How Easy Has the Fed Been?

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It is now generally recognized that the Fed should have begun raising interest rates sooner than it did. The Fed now has to play catch up. The Fed has kept interest rates low since the Great Recession in 2009, and an interesting question is whether this policy is consistent with its behavior prior to 2009.

The Fed’s mandate is to try to achieve full employment and low inflation. The Fed tends to raise interest rates when inflation is high or unemployment is low. This behavior can be approximated statistically by estimating what is called an “interest rate rule.” The rule estimates how much the Fed changes the interest rate when inflation changes or unemployment changes. I first estimated such a rule in 1978 and have been updating it since.

Results analyzing this rule are informative. Prior to the Great Recession the Fed’s behavior was well approximated by the rule. When inflation was high it raised rates, and when unemployment was high it lowered rates. When the Great Recession hit, however, the rule called for negative interest rates, and the best the Fed could do was to keep the short term interest rate at essentially zero. In other words, the Fed could not follow the rule even if it wanted to.

The rule called for zero or negative interest rates through about 2013, and the Fed kept the interest rate at essentially zero throughout this period. In 2014, however, the rule began calling for rising interest rates up to the beginning of the Pandemic as the unemployment rate began to fall. The Fed on the other hand kept

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the interest rate at essentially zero or very low through 2017. Even after 2017 the highest the interest rate got before the Pandemic was 2.4 percent in the first quarter of 2019. The unemployment rate fell from 7.0 in the fourth quarter of 2013 to 3.6 in the fourth quarter of 2019, and the Fed reacted very modestly to this. By the fourth quarter of 2019 the rule called for an interest rate of 4.6, and the actual value was only 1.6. This is a large change from the Fed’s behavior prior to the Great Recession.

The Pandemic period is also informative to examine. In the first quarter of the pandemic, which is the second quarter of 2022, the unemployment rate was 13.0 and the inflation rate was -3.8. Given these values, the rule called for an interest rate of -4.6. In the next quarter inflation was 4.1 percent but the unemployment rate was still high at 8.8 percent, and the rule called for an interest rate of -2.5. After that the unemployment rate continued to fall, and inflation began to increase in the second quarter of 2021. In the fourth quarter of 2021 inflation was 7.3 percent and the unemployment rate was 4.2, and the rule called for an interest rate of 5.3. In the first quarter of 2022 inflation was even higher and the unemployment rate even lower, and the rule called for an interest rate of 6.4. The Fed on the other hand kept the interest rate at essentially zero throughout this period. (It began raising the rate in March 2022.) This is a second example where Fed behavior was different than historically. After the unemployment rate began falling and inflation began to pick up, the Fed did not react as the rule said it should.

Why the Fed changed its behavior in 2014 is an interesting question. Somehow the Fed convinced itself that there was a structural change in the economy that allowed it to keep interest rates low in the face of low unemployment without generating future inflation. It became convinced that it could directly control inflation expectations and thus actual inflation. This turned out not to be the case, and the economy is now paying the price of this change of behavior.