Popular Economics Weekly
*Week of April 9, 2007*
**WHERE IS INFLATION?**

The Fed can't seem to make up its mind. The just released minutes of its March FOMC meeting revealed that it didn't know if the economy was slowing, or inflation rising! The first should mean that consumers are growing more cautious. The latest indications are that consumers are looking for bargains in consumer goods and home buying, which is good for inflation. But with wages and employment rising, consumers also have money to burn and may feel confident enough in their job situation to push up prices.

And so FOMC members in their March meeting were presented with one of the worst case scenarios for central bankers, simultaneous signs that economic growth was on surprising thin ice with inflation gathering an uncomfortable amount of momentum. And so Fed Governors equivocated in the minutes of that meeting, which gives us economists the opportunity to second-guess the Governors.
What were the particular words that set off some red flags to investors? "This combination (of slower growth plus inflation)...suggested increased downside risks to economic growth and greater uncertainty that the expected gradual decline in core inflation would materialize," the minutes stated.

The danger looming over the Fed's shoulders is that old bugaboo of the 1970s called "stagflation". It was an era of large wage increases, with the federal government also in deficit mode and so flooding the markets with excess liquidity at the time of slower economic growth and high unemployment—hence double-digit inflation that wasn't cured until the 1980s after two recessions had passed.

No one wants a reoccurrence, of course. Though what set off the 1970's inflation was the 1973 Arab oil embargo that caused oil prices to skyrocket and gasoline shortages, for those who remember. We still have too-high oil prices but no oil shortages at the moment. This could change, of course, but due to greater energy efficiencies, such shortages would not have the same impact today, say energy experts.
The signs of slowing consumer spending are mainly in retail sales, although March's chainstore sales soared 5.6 percent, but that may have been due to an early Easter. Sales have been in the 3 percent range of late, half of the 6 percent average during the boom years.

This is largely due to falling home and auto sales, (which comprise approx. one-third of retail sales).
Consumers are spending less because their borrowing costs have risen with interest rates, while cheaper home equity loans have been disappearing along with home equity as housing prices fall. The home is no longer a cash cow, in other words.

But the housing slump is also a danger sign for employment, as the construction sector lost 61,000 weather-related jobs in February, but gained back just 56,000 in March. There are many other housing-related trades such as banking, insurance and 'professional services' (architects, surveyors, etc.) that are beginning to slump, also.
During a week of otherwise slower economic growth signs, employment added 180,000 payroll jobs and dropped the unemployment rate to 4.4 percent, which many economists consider an anomaly.

Why? March ISM industrial and services sector indexes declined, the Index of Leading Economic Indicators (LEI) slowed, and consumer confidence has been declining. Add the fact that the National Association of Realtors now predicts that national existing-home prices will actually decline for the first time since it began keeping records—in 1968.

LEI—The Conference Board's index showed a drop in future economic activity, with its
leading index declining 0.5 percent. The leading index has been flat to declining in nine of the last twelve months, not a good sign for future growth. Consumer expectations, a negative yield curve, and higher initial unemployment claims (up to 339,000 in February) were the main culprits.

CONFIDENCE—Both the U. of Michigan and Conference Board sentiment indexes declined in March to the lowest level in 6 months.
"The recent turmoil in financial markets coupled with the run-up in gas prices may have contributed to consumers' heightened sense of uncertainty and concern," said the Conference Board's press release. Inflation expectations did rise from 2.9 to a 3.3 percent annual rate (high) over the next 5 years in the U. of Michigan survey, which has to be worrying Fed officials.

Another important indicator for Fed officials was personal consumption expenditures, which fell to 3 percent in February, while core (PCE)

inflation increased at a 2.3 percent rate, just above the Fed's 2 percent de facto target rate.

Another reason for the consumer slowdown is that real disposable (after inflation and taxes) incomes are rising 2.6 percent, the slowest rise in 7 months, according to CBS Marketwatch. And the personal savings rate is still a negative 1.2 percent. It has now been negative for 22 consecutive months. This means that consumers continue to spend more than they are earning, one more sign that consumers are skating on "thin ice".

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