How Easy Has the Fed Been?

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It's now generally recognized that the Federal Reserve should have begun raising interest rates sooner than it did. It kept interest rates low since the Great Recession in 2008–2009 and now has to play catch up. Was the Fed's low-rate policy consistent with its behavior prior to 2008, and if not, what difference might that have made?

The Fed's mandate is to guide the economy to achieve full employment and low inflation. To do that, the Fed tends to raise interest rates when inflation is high or unemployment is low and to lower them when the reverse is true. This behavior can be approximated statistically 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 updated it with data through 2008.

Prior to the Great Recession the Fed's behavior was well approximated by my estimated rule. When inflation was high the Fed raised rates, and when unemployment was high it lowered rates.

When the Great Recession hit, the rule actually called for negative interest rates, but 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 pre-Great Recession rule began calling for positive interest rates in 2011, but the Fed kept the interest rate essentially at zero through 2015. Even when the

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Fed began raising rates in 2016, it did not raise them as much as the rule directed. In other words, the Fed did not go back to its pre-2008 behavior. Inflation was low during 2016 and thereafter but unemployment was falling, and the Fed did not respond to that change as much as it would have by following the rule in place before the Great Recession. In the fourth quarter of 2019, just before the pandemic, the unemployment rate was 3.6 percent, and the interest rate set by the Fed was 1.6 percent; the estimated rule, however, called for an interest rate of 4.2 percent.

The change in Fed behavior is even more remarkable during the pandemic. Once the economy was clearly expanding by the fourth quarter of 2020, with inflation rising rapidly and unemployment falling rapidly, the old rule would have called for increasing interest rates. The Fed, however, kept the interest rate at essentially zero until March 2022. In the first quarter of 2022 inflation was 8.3 percent, and the unemployment rate was 3.8 percent. The pre-2008 rule would have called for an interest rate of 5.6 percent; the actual interest rate was only 0.3 percent, which is a huge difference.

Why did the Fed change its behavior after the Great Recession and stay with that change especially after the economy began recovering from the pandemic? One speculation is that the Fed had and may still have the general view that it can control inflation through the various announcements it makes, for example, after Open Market Committee meetings and in Congressional testimony. The theory is that the Fed's credibility is great enough to change inflation expectations and thereby 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 hypothesis can help explain recent Fed behavior. Inflation was low between 2011 and 2019, and if it could be controlled through announcements, there would be no need to move early even with low and falling unemployment. And the view of many, including the Fed, up until about the beginning of 2022 was that almost all of the inflation that began with the pandemic in 2020 was due to supply shocks and other transitory issues. Once these were over the Fed believed its influence on inflation expectations would be enough to lower inflation back down to around 2.0 percent. With this belief in the power of its voice, the Fed did not need to act early as it would have done in the past. This turned out to have been a mistake. The correction may now have to be large.