

Hormuz, inflation and fed policy

Inflation is a measure of how much less valuable dollars become over time. During the Covid Pandemic, the Federal Reserve substantially increased the money supply, which led

Joe McGarrity



to high inflation rates, peaking at a 9 percent annual rate in June 2022. In order to bring down inflation, the Federal Reserve tightened the money supply. This worked because dollars (and everything else) become more valuable as they become less abundant. And when dollars are less abundant, people and banks demand more compensation for giving up their dollars to those who want to borrow them. The compensation banks get for lending money is the interest rate. So when money is more valuable, banks charge a higher interest rate.

The higher interest rate increases the cost of borrowing money. People react by taking out fewer loans to buy cars and other big-ticket items. Firms react by taking out fewer loans to purchase new equipment and facilities. With fewer people looking to make purchases, less people are bidding for resources, so the prices will not be driven

up as much as they otherwise would be.

Stepping back and looking at how the Federal Reserve reacted to the high inflation rates over the last few years, it seems obvious that the Fed's general policy was correct. The Fed altered the money supply to drive up interest rates. One could argue that the Fed should have tried to increase the interest rate more or less than it did, but at least the Fed was correct on which way it wanted to move the interest rate.

Given the Fed's success in bringing down inflation, many people have the idea that when faced with high inflation rates, the Federal Reserve should always adopt policies that lead to higher interest rates. I think we are about to enter a time when this would be a very bad idea.

Most likely, the inflation rate is about to get much higher. Iran has attacked oil tankers in the Strait of Hormuz, cutting off twenty percent of the world's oil supply. Oil will become more valuable as it becomes less abundant, which causes oil prices to increase, resulting in higher gasoline and diesel fuel prices. Trucking companies will pass their higher fuel costs on to their clients. Those companies in turn will pass their higher shipping costs onto their consumers, resulting in higher retail prices. So

many prices will increase that the inflation rate will increase.

But at the same time that the inflation rate will be increasing, the economy will be producing less output. There will be less output because the higher fuel prices reduce the quantity of products that firms can profitably produce.

When the economy is experiencing a high inflation rate and producing a low level of output, a Fed policy of increasing the interest rate to combat inflation is probably a bad idea. Will higher interest rates reduce inflation? Sure they will. But the higher interest rates will also reduce the incentive of consumers and firms to borrow. This reduced economic activity will lead to a decrease in output. Unfortunately, this reduction in output will occur at a time when output is already at an abnormally low level and could result in a recession.

The Federal Reserve's manipulation of interest rates can lead to better economic conditions if done well. But it can also lead to poor economic conditions if done poorly. I hope the Fed resists the temptation to adopt policies that lead to high interest rates during a time when the inflation rate is increasing because of a disruption in oil supply.

Joe McGarrity is a Professor of Economics at UCA. He can be reached at joem@uca.edu.