

# How's the Fed doing?

**I**nflation occurs when a country expands its money supply faster than it expands its production of output. With the extra money, people bid up the prices of goods and services, giving us inflation.

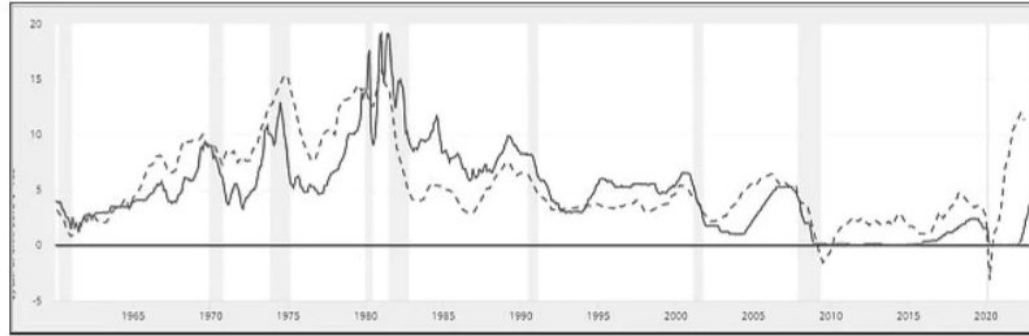
**Joe McGarrity**



Over time, money has become increasingly difficult to measure, so economists have kept track of a variable that moves with the money supply and that is much easier

to measure. This variable is the interest rate. The interest rate most closely tied to the money supply is the federal funds rate. It is the rate banks charge each other for overnight loans. When money is in short supply, banks can get away with charging higher interest rates, mostly because other lenders won't have enough money to lend at lower rates. When money is relatively abundant, banks will offer low interest rates because if they do not, other banks will – since these other banks are flush with cash and seeking to make loans.

If the Federal Reserve refrains from supplying too much money to the economy, the inflation rate will be low. Unfortunately, the Fed hasn't done this. To illustrate how the Federal Reserve has pumped too much money into the economy, we can turn to the Taylor Rule. The Taylor Rule is a simple formula that suggests the optimal federal funds rate. There are many different versions of the Taylor Rule, but a common one suggests that the federal funds rate should increase as the inflation rate gets higher



Submitted graph

The graph, from the St. Louis Federal Reserve, depicts with a dashed line, the suggested federal funds rate, according to the Taylor Rule. The actual federal funds rate is shown with the solid line.

and decrease if the economy is operating at a Gross Domestic Product below where we would expect it to be if there were no business cycles.

The accompanying graph, from the St. Louis Federal Reserve, depicts with a dashed line, the suggested federal funds rate, according to the Taylor Rule. The actual federal funds rate is shown with the solid line. In three time periods, the prescribed interest rate far exceeded the actual interest rate. First, from the mid-1960s to 1980, the actual federal funds rate was too low – at least compared to the prescribed rate. The low federal funds rate signaled that there was too much money in the economy and, indeed, this is a period that is notoriously linked to high inflation rates. As I hinted at earlier, excessive money won't create extra wealth. Instead, it will be used to bid up of the prices of existing goods and services. These price increases will occur throughout the economy and cause inflation.

The second time period, when the prescribed interest rate far exceeded the actual rate, was the first half of the 2000s. While this excessive money supply did

not lead to inflation, like it did in the 1970s, many economists believe it caused the financial crisis of 2007/ 2008. They argue that investment banks had a lot of cash and not enough sound investment opportunities, so they turned to risky investments in order to make some kind of return on their money. When these risky investments lost money, many of the investment banks looked insolvent, which led to the crisis.

We are currently living through the third and final period of when the optimal federal funds rate greatly exceeds the actual rate. This period has been going on for a while (since 2011). Not only that, as the graph shows, the gap between the suggested and actual rates is larger now than at any time since 1960. Given how the 1970s and financial crisis of 2007/2008 turned out, the current low federal funds rates are worrisome. These current low federal fund rates may end up causing significant economic hardships in the future just as the low federal funds rates caused catastrophic economic hardships in the 1970s and late 2000s.

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