The real narrative of the 2008 Great Recession

By Byron A. Ellis – January 30, 2012

It has become widely accepted that the primary role of central banks, such as the Federal Reserve (Fed), is to maintain price stability. And, many central banks formally and informally use inflation targeting (IT) as a tool for achieving "price stability."

Inflation targeting central banks often claim that economic growth is not their main focus. They believe that price stability leads to economic growth, employment, and poverty reduction.

To achieve price stability central banks, manipulate interest rates. If they believe inflation will rise, they increase the interest rate. Increasing the interest rate requires draining excess reserve from the banking system. Thus, reducing credit and demand for goods and services.

Through IT many central banks achieved lower inflation rates. However, their overall policy record for achieving economic growth has been disappointing, because there is often a trade-off between inflation and unemployment.

Lowering inflation requires reducing or constraining the money in circulation. If the money in circulation is not growing or it is decreasing, consumers will not have enough income to purchase all goods and services available. Likewise, small businesses will be unable to obtain credit for investment and job creation.

The adoption of IT by central banks may indicate that they do not understand the employment creation mechanism or that they are oblivious to the suffering of the unemployed and its potential effect on the nation's security.

Apparently, prior to the Great Recession the Fed, like many Americans do today, believed that less money in circulation is helpful to the economy. This view, however, is theoretically and empirically false.

Confronted with the Great Recession, the Fed reversed course and significantly increased the money supply in the banking system causing the federal funds rate to fall.

Bank reserves increased from approximately $50 billion prior to the recession to about $1.6 trillion during the recession. Unfortunately, the banking system did not make those funds available to the public. And, it does not appear that the Fed, Congress nor the President pressured them to expand credit.

IT policies are responsible for destabilizing the balance sheets of many consumers and merchants. And, destabilized balance sheets do not have access to credit intermediaries.

As a result, many homeowners and merchants cannot refinance their loans and banks continue to foreclose on them.

However, the main narrative of the cause of the Great Recession is that subprime borrowers are responsible for the crisis. The second narrative is that Wall Street created the crisis and the third narrative is that the crisis was a very broad-based event, including many factors. These narratives are made up stories with no factual evidence and they hide the principal reason for the Great Recession.

For the sake of simplicity, let's partition the economy into buckets with given values. Say, we have a bucket for money in circulation, for goods and services produced, for excess reserve in the banking system, for available labor, and so on.

In a vibrant economy, the value of the money in circulation would be sufficient to purchase all the goods and services produced. Moreover, most of the available labor would be allocated to produce goods and services. And, it would accommodate new entrants in the labor force by borrowing funds from the excess reserve bucket in the banking system to expand the money in circulation, and hence demand.

If the central bank drains money from the excess reserve bucket, it would restrict the creation of new loans for investment and consumption (contracting the money in circulation). Thus, choking off demand and job creation.

The central bank drains funds from the banking system through its open market operations; where it sells securities to the banking system (gives securities and takes money). When securities are sold to the banking system, the federal funds rate increases because banks have less money.

Thus, by examining the federal funds rate we can determine if the Fed drained reserves from the banking system. Data from St. Louis Fed indicates that the increase in federal funds rate started in 2004 and ended on October 08, 2007.

The federal funds rate graph from the St. Louis Fed also indicates that whenever the Fed drains funds from the banking system recessions occur; the shaded areas indicate recessions.

If this fourth narrative of the crisis is correct and historical evidence seems to validate it, then the focus must be on the Fed and not on subprime borrowers.

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