OUTLINE — November 27, 2017

- A series of review questions!
- The Fed & Monetary Policy
  - Monetary Policy: Adjusting interest rates
  - Taylor rule
- Evaluations (need electronic device)

Comprehensive Essay Question was distributed Nov. 20

Essay due via bCourses Tues Dec. 5, 8:00 am

Olney reviews here, RRR week, but at 10 a.m. (yay!)

What makes Phillips Curve shift?

1. Change in inflationary expectations
2. Cost shocks (also called "supply shocks")
3. Change in labor productivity growth rate

Most recent statement (Nov 1 2017)

Information received since the Federal Open Market Committee met in September indicates that the labor market has continued to strengthen and that economic activity has been rising at a solid rate despite hurricane-related disruptions. Although the hurricanes caused a drop in payroll employment in September, the unemployment rate declined further. Household spending has been expanding at a moderate rate, and growth in business fixed investment has picked up in recent quarters. Gasoline prices rose in the aftermath of the hurricanes, boosting overall inflation in September; however, inflation for items other than food and energy remained soft. On a 12-month basis, both inflation measures have declined this year and are running below 2 percent. Market-based measures of inflation compensation remain low; survey-based measures of longer-term inflation expectations are little changed, on balance.

Monetary Policy & Dual Mandate

- Fed (usually) has one tool: interest rates
  - *Why "usually"?* Because once FFR hit the ZLB, Fed did turn to Quantitative Easing. But that was unusual.
- Dual mandate: employment & inflation
- Fight Inflation?
  - Fed raises interest rates
- Fight unemployment?
  - Fed lowers interest rates

Fighting unemployment & inflation

When the fight is over . . .

- Inflation & GDP growth ok now? Then Fed gradually returns interest rates to "neutral" level
  - Called "normalization" … & that's what Fed started in Dec. 2015
- Important to keep *counterfactual* in mind!!!
  - Higher interest rates do not necessarily cause recession
  - But higher interest rates *ceteris paribus* do cause slower growth

Some fights are straightforward

- Inflation up?

  Fed undertakes *contractionary* monetary policy
  - Raises interest rates
- Net effect?
  - unemployment
  - inflation

Other fights also straightforward

- Unemployment up?

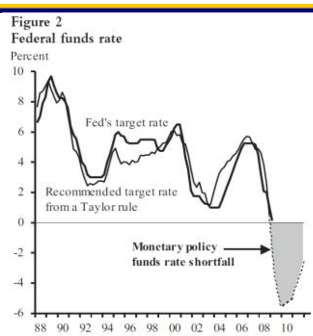
  Fed undertakes *expansionary* monetary policy
  - Lowers interest rates
- Net effect?
  - unemployment
  - inflation

Some fights are unpleasant (at best)

- ↑ inflationary expectations due to cost shock
- Fed fights back:

  ↑ interest rates
- Net effects?
  - Unemployment
  - Inflation
  - Fed typically does not "slay" inflation; just fights it

Taylor Rule & Actual FFR, pre-2008



Source: http://www.frbsf.org/economic-research/publications/economic-letter/2009/may/fed-monetary-policy-crisis/

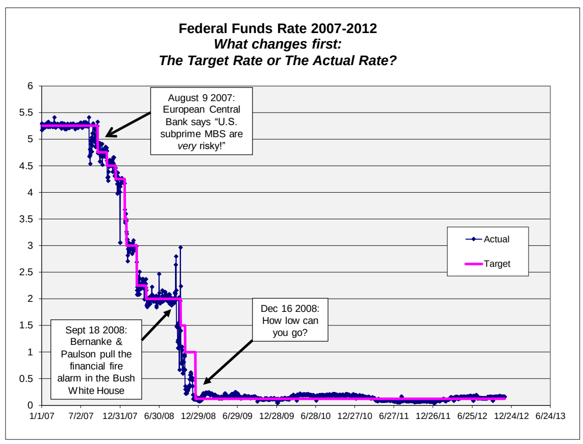
Inflation Hawks And Doves

- Taylor Rule
  - Fed reacts to inflation and unemployment
- Inflation hawk
- Inflation dove

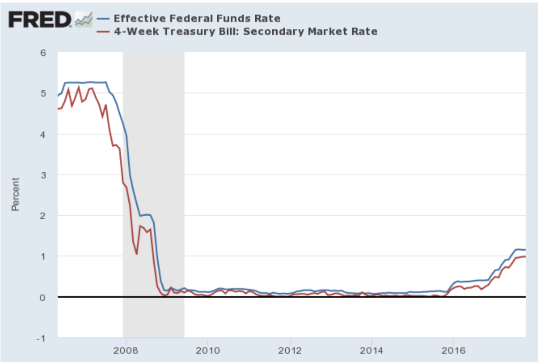
How it's supposed to work

Fed goal: inflation rate 2%, unemployment rate 4-5%

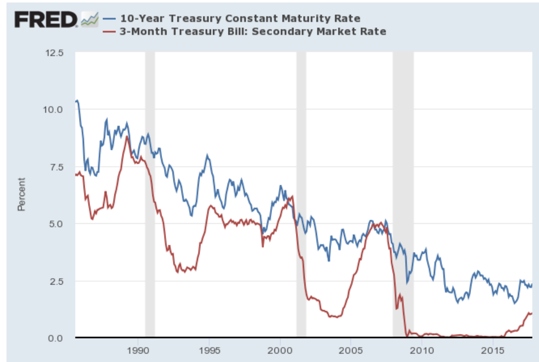
- Fed targets federal funds rate
- Substitution between assets changes other interest rates
- Exchange rates change
- Investment & net export spending respond
- Through multiplier, GDP changes
- Employment & unemployment change
- Impacting wages
- And changing inflation



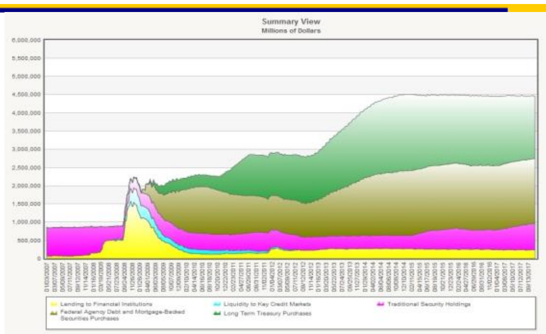
FFR & Short-Term Government Rate



Long-Term & Short-Term Rates



Fed Balance Sheet 2007-2017

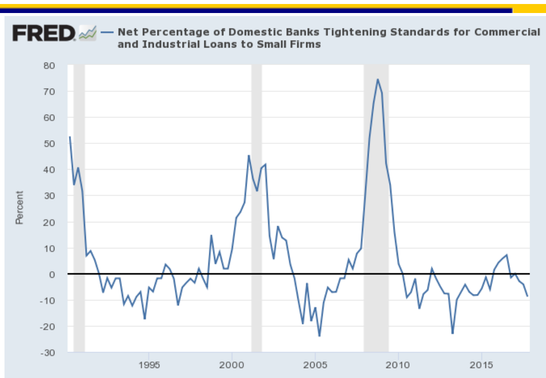


The Fed's Balance Sheet (saw this Nov. 17):
https://www.clevelandfed.org/our-research/indicators-and-data/credit-easing.aspx

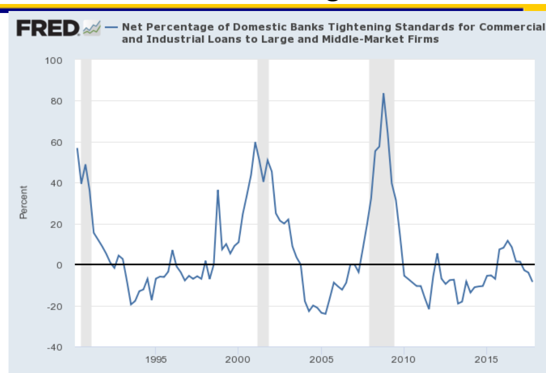
Why Fed policy didn't cure economy

- At least initially, Fed's target & actual FFR differed
- FFR & short-term government rate were at the Zero Lower Bound by December 2008
- Long-term interest rates didn't fall as far as short-term rates
  - And so Fed undertook Quantitative Easing to lower long-term rates
- Lenders were not lending

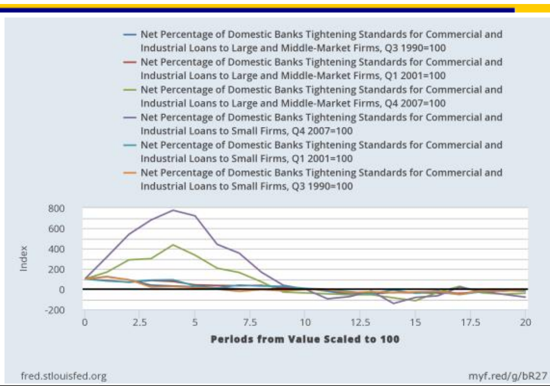
Banks Tightened Lending Standards



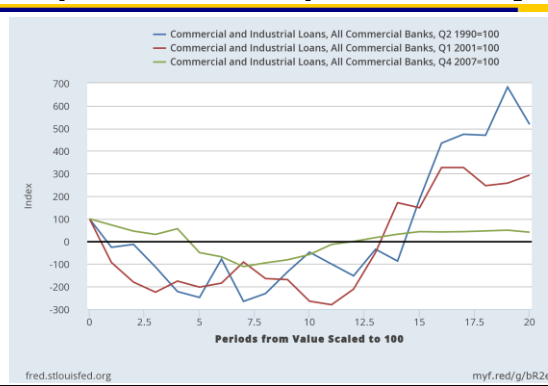
For Midsize & Large Firms, too



And this recession was unusual



By 2012, still very little lending



Banks no longer “lend all excess reserves”

Economics online evaluations

1. Please take out your electronic device; phone, laptop, or tablet, etc.
2. Open up a web browser; Chrome/Firefox work best.
3. You can access the evaluation at:

   https://course-evaluations.berkeley.edu

   Or, click on the invitation link provided in the email sent by:

   course-evaluations@berkeley.edu

   (Problems? Check ‘spam’ and ‘all mail’ folders for the email)
4. Click on “submit” once you have completed your evaluation. (You will be taken to a confirmation page verifying the evaluation has been submitted)
5. Click the “save” button if you are not finished. You can return to the evaluation to complete it by the deadline **Sunday, December 10 (?).**