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WEEK OF JANUARY 16, 2006—WHAT INFLATION?

The remark—"What inflation?"--was attributed to incoming Fed Chairman Ben Bernanke recently, when asked whether inflation would subside in 2006. His remarks have significance not only because he succeeds Alan Greenspan as Fed Chairman and so may be indicating future monetary policy, but because mortgage interest rates are closely tied to bond yields. And longer-term bond yields are tied to expectations of future inflation.

So, do we have an inflation problem? The main inflation indicators for December—the wholesale Producer Price and retail Consumer Price Indexes--were benign because energy prices have declined significantly since the hurricanes. The CPI actually fell 0.1 percent, while the core rate rose 0.2 percent (without food and energy). This is because retail energy prices have fallen a total of 10.2 percent in the past 2 months.

The 10-yr Treasury Bond yield has become the benchmark for 30-year fixed mortgage rates, in particular. It has fluctuated in a narrow range—4 to 4.6 percent—since 2004. 30-year fixed mortgage interest rates have consequently remained between 5.25 to 6 percent during that time.

The signs that inflation may decline in 2006 hinge on several factors that Fed officials will look at. They indicated in their Dec. FOMC meeting minutes interest rates had reached a "neutral" level that approximated an economy neither too hot, nor too cold. That outlook was based on 2 main factors. First is the fact that consumer spending has been declining of late due to higher interest rates. The second factor is that wage and salary costs—embodied in the so-called Employment Cost Index—have been stable, even as we are approaching full employment.

Consumer spending had been rising at a 6 percent clip during 2005, but dipped to 3.4 percent during the Christmas season. Household incomes, however, have been rising approximately 2 percent per year, less than the current inflation rate (of 3.4 percent). This is why consumers in 2005 spent more than they earned, reports Barron's Magazine. In fact, "Last year, the $375 billion in disposable income was way short of the $500 billion increase in consumption," said Stephanie Pomboy of MacroMavens, as quoted in Barron's.

This means that consumers had to borrow to consume, yet even consumer borrowing contracted in Q4 2005—for the first time since the 1991 recession. Why? The volume of home equity loans is no longer growing—has in fact contracted back to 2000 levels, just prior to the last recession. And so, "the greatest consumer buying binge ever is starting to fade," said Barron's Alan Abelson.

The Employment Cost Index put out by the Labor Dept. is also closely watched by the Federal Reserve because it tracks rising wage costs, and wages and benefits make up almost two-thirds of product costs. So Fed officials believe it is a main driver of inflation expectations.

Others, such as the Economic Policy Institute (EPI), however, dispute that claim. The power of blue-collar workers in particular to influence their incomes has been waning since the 1980s, because union membership has declined in tandem with globalization of the workforce (and competition from lower-paying but equally skilled foreign workers).

The increase in employee costs has consequently been declining steadily. Such costs were rising from 10-12 percent in 1980--when workers earned a larger share of corporate revenues--to less than 4 percent in 2005. It is not therefore credible to say that wages and salaries have an inflationary effect on production costs today.

But has inflation been defeated? No. Not with crude oil back up to $68 per barrel, and Bin Laden, Iran and Nigerian rebels continuing to stir things up. And not with consumers in developing countries wanting more of what we consume. China's per capital consumption of oil is just 1.7 barrels per year today, for instance, whereas Americans consume 27 barrels per person per year. The U.S. has 740 vehicles per 1,000 and China just 3 per 1,000, but are now buying cars "hand over fist", according to Barron's. Need we say more?

The consequences of these counteracting forces will probably keep excessive inflation (and higher interest rates) at bay in the near term. But rising energy consumption in other countries, and our own out-of-control budgets—that have led to record consumer, federal and foreign trade deficits—must eventually nudge inflation higher. Much will depend on the willingness of foreigners to continue to invest their excess savings in U.S. assets.