The Fed Lauded and Rewarded for Crashing the Economy
By Byron A. Ellis – September 04, 2009

Aggregate demand is the total demand for goods and services produced in the economy. To maintain a growing economy or reduce unemployment, aggregate demand must increase. Policymakers can affect aggregate demand through monetary and fiscal policies. The Federal Reserve (Fed) controls monetary policy and the executive branch usually initiates fiscal policy, but Congress controls fiscal policy.

The instruments of monetary policy are control over the banking system, changes in the money stock, and interest rates. Instruments of fiscal policies are tax rates changes and government spending. Both policies, monetary and fiscal, affect the economy through changes in aggregate demand.

However, the effects of either policy, in terms of timing and demand, are not fully predictable. Nonetheless, if the Fed increases the money supply and the banking system provides credit, the level of demand and employment are likely to increase. Conversely, if the Fed decreases the money supply or maintains a flat rate of monetary growth, the banking system must constrain credit and the level of demand and employment will eventually decrease.

Since 2003 the Fed policy was to diminish monetary growth. Therefore, such policy was a key contributor to the current diminished demand and high levels of unemployment. In a nutshell, the Fed policy contributed to the 2008 recession.

Imagine the country or the world, for that matter, as a growing household whose income has been flat or diminishing for four consecutive years. Say, the household membership grew by one member every year during the four years. Therefore, given a household flat or diminishing income, it would not be able to increase its level of demand, except if it borrows to augment its income. Moreover, if the price of goods and services were increasing, the amount of goods and services that the growing household could purchase with flat income would diminish over time. Thus, forcing the household to reduce its level of demand.

As the level of demand diminishes, business inventory accumulation increases. As inventory increases, production falls, leading to layoffs; which further reduces consumer demand. As this phenomenon affects more and more households, aggregate demand slowly diminishes.

It is clear from the above example that it is lack of income that causes recessions. And, lack of income results from poor management of the money supply. The Fed is the only authority in the United States that manages the money supply.

However, policymakers and the news media have deflected blame from the Fed to sub-prime borrowers, even though yearly investment in the housing market is less than five percent of the gross domestic product (GDP). And, like poorly managed banks, the central bank (the Fed) has been lauded and rewarded for its poor performance, while middle-class Americans are holding upside-down mortgages due to Fed-induced recession.