Dave Working

Homework #3

Mar. 23, 2005

"Greenspan's Real Mistake"

Wall Street Journal

March 21, 2005

Class: Friday, March 18, Item III: Short-Run Effects of Money

This article argues that the actions of Alan Greenspan and the FROMC since 2003 are the cause of a recent upswing in prices and a possible future inflation spike. It begins by saying that the Fed is responsible for helping the economy rebound after the most recent recession, by successfully lowering interest rates and putting more money into the economy. However, the author argues that this monetary policy was maintained for too long, and interest rates should have been raised sooner to keep the rising GDP in check. Instead, Mr. Greenspan waited until June 2004 to start raising short-term interest rates, after allowing negative real rates for three years. The author warns that the ramifications of these actions have already started to take hold in the commodities markets, as gold and oil have risen steadily for some time. Although indices such as the CPI have not yet reflected higher inflation, the author comments that these indices lag behind the real market actions and will soon catch up to what is actually occurring. In closing, the author predicts a sharp, immediate raise in interest rates and a draining of dollar liquidity through open markets as methods the Fed might soon use as ways of combating this new-found rising inflation.

The article reflects our class topic in its discussion of the forces that would cause upward pressure on prices, causing inflation. A drop in interest rates raises the aggregate demand curve and stimulates rGDP growth, which is why the Fed lowered rates during and after the most recent recession. Similarly, a rise in interest rates lowers the AD curve and brings an economy operating above potential GDP back down to equilibrium. If interest rates are not raised and the AD curve stays too high, as the author of the article claims is the case, the SAS curve moves upward to a new equilibrium point in order to bring rGDP back to potential, but in the process raises prices and therefore causes inflation. This phenomenon is the underlying cause of what the author says has happened over the last three years.

Word Count: 348