Was the Fed Too Easy for Too Long?

Douglas W. Elmendorf
The Brookings Institution
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Between January 2001 and June 2003, the Federal Reserve cut the target federal funds rate from six-and-a-half percent to one percent—the lowest level in decades. The Fed then held to that target until June 2004, before raising the funds rate slowly and steadily during the following two years. Some observers have argued that the Fed kept rates too low for too long, and that the abundance of low-cost credit set the stage for the housing boom-bust and current financial turmoil. If correct, this criticism would have important implications for the future conduct of monetary policy.

However, the criticism is not consistent with overall macroeconomic conditions as seen in the past four years or projected by most forecasters for next year. The paths of inflation and unemployment imply that monetary policy should have been a little less expansionary during this period, but the slightly better policy that one can envision with hindsight would *not* have materially altered recent events. Before going on, I must note that I worked on economic forecasting and analysis at the Federal Reserve Board from 2001 through 2007. This discussion, though, is based entirely on public data and published model results.

Recent Monetary Policy Should Have Been Tighter …

At the Federal Reserve's annual conference in Jackson Hole this year, John Taylor showed that the extended period of low interest rates contributed significantly to the run-up in housing construction and house prices. In another paper at the same conference, Ed Leamer noted that residential investment has traditionally been more cyclical than other categories of output. Neither observation is surprising: The Fed influences the economy by adjusting interest rates, so interest-sensitive sectors vary the most. But, more important, neither observation implies that the Fed should conduct policy in order to reduce volatility in the housing market: Monetary policy must be judged by overall economic conditions, not conditions in a particular sector.

We can review recent economic history using the predictions of Federal Open Market Committee members cited in the Fed's semiannual *Monetary Policy Report to Congress*. Between 2004 and 2007, core inflation consistently turned out higher than the FOMC had expected (see figure 1). One important cause was probably the pass-through of rising oil prices. But this supply shock was not the only problem. The unemployment rate consistently came in below the FOMC members' forecasts, implying that resource utilization exceeded their expectations (see figure 2). One clue to the source of this overshooting is that growth of real GDP regularly fell short of FOMC projections during this period (see figure 3). In combination with the unemployment-rate surprise, we can surmise that FOMC members expected faster growth of potential output than actually occurred. These data show that the Federal Reserve did not achieve a perfect soft landing.

… But Only By a Small Amount …

That said, these errors in monetary policy that can be seen in retrospect were quite small. Suppose that the FOMC began raising the target federal funds rate in April 2004 (rather than June 2004 as actually occurred, see figure 4) and raised it 25 basis points at each meeting for the next two years (as did actually occur). In this alternative scenario, the funds rate would have been 50 basis points higher from the third quarter of 2004 through the second quarter of 2006.

What would have been the effect on the economy? This question can be answered using simulations of the Fed's large-scale econometric model reported in a paper by Fed economists David Reifschneider, Bob Tetlow, and John Williams. Based on their figures, this higher funds-rate path would have added about 0.4 percentage point to the unemployment rate and trimmed 0.3 percentage point from the inflation rate by mid-2006. As a result, the unemployment rate would have been close to five percent. FOMC members apparently view that level as consistent with stable inflation, because their projections repeatedly show the unemployment rate heading back to 5 percent (from above in 2004 and 2005, and from below in late 2006 and 2007). The inflation rate in this scenario would have been about 2 percent, which many observers view as the upper end of the Fed's comfort zone. Therefore, from the perspective of the overall economy, this slightly less expansionary policy stance would have produced a better economic outcome, at least to date.

What would have been the effect on the housing market? Given the apparently irrational exuberance of housing demand in recent years, this question involves psychology as well as economics. Alan Greenspan and others have argued that small adjustments to financial conditions cannot slow the expansion of a bubble. However, it is possible that this extra tightening would have been the straw that broke the camel's back early. The best guess is probably that such a small adjustment in policy would have only slightly damped the courses of construction, house prices, and mortgage lending.

… and the Costs of Much Tighter Policy Would Have Outweighed the Benefits

Of course, the Federal Reserve could have raised the funds rate even higher. In Taylor's paper, he endorsed a policy that would have set the funds rate above its actual value beginning in 2002 and 3 percentage points above its actual value by early 2004. This alternative policy would certainly have damped the excesses in the housing market, as Taylor showed.

However, the policy would also have had very high costs and very uncertain benefits for the overall economy, which Taylor did not show or discuss. On the cost side, the model simulations imply that the unemployment rate would have been more than a percentage point higher during several years when the economy was already dealing with significant unused labor resources. On the benefit side, reducing the extent of the eventual housing downturn and dislocations in financial markets would probably have lowered the unemployment rate over the next year. Yet, recent surveys of economists by *Bloomberg* and the *Wall Street Journal* suggest that the Fed easing this fall is likely to keep the unemployment rate from rising above 5 percent next year anyway. Presumably the alternative policy also would have reduced the number of households that took out mortgages they cannot now afford, but only by making borrowing more expensive for many other households whose mortgages have served them well. Monetary policy is simply too blunt to serve as an effective substitute for regulatory policy.

Conclusion

If the current housing bust and financial turmoil ultimately lead to a significant economic downturn, the appropriateness of monetary policy during the past several years should be revisited. However, based on the information available today, the criticism that the Fed should have raised interest rates substantially to rein in the housing sector is misguided. Macroeconomic outcomes suggest that monetary policy was a little too easy for too long, but the adjustments that appear optimal in hindsight would not have fundamentally altered the housing cycle and related developments.

References and Further Reading

Federal Reserve Board, *Monetary Policy Report to Congress*, 2000 through 2007.

Leamer, Edward E., “Housing and the Business Cycle,” August 2007.

Reifschneider, David, Robert Tetlow, and John Williams, “Aggregate Disturbances, Monetary Policy, and the Macroeconomy: The FRB/US Perspective,” *Federal Reserve Bulletin*, January 1999.

Taylor, John B., “Housing and Monetary Policy,” September 2007.

Acknowledgements

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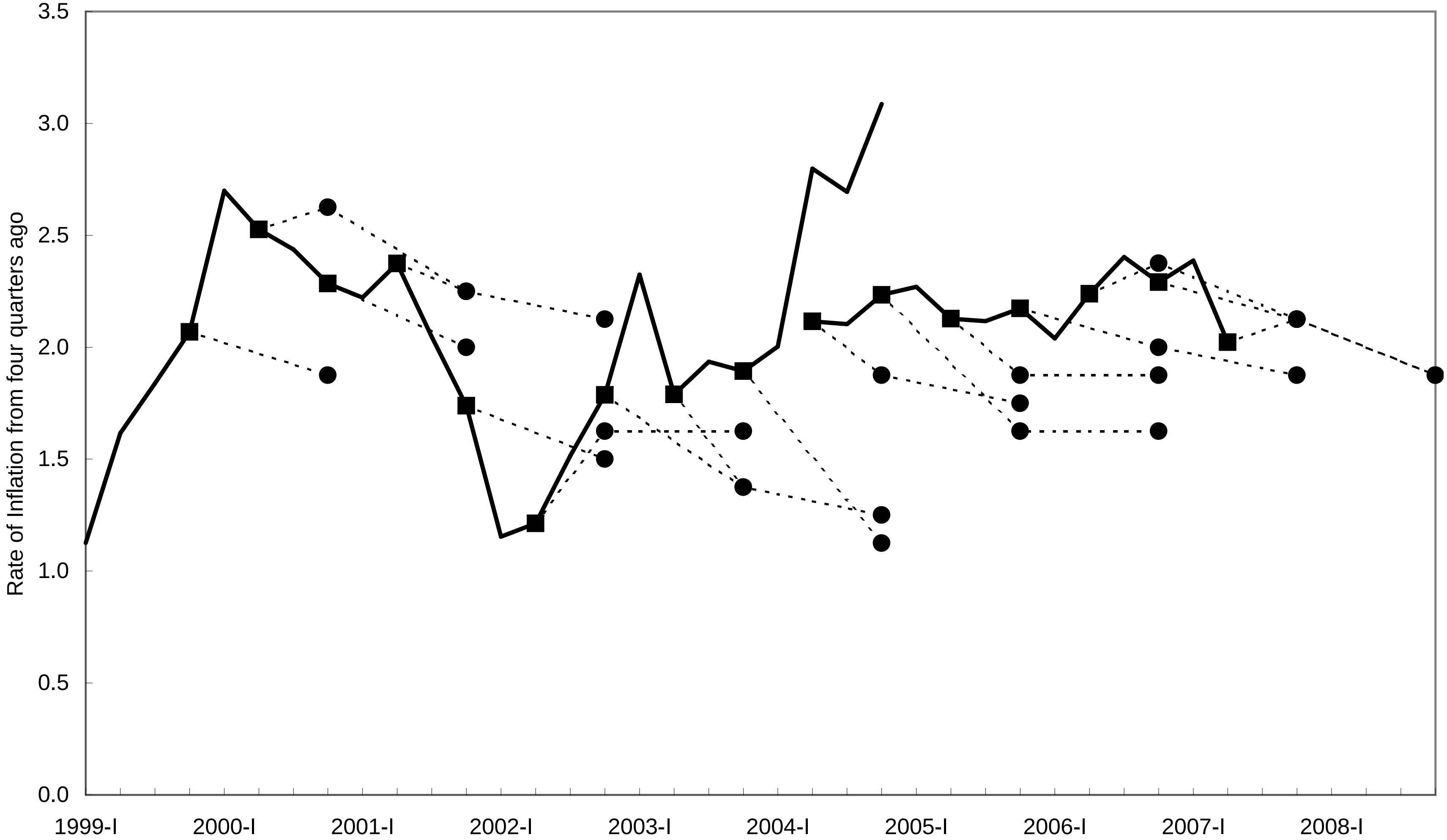
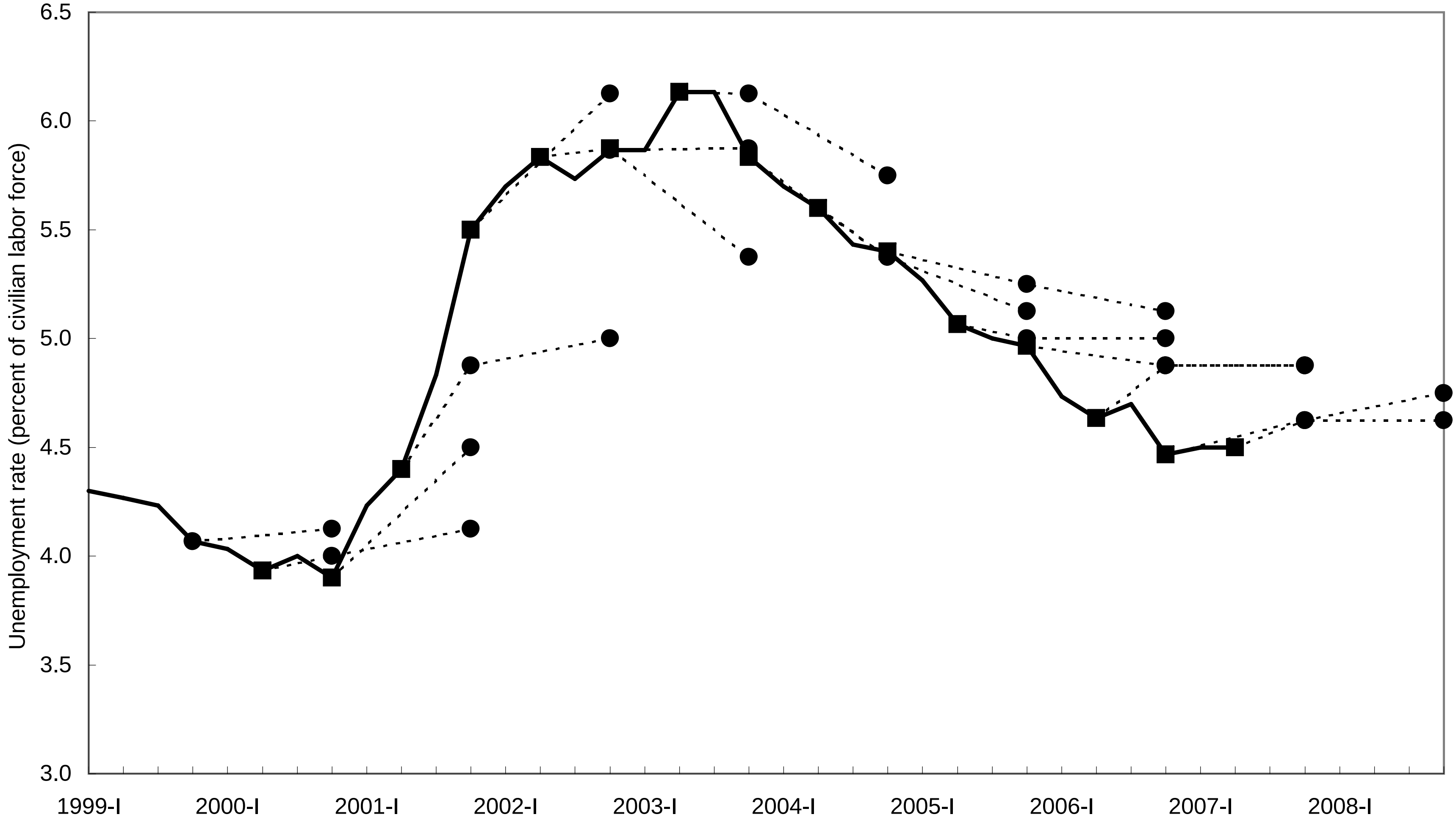
Figure 1. Actual and Projected Inflation, 1999Q1-2008Q4[a]



Source: BEA and FOMC *Monetary Reports* .

a. The bold lines are PCE inflation from 1999 Q1 to 2004 Q4 and core PCE inflation from 2004 Q2 to 2007 Q2. Squares indicate inflation on the date of projection; circles are projections, connected by dotted lines to the actual value on the date of projection.

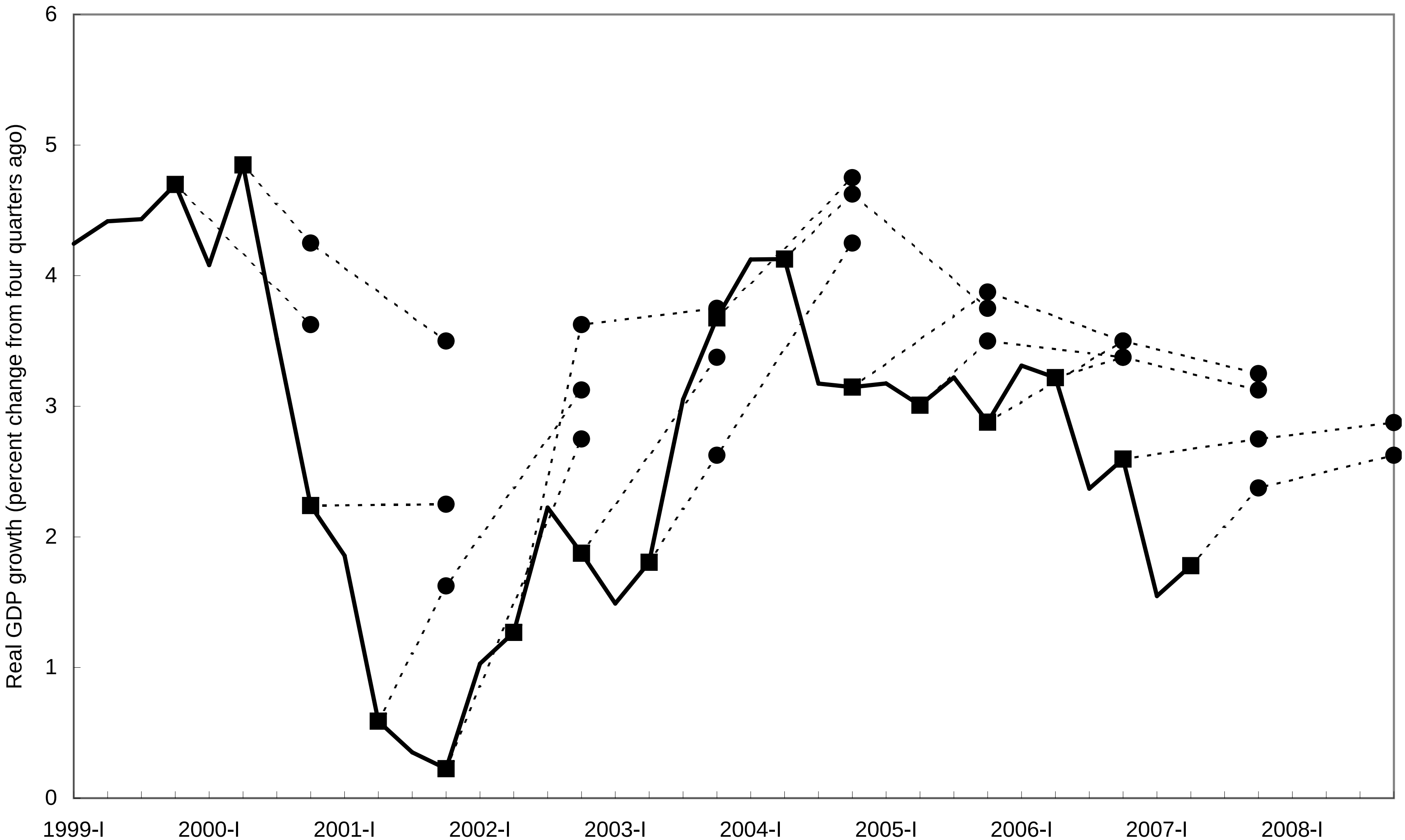
Figure 2. Actual and Projected Unemployment Rates, 1999Q1-2008Q4[a]



Source: BLS Employment Table A-1 and FOMC *Monetary Reports*.

a. The bold line is the actual unemployment rate. Squares indicate the unemployment rate on the date of projection; circles are projections, connected by dotted lines to the actual value on the date of projection.

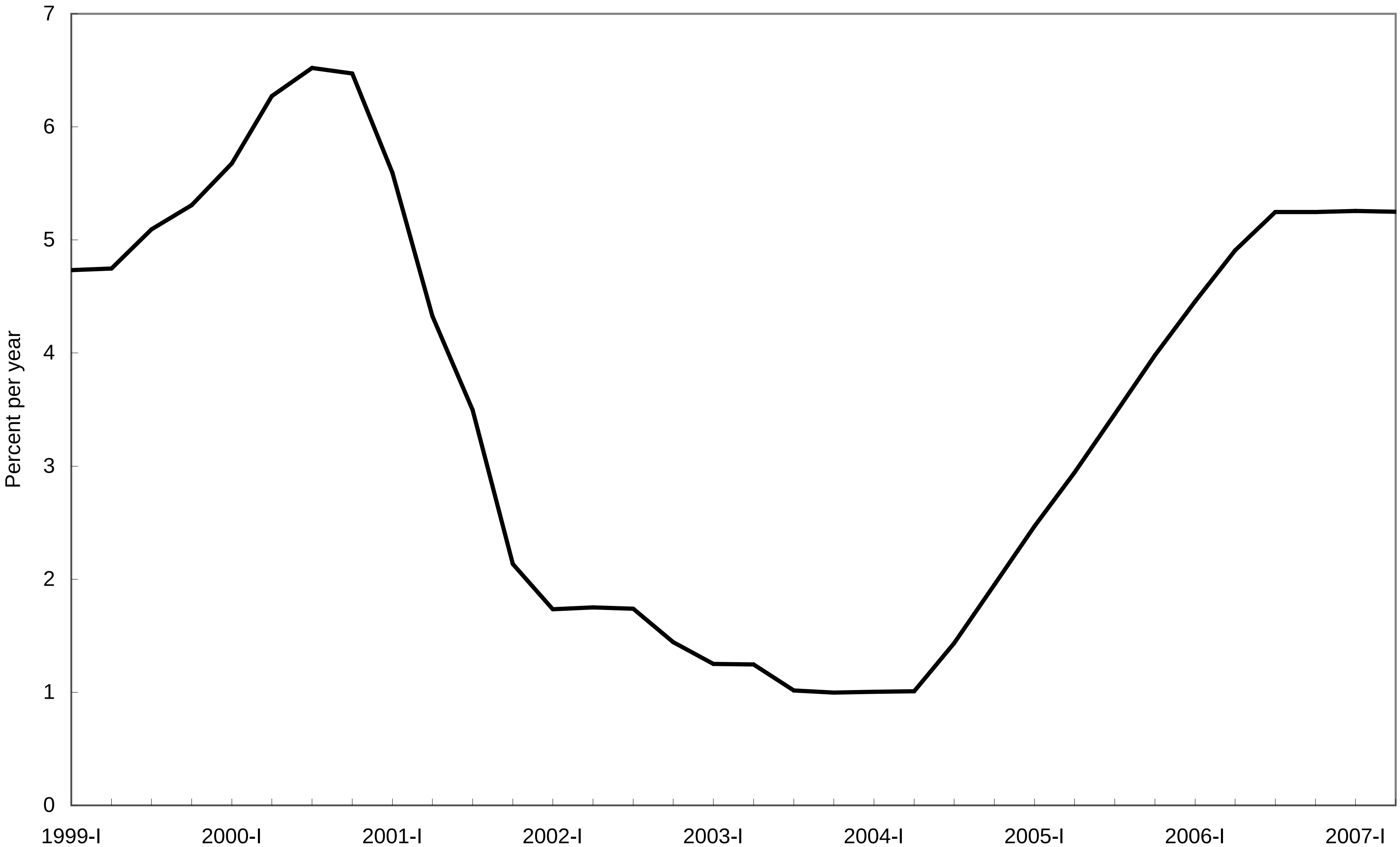
Figure 3. Actual and Projected Real GDP growth, 1999Q1-2008Q4[a]



Source: BEA and FOMC *Monetary Reports* .

a. The bold line is the actual GDP growth rate. Squares indicate GDP growth on the date of projection; circles are projections, connected by dotted lines to the actual value on the date of projection.

Figure 4. Federal Funds Rate, 1999Q1-2007Q2



Source: Federal Reserve Board, H.15