



Worksheet 18.2

Will the Fed's Easy Money Policy Fuel Global Inflation?

In 2008, Harvard Economist Kenneth Rogoff believed that inflation posed a major problem to many of the developing economies at the time. Read from 'Inflation in Russia, Vietnam, Argentina' to 'people won't notice' from the article ['Inflation reality check'](#).

Usually, inflation can be reduced with restrictive monetary policy, or the selling of bonds on the open market, which reduces the money supply, raises interest rates and slows down consumption and investment, and thus the pressure on prices in the economy. In 2008, however, the US Central Bank, the Federal Reserve, was in the process of expanding money supply and lowering interest rates in an attempt to avoid a recession in the United States.

In a world of isolated, self-sufficient economies, US monetary policy would only affect the US economy; however, in a globalized economy policies like those used by the US fed have unintended consequences for the rest of the world. Read paragraph 'America's inflation would' to 'of the global economy' from the article linked to above.

The reason other countries must copy the Fed's monetary policies has to do with exchange rates, which many countries try to peg to varying degrees to the value of the dollar. One of the determinants of exchange rates is relative interest rates between countries. If the US lowers interest rates, and a country like Argentina keep rates high, global investors looking for a return on their savings will take their money out of investments in the US and invest it in assets in Argentina, where they can earn a greater interest rate. This drives up demand for the Argentinean peso and leads to an appreciation of that currency. A stronger peso could have negative impacts on demand for Argentina's exports as they become more expensive to foreign consumers.

In order to avoid appreciation of its currency and declining the harmful effect it would have on its exports, Argentina is thus forced to lower its own interest rates as the Fed cuts those in the US.

When you consider that much of the world adjusts its currency in relation to the dollar, you can see how an easy money policy in the US could lead to falling interest rates worldwide, triggering all sorts of new consumption and investment, driving price levels ever higher.

Questions:

1. If a US interest rate cut is not matched by countries that tie their currency to the dollar, what would happen to the value of those countries' currencies, and why would this be harmful to those countries economies?
2. Why are lower world interest rates inflationary?



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3. What would happen to the value of the Brazilian Real if the US central bank lowered interest rates and the Brazilian Central Bank kept them high? What are the costs and benefits for Brazil of maintaining the value of its currency against the dollar even when US interest rates are falling?
4. Do you think low inflation or low unemployment should be the primary concern of governments in developing countries? Why are these two objectives hard to successfully achieve simultaneously?