Economics 216, Fall 2020

Bates College

Homework Assignment #1, Key

1. Since the 1980s, the FOMC'sinterest rate policy consists of two parts. First, when expected inflation deviates from 2%, the Fed has acted symmetrically. For each 1% that expected inflation exceeds 2%, the Fed raises rates by about 2%. Likewise for each 1% that expected inflation falls short of 2%, the FOMC lowers rates by about 2%. Second, teh Fed has also responded symmetrically to deviations of unemployment from its full employment level, raising rates when unemployment is lower and lowering rates when unemployment is above this level. The exact figure for full employment has always been unclear.

There are two significant changes in the FOMC's August 27, 2020 announcement. First, the Fed will now seek to achieve average inflation of 2%. It will tolerate periods of modestly higher inflation following periods of lower than 2% inflation. This suggests that the Fed will be slower to raise rates and will wait for actual inflation to hit at least 2% before doing so. Second, the Fed will no longer respond when unemployment is below its full employment level but will continue to do so when unemployment is above this level. This is because the relationship between unemployment and inflation has weakened on recent years.

2. The Fed hopes that this new policy will help keep expected inflation near 2% which will give it more ability to influence inflation. This is not a big deal for the current covid-19 crisis. It had already been clear that the FOMC would not raise rates for at least a couple of years.

There are a few drawbacks. First, although inflation has not been a major problem in recent years, it is possible that the Fed could struggle to bring inflation back to 2% if it is allowed to go higher. Second, this policy could result in lower interest rates over the long-term if the Fed continues to struggle to hit 2% inflation. This could allow financial imbalances, such as excessive debt levels, to build. Corporate debt levels, for example, remain near record levels and could be made worse.

3. In 2015, the Fed began raising rates from their effective lower bound even though core-PCE inflation (measured year over year) was at just 1.2% and unemployment was near full employment levels. By early 2019, the FOMC had raised the Federal Funds rate target to the 225-250 bps band even though inflation was still struggling to reach 2%.

Under this new approach, the Fed would have waited for more evidence of actual inflation rising before raising rates. The Federal Funds rate would have stayed at the effective lower bound for longer and if the FOMC did decide to raise rates, it would not have reached 225-250 bps.

4. This is an open ended question. The best answers provide a specific framework that the FOMC could use to operationalize the new policy. One example is that the Fed should use the average of core-PCE inflation over the past three years to set rates. This is a relatively short timeframe that prevents the FOMC from being too slow to respond to inflation over 2%. Likewise, the Fed might decide not to raise rates until headline unemployment falls below 6%.