Have Fed policies made a recession likely?

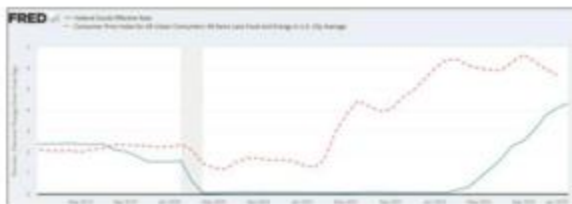
Joe McGarrity

Can the Federal Reserve orchestrate an increase in interest rates that is large enough to bring inflation back down to 2 percent but small enough to avoid throwing the economy into a recession? If history is any guide, no. The Fed is rarely successful in performing this delicate balancing act. But as Nobel Laureate Paul Samuelson noted, and I am paraphrasing here, hoping that the Fed can manipulate the interest rate to pull off the delicate balancing act I just described is like a second marriage – a triumph of hope over experience.

Two months ago, most pundits thought the Fed would cause a recession. They noted that for a period of time, the Fed was reducing the money supply so quickly that the federal funds rate was increasing by three quarters of a percentage point every six weeks. The federal funds rate, which I have mentioned in two of my previous three columns, is the interest rate banks charge each other for overnight loans. The dedicated reader of my columns may remember that when the Fed shrinks the money supply, the federal funds rate increases since, with less money available, banks can get away with charging higher rates. And conversely, when the Fed expands the money supply, the federal funds rate decreases since banks can only lend out their extra money by lowering rates.

On the surface, the fears of imminent recession seemed reasonable since rapid increases in the federal funds rate have usually resulted in recessions. In these cases, the Fed took so much money out of the economy that people cut back on consumption and firms cut back on investments to such an extent that the economy went into a recession.

But now, pundits think the Fed might be successful in this balancing act. These pundits note that the inflation rate is coming down and the economy seems to be doing well. GDP is growing at typical rates and the unemployment rate is at a 50-year low.



This graph, created with data from the St. Louis Federal Reserve, illustrates that the federal funds rate (depicted with a solid line) is still below the inflation rate (shown with a dashed line). The graph also makes clear that those rapid increases in the federal funds rate occurred when this rate was way below were it should have been.

So who is correct – the pundits from two months ago or the pundits now? I can't say since it probably depends on what the Fed does in the coming months. But I can explain why the pundits' worries from two months ago were unfounded. While it is true that the Fed manipulated the money supply to quickly drive up the federal funds rate, this rate was already way lower than it should have been. The Fed wasn't bringing the interest rate to excessively high levels. Instead, it was bringing the interest rate closer to where it should have been anyway.

What should the federal funds rate be? Generally, the federal funds rate should be higher than the inflation rate. For instance, the Fed wants a 2 percent inflation rate. So when the inflation rate is higher than 2 percent, the federal funds rate will usually be higher than 2 percent. The higher interest rate compensates the banks for making loans. It also serves to curtail economic activity, so people won't bid up the prices of goods and services, a bidding process that is responsible for inflation. With the high interest rate, the Fed hopes to hamper economic activity enough so that the aforementioned bidding process only increases the average price level by 2 percent per year.

However, there are some times when the federal funds rate should fall below the inflation rate. These are times when the economy is growing slowly or when the unemployment rate is high. In these cases, the Fed hopes to encourage economic activity by increasing the money supply – which of course, brings down the federal funds rate. In this case, the Fed anticipates that the extra money will spur spending and increase GDP growth to create a business climate that encourages firms to hire more workers (which would bring down the unemployment rate). But we are not living in these times. As I already mentioned, GDP is experiencing normal growth and unemployment rates are well below normal.

Therefore, by all accounts, the current federal funds rate should be higher than the inflation rate. But it isn't. Consider the accompanying graph created with data from the St. Louis Federal Reserve. It illustrates that the federal funds rate (depicted with a solid line) is still below the inflation rate (shown with a dashed line). The graph also makes clear that those rapid increases in the federal funds rate occurred when this rate was way below were it should have been.

I don't think the sharp increase in the federal funds rate will throw the economy into a recession. Instead, the rapidly increasing federal funds rate was just making up for the fact that the Fed kept this rate too low for too long.

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