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WEEK OF AUGUST 15, 2005—A SOFT LANDING?

> "Because so many variables can shift the inflation-unemployment tradeoff, the Fed tries to keep track of it all. Many economists summarize the answer with a number called the NAIRU, standing for "non-accelerating inflation rate of unemployment." When unemployment rises above the NAIRU, inflation tends to fall below rates experienced in the recent past. When unemployment falls below the NAIRU, inflation tends to rise."
>
> --Gregory Mankiw, former Council of Economic Advisors Chairman—

We are again hearing talk of the Federal Reserve engineering a "soft landing". This means slowing down economic activity gradually enough so that it doesn't cause a recession, in a word. It must be slowed down to what the Fed perceives to be a neutral growth rate that is not too hot or too cold; a goldilocks economy where growth and inflation are balanced.

The "tradeoff" between inflation and unemployment that the NAIRU unemployment rate attempts to measure is a daunting task during the best of times. And with record consumer debt, a war, as well as budget and trade deficits, these are not the best of economic times.

Conventional economic wisdom has postulated that a capitalist, market-based economy with strong private property rights, cannot achieve actual full employment—i.e., putting everyone to work who wants to work—without the specter of inflation. This is embodied in the so-called Phillips Curve, a formula that says when the unemployment rate is (too) low inflation tends to increase while when the unemployment rate is high inflation tends to decrease.

And the NAIRU is really the lowest unemployment rate that does not cause inflation to "accelerate", as Dr. Mankiw has said. The booming economy of the mid-nineties had low oil prices and a strong dollar, which gave us a moderate inflation rate of 2.5-3 percent. Yet most economists at the time thought that a 5.5 percent unemployment rate was the lowest rate possible without unacceptable inflation.

The genius of Chairman Greenspan was to recognize that the unemployment rate could go even lower—to 3.8 percent at one point—without a surge in inflation. But it could only do so if all that investment in high tech achieved a higher labor productivity rate—which it did. And so the Fed kept its foot off the economic brakes for the rest of the 1990s, helping us achieve the longest post-war recovery on record—10 years.

However, Greenspan did not succeed in a soft landing in 1999. The Fed had raised its so-called fed funds overnight rate to 6.5 percent at the time in an attempt to corral the irrational exuberance of stock market investors. (Wall Street's Prime Lending Rate rose to 9.5 percent.) The result was the dot-com bubble bursting and subsequent stock market plunge that lost more than $4 trillion in stock equity.

The Fed means to be more cautious this time, hence the wording in its latest FOMC releases of "removing accommodation at a pace that is likely to be measured." The fed funds rate is at 3.5 percent today, and predicted to rise to at least 4 percent by year's end. Some pundits are predicting it could rise higher if current levels of economic activity continue into next year. This is with the unemployment rate at 5 percent, nowhere near the lowest jobless rate of the nineties.

Why is the Fed so concerned about inflation? Last month's core inflation was unchanged, but July's showed a large rise due to soaring energy prices. And there is undisputable inflation in coastal housing markets, but nowhere else. Yet housing supply is slowly catching up with demand as for-sale inventories grow, which should slow down the price rises. So, the Fed continues to put the squeeze on bank lending by raising their cost of borrowing money.

RETAIL SALES—July sales soared 1.8 percent, mainly due to record auto sales as manufacturers discounted to make room for new models. Retail sales are now up a whopping 10.3 percent in past year, the fastest growth in 11 years. But consumers had to borrow a near-record $14.5 billion to finance their purchases in July.

CONSUMER PRICES—The Consumer Price Index (CPI) rose 0.5 percent—on the high side—but only 0.1 percent without food and energy price rises. It is up 3.1 percent in 12 months, however, which is still above the Fed's acceptable range of 1-2 percent for retail inflation.

WHOLESALE PRICES—July's PPI jumped a whopping 1 percent, and core prices were up 0.4 percent. The culprit was a 10.5 percent jump in gas prices. Wholesale inflation accelerated on a year-over-year basis to 4.6% from 3.6% a month earlier. Still that is lower than the annual peak of 5.2% reached in November.

REAL WAGES—This important number just out for July showed a drop of 0.2 percent in real average weekly earnings over June. It is mainly because of the higher CPI inflation. Inflation is deducted from nominal increases in hourly wages to get the average. Nominal wages are up only 2.7 percent in 12 months, therefore below the annual CPI inflation rate of 3.1 percent. Consumers have to borrow more than they earn to even keep up with inflation, in other words!

The latest economic data show annual Gross Domestic Product growth at 3.5 to 4 percent, which is about what a so-called neutral growth rate—the sum of population growth + productivity rate—should be. Retail sales are booming, for one thing. Yet the situation is actually reversed from the nineties—oil prices are soaring and the dollar's value is lower—so inflationary forces are at work. This may be the Fed's rationale for continuing to remove accommodation.

Higher oil prices are becoming a real problem, by putting pressure on consumers and widening our trade deficit. It takes away buying power. Consumer sentiment fell in the U. of Michigan's latest survey across the board, mainly because of higher gas prices, according to the survey. Its current conditions index fell 3 points, and future expectations more than 4 points. The $67 per barrel crude oil price will also result in a wider trade deficit, could push further down the dollar's value, which would then cause oil prices to rise further! So the Fed's Governors have little choice but to continue to raise interest rates in the hopes that it slows the economy just enough, without causing a recession—the hoped for soft landing.

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