

## Fed Policy and the Specter of Prolonged Global Stagflation

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Recent economic indicators are frightening and raise serious concerns about the world economy in a globalizing world. Since August 2007, the US dollar has depreciated from 1.37 to 1.55 dollars per Euro, oil prices have jumped from 65 to 110 dollars per barrel to translate into higher prices of final goods and services, gold prices from 670 to 1000, and most other commodities and food prices have risen at unprecedented rates around the globe. Simultaneous with these developments, a global credit crisis has cast an ominous shadow on global finance. All of these developments are having severe implications for governments, businesses and individuals around the world. The underlying factor behind these developments has been lax monetary policy and the resulting inflation, rapid inflation, not only in real estate prices, but also in all goods and services, and lax supervision of the financial sector.

Inflation is defined as a high rate of price increase and fast depreciation of money. For households and wage earners, it is growing impoverishment as less food and other necessities are affordable. Inflation imposes a heavy tax on cash balances that are held by businesses and individuals; incomes are eroded away; and most and financial assets lose real purchasing power. People with fixed income and pensions are penalized severely as the cost of living rises. Inflation entails a tremendous redistribution of wealth in favor of debtors at the expense of savors and creditors, erosion of financial savings, and considerable loss in social welfare. As inflation gains speed, less and less goods get to markets. Suppliers make higher turnover with fewer goods sold. Inflation destroys competitiveness, lowers productivity, creates relative price distortions, and increases transactions costs. If workers become disenchanted and demand wages increases to compensate for the loss of purchasing power, inflation will become a spiraling phenomenon.

How did the world and in particular the US economy reach this inflationary stage and perhaps end of three decades of prosperity? By far the main root cause is the Fed's excessive expansionary monetary policy since 2000. The danger for the Fed is always that it may fall under the influence of politicians or be called to finance growing public sector deficits (see e.g., M. Friedman, 1959, A Program for Monetary Stability). For these reasons, scholar such as Friedman prescribed fixed rules for the conduct of monetary policy against which the performance of Fed policymakers can be assessed, and warned against discretionary powers.

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In the last seven years, the Fed has defiantly followed an aggressive expansionary policy, which consisted of reducing the interest rates to lowest records in post-war period, disregarding credit risks as irresponsible mortgage lending fueled the housing bubble, and ignoring the rapid depreciation of the US dollar. In a globalizing world many other major central banks followed the same policy. Major key interest rates fell more or less simultaneously, entailing huge worldwide expansion of demand for goods and services and assets and spectacular commodities inflation. Fed's low interest rate policy reduced the cost of deficit financing for the US government and enabled it to finance growing fiscal deficits, doubling the outstanding government debt over less than six years. Housing prices rose at phenomenal rate and so did oil, gold, and other commodities prices, while the dollar fell significantly in value. To keep interest rates low, the Fed injected as much liquidity as required to accommodate any demand for reserves by the banking system and credit expansion. Money supply has risen faster than real growth and commodities supply. From the basic money theory equation:  $P.Y = V.M$ , where  $P$  are prices,  $Y$ , real output,  $V$  is money velocity, and  $M$  is money, and since an increase in  $M$  has no counterpart in terms of goods and services, the more obvious effect of injecting money would be a rise in prices. The consequences of a lax monetary policy are not hard to predict.

The Fed has been pursuing many objectives simultaneously: restoring housing prices so owners will keep thinking they are wealthy and continue to spend lavishly, maintaining stock index on a rising path, and preserving full employment; in the process, the Fed was minimizing the negative effects of inflationary pressures and risk of a falling dollar. It would appear that the Fed is dominated by the conviction that it can attain many objectives instantaneously and without conflict by lowering interest rates and injecting money. It responded hastily to downturns in the stock market by promptly lowering rates and injecting billions of dollars in liquidity without due assessment of drawbacks of further loosening of the monetary conditions. It would appear that the Fed has not so yet realized how damaging its actions since August 2007 have been when it started to aggressively lower interest rates. Pumping billions in liquidity into the economy is only pumping more paper money that has no real output backing and will only add more pressure on prices. The situation has only deteriorated further. Had the Fed avoided such loosening actions, the observed deterioration of financial indicators might not have occurred. The Fed wanted to achieve a miracle that no central bank or government had yet achieved: achieving economic growth with galloping inflation and deteriorating financial conditions. It is obvious by now that lowering interest rates has set a vicious circle of depreciating dollar and higher energy prices. While borrowing cost may be lowered, the general increase in energy and input prices will largely offset cost savings arising from lower interest rates and increase overall production costs for producers. It also reduces purchasing power for households.

At the international level, with dollar losing rapidly its reserve status, capital inflows to the US will diminish, world trade would rely on other currencies only to the extent these currencies remain stable in terms of their purchasing power. If these currencies loose in turn

their purchasing power, countries, including oil and commodities producers, will be less inclined to accumulate depreciating currencies, and therefore will supply less oil and non oil commodities. This in turn will slow considerably world trade and therefore economic growth.

The solution to the present inflation is not a novel one. Paul Volcker had the courage and farsightedness to implement the needed policies in the late 1970s and early 1980s. It consists of strictly controlling the growth of high-powered money and letting the economy adjust to a sound and safe monetary policy. Controlling the money base is in essence a basic principle of the quantity theory of money and has long been prescribed by famous economist such as the late Milton Friedman. Fiat money, because it is almost costless to print, should not become an instrument in the hands of public powers who use it the way they want in response to budget deficits, hiccups in the stock market, or other purposes no matter how laudable they could be. Full employment is often cited as an objective of monetary policy and provides a reason for central banks to relax monetary policy. But it is quite apparent from accepted economic theory that the full employment objective does not fall under the purview of central banking. What is required from a central bank is a sound management of liquidity and the banking system. Full employment is a long-term objective of government development strategies. Monetary policy can contribute to this objective only to the extent it remains safe and stable. The basic principle in central banking is for the monetary authorities to abide by monetary orthodoxy and safety rules for the protection of the value of money and enforce regulatory and legislative regulations in the supervision of the banking system. Lawmakers should compel the central bank to observe its obligations for safe conduct of money policy. In pursuing this objective, central banks should focus on controlling money supply growth and adhering to safe and sound credit policies. With stable money supply, the economy will be able to make temporary adjustment to economic fluctuations and external shocks. Central banks should appreciate their limited role. Monetary policy is not meant to be a quick fix to every economic problem. If it were the case, poor countries would only have to print money and grow rapidly richer.

Only by strictly controlling monetary aggregates and accepting a temporary recession and adjustment can policymakers contain the prevailing deteriorating economic and financial situation. If not, stagflation will be more damaging, protracted, and enduring than a cost of temporary adjustment. The monetary rule for targeting interest rates is not a safe and is inherently known to cause booms and busts. The safe conduct of monetary policy is a priority objective and is prerequisite for sustained growth, employment and prosperity. There is no other alternative to choking off inflation and voiding its dynamics except through reducing the money base; the quicker and stronger the central bank's reduction of money supply, the shorter economic recession will be and the faster the economy will return to stable long-term economic path. Continuing the present stance will aggravate the present crisis; it has become a vicious circle of lower interest rates, falling dollar, racing oil, gold, food and commodities prices, accelerating inflationary pressures, and worsening economic growth prospects.

At the same time and simultaneously, the Fed and other regulators in the US should admit the fact that the present crisis was not brought about by high interest rates and thus it will not disappear by reducing interest rates. Exploding credit deterioration has been the other blade of the scissor that has severed the normal functioning of financial markets. Regulators must shore up the segments of the market that are suffering not because of excesses but because of the general fear prevailing in the market; this includes the municipal bond market which is largely safe but may be damaged if the regulators do not step in to provide needed guarantees. In sum prudent monetary policy supported by selective federal guarantees and programs are the medicine that the federal authorities should administer to the markets now before more damage is done.