Financial FAQs

Fed Beige Book Confirms Slow Recovery

The Federal Reserve's Beige book report on the U.S. economy that preceded its September FOMC meeting confirmed we are in a very slow recovery mode—but only reading between the lines tells us why. Sure, jobs are still scarce, and consumers "cautious", but that is not the real reason we will have a slow recovery.

The Fed's own words reveal that rather than creating more jobs, the Fed is still focused on fighting inflation. That means putting a cap in economic growth—and specifically targeting wages and salaries, since wage and salary earners make up something like 80 percent of the workforce. Yet without strong wage growth, the economy lacks a strong demand for its goods and services, since consumers (i.e., mostly wage earners) make up 70 percent of economic activity in the U.S. economy.

The Beige Book hinted at its inflation bias when it said, "Upward price pressures remained quite limited for most categories of final goods and services, despite higher prices for selected commodities such as grains and some industrial materials. ***Wage pressures also were limited, although a few Districts noted increased upward pressures in a narrow set of sectors experiencing a mismatch between job requirements and applicant skills.***

The Fed has been in this mode since the stagflation of the 1970s. Before that, Fed policy had been to encourage full employment, and so allowed slightly higher inflation in the 2-3 percent range. But when stagflation hit—due more to the running oil embargos and winding down of Vietman War—the Fed decided to add a second mandate to fight inflation by bringing the defacto annual inflation target below 2 percent.

That meant restricting credit at the first sign of inflation pressures, which impedes further expansion and hiring, since said expansion depends in large part on the availability of credit. That is why Alan Greenspan raised interest rates without warning in 1994 and so bankrupted Orange County. Average household wages have been stagnant since then, even with working couples—which meant women with children had to enter the workforce to make up for the income lack. This has made a huge difference in our social structure, as well, needless to say.

So why does the Fed continue with such an inflation bias today, when inflation has been almost non-existent for decades? Bernanke even labeled the last two decades The Great Moderation, because inflation had remained so low. It was, in a word, to keep interest rates as low as possible because of the huge budget deficits that began in 1980 and rose sharply again in 2000—both times due to overly large tax cuts. Right now, the interest expense of federal debt isn't more than 18 percent of our $3.55 trillion annual budget. But if rates rose substantially, it would become much more expensive, obviously.

Yet unless we spend more on stimulating the economy during these down times, revenues won't increase enough to allow a reduction in debt—at least as a percentage of GDP. As Paul Krugman pointed out recently, it is precisely such government stimulus

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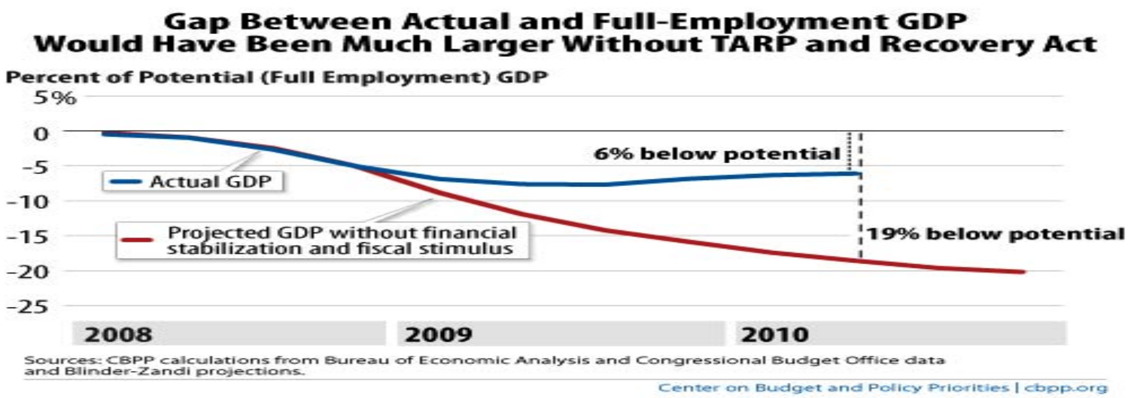
spending using borrowed money that reduced the 150 percent of GDP debt load generated by WWII.

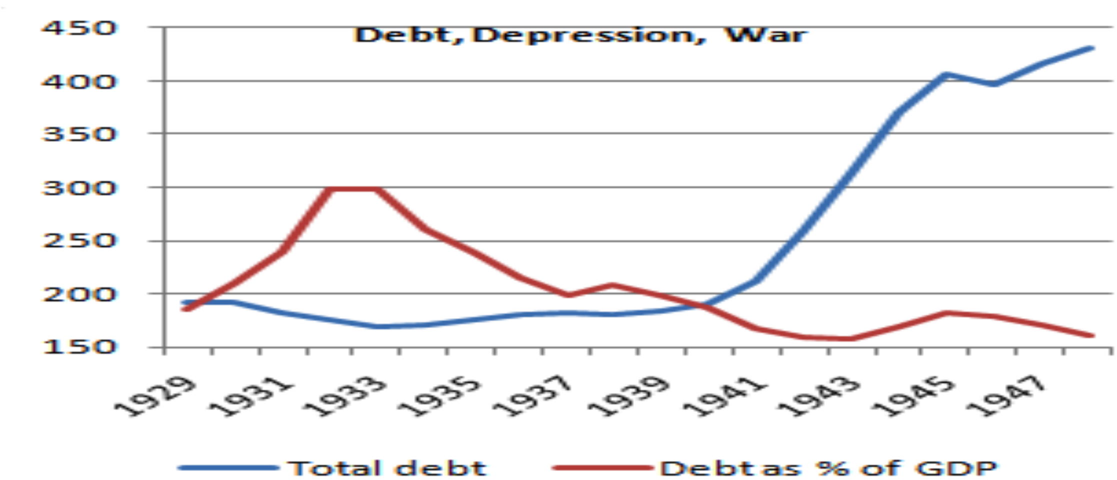
And we are in a similar situation today. The loss of output from the second worst depression in modern history could require as much stimulus spending in peacetime, as was required for WWII.



The economy is slowly turning around, but it is obvious that more stimulus is needed. In fact, the best measure of its lack, is what is called the "output gap", which measures the difference between present and full employment output potential. The San Francisco Federal Reserve says it was minus 6.1 percent in Q1 2009, as we discussed in a recent column, but would have been as high as 19 percent without the TARP and ARRA stimulus spending.

The output gap depends on such factors as the supply of workers and their productivity. During a boom, economic activity may for a time rise above this potential level and the output gap is positive. During a recession, the economy drops below its potential level and the output gap is negative. In theory, then, the output gap can play a central role in monetary policy deliberations and strategy.

And deficit spending in fact works during extreme downturns. Because it stimulates economic growth and some inflation, which history documents is the only way to increase revenues enough to pay down such monumental debt. Krugman documents this with a graph of Depression-era debt compared to debt as a percentage of GDP. It shows that government deficit spending actually boosted economic growth (GDP) enough to lower total debt as percentage of GDP from 1933 to 1947, when the federal deficit grow to 150 percent of GDP. Why? Because it boosted revenues, whereas debt reduction measures during the Hoover Administration decreased revenues from 1929 to 1933.



Unfortunately, it does look like such 'structural' unemployment as we have—due in large part to so many jobs going overseas—will keep unemployment high for years if not decades to come, as we said last week. So it is time for the Fed to remove its inflation bias—in both words and deeds. *The worries of business over any rise in the future cost of funds is surely much more based on the Fed's tendency to raise interest rates at the slightest hint of incipient inflation*, than the size of our federal debt—which would in any event be substantially reduced with a stronger economy, as it was in the late 1990s.

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