Does the fed cause recessions?

This graph shows the federal funds rate over time. When the federal funds rate changes slowly, the Federal Reserve was following Blinder's advice and the outcomes were good. During these times, from 1955-1967 and from 1986-2004, the economy had fewer recessions than normal (in the graph, the recessionary periods are shaded).

The economy will fluctuate and recessions will occur. Government policies can't eliminate recessions, but good government policies can reduce their frequency and severity. While most people look to the president and Congress to provide these policies, the Federal Reserve is a more important player in creating economic policy.

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To keep our economy out of a recession, the Fed has one main policy tool: it manipulates the money supply. If it creates too much money, we have inflation. Why? Because with the extra money, people bid up the prices of existing goods and services, resulting in an increase in the average price level and therefore an increase in inflation. If the Fed creates too little money, we can have a recession. Why? Because with less money available, people make fewer purchases and firms make fewer investments. This drop in economic activity leads to a recession.

The Fed's task is difficult. The optimal amount of money in the economy changes over time in a pattern that appears erratic. But, Princeton economist and former vice chair of the Federal Reserve, Alan Blinder, gave the Fed some guidance. In his book, Central Banking in Theory and Practice, he argues that the Fed should make small predictable changes to the money supply. Blinder argues that even when a big change is needed, the Fed can stretch out this change over a long period of time and let financial markets know what they plan to do.

Economists often keep track of changes in the money supply by looking at the federal funds rate. It is the interest rate banks charge each other for overnight loans. Economists use the federal funds rate because it is much easier to observe than the money supply. Here is how the federal funds rate illustrates what is going on with the money supply. When the money supply contracts, banks have less money, so a bank can get away with charging high interest rates. Other banks won't have enough money to offer loans at a lower rate, so they won't be able to steal business from the bank charging a high interest rate. All banks will be able to get away with charging these high rates, so they will. In contrast, when the money supply expands, banks have plenty of money to undercut a bank attempting to charge a high interest rate. Borrowers will seek the lowest interest rates they can obtain and the competitive process will bring down the interest rate.

The accompanying graph shows the federal funds rate over time. When the federal funds rate changes slowly, the Federal Reserve was following Blinder's advice and the outcomes were good. During these times, from 1955-1967 and from 1986-2004, the economy had fewer recessions than normal (in the graph, the recessionary periods are shaded).

In contrast, when the federal funds rate changed rapidly, the economy experienced recessions more frequently than normal. As you can see in the graph, there were rapid increases of the federal funds rate in the late 1960s, in the mid and then late 1970s, in the early 1980s, and in the early 2000s. In each case, the rapidly increasing federal funds interest rates were followed by recessions.

One reason why the Fed wasn't following Blinder's prescribed approach during these time periods was that it had done such a poor job that it felt it needed to rapidly correct its previous mistakes. In the earlier time periods, the Fed introduced too much money into the economy, which caused high inflation. In the later 2000s, the excess money in the economy caused a run up in housing prices, which probably caused the financial crisis of 2008. In all of these situations, once the Fed realized the consequences of its easy money policies, it tried to quickly take money out of the economy, which caused a steep increase in the federal funds rate.

Unfortunately, we are now living in a time when the Fed is again trying to quickly make up for its poor decisions. The Fed, once again, introduced too much money into our economy, which caused our current high inflation rates. And once again, the Fed is trying to quickly bring down the inflation rate by taking substantial amounts of money out of the economy. You can see the result of this in the rapidly increasing federal funds rate at the end of the graph.

If the federal funds rate continues its steep ascent and if history is a guide, we may soon see another recession. People may find it frustrating to learn that the Federal Reserve is an independent body. Its policy makers don't come up for re-election. Instead, they are appointed. But, if you feel the need to blame someone for the Fed's poor performance, especially if it does result in another recession, keep in mind that both Trump and Biden nominated the current Fed chair. So during the next presidential election, in the primaries or in the general election, you may have your chance to punish a politician who nominated the chairman who is currently presiding over the Fed's policy-making body.

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