Fed Challenge Brief:

Psychological Variables

Overview

What the public expects to happen in the economy affects their responses to changes that policy makers implement. Therefore, it is important for policy makers to consider expectations of consumers and businesses when formulating monetary policy because those expectations will help to determine the effectiveness of policy decisions.

In addition, consumers' and businesses expectations give insight into their current and future behavior. It is consumers' and businesses behavior that policy makers seek to influence in order for their policies to affect the state of the economy. It is important to understand expectations, and how they determine both the selection and effectiveness of monetary policy.

Credibility

Credibility implies believability. When discussing monetary policy, it is important to determine whether the Fed is **credible.** In this context, the term credible refers to the Fed following through on policy-related goals it communicates to the public.

For example, if the Fed states as its goal to keep inflation low and does so, the public will come to view the Fed as credible.

Once achieved, credibility assists the Fed in conducting monetary policy. With credibility, for example, the Fed has the leeway to temporarily deviate from low inflation (to address a shock in the real economy) without causing disruptive consequences, because the public believes the Fed will maintain low inflation over the longer term.

Additional Resources

The University of Michigan: http://www.umich.edu/

The Conference Board: http://www.conference-board.org/

The Dismal Scientist has information about the consumer confidence index, an index of business confidence, and a "Taylor Rule Calculator" on their site, as well as other interesting and useful data and information: http://www.dismal.com/

Expectations

The effect of a policy change depends on the public's reaction to the change. The public's reaction depends on how the change differed from what they expected. Therefore, the public's **expectations play a key role in determining the effects of monetary policy.**

For example, if people expect the Fed to maintain low inflation, sharp decreases in short-term interest rates may not affect longer-term interest rates. On the other hand, if the decreases are viewed as promoting higher inflation, longer-term interest rates will move up.

Expectations about the Federal Funds Rate can be observed in the **Federal Funds Futures market**. Market participants, researchers and policy makers often use Federal funds futures as a proxy for the market's expectation of changes in monetary policy. In recent years, the Federal Funds futures rate has provided more information about future changes in monetary policy than the spot rate contains. That is, changes in the futures market are good predictors of how the Fed Funds rate will be changed.

Consumer Confidence

Consumers' behavior is affected by the current state of the economy, for example employment status and income level. But consumers' behavior is also affected by how consumers feel about the future state of the economy. Even if things are good for households, they may reduce consumption if they believe things are going to be worse in the future. Conversely, if things are bad for households, they may actually increase consumption if they expect a significant positive change in the near future. Since consumption expenditures are so important in the economy (they make up approximately 2/3 of gross domestic product) consumer expectations is an important variable for policy makers to consider.

Consumer confidence is usually measured using surveying of consumers. Two commonly used consumer confidence indices are calculated and reported by the University of Michigan and the Conference Board.