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 2008–2009, and an interesting question is whether this policy is consistent with its behavior prior to 2008.

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 using 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, 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 have followed the rule even if it had wanted to.

The rule began calling for positive interest rates in 2011, but the Fed kept the interest rate essentially at zero through 2015. Even when the Fed began raising rates in 2016, it did not raise interest rates as much as the rule called for. In other words, the Fed did not go back to its historical behavior. Inflation was low during this

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period but unemployment was falling, and the Fed did not respond as much as it had in the past to the falling unemployment. In the fourth quarter of 2019, right before the pandemic, the unemployment rate was 3.6 percent, the interest rate set by the Fed was 1.6 percent, and the rule called for 4.2 percent.

This change in Fed behavior is even more remarkable during the pandemic period. Once the economy was clearly expanding by the fourth quarter of 2020, the rule began calling for increasing interest rates. Inflation was rising rapidly and unemployment was falling rapidly. The Fed, however, kept the interest rate at essentially zero until March of 2022. In the first quarter of 2022 inflation was 8.3 percent, the unemployment rate was 3.8 percent, and the rule called for an interest rate of 5.6 percent. The actual interest rate was only 0.3 percent, a huge difference from what the rule called for because of the high inflation and low unemployment.

It is interesting to speculate why the Fed changed its behavior after the Great Recession and especially after the economy began recovering from the pandemic. The Fed has had and may still have the general view that it can control inflation through its announcements by directly controlling inflation expectations. Its “credibility” is enough to change inflation expectations and thus actual inflation. Survey evidence suggests that this is not the case and that inflation expectations are primarily determined by current and past inflation—witness the effect of gasoline prices on expectations. The Fed can affect inflation expectations only by affecting actual inflation.

This view can help explain recent Fed behavior. Inflation was low between 2011 and 2019, and if it can be controlled through announcements, there is no need to move early even with low and falling unemployment. Regarding the pandemic period, the view of the Fed up until about the beginning of 2022 was that almost all of the inflation that began in the middle of 2020 was due to supply and other transitory issues and that once these were over the Fed’s influence on inflation expectations would be enough to lower inflation back down to around 2.0 percent. The Fed did not need to act early as it would have done in the past. This turned out to have been a mistake, and the catch up now may have to be large.