Popular Economics Weekly

WEEK OF DECEMBER 12, 2005—MORE FED WORK?

The jury is out on more Federal Reserve tightening moves. Its December 11 Federal Open Market Committee meeting brought it one step closer to a pause by removing the word "accommodative" from its press release, after the 13th consecutive rate hike. This could cause a drop in mortgage rates next year, since both short and long-term interest is tied to government indexes—whether the Cost of Fund Index (COFI), or 10-yr Treasury Bond yield.

But the Fed is keeping all options open, just in case. "The Committee judges that some further measured policy firming is likely to be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance," said the release. "In any event, the Committee will respond to changes in economic prospects as needed to foster these objectives."

It was a subtle change, which could mean several things. Firstly, the Fed Governors no longer consider short-term interest rates, at least, as being stimulative to economic activity. This means that the overnight rate—which is a banks' basic cost of funds—finally inched above the current inflation rate. The fed funds overnight rate was raised to 4.25 percent. Interest rates that are below the inflation rate generally mean expanding credit. And with the Prime Rate now at 7.25 percent, consumers have to think twice about financing their purchases with a credit card.

Though higher interest rates have not yet cut into consumer spending—it is still rising at a 6.3 percent annual clip—consumers have had to borrow from their homes to do it. The Federal Reserve reported that American households had increased their total household debt by 9.1 percent in the third quarter to $11 trillion, the fastest rise in 18 years. Mortgage debt grew 14 percent while credit card debt increased 5.4 percent.

Federal government borrowing rose by 5.1 percent in Q3, while state and local governments borrowed 12.5 percent more. More noteworthy was that the so-called net national savings fell by $120.5 billion, the first time it was negative since the Fed began tracking data way back in 1952. This can mean only one thing. We are now running on borrowed time, as well as borrowed money. The only way to ease such a debt load is with higher inflation, which means cheaper money.

Secondly, the Federal Reserve's stated policy is not to allow higher inflation, but it cannot also choke off economic growth. So it has no choice but to print more money if economic growth falters. Look, therefore for the dollar to continue to lose value, while gold, oil, and other precious commodities continue to increase in value—i.e., price. This is the inevitable result of too much public and private debt.

The rest of the news was more upbeat. What with labor productivity soaring, third quarter's Gross Domestic Product growth also exceeded 4 percent. Both personal consumption and government spending fueled the increase. The GDP is our main measure of economic growth, and it has averaged 4 percent growth now for almost 2 years. But can such growth continue when consumer spending makes up 71 percent of the GDP?

INFLATION—Consumer prices fell a record 0.6 percent in October, the "fastest" drop in CPI since 1949, according to the Bureau of Labor Statistics' release. It was due to a 8 percent drop in energy prices, which have stabilized since the hurricanes as more refineries come on line and oil producers rush in more supplies. But energy prices are still 18 percent higher than last year at this time. So-called core inflation, without food and energy factored in, is up just 2.1 percent, which is still at the upper end of the Fed's defacto inflation target.

The Treasury Dept. reported a record $106.8 billion capital inflow into the U.S. in October. This is a sign that some, but not all foreigners are still willing to finance our debts. Chinese and Japanese holdings of our Treasury Bonds have declined of late. But that could be more due to the need to invest in their own country's economy. Japan is finally pulling out of the two decade slump of its own real estate and stock markets. China may also be investing more at home in preparation for its hosting of the 2006 Summer Olympics.

We are therefore able to see what keeps the Federal Reserve Governors cautious about inflation. Everyone knows that the enormous debt loads carried by both governments and consumers are not sustainable. We cannot grow out of them, in other words. And Social Security and Medicare entitlements will only increase as the baby boomers begin to retire in 2010, adding $Trillions more to our national debt.