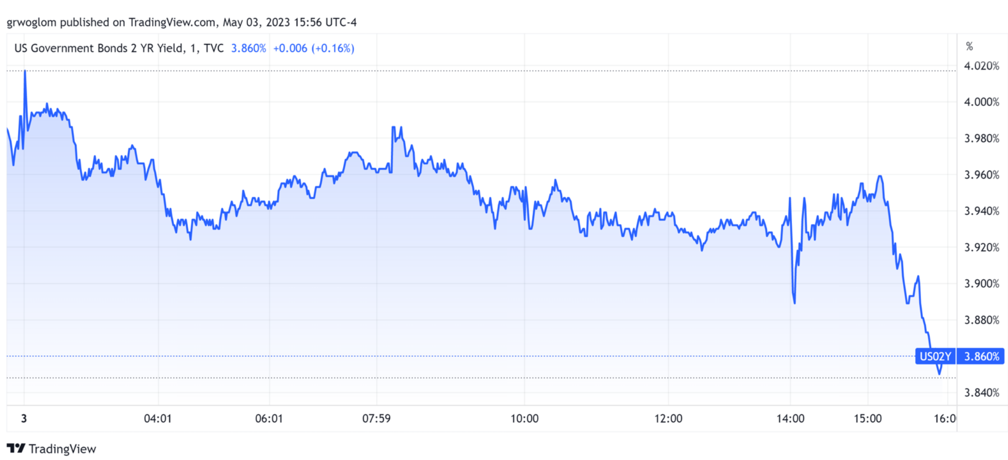
31

31

Forward Guidance: May 3rd



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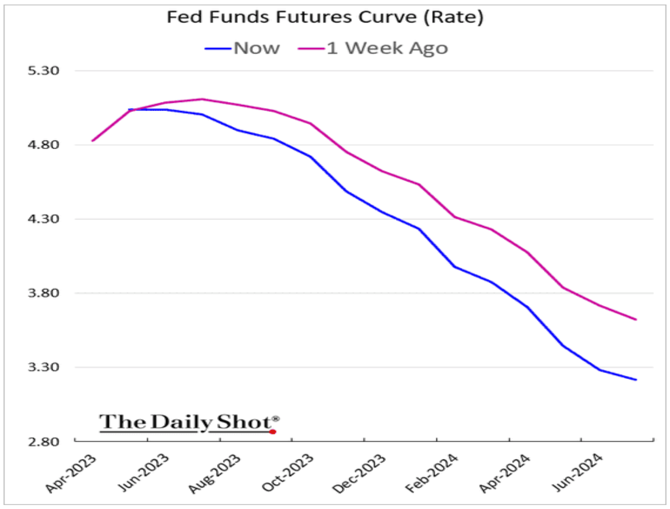
32

32

Forward Guidance: May 3rd



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33

33

QE And Long-term, Risky Rates

- Financial investors require a higher interest rate on risky bonds, than on safe short-term Treasuries.
- The greater the supply of risky bonds, the higher 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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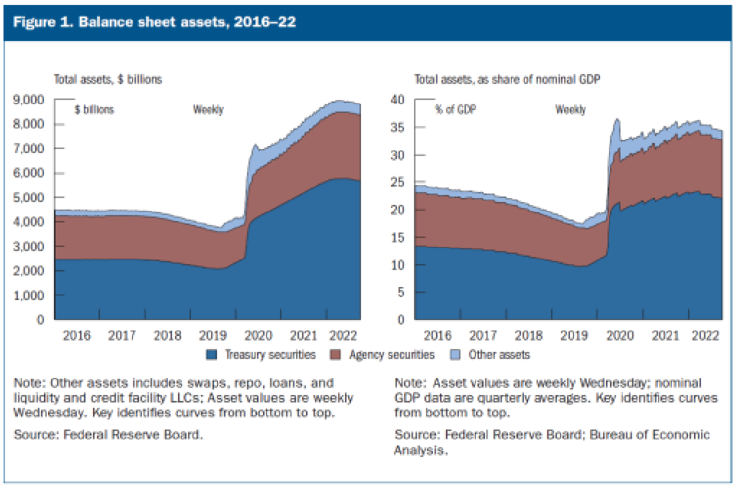
34

34

QE Has Been a Big Deal



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Source: Federal Reserve Board

35

A Policy Strategy: Stabilize Expectations of Inflation

- Monetary Policy is much easier if people believe that the Fed will achieve its inflation target.
- In central bank jargon, if expectations are stable and “well anchored.”

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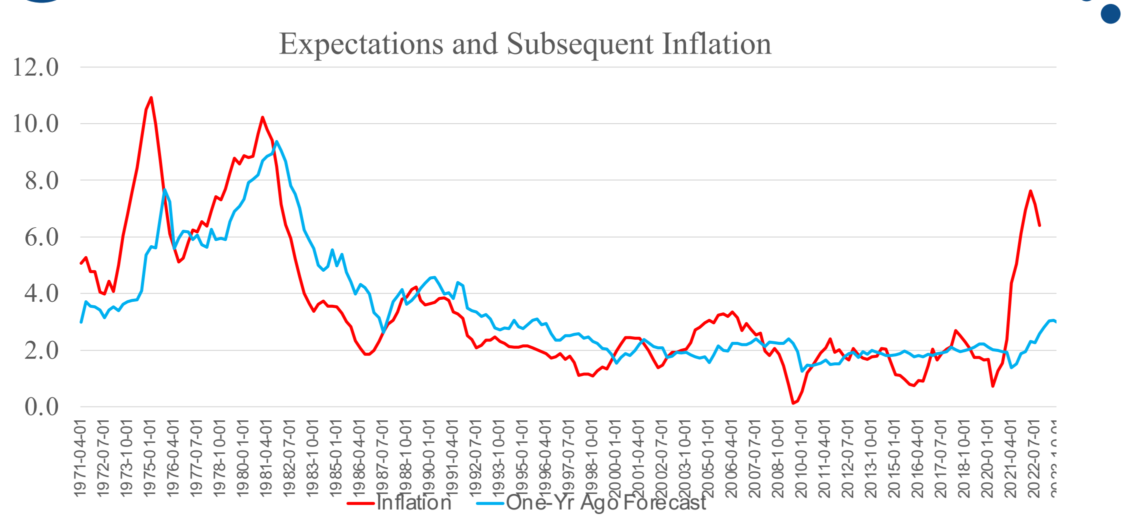
36

36

"Anchoring" Inflation Expectations



Forecasts: Philadelphia Fed, "Survey of Professional Forecasters"

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37

37

Anchoring Requires Credibility

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

- **Requirements for Credibility**
  1. Transparency (Communication)
  2. Accountability (Performance)
  3. Political Independence

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38

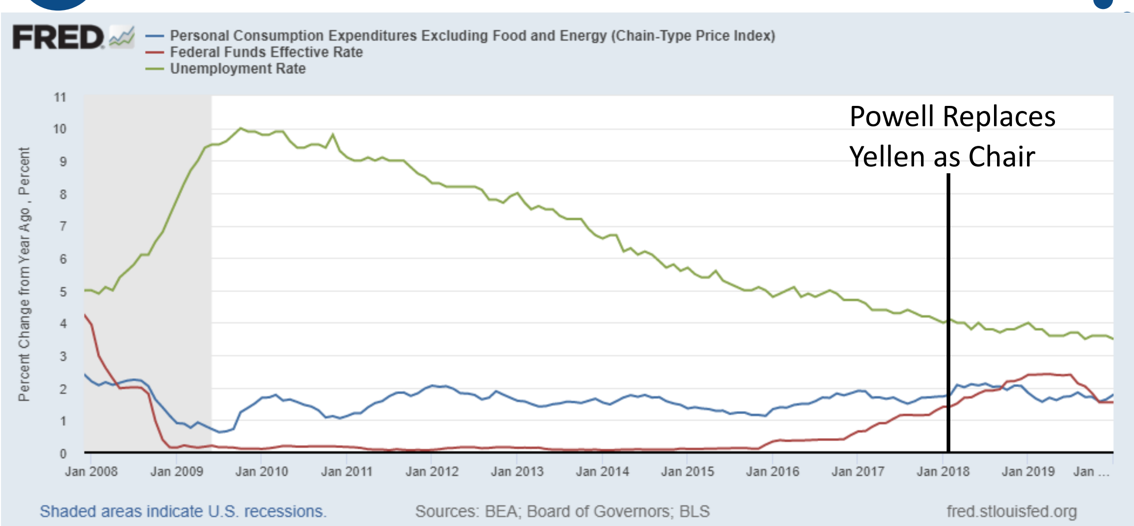
38

The Great Moderation

- Volcker paid a price in the early 1980s, but the price paid dividends from 1990 through 2008.
- During the latter 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?

39

Why Did Powell Do It?



40

Policy Changes under Powell

- In the Fed's dual mandate put more emphasis on the employment goal relative to the inflation goal.
- Inflation goal switched from targeting forecasted *future* inflation to trying to achieve average *realized* inflation of 2%

Have they forgotten about Lags!

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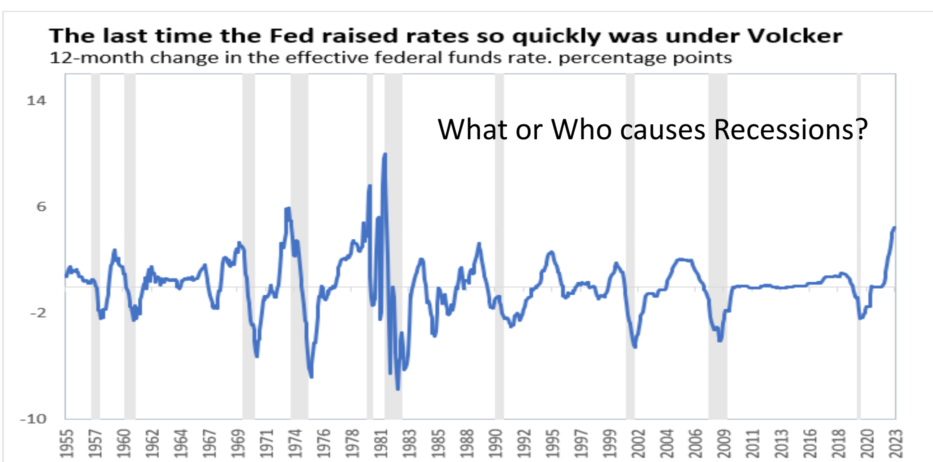
41

41

Is Powell Now Channeling Volcker?



Source: Federal Reserve. Note: The shaded areas are recessions according to the NBER.

Amazingly, (to me anyway), the Fed reaffirmed targeting average realized inflation!

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42

42

What's at Stake

- A rise in inflationary expectations would probably mean higher and more variable inflation.
- Oversteering leading to a steep recession ("hard" landing).
- Curbing inflation could lead to widespread bank failures (Pacific West?).

And, the Fed needs to navigate:

1. At the start of a presidential election cycle, with
2. Pervasive uncertainty. (e.g., credit crunch)

43

Since We Last Met

44

Fed Plans, as of March 22

Variable (in percent)	Medians			
	2023	2024	2025	Longer Run
RGDP growth	0.4	1.2	1.9	1.8
Dec.	0.5	1.6	1.8	1.8
Unemployment	4.5	4.6	4.6	4.0
Dec.	4.6	4.6	4.5	4.0
Inflation	3.2	2.5	2.1	2.0
Dec.	3.1	2.5	2.1	2.0
Core Inflation	3.6	2.6	2.1	
Dec.	3.5	2.5	2.1	
Federal Funds	5.1	4.3	3.1	2.5
Dec.	5.1	4.1	3.1	2.5

Is this a so-called "soft" landing? Why is the Fed forecasting a rise in the unemployment rate and can't they do something about it?

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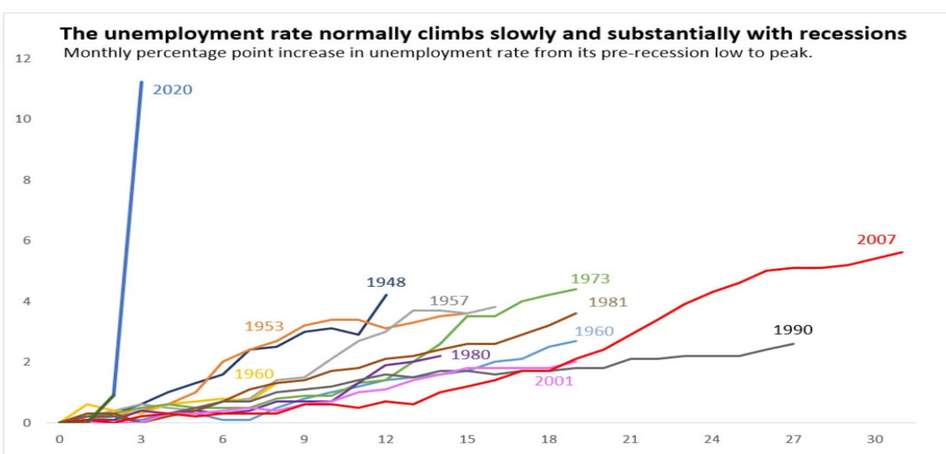
Remember Senator Warren: She is Right



Source: Bureau of Labor Statistics. Calculations by Claudia Sahm.

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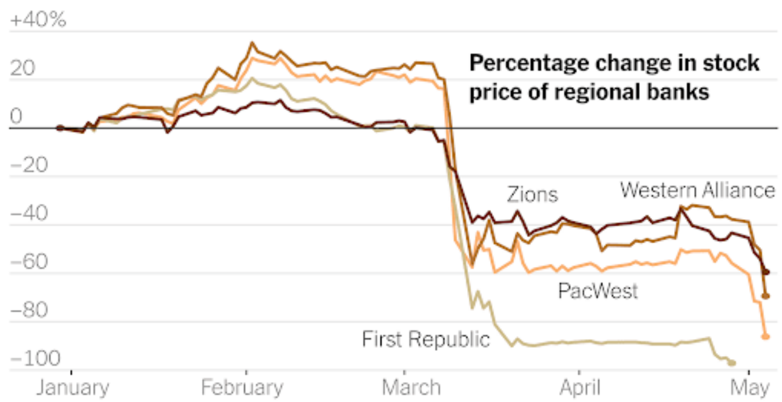
46

The Banking Crisis is Not Over



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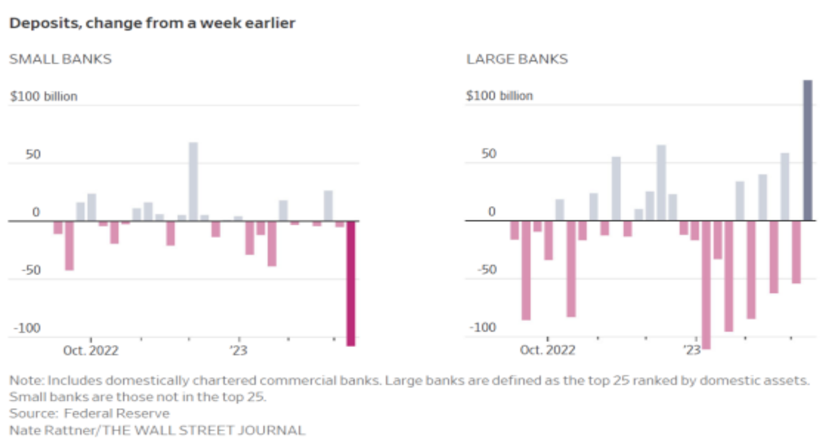
47

47

Short-term and Long-Term Problem?



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48

48

And, Then There is the Debt Ceiling Fiasco

- **Biden Can:**
  1. Declare Debt Ceiling unconstitutional due to 14th amendment.
  2. Direct the Treasury to Mint a $5 trillion coin.
  3. Direct the Treasury to replace existing bonds with very high coupon payments, so that they sell for more than their face value.

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49

49

Recommended Reading

- **https://www.nytimes.com/interactive/2023/05/18/opinion/jobs-inflation-economy.html?smid=nytcore-ios-share&referringSource=articleShare**

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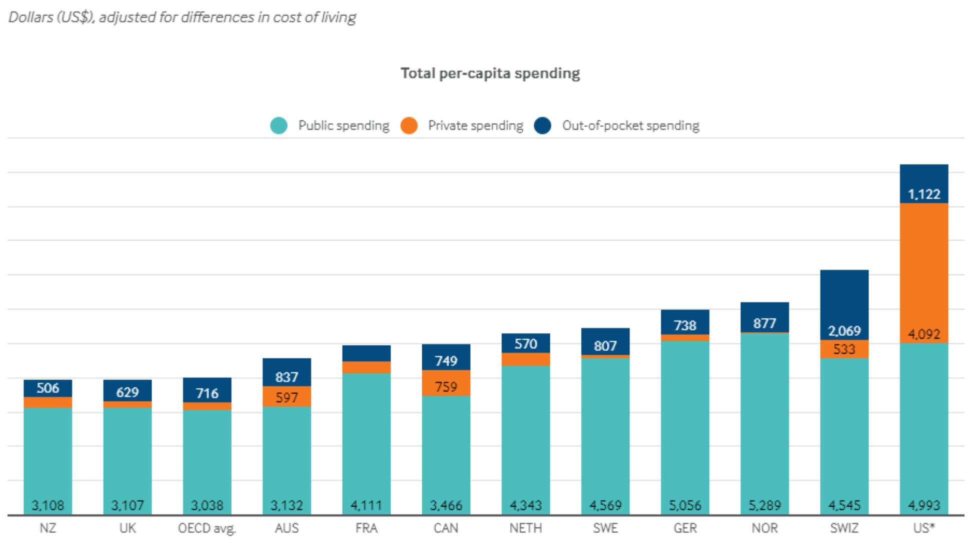
50

50

International Comparison: Health Spending



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51

Let's Hear from You!

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52

52