PopularEconomics.com

Financial FAQs

Another Soft Landing?

The Federal Reserve is trying to engineer another soft landing of the economy. What does it mean? The Fed must steer economic activity down a middle path between the periods of high inflation and high unemployment that normally occur during business cycles. The U.S. is currently in an 'up' cycle and in danger of overheating, as evidenced by soaring prices and a very low (4.8 percent) unemployment rate.

The Fed has therefore been attempting to slow economic activity by raising interest rates 17 times since June 2004. It did not raise rates at its August 8 FOMC meeting in order to see if the prior rate hikes are having an effect. The trick is to slow it without causing another recession, which is the definition of a soft landing—not easy under any circumstances. Former Fed Chairman Greenspan succeeded in engineering a soft landing only once—in 1994---but failed in the recessions of 1991 and 2001.

The job under new Chairman Ben Bernanke will be harder because of all the inflationary pressures. We now have several Mideast wars, a War on Terror, N. Korea, and Iran that add a 'risk premium' of at least $15 per barrel to oil prices, according to experts. This is on top of India and China's double-digit rate of economic growth, on top of the dollar steadily losing value (making imports more expensive), and the huge budget and trade deficits that add to the inflation equation.

Some economists, including Northwestern's Robert Gordon, believe that inflation is now so embedded in our economy that we are in danger of repeating the stagflation of the 1970s, when Vietnam War spending and high oil prices combined to create both high inflation and high unemployment, which is the definition of stagflation.

Sound familiar? We have discussed the misery index in past columns, which is the sum of inflation and unemployment rates used to measure stagflation in the 1970s. It rose as high as 20.76 in 1980, when our inflation rate rose to a record 14.76 percent.

Dr. Gordon, a world famous authority on the behavior of unemployment as it relates to inflation, now believes that we would have to shed at least 2 million jobs to eliminate the danger of inflation becoming embedded for years to come, according to the New York Times. Why? Because wages now account for three-quarters of all production costs. Yet contrary to the 1970s, wages have been barely rising in the latest recovery. They would have to rise faster than labor's productivity rate for the classic stagflation to occur. In fact, productivity has risen 14 percent in the past 5 years, whereas real (after inflation) wages have risen just 2 percent.

So can there be another scenario, one where the Fed does engineer a soft landing, rather than stagflation? The two most important factors would be the same as in the 1970s—tackling deficit spending and the sky-high oil prices. Firstly, pay down the federal budget deficit and so take some of the excess money supply out of circulation that is pushing up the inflation rate, and pushing down the dollar's foreign exchange rate.

Secondly, less geopolitical uncertainty—like solutions to the Israel-Palestinian confrontation and Iraq War—would certainly lower the risk premium on oil, regardless of other factors. Most economists agree that it is out of control energy prices boosted by the dollar's falling value, not wages, that is the main cause of inflation. We pay a risk premium for all dysfunctional behavior, in other words, economic or otherwise.

© Copyright 2006