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RESEARCH SUMMARY

Inflation Expectations and the 2008 Financial Crisis: How the Federal Reserve Got It Wrong

As we approach the 10th anniversary of the Great Recession, a new analysis of the evidence suggests that, before the September 2008 collapse of Lehman Brothers, the Federal Reserve's policy decisions, likely motivated by an exaggerated and misplaced fear of inflation, deepened the recession, thereby intensifying the stresses disrupting a weakened financial system.

This is David Glasner's argument in "The Fisher Effect and the Financial Crisis of 2008." While the Fed was laser-focused on inflation, the real danger was recession and financial instability.

With real (inflation-adjusted) short-term interest rates close to zero, the Fed was trying to restrict credit to keep inflation expectations from rising. Unable to borrow, and facing a precarious financial environment and a deteriorating real economy, cash-strapped firms, merchants, and traders began liquidating their positions, triggering a cascading collapse of asset prices.

At this critical moment, falling inflation expectations reinforced the downward pressure on asset prices and output and employment. Yet the Fed, still fixated on an imagined threat of inflation, delayed reducing nominal interest rates, further exacerbating the crisis.

WHEN INFLATION CAN BE A GOOD THING

Inflation, with good reason, is generally regarded as undesirable. But when real interest rates are close to zero, deflation or expected deflation can be even worse. Deflation causes people to hoard money, and an increased demand to hold cash reinforces a downward spiral of falling asset prices and shrinking output and employment.

In such dire circumstances, monetary expansion intended to raise prices and temporarily increase inflation can actually help prevent a recession and start a recovery. The real failure of the Fed was to maintain the anti-inflationary policy, which caused a downturn late in 2007, long after it became necessary to shift to an expansionary policy.

KEY TAKEAWAYS

- The Fed was inappropriately worried about rising inflation in the first nine months of 2008. The evidence shows that stock prices were positively correlated with inflation expectations during this critical period.
- Unusually low or negative real interest rates are a sign of economic weakness. In such circumstances, trying to reduce expected inflation can induce people to prefer holding cash to real assets, triggering a decline in asset prices and a recession. A temporary increase in inflation may be beneficial under these conditions.

- A sound monetary policy would allow inflation to vary with economic conditions—rising when economic growth slows in order to prevent recession, but falling when economic growth rises to maintain price stability over the course of the business cycle.