Monetary Policy Redux

Final Exam Facts

News

Review

How does the Fed decide the appropriate setting for the federal funds rate?

Policy case studies.

Carolina Course Review

Final Exam Facts

Final Exam is December 18, noon-3:00 PM

Only the college can excuse an absence from the final exam.

Those with excuses must present them to me by Wednesday, December 9.

The only makeup exam is December 19, 9:00 AM.

Office hours for the final exam period have been posted on the web page.

Final comprises approximately 50 multiple choice questions (approximately 12,13,25).

Bring your UNC ID card. We will check ID.

Bring a four function calculator if you wish.

Recovery

The New York Times

December 5, 2009

OFF THE CHARTS: The Jobless Rate May Have Hit Its Peak

BY FLOYD MORRIS

The peak in unemployment in the United States has probably passed, according to one economic indicator that has proved reliable in all previous recessions since World War II.

If it is correct, it indicates that the recovery from the 2007-09 recession will be very different from the "jobless" recoveries after the last two recessions, when the unemployment rate continued to rise for many months after the recession officially ended.

That indicator is part of the monthly survey done by the Institute for Supply Management, in which manufacturing companies are asked if their business is getting better or worse.

The data was released earlier this week, before the government reported on Friday that the unemployment rate had fallen to 10 percent in November, from 10.2 percent the previous month. If the indicator is accurate, the October figure will prove to be the high rate for this cycle.

Use Your Clickers to Answer the Following Graded Question.
Beginning late in 2007, the Fed decided to stimulate the economy. To do so, the Fed _______ government bonds and _______ the Federal Funds Rate.

A. Bought, Increased
B. Sold, Increased
C. Bought, Decreased
D. Sold, Decreased

How Does Monetary Policy Affect The U.S. economy?

When the Fed lowers (raises) the federal funds rate, other interest rates tend to fall (rise).

The Fed affects aggregate demand indirectly by changing the federal funds rate and indirectly changing the rates that effect borrowing decisions.

Interest Rates Move Together

Why Interest Rates Move Together

Other things equal...
Lenders want the highest possible rates.
When the Fed lowers the Federal Funds rate it starts a chain reaction of lower rates as lenders move from lower-rate to higher-rate bonds.
Use Your Clickers To Answer The Following Graded Question.

Suppose that the economy is operating at point E in the diagram. What should the Fed do?

The Fed should ___ government bonds and thereby ___ the federal funds rate.

A. Sell, Lower  B. Buy, Lower  C. Buy, Raise  D. Sell, Raise

Given the pictured scenario, the Fed should raise interest rates and lower demand.
How does the Fed decide the appropriate setting for the federal funds rate?

1. The Fed assesses how the economy is doing presently.
2. The Fed estimates how the economy will do in the future.
3. The Fed compares its estimates with its goals for inflation and output growth.
4. If there is a gap between the goals and the estimates, the Fed will act.

The policy process is harder to implement than it may appear

Estimates of future economic conditions contain errors.
The Fed may estimate the future course of the economy as accurately as possible and still be wrong.
A case in point is monetary policy in the 1970’s.

Monetary Policy in the 1970’s

The 1960’s was a high growth decade.
The Federal Reserve forecast that the same high growth was possible for the 1970’s.
When growth was slower than expected, the Fed lowered interest rates to stimulate the economy.
The result was an increase in the inflation rate—the onset of the Great American Inflation.

High growth in the 1960’s led the Fed to forecast high growth in the 1970’s

<table>
<thead>
<tr>
<th>The U.S. Macroeconomic Experience, Decade by Decade</th>
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<tr>
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<tr>
<td>-------</td>
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<tr>
<td>Real GDP Growth</td>
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<tr>
<td>Average</td>
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<td>Standard Deviation</td>
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<td>Inflation</td>
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<td>Average</td>
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<tr>
<td>Standard Deviation</td>
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<td>Unemployment</td>
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<td>Average</td>
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<tr>
<td>Standard Deviation</td>
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Note: Real GDP growth is the growth rate of inflation-adjusted gross domestic product from year to year prior to inflation. Inflation is the rate of change in the consumer price index over the previous 12 months. Unemployment is the monthly, seasonally adjusted percentage of the labor force without a job.
Source: Department of Commerce, Department of Labor, and author’s calculations.
When growth turned out to be slower than expected, the Fed stimulated the economy.

The result was an increase in inflation.

Here is how we would use our model to explain the 1970’s.

Monetary Policy In 2001

In March 2001, a recession began in the U.S.

On September 11, 2001, the attack on the World Trade Center shook American confidence and threatened to deepen the recession.

The Federal Reserve responded by lowering the Federal Funds rate.
Real Growth Fell in 2001

The Fed Responded with Stimulus

Here is how we would use our model to explain Fed policy in 2001

In 2004
The Federal Reserve Reversed Course
The fall in housing prices triggered the current recession. The Fed initially responded with its traditional remedy—lower Federal Funds rates. But banks and other lenders have been reluctant to lend even though the Fed has taken steps to provide them with cash. Lowering the Federal Funds rate has been insufficient to provide the stimulus needed to return the economy to full employment.
Why Monetary Policy Did Not Work
Banks Hold Excess Reserves Rather Than Lend

<table>
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<tr>
<th>Aggregate Reserves of Depository Institutions</th>
<th>Billions of Dollars</th>
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</thead>
<tbody>
<tr>
<td>October, 2007</td>
<td>October, 2009</td>
</tr>
<tr>
<td>Total Reserves</td>
<td>42.5</td>
</tr>
<tr>
<td>Required Reserves</td>
<td>41.0</td>
</tr>
<tr>
<td>Excess Reserves</td>
<td>1.4</td>
</tr>
</tbody>
</table>

How our model would depict the recession of 2007

Higher Government Spending and Lower Taxes can Stimulate Aggregate Demand

The Econ 101 Team Asks You To Remember That

The best things in life aren’t free.
Use Your Clickers To Answer The Following Non-Graded Question.

Which statement best describes the technical performance of your clicker during the semester?

1. I had no technical difficulties with my clicker.
2. I had minor technical difficulties (e.g., batteries), that I handled easily on my own.
3. I had a major problem with my clicker that was my own fault (e.g., getting it wet, losing it).
4. My clicker failed and had to be replaced through no fault of my own.
5. I had a different experience than any of the above.

Carolina Course Review

Department/Course/Section Econ 101-008
Instructor Michael Salemi
Course ID Number 12020032

Section F: Optional Questions
28. This course helped me to understand economic concepts that I can use throughout my life.
29. The use of clickers helped me to learn.
30. The instructor should continue to use the clickers in the future.
31. My recitations were conducted in a way that helped me learn economics.