Maiden Lane Division: Preliminary Competition Case

Note: Terms in blue are defined in the Glossary.

The Federal Reserve has a dual mandate. That is, it has two major goals that it tries to achieve. These goals are price stability and maximum employment. These goals were established by the Federal Reserve Act of 1913, which established the Fed. Therefore, the Fed cannot choose to ignore those goals, although sometimes they conflict with each other, and thus the Fed must choose which is most important at any point in time.

The following scenario describes a hypothetical situation for the United States economy. Quarterly data for five years is given after the case for each of the indicators discussed. Use this data and your knowledge of economic relationships to determine what you think that the Fed should do in this situation.

Suppose that four years ago, the United States experienced an unusual economic shock that caused output to fall significantly. Since then, the economy has recovered somewhat, but output and income growth is still very slow. Growth of income and output in the economy is measured by Gross Domestic Product (GDP). GDP is the usually the first indicator that economists consider in evaluating the strength of the economy (Table 1).

A major concern of the Federal Reserve is price stability, or having prices grow at a steady and acceptably low rate. In this case, price growth, or the rate of inflation, is very low. In fact, it is so low that there may be concerns about deflation. Table 2 below gives data for the Consumer Price Index (CPI) for the last five years. The CPI is given both for the overall index (topline or headline CPI) and the core CPI, which does not include food and energy prices, which move considerably more from day to day.

The Fed is also concerned about conditions in the labor market. Since output growth has been low, firms have laid off or fired workers. The natural rate of unemployment in this scenario is estimated to be 5.5%. Table 3 gives the unemployment rate for the last five years. Another measure of how the labor market is doing is payroll employment, which is also given in this table.

In bad economic times, workers may stop looking for jobs even though they are willing to work, because they are discouraged, or they may accept part time work when they would prefer full time work. Two other measures of the strength of the labor market are the U-6 rate, which includes workers who have stopped looking but would like work, and some other types of workers who are not working as much as they would like. This rate is also shown in Table 3.

GDP can be broken down into its parts. That is, it can be categorized by what part of the economy is purchasing goods and services. There are four categories, Consumption, Investment, Government Spending, and Net Exports. Each of those components tells a bit more of the story of what is happening with the economy (Table 4).

The primary way in which the Fed influence the economy is through the relationship between the money supply, interest rates, and investment, the monetary transmission mechanism. The Fed sets a target for the federal funds rate, the rate at which banks lend to each other. The Fed influences the supply of money by buying and selling government bonds, which in turn changes interest rates. For example, if the Fed buys bonds, there will be more money in the economy, which will cause interest rates to fall (because with more money available, banks are willing to lend it more cheaply). Lower interest rates in turn increase investment and some kinds of consumption in the economy, and since spending on these things increases, GDP and employment increase. Table 5 shows the value of the effective federal funds rate for this period (the rate that actually existed in the market, which should be around the target rate).

Two other measures that the Fed often considers are consumer confidence and inflationary expectations. As shown in the table below, consumer confidence in this period has been low. During this period, inflationary expectations have been relatively stable. The term that the Fed often uses for this is to say that inflationary expectations are not "well anchored."

In this table, consumer confidence is measured by the University of Michigan Consumer Sentiment Index. Since this is an index number, the most important thing is how it is changing, rather than the actual number (Table 6).

Another factor of interest in this time period is the behavior of oil prices. Due to instability in the rest of the world, oil prices have been falling sharply over the last two years. Usually the Fed is not concerned about the prices of single goods, but the price of oil affects many things in the economy. Data for oil prices is given in Table 7.

Use the information above to analyze the state of the economy, and explain the choices that the Fed faces. Consider the focus questions in writing your case analysis. Based on your analysis, what policies would you recommend that the Fed implement?

Focus Questions for Case Analysis

1. How would you describe the current state of the economy?
2. What is each component of GDP doing, and why do you think that is happening?
3. Describe the condition of the labor market.
4. Do you think that consumer confidence is having an effect on the economy?
5. How might falling oil prices affect the economy?
6. What difficulties does this situation present for the Fed?
7. What are all of the options that the Fed has in this situation?
8. What do you think that the Fed's best course of action is?