ECONOMICS MADE EASY 10

A Journalism Workshop

Overview of Federal Reserve and Monetary Policy

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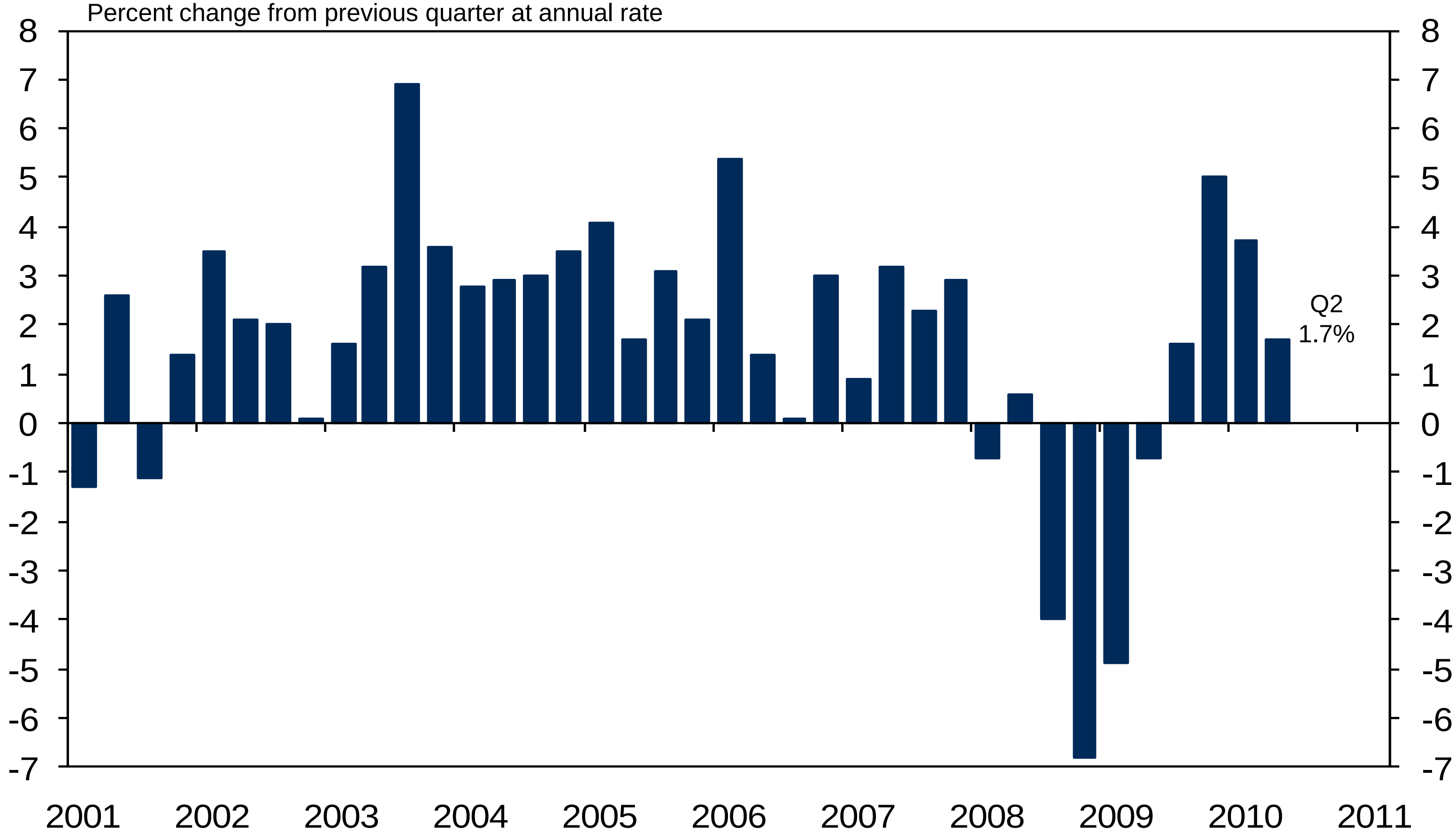
Real Gross Domestic Product



Source: Bureau of Economic Analysis/Haver Analytics

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The Federal Reserve

- Mission: To foster a stable banking system and a healthy, growing economy
- Role of monetary policy:
  - Maximum employment
  - Stable prices
  - Moderate long-term interest rates

Addressing the Mandate

- The Federal Reserve System can help stabilize prices (create only “modest” inflation) through its influence over the money supply.
- A stable price environment will foster maximum long-term employment.
- Stable prices will also lead to moderate long-term interest rates.

Monetary Policy is the Control of Money in an Economy

- Typically, central banks – like the Federal Reserve – have an exclusive right, or monopoly, on control over the supply of money.
- These institutions often buy government debt and pay “money,” thus reducing the amount of debt.
- Central banks typically gauge changes in money by looking at changes in the quantity or interest rate.
- The Federal Reserve has used an interest rate gauge in recent years, though purchases of assets have also played an important role recently.

Monetary Policy Objectives in Normal Times

- Policy attempts to supply the correct amount of money so that the economy can function optimally.
- Since money makes buying and selling more efficient or “easier,” the “correct” amount of money generally means that growth in money roughly matches trend growth in economic output.
  - If money growth dramatically exceeds trend economic growth, inflation can accelerate, leading to economic underperformance.
  - If money growth falls short of trend economic growth, the cost of money can be high, also leading to economic underperformance.

Monetary Policy Objectives in Normal Times

- Looking at this through interest rate movements:
  - Interest rates are correct when
    - Consumers make sustainable purchase and savings decisions, and
    - Businesses make sustainable production and investment decisions.
  - If interest rates are too low, consumers view consuming "today" as attractive and choose to save too little.
  - If interest rates are too high, consumers opt to save more rather than consume. Business may curtail investment, which may lead overall demand and labor markets to weaken.

What to Watch in Normal Times

- To conduct monetary policy properly then is to set interest rates at a level that balances demand in the economy with the economy's capability to produce.
- Interest rates (the federal funds rate) are set in the Federal Funds Market. The Fed effectively controls the interest rate by controlling the amount of Treasury Securities it buys and the amount of money it pays out (or injects).
- As we will see, though, the Federal Reserve also injects money into the economy by buying assets.

What to Watch in Normal Times

- What guides the Fed?
  - The Fed watches trend growth of the economy to get an idea of the need for interest rate adjustments.
  - If economic growth is well above or well below trend, the interest rate stance may be inappropriate.
- The Fed also watches the rate of inflation
  - If inflation is rising, it's a sign that interest rates could be too low (or accommodative).
  - Falling inflation rates (especially if the rate of inflation is already low) suggest interest rates may be relatively high (or restrictive).

Looking Ahead in Normal Times

- Of course, the Fed shapes the public's expectations of what it will do with policy in the future as well through public statements.
- These actions affect longer term interest rates, also affecting perceptions of future economic conditions, including inflation.

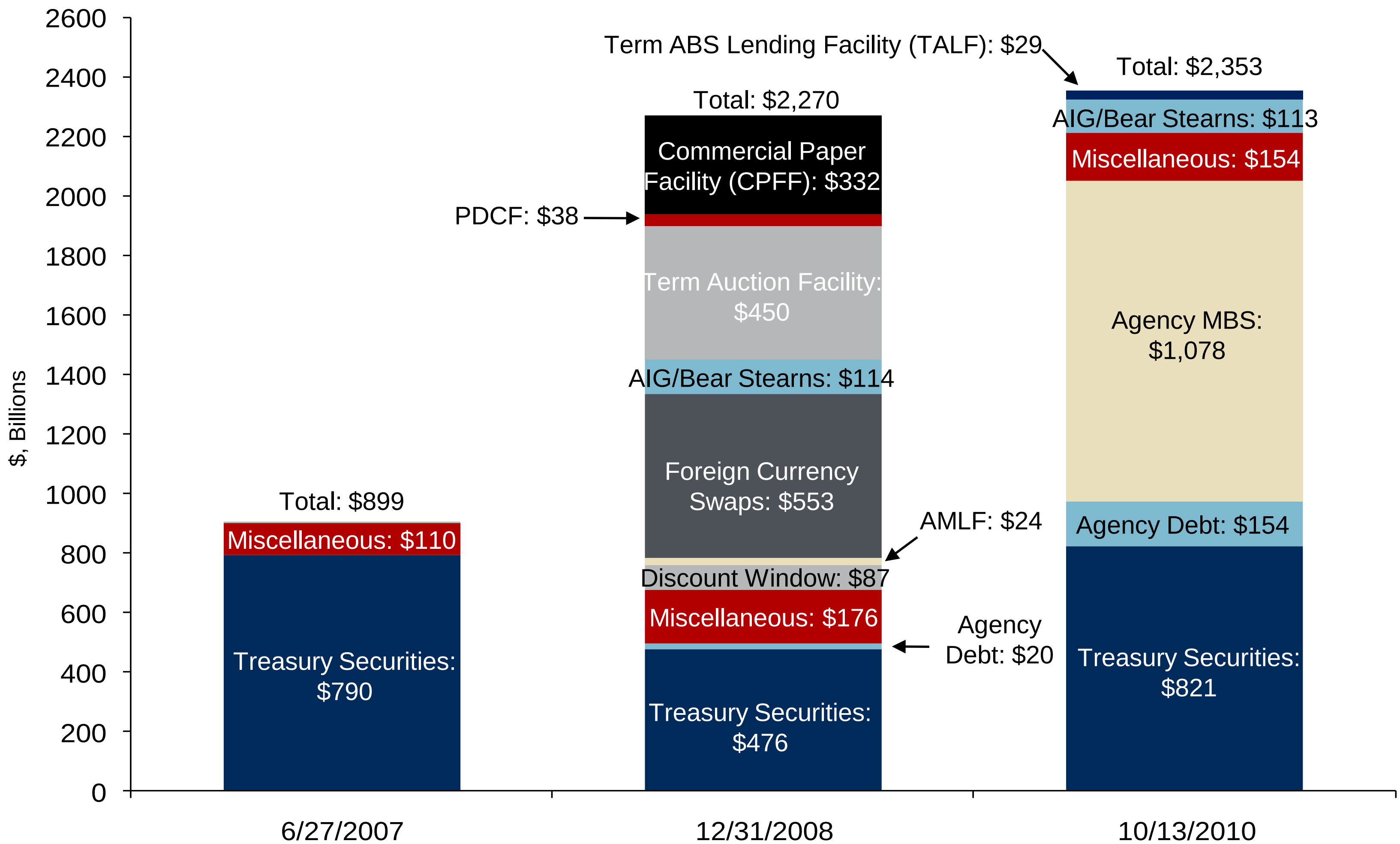
The Taylor Rule

- The Taylor Rule is widely viewed as a simple description of the factors that drive the Fed's monetary policy decisions.
- The rule specifies that the Fed will adjust its interest rate (the federal funds rate) target based on the state of economic growth and inflation.
- Under the rule, adjustments to the nominal federal funds rate may be required if economic conditions are not judged sustainable.
- For example:
    - When inflation exceeds desired inflation, the Fed tends to raise the federal funds rate.
    - When GDP growth is above potential or trend growth, the Fed tends to raise the federal funds rate.
    - If these measures are opposite, the Fed tends to lower the federal funds rate.

What If Times Are “Unusual and Exigent”

- In unusual and exigent circumstances, typical interest rate policy may be insufficient.
- Concerns about the future may arise, requiring the public to demand large amounts of money (liquidity) to offset its concern.
- In the past two years, the Federal Reserve has added money by purchasing financial assets. This is called quantitative easing.

Federal Reserve System Assets



Notes: PDCF is the Primary Dealer Credit Facility. AMLF is the Money Market Liquidity Facility. Discount Window Lending and Foreign Currency Swaps are less than $1 billion as of 9/22.
Source: Board of Governors/Haver Analytics

FOMC Statement – September 2010

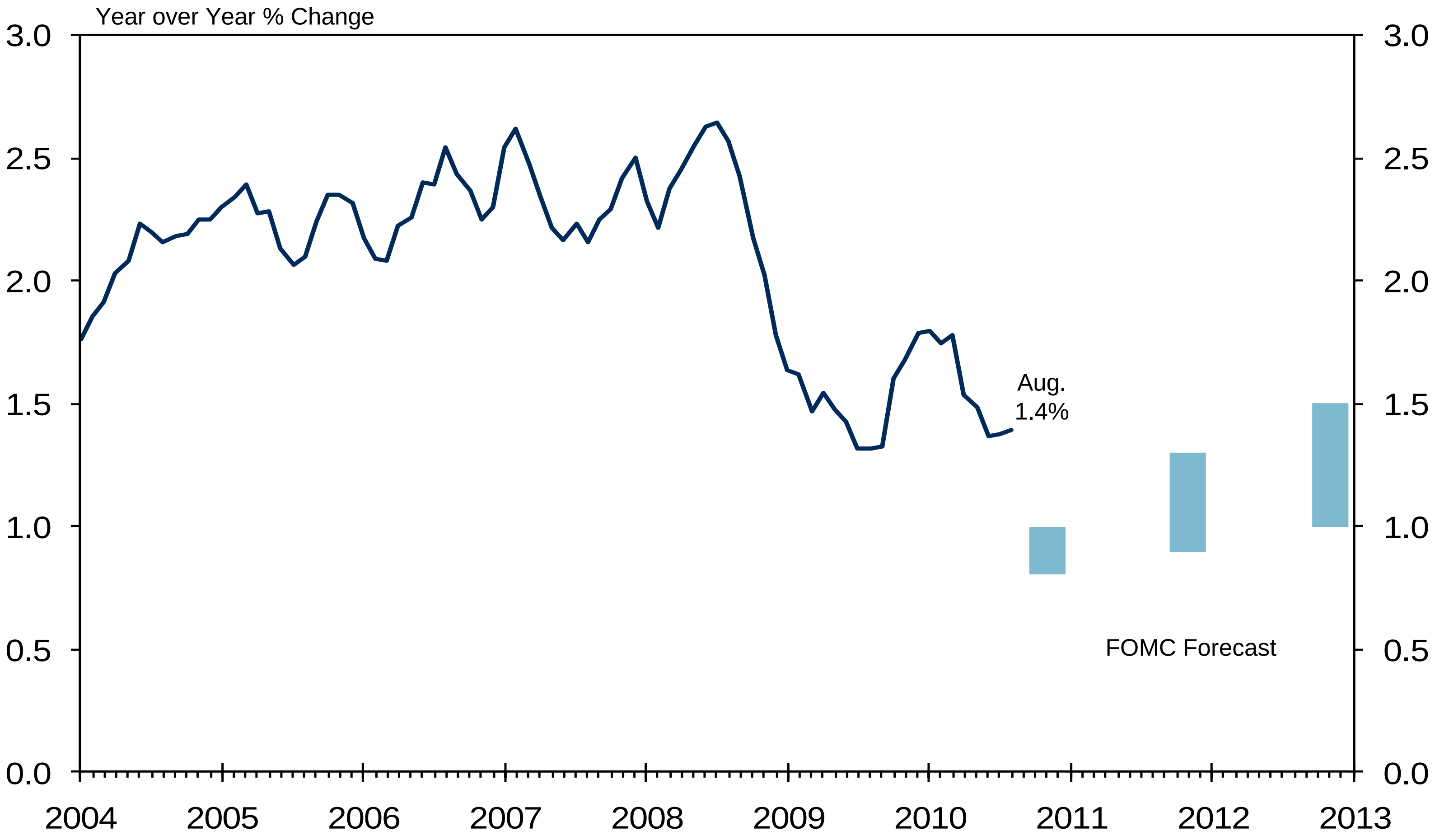
Information received since the Federal Open Market Committee met in August indicates that the pace of recovery in output and employment has slowed in recent months. Household spending is increasing gradually, but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit. Business spending on equipment and software is rising, though less rapidly than earlier in the year, while investment in nonresidential structures continues to be weak. Employers remain reluctant to add to payrolls. Housing starts are at a depressed level. Bank lending has continued to contract, but at a reduced rate in recent months. The Committee anticipates a gradual return to higher levels of resource utilization in a context of price stability, although the pace of economic recovery is likely to be modest in the near term.

Measures of underlying inflation are currently at levels somewhat below those the Committee judges most consistent, over the longer run, with its mandate to promote maximum employment and price stability. With substantial resource slack continuing to restrain cost pressures and longer-term inflation expectations stable, inflation is likely to remain subdued for some time before rising to levels the Committee considers consistent with its mandate.

The Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels for the federal funds rate for an extended period. The Committee also will maintain its existing policy of reinvesting principal payments from its securities holdings.

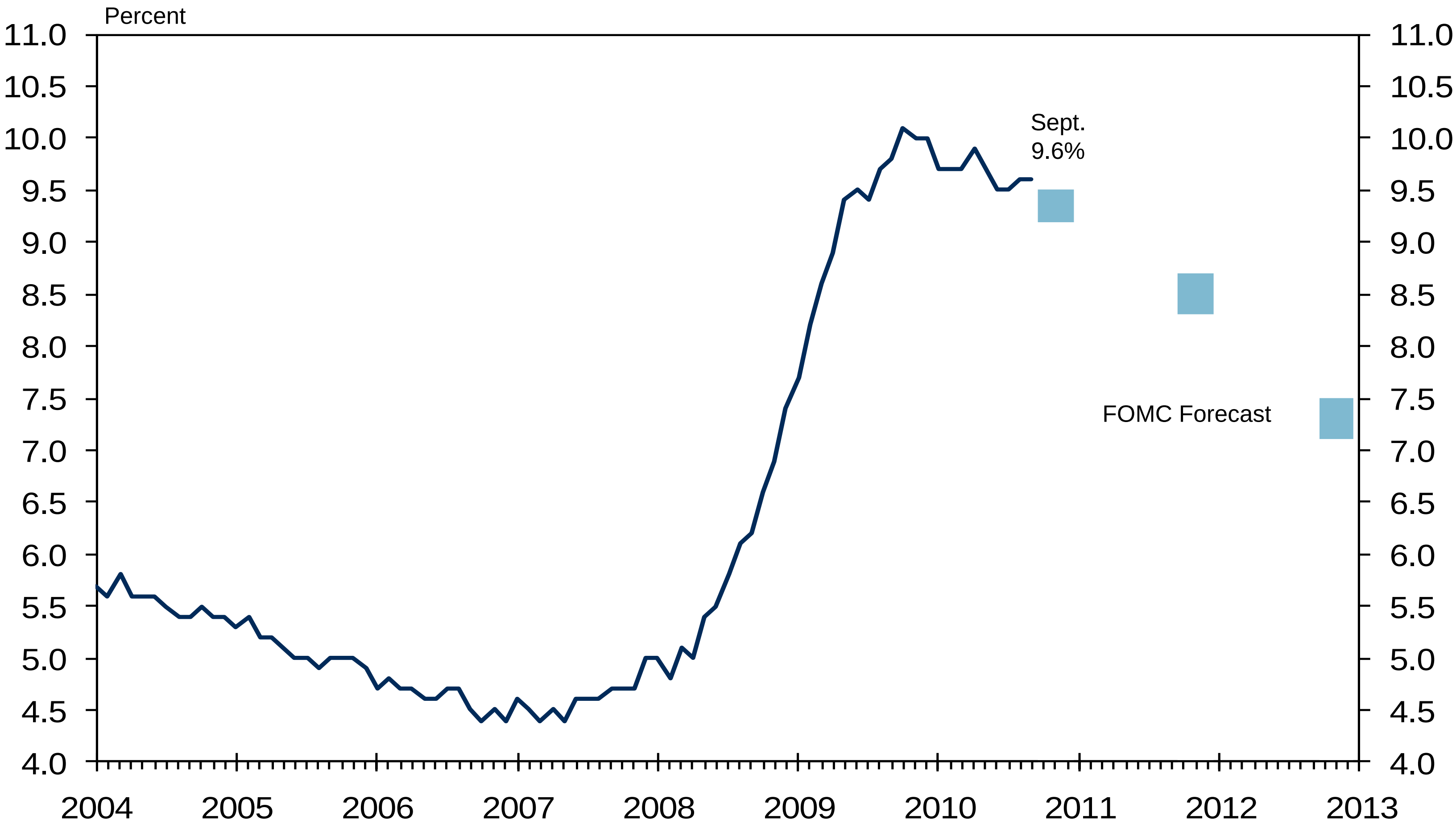
The Committee will continue to monitor the economic outlook and financial developments and is prepared to provide additional accommodation if needed to support the economic recovery and to return inflation, over time, to levels consistent with its mandate.

Core Consumer Expenditure Price Index



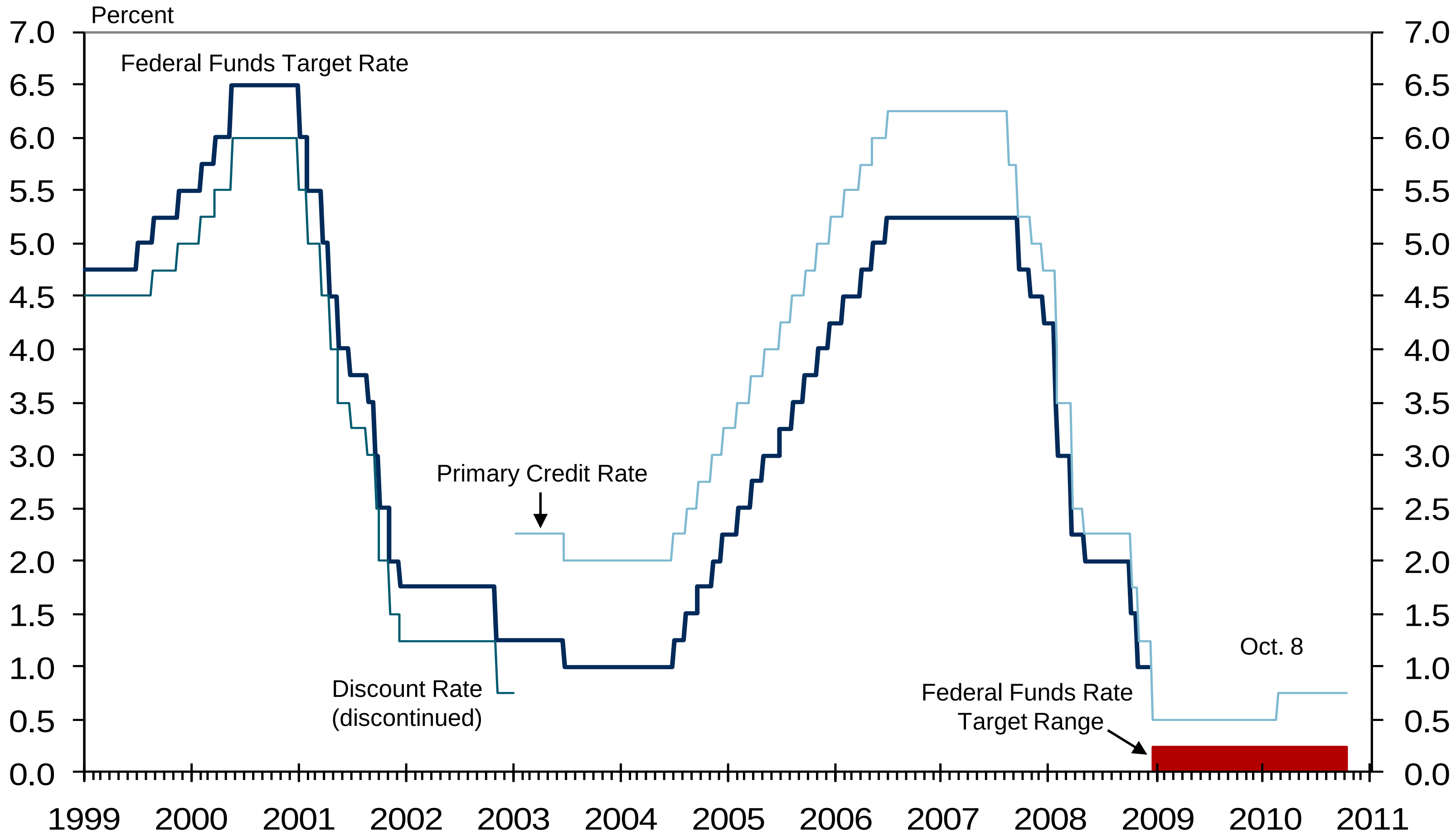
Notes: FOMC forecast is the central tendency for Q4/Q4 percent changes, from the June 22-23 meeting. Core PCE Price Index includes expenditures on food services.
Source: Bureau of Economic Analysis, Board of Governors, Haver Analytics

Civilian Unemployment Rate



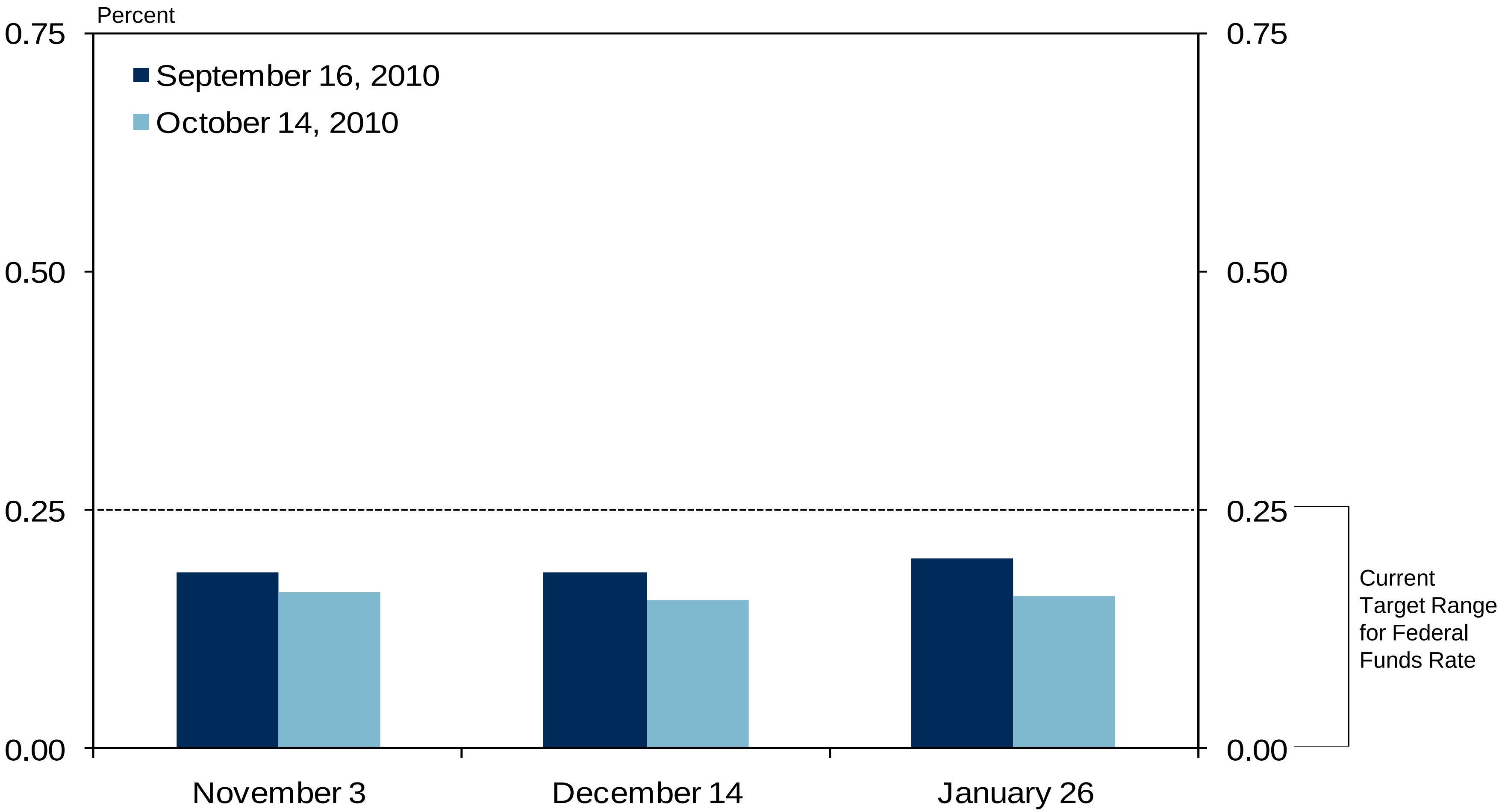
Notes: FOMC forecast is the central tendency for the Q4 levels, from the June 22-23 meeting.
Sources: Bureau of Labor Statistics, Board of Governors, Haver Analytics

Monetary Policy Instruments



Source: Board of Governors/Haver Analytics

Expected Federal Funds Rate



Note: Derived from Fed funds futures contracts.
Source: Chicago Board of Trade

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