
Is the Federal Reserve System (FED) and its monetary policy responsible for expansion and contracting the business cycle?

Pellegrino Manfra
City University New York, USA

Keywords

Federal reserve system, business cycle, monetary policy, quantitative easing

Abstract

The term "business cycle" describes the pattern of fluctuations – expansions and contractions – in economic activity over time. Periods of expansion are measured from the bottom (trough) of the previous cycle to the top (peak) of the next cycle. Contractionary periods, on the other hand, are measured from peak to trough. The official U.S. business cycle dates are provided by the National Bureau of Economic Research.

The third millennium has started with two extensive financial crisis: the dot com bubble in 2000 and the housing crisis in 2007 – both started in the U.S. In both cases there is evidence that the FED first had low interest rate causing the bubbles later increased interest rate to pop the bubbles. Despite the conventional view, there is evidence that the Fed has not been as effective as once thought in accomplishing its stabilization goals, and even some evidence that the Fed era has had more economic instability.

September 15, 2018, it will be 10 years since Lehman Brothers filed for Chapter 11 throwing the U.S. and much of the world into the greatest financial crisis since the Great Depression. The financial crisis has since reshaped economies and financial markets and its effects are still being felt ten years later. With zero percent interest rate and massive injection of quantitative easing the U.S economy is far below the pre-crisis era. Growth rates in the last ten years have been averaging about 2.1% - below the 3% before 2007 crisis. World trade, foreign direct investment and productivity have not gained since the financial crisis of 2007. They are all significantly below pre crisis era. What caused the crisis, however, is still a matter of some debate among economist however the expansionary monetary policy of the FED and lower interest rate in 2003 and 2004 was a serious factor that contributed to the crisis. One of the inescapable truths of the past 10 years is that the central bank policies introduced to mitigate the crisis may be sowing the seeds of another one. As in the run-up to 2007, ultra-low interest rates have been distorting the world's finances. In addition, quantitative easing (QE) and an abundance of cheap money flowing into the markets has also pushed up the world's debt burden. This paper examines how the FED in this process has exacerbated the business cycle.
