The economy's future

The economy is in a recession and the inflation rate is high. These are bad times, and some people have begun to wonder: what will economic conditions look like in the months ahead? The answer depends on whether the Federal Reserve continues its recent policies. In recent months, the Federal Reserve reduced the money supply by selling Treasury bills and other assets, which took money out of circulation.

Joe McGarrity

As a result, financial institutions were able to charge high interest rates when they made loans – mostly because their competitors didn't have enough money available to offer loans at lower rates.

Even though the interest rate has increased, it is still low by historical standards. No one knows what the Federal Reserve will do next. We are all left to wonder: How much money will the Federal Reserve take out of the economy? How high will interest rates get? The answer to these questions will determine how long we continue to have high inflation rates and how severe the recession will be.

One possibility is that the Federal Reserve adopts a policy that rapidly brings inflation down to normal levels. In this case, the Federal Reserve will adopt a policy that substantially increases the interest rate. When the interest rate increases, borrowing money becomes more expensive, so consumers and firms will want to take out fewer loans. Now that consumers are borrowing less money, they will purchase fewer cars and other expensive items that they usually finance through loans. Firms, for their part, will decline to buy some new equipment – now that borrowing money has become more expensive.

These decreases in purchases will cause the firms attempting to sell products to accumulate inventory. In order to get rid of this inventory, these firms will drop their prices. At the lower prices, buyers purchase some of this inventory. The decrease in prices will put an end to inflation (inflation is just the percentage increase in the average price level).

But these lower prices will have an adverse effect on the economy. The lower prices give firms an incentive to produce less output. When firms reduce their production, the recession becomes more severe. Remember, a recession is a prolonged period of negative or slow growth in gross domestic product (GDP), and GDP is simply the value of the output a country produces. As a result, the cutback in production causes a decline in GDP and makes a recession worse.

In a second scenario, the Federal Reserve adopts a policy that causes a smaller increase in interest rates than occurred in our first scenario. In our second scenario, at these relatively low interest rates, consumers and firms will continue to try to make purchases at a pace that suppliers can't satisfy. Shortages will exist. In order to get products, buyers will bid against each other, causing prices to rise, which in turn causes inflation to remain high.

While the persistent high inflation rates are a downside of the low interest rate policy, there is an upside. The recession won't be as severe. Because the interest rate never increased enough to dampen the demand for products, firms never accumulated inventories, so the price level never dropped. As a result, firms never cut back on their production, which they would have done in response to lower prices. Without the drop in production, the recession is less severe.

In future months, the Federal Reserve will have to decide how much emphasis it wants to put on bringing inflation down. Getting rid of inflation will cause economic hardship and lead to a more severe recession. Less aggressive policies will ensure that inflation remains with us for a long time. The Federal Reserve's choice is like the choices sick people have when taking medicine. Will they take enough foul-tasting medicine to get well soon, or will they take only a little bit and suffer through a long bout of illness? It will be interesting to see what the Federal Reserve decides to do.