Popular Economics

Promoting the Popular Understanding of Economics

Popular Economics Weekly

When to Tighten Credit?

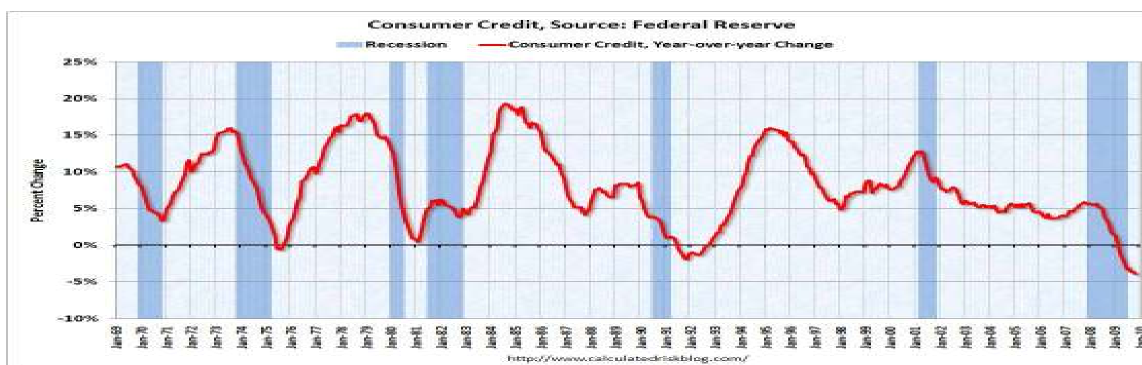
The Federal Reserve's latest Open Market Committee minutes highlighted the growing debate over when should the Fed begin to raise interest rates. "Some saw inflation risks as tilted to the downside, reflecting the quite elevated level of economic slack and the possibility that inflation expectations could begin to decline in response to the low level of actual inflation", said the minutes. "But others felt that inflation risks were tilted to the upside, particularly in the medium term, because of the possibility that inflation expectations could rise as a result of the public's concerns about extraordinary monetary policy stimulus and large federal budget deficits."

This is a crucial question for many reasons-not the least is how it affects the credit markets. Record low interest rates are helping real estate to (slowly) recover, for one. The Fed should not act too soon, according to a Japanese banking expert, or we could repeat their decade-long malaise of the 1990s.

The Fed has another reason for keeping interest rates so low for this length of time, one they have not adequately explained. We are in a so-called "liquidity trap" similar to the Japanese experience. A huge mountain of money—more than $1.2 trillion in excess reserves, according to the Fed and $900 billion in MZM money at zero maturity in bank accounts earning almost zero interest—is not being put to work to grow the economy.

It is not being invested, in other words, as banks and investors have become hoarders in order to pay down record debt, rather than risk-takers. And so the Fed is pushing them to seek higher returns by keeping rates so low.

Consumers continued to pay down their debts in record amounts in November. Consumer credit has declined for a record 10 straight months - and declined for 13 of the last 14 months and is now 4.5 percent below the peak in July 2008. It is difficult to get a robust recovery without an expansion of consumer credit - unless the recovery is built on business spending and exports.



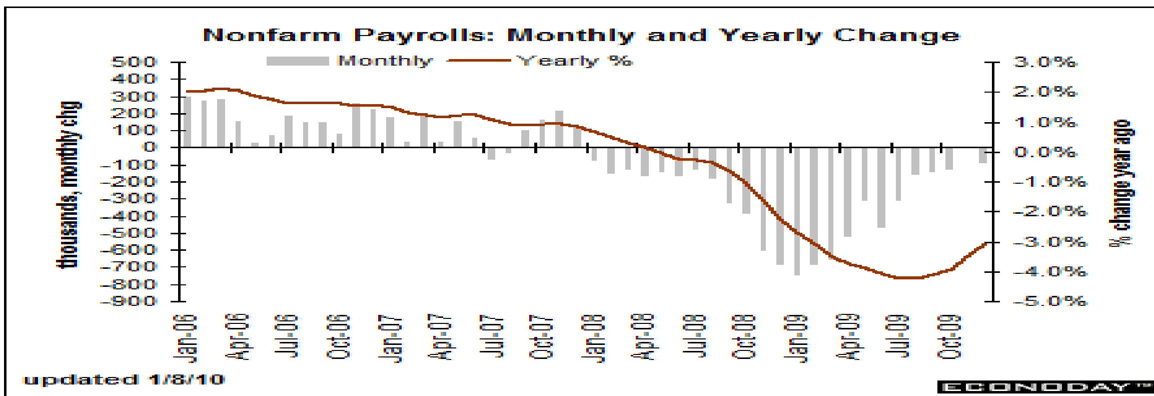
4141 State St., #E13 Santa Barbara, CA 93110 Editor@populareconomics.com

There is a danger in pushing investors to see higher investment returns, however. Fed Chairman Bernanke gave a surprising speech to the American Economic Association recently that maintained it was regulatory failures that caused the housing bubble, not interest rates being held too low.

But he is only partially right. For it was the record low interest rates of 2004-05 that pushed investors to seek higher yields elsewhere—in unregulated subprime and other Alt-A loan programs of that time. In fact, 24 of the 25 largest issuers of subprime and Alt-A loans in this decade were unregulated financial entities outside the purview of federal regulation, according to Paul Krugman.

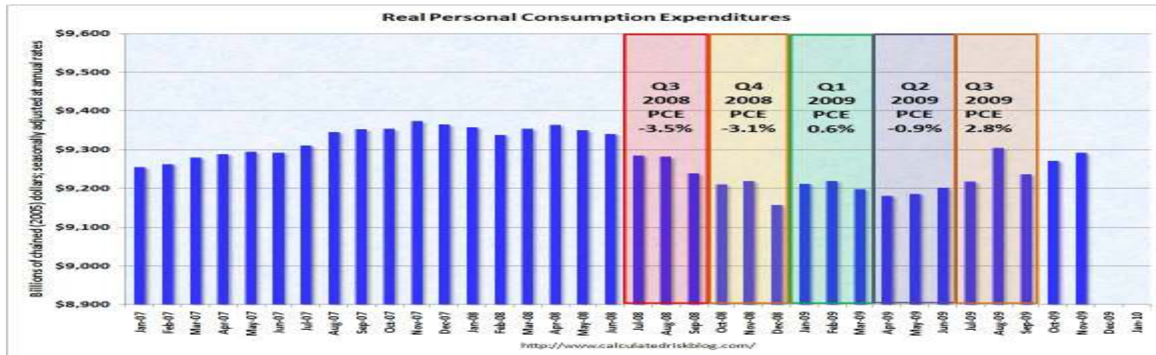
So this could happen again, if regulatory oversight remains weak and the financial sector again finds ways to make money in the "shadow" banking system outside the control of the various regulatory agencies.

In other news, the December unemployment report was surprisingly weak, as payrolls lost another 85,000 jobs. Even government cut back on hiring. The December drop was led by an 81,000 fall in the goods-producing sector which included a 53,000 decline in construction and a 27,000 decrease in manufacturing. The service providing sector dipped 4,000 after a 62,000 gain in November. The largest decreases were in trade & transportation, down 37,000, and in government, down 21,000. The big positive was a 50,000 jobs jump in professional & business services with temp help jumping 47,000. Temp hiring tends to be a leading indicator for overall payrolls.

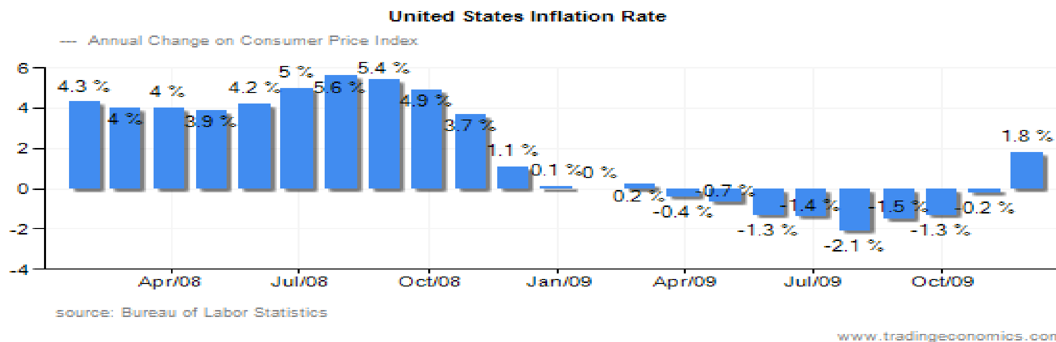


Employers seemed to have misjudged the strength of holiday consumer spending. For about three dozen of the country's biggest chains, sales at established stores actually increased an average of 2.8 percent in December from a year ago, according to the International Council of Shopping Centers (ICSC), a trade group.

Sales for the last two months of the year jumped 1.8 percent, compared with a record 5.6 percent drop in 2008 -- marking the strongest holiday performance in three years. This tallies with the recent increases in wages and salaries that are enabling consumers to both pay down their debts and begin to spend again.



This could mean a 4 percent jump in Q4 Gross Domestic Product growth. But debt hawks shouldn't call for early tightening and removal of stimulus spending, until the unemployment rate declines to a tolerable level.



In fact, historically, there is no real inflation danger with high unemployment. Inflation only rose during the last cycle when the unemployment rate fell below 6 percent. And the severity of this downturn means that won't happen for years.

Harlan Green © 2009