ECON 425

Final Work

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Option 1 – Monetary Policy

**Contextual information**

It is December 16th, 2008. The FOMC is meeting today to discuss monetary policy changes. In October, the Fed decided to lower the federal funds rate 50 points to a rate of 1 percent as a response to slowing economic activity.[[1]](#footnote-1) On December 1st, the National Bureau of Economic Research officially declared that the US has entered a recession.[[2]](#footnote-2) Since the last report, economic indicators have continued to weaken: There has been a noticeable decline in retail sales, manufacturing activity, real estate purchases, and business and consumer lending. The sectors of agriculture, mining, and energy have experienced mixed outcomes. In general, labor markets have weakened, and price pressures have decreased.[[3]](#footnote-3) Additionally, financial markets have seen further decline as investors have become more pessimistic about the future of the economy. The deterioration of the labor market and the decline in industrial production were much more dramatic than we had previously forecasted. As a result, we now expect GDP to fall about 5 percent in the next 2 quarters. With respect to fiscal policy, we expect a 2-year $500 billion stimulus package to be enacted early next year. Factoring in this policy change, we project GDP to start gradually increasing around mid-2009 and lead to a total annual change in GDP of -1 percent. Unemployment is projected to continue increasing to about 8 percent in 2010. We forecast PCE inflation to be about 1 percent in 2009 and 2010.[[4]](#footnote-4) Finally, markets currently expect the FOMC to lower the federal funds rate by 50 points.[[5]](#footnote-5)

**Contextual data**.

Consider the following information from FRED[[6]](#footnote-6). It offers some context for the economy around the time period. Specifically, the included data covers five years before and five years after December 2008.

1. **GDP:** From the first quarter of 2008 to the second quarter of 2009, the US economy is in recession as indicated by the shaded region. December 16th, 2008 falls between this region. The GDP at the end of Q4 in 2008 is 14,608.209 (in billions of USD).

A graph showing the growth of a product

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1. **Inflation:** We consider inflation measured by the consumer price index. This metric reflects the annual percentage change in the cost to the average consumer of acquiring a basket of goods and services that may be fixed or changed at specified intervals. This metric is calculated using the Laspeyres formula. During this time period, inflation went down dramatically, even becoming negative around 2009.

A graph of a graph showing the price of the united states

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1. **Interest rate:** The federal funds effective rate is another important metric during this time period. We can observe that there were significant rate cuts leading to an extended period of near 0 percent rates. The near 0 percent rates lasted a decade, ending in late 2015.

A graph of a financial graph

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1. **Unemployment rate:** Before 2008, the unemployment rate was steady around 5 percent. During the time period of interest, it dramatically increased, reaching a peak of 10 percent in October 2009. Interestingly, this time is not included in the shaded region.

A graph showing the growth of unemployment rate

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**Theory and Decision**

Considering the economic situation of the time, we are clearly in the middle of the housing market crisis of 2008 and 2009. Ignoring the fact that we already have the graph of the federal funds rate for this period, we use theory to inform and explain *our* decision as if we did not already have this knowledge. Before the recession, the GDP was increasing, there was a moderate level of inflation—though it was increasing—, the federal funds rate was stable, and the unemployment rate was low. During the recession, inflation decreased dramatically due to decreases in consumer spending and an overall economic slowdown. This holds true for our time period of interest, December 16th, 2008. Accordingly, economic factors drove aggregate demand down, putting downward pressure on inflation. [[7]](#footnote-7) Since the threat of deflation could be more devastating than the threat of inflation, we believe that the best course of action to lower the interest rate. Recognizing a powerful, new stimulus package will be enacted in early 2009, we think the target federal funds rate should be 0.5 percent. The theory behind this decision is that lowering the interest rate will stimulate consumer spending and stimulate investment. Lower interest rates make borrowing cheaper. We want businesses to invest in large projects and consumers to make large purchases. Furthermore, this policy will help offset disinflation by increasing the money supply. If necessary, we believe that the federal funds rate may possibly be reduced to 0 percent in upcoming meetings, depending on whether economic forecasts worsen. Effective forward guidance is also needed as part of implementing policy. This is important because providing people with information about future monetary policy can help boost the economy. As a summary, our decision is the following.

* + 1. Set a target federal funds rate of 0.5 percent.
    2. Potentially implement a 0 percent interest rate policy if necessary.
    3. Continually provide effective forward guidance.

**Statement**

The Federal Open Market Committee decided today to lower its target for the federal funds rate 50 basis points to 0.5 percent. Contributing to this decision has been the continued decline of many economic indicators. Of note among these indicators is a marked deterioration of labor markets and industrial production. At the same time, prices have continued to decline. We now project inflation to be at 1 percent for the next couple of years. Despite the bleak circumstances, the Committee believes that the economy will stabilize in the coming year with the implementation of a new stimulus package. The Fed will continue to closely monitor the economy and reaffirms its promise to ensure economic growth and price stability. If necessary, the Fed is willing to further lower the federal funds rate and maintain a lower interest rate for an extended period to reach this goal.

**Comparison**

The primary difference between our decision and the Fed’s decision was that the Fed decided to employ a target range (for the first time) of 0-0.25 percent while we decided to employ a target of 0.5 percent. We believe that the Fed’s decision is reasonable. We ended up considering a smaller change than the Fed primary due to seemingly optimistic future projections and an emphasis on a new stimulus package. In addition, we were reluctant to surrender control of the economy and enter a liquidity trap. The decision of the Fed to shock the market with a much more dramatic decrease in target federal funds rate than expected would certainly offer a temporary economic boost when it was direly needed. Other than the federal funds rate, the Fed decided to employ a few extra policies to support mortgage and housing markets and facilitate the extension of credit to households and small businesses. These extra policies were likely enacted to further confidence in the economy. Through policies like these, the Fed may have hoped that it could further boost the economy despite entering a liquidity trap. Ultimately, considering the fact that economic indicators like GDP, unemployment, and inflation ended up becoming much worse than what the Fed projected, we believe that the more impactful decision of the Fed was definitely better than ours.

**Conclusion**

The analysis of the economic conditions in December 2008 reveals a period marked by significant economic downturns, including declining output and rising unemployment rates. The dramatic decrease in inflation, reaching negative levels, underlines the severity of the economic contraction.

Our policy decision to lower the federal funds rate to 0.5 percent was based on the need to stimulate economic activity through increased consumer spending and investment. By making borrowing cheaper, we aimed to encourage businesses to invest in large projects and consumers to make significant purchases, thus injecting liquidity into the economy.

Upon comparing our decision to the Fed’s actual decision of setting a target range of 0-0.25 percent, we acknowledge that the Fed’s more aggressive approach was likely more effective in providing a necessary economic boost. The additional policies implemented by the Fed to support mortgage and housing markets and facilitate credit to households and small businesses further strengthened the impact of their monetary policy.

Given the worsening economic indicators beyond initial projections, the Fed’s decision to implement a lower target range and additional support measures was prudent. Our more conservative target, while theoretically sound, may not have provided the immediate and robust stimulus needed during such a critical period.

Overall, this exercise highlights the importance of flexibility and responsiveness in monetary policy, particularly during times of economic crisis. Future policymakers should consider the potential benefits of more aggressive (but still appropriate) measures when facing similar economic challenges.

**References**

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1. <https://www.federalreserve.gov/newsevents/pressreleases/monetary20081029a.htm> [↑](#footnote-ref-1)
2. <https://www.nber.org/news/business-cycle-dating-committee-announcement-december-1-2008> [↑](#footnote-ref-2)
3. <https://www.federalreserve.gov/fomc/beigebook/2008/20081203/fullreport20081203.pdf> [↑](#footnote-ref-3)
4. <https://www.federalreserve.gov/monetarypolicy/files/FOMC20081216gbpt120081210.pdf> [↑](#footnote-ref-4)
5. <https://www.federalreserve.gov/monetarypolicy/files/FOMC20081216bluebook20081211.pdf> [↑](#footnote-ref-5)
6. <https://fred.stlouisfed.org/> [↑](#footnote-ref-6)
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