The Fed and the New Economy

May 2002

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Summary

This paper studies the interest-rate policy of the Federal Reserve under Alan Greenspan. For the period from Greenspan's appointment in 1987 through 1995, this policy is well-explained by a simple "Taylor" rule: the Fed raised rates by about 1.5 points for each one-point increase in inflation, and lowered rates by about two points for each one-point rise in unemployment. However, this policy rule broke down during the "New Economy" of the late 90s. Because of falling unemployment, the previous policy rule predicted rising interest rates, but in fact the Fed held rates steady; the divergence between predicted and actual rates grew to more than 200 basis points. We find, however, that the Fed's policy rule becomes stable with a simple amendment: economic slack is measured not by the raw unemployment rate, but by the deviation of unemployment from the NAIRU. Our NAIRU series are based on contemporaneous estimates by academics and government agencies, which declined over the late 90s. In the end, therefore, we conclude that a fairly simple Taylor rule does describe Fed behavior throughout the Greenspan era. This result suggests that variables other than unemployment and inflation do not play major roles in Fed policymaking.