Osher Lifelong Learning Institute, Winter 2023

Contemporary Economic Policy

University of Massachusetts, Boston
March-April, 2023

Host: Jon Haveman, Ph.D.
National Economic Education Delegation

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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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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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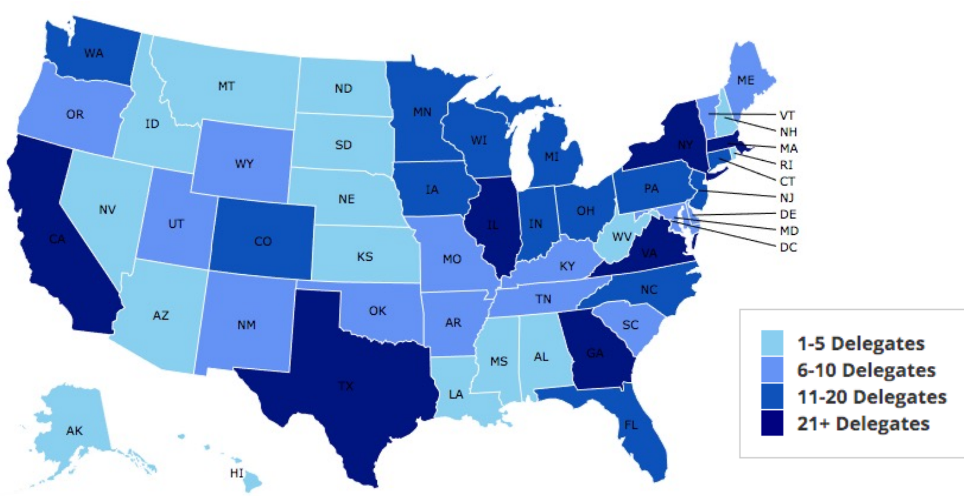
Where Are We?



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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
- Healthcare Economics

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Course Outline

- **Contemporary Economic Policy**
  - **Week 2 (3/20): Monetary Economics (Geoffrey Woglom)**
  - Week 3 (3/27): Trade and Globalization (Alan Deardorff, Univ. Michigan)
  - Week 4 (4/3): Trade Deficits and Exchange Rates (Alan Deardorff)
  - Week 5 (4/10): Healthcare Economics (Jon Haveman, NEED)
  - Week 6 (4/17): Climate Change Economics (Sarah Jacobson, Williams College)

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Outline for the Talk

1. The economic determinants of inflation and unemployment.
2. The Fed's policy tools for influencing interest rates and thereby affecting aggregate demand and the economy.
3. A closer look at changes that Chair Powell made in Fed policy that contributed to the run up in inflation.
4. Monetary Policy Challenges ahead,

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What Is a Central Bank, such as the Fed?

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

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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)**

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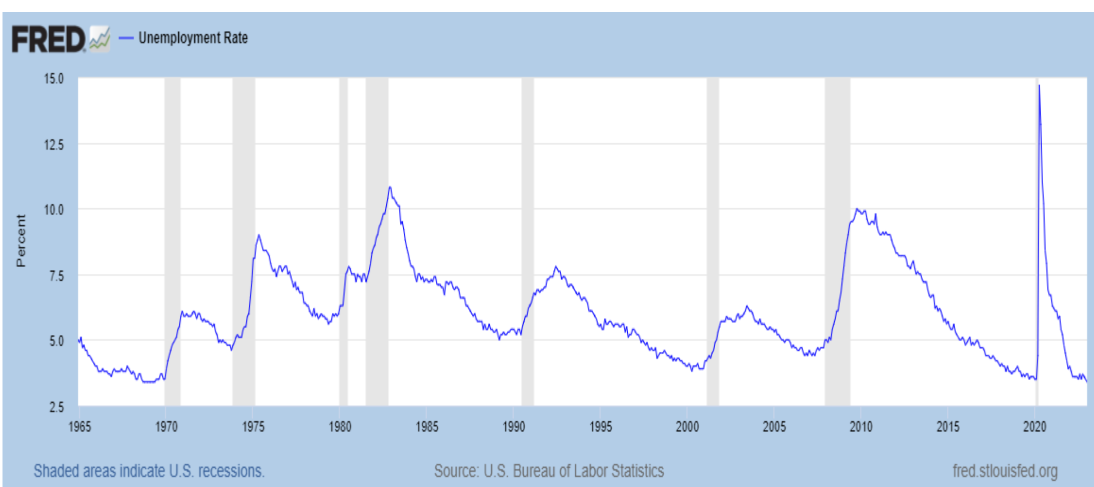
Track Record on Unemployment



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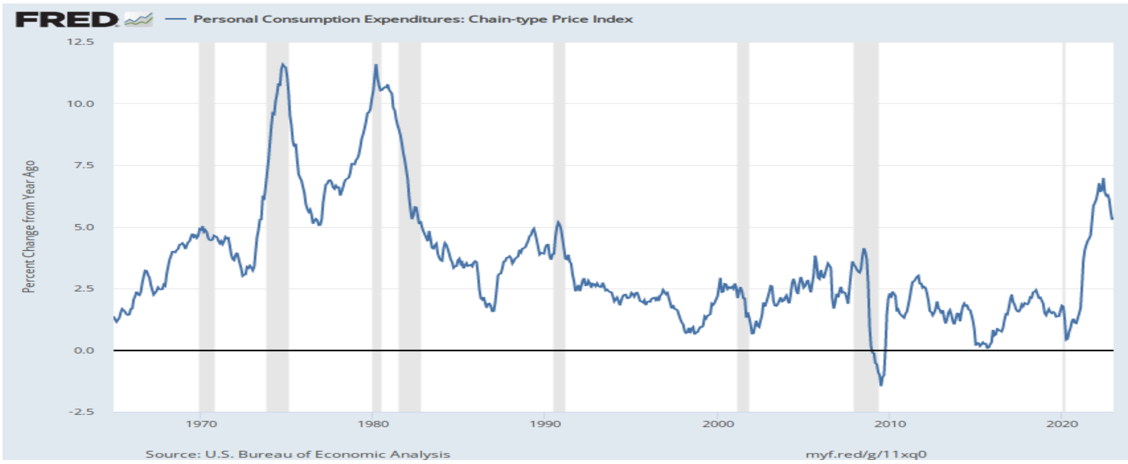
Track Record on "Price Stability"



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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.
  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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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.
- 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

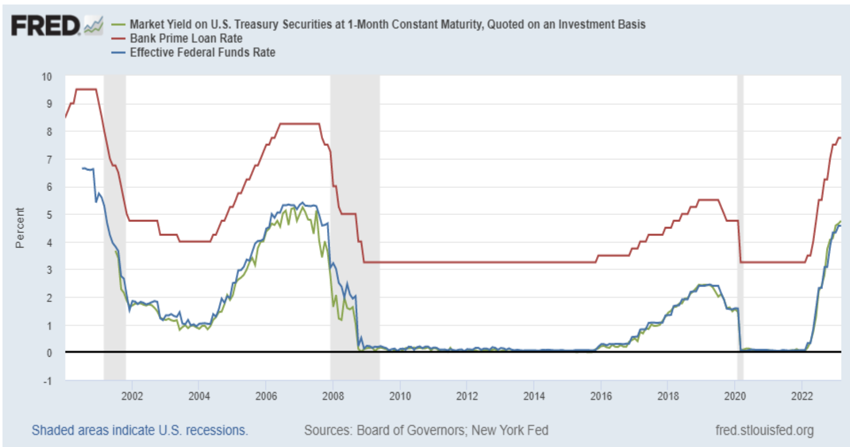
One Big Complication: Lags

- 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.
Red is the prime bank lending rate.
Green is the rate on 3 month Treasuries.

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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 1/31-2/1/2023 FOMC Meeting mentions:

- Money Supply, M1, M2 – 0 times
- Federal funds rate – 13 times

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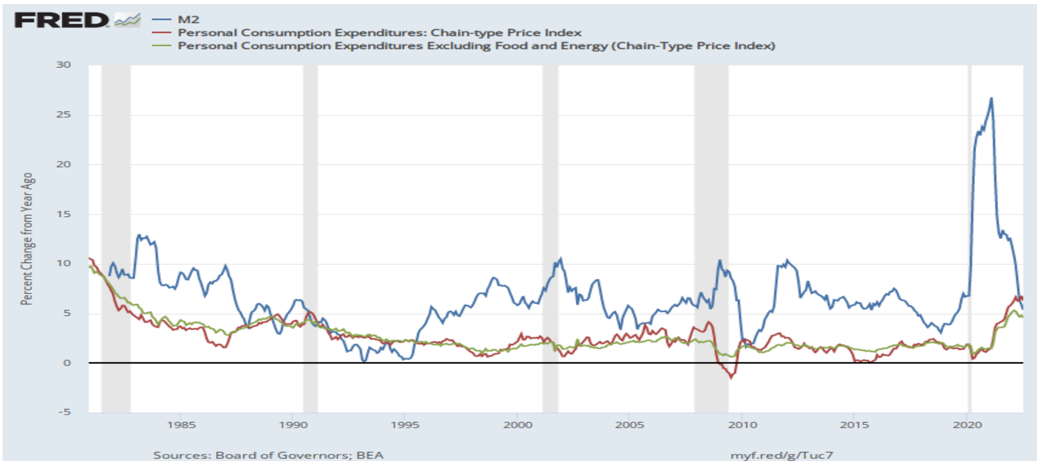
Do You See a Relationship?



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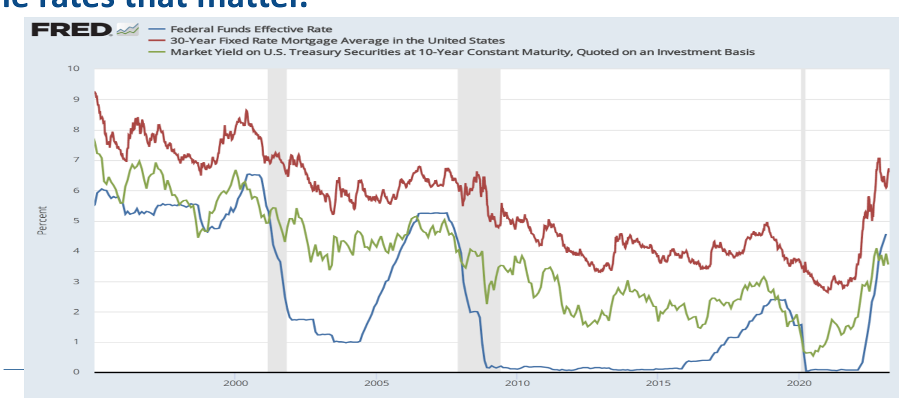
The Importance of Long-Term Interest Rates

- 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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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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Forward Guidance

The Fed "guides" financial market participants about what they intend to do in the future. From the Policy Statement since September:

- "The Committee anticipates that ongoing increases in the target range will 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 Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments."

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The Meaning of "Extent"

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When the Fed Talks, Wall St Listens!

2Yr Treasury Rate,
March 7th

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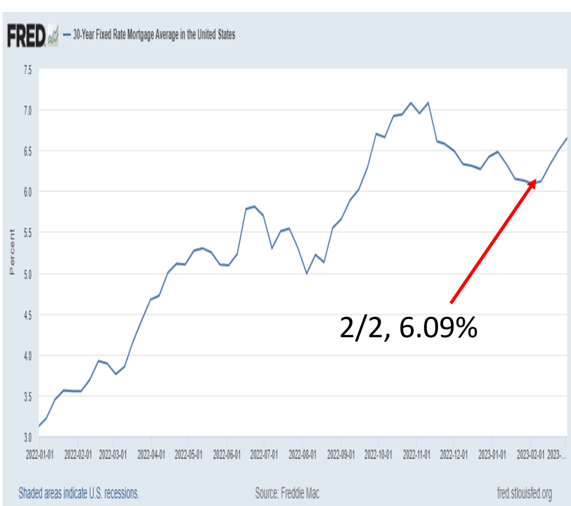
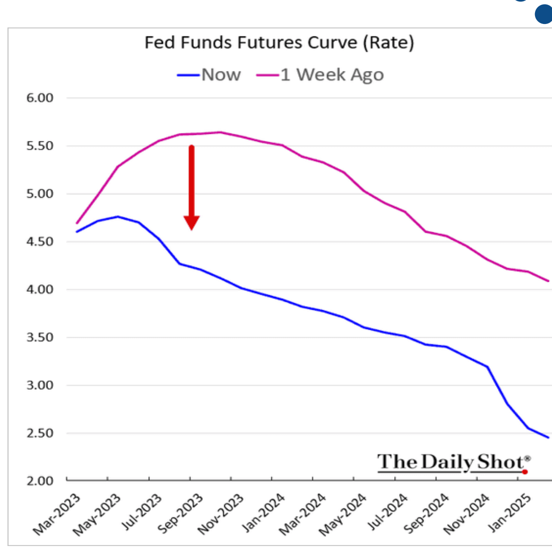
On March 7 Powell Emphasized Rate Hikes?





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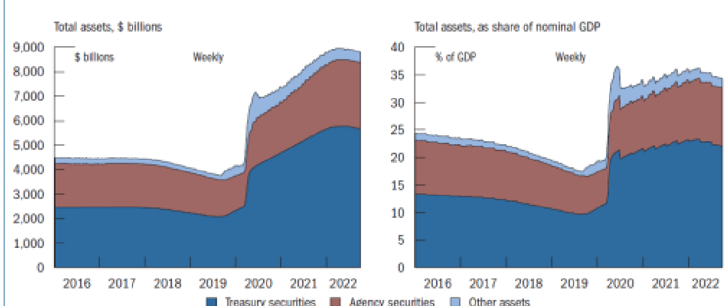
QE And Long-term, Risky Rates

- 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.

QE Has Been a Big Deal

Figure 1. Balance sheet assets, 2016–22



Note: Other assets includes swaps, repo, loans, and liquidity and credit facility LLCs; Asset values are weekly Wednesday. Key identifies curves from bottom to top.

Source: Federal Reserve Board.

Note: Asset values are weekly Wednesday; nominal GDP data are quarterly averages. Key identifies curves from bottom to top.

Source: Federal Reserve Board; Bureau of Economic Analysis.

Source: Federal Reserve Board

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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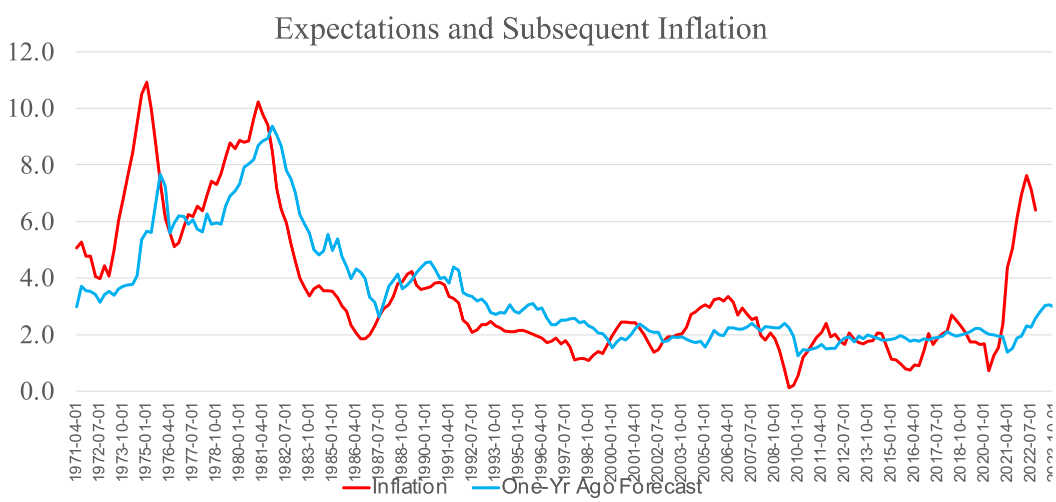
"Anchoring" Inflation Expectations



Forecasts: Philadelphia Fed, "Survey of Professional Forecasters"

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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)
  3. Political Independence

Things to think about: The Fed through monetary policy has the most influence on the short-run behavior of the (world) economy. These governmental decisions are made "technocratically" and not democratically. Is that a problem?

The Fed is mandated to not consider effects on other countries.

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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?**

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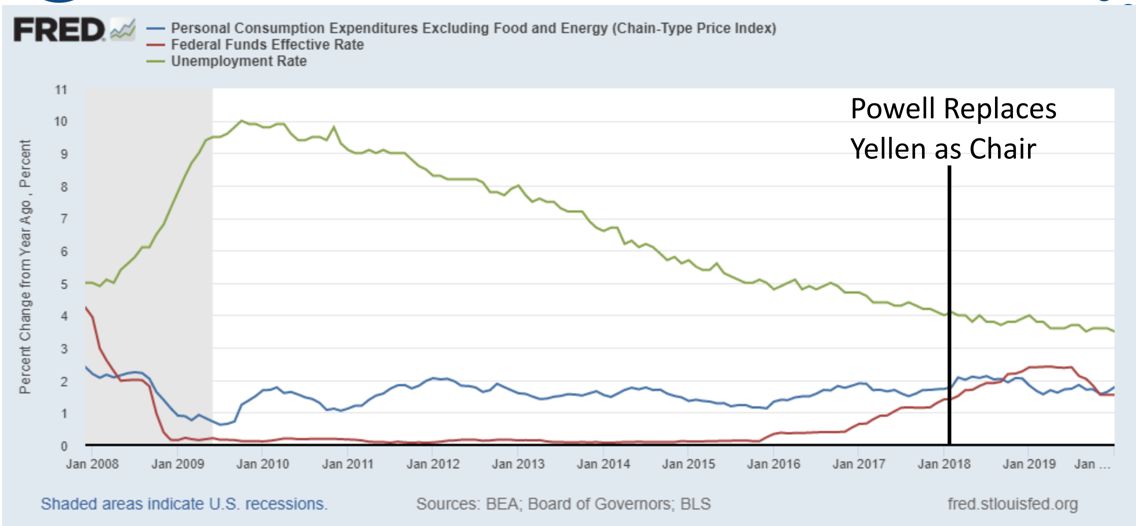
Why Did Powell Do It?



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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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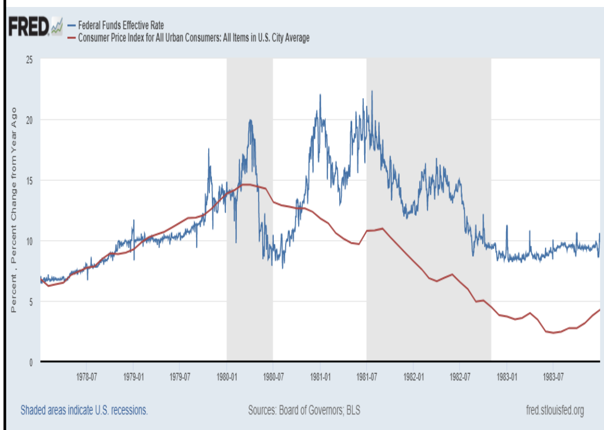
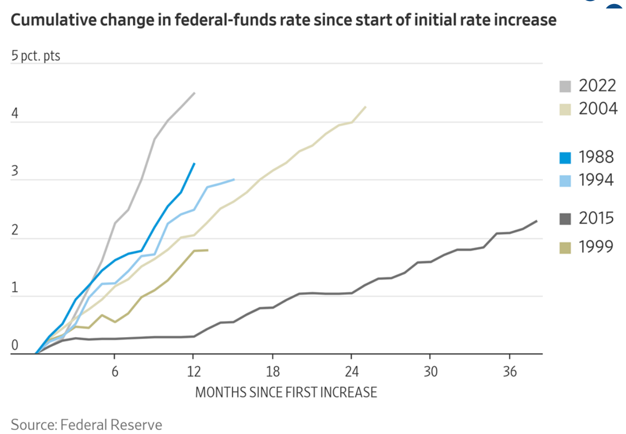
Is Powell Now Channeling Volcker?





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

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What's at Stake

- A rise in inflationary expectations would probably mean higher and more variable inflation (unlikely).
- Oversteering leading to a steep recession.

And, the Fed needs to navigate:

1. At the start of a presidential election cycle, with
2. Pervasive uncertainty.

And there is more work to be done on inflation!

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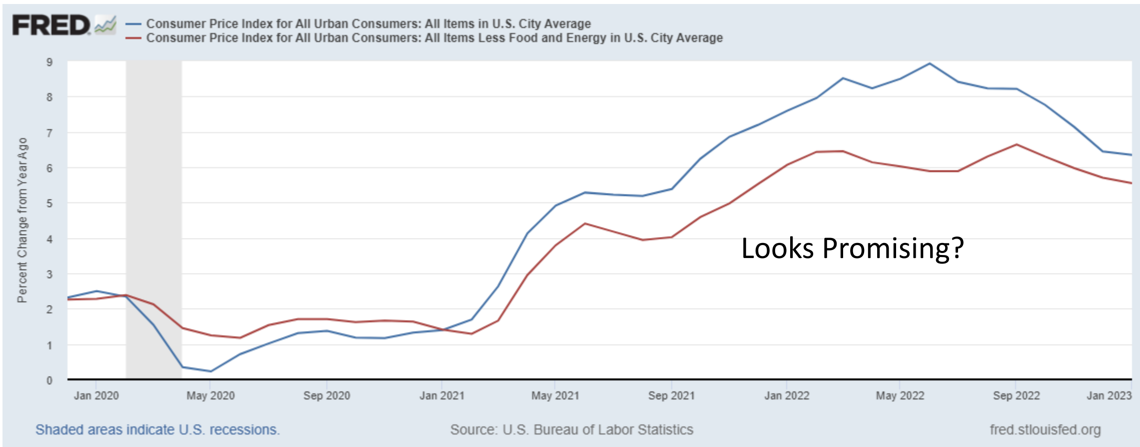
Inflation during the Recovery



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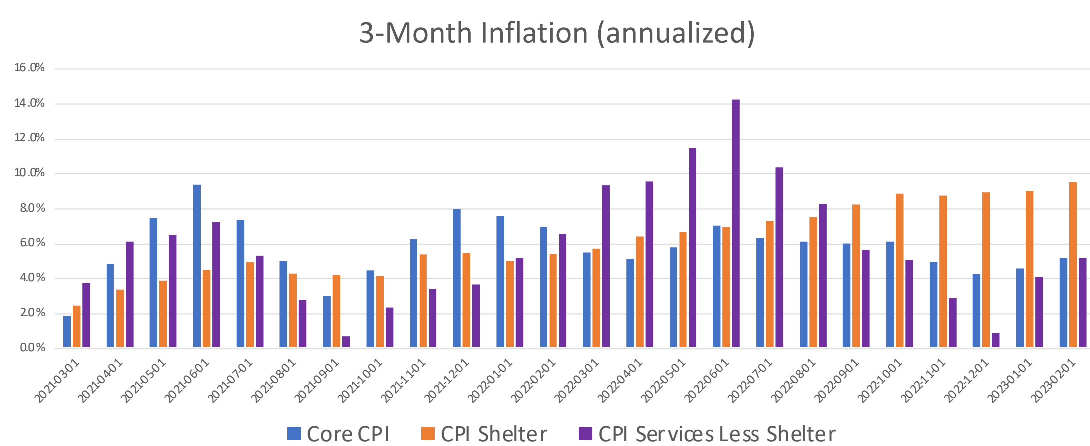
Inflation: A Closer Look



Source: BLS accessed from Fred

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Sadly, It Looks as if Things Could Get Worse

Credit Suisse a large Bank (45th largest in the world) with a significant US presence is in trouble

WSJ, 3/15: "Credit Suisse has been the problem child of European banking for several years. Repeated scandals and financial losses have hammered the 166-year-old bank, which combines a wealth-management business catering to the world's elite rich with a Wall Street investment bank."

But, the danger is contagion and European bank shares were down.

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Turbulence in the Treasury Market

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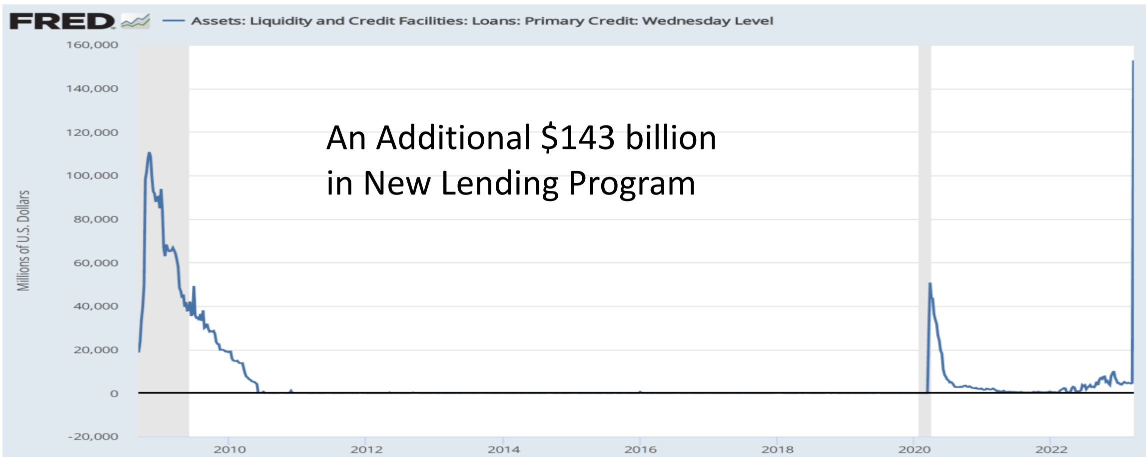
The Fed Has Been Providing Liquidity



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Recent Developments: ECB 50 bp rate increase

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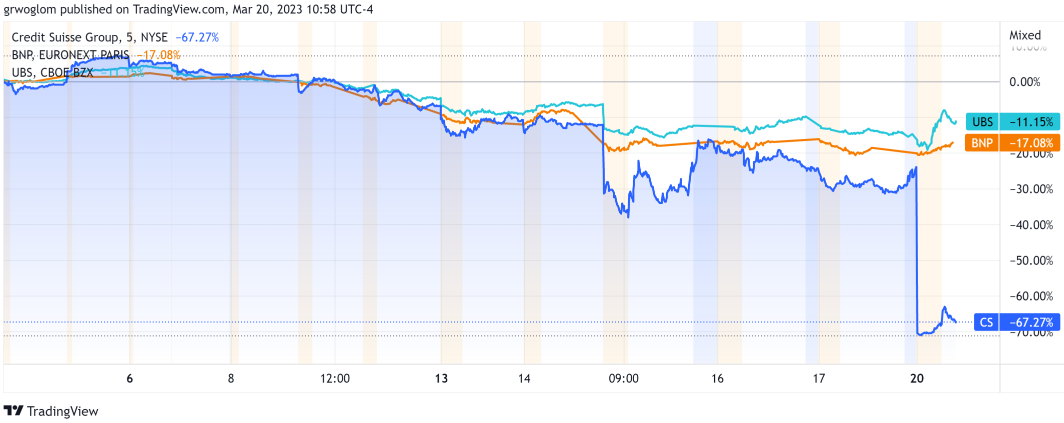
European Banking May be Calming

grwoglom published on TradingView.com, Mar 20, 2023 10:58 UTC-4



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Finally, the Fed Meets this Week

- Widely anticipated 25 basis point increase in the fed funds rate.
- More important will be the forward guidance.
- Policy statement announced 2:15 on Wednesday.

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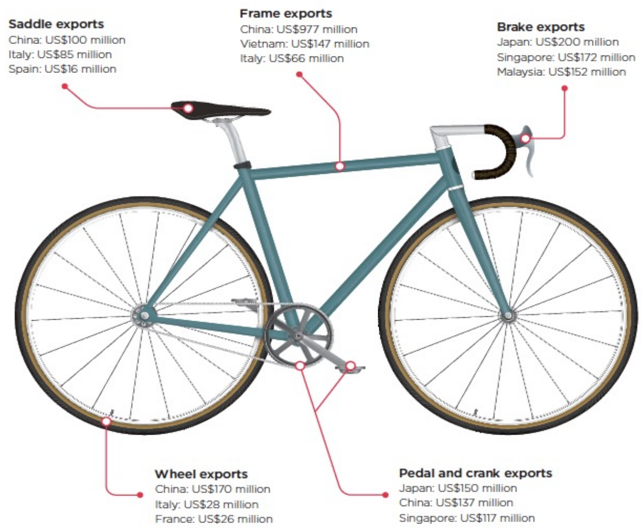
Trade: Bicycle Supply Chain

Figure 1.1 Where do bicycles come from?



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Source: World Development Report 2020

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Let's Hear from You!

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