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WEEK OF MAY 15, 2006—WHY INFLATION?

The Federal Reserve has 2 mandates; to foster growth and combat inflation—should growth exceed certain limits. It is a balancing act, needless to say, that was mandated in the late 1970s after years of stagflation had created both higher unemployment and higher inflation that ate into the incomes of wage earners.

The 1970's stagflation convinced Congress and the Fed that combating inflation was as important as keeping Americans employed. Unfortunately, they used a formula called the Phillips Curve to try to predict incipient inflation. It said that although full employment was a desirable goal of economic policy, too much employment led to too much inflation.

Unfortunately, our new Fed Chairman has only recently discredited the formula that cost countless jobs in the name of fighting inflation. It cost jobs because in fact full employment was never achieved. Anytime the unemployment rate dipped below 6 percent during the 1990s, the Fed under Chairman Greenspan would put on the credit brakes, raising interest rates sometimes precipitously rather than wait for inflation to actually appear.

This was a draconian measure that did lower inflation expectations and helped to give us a 20-year period that Chairman Bernanke maintains was an era of "Great Moderation" with smaller fluctuations in economic activity. What he doesn't mention, though, was the contribution to lower inflation made by the decline in real wages for 80 percent of our workforce that had begun in the 1970s because of the globalization of the work force.

Real wages declined in part due to shrinking labor unions, directly related to the decline in manufacturing and rise of service and white-collar jobs. So the Great Moderation in inflation expectations has been as much a shift in our economy to lower-paying jobs and consequent loss of Labor's bargaining power, as it is to the Fed's vigilance against inflation.

Since the 1970s, then, 80 percent of our workforce has seen no real (after inflation adjusted) increase in incomes, except for a brief period in the late 1990s when the unemployment rate was allowed to dip to 3.9 percent. And since wages make up two-thirds of product costs, it has meant less pressure on producers to raise their prices.

But inflation may be accelerating again. This is not only from sky-high energy prices and a cheaper dollar, but foreign investors as well (rather than rising wages as in the 1970s). Energy prices are rising because of a triple-whammy; the Iraq War (adding $10-15 price premium, according to most analysts), the rising energy demands of developing countries including India and China, and falling value of the dollar.

One reason oil was kept cheap in the 1990s was because of the strong dollar policy of the Clinton Administration and Treasure Secretary Rubin, since we have to pay for oil in dollars. The Bush Administration has reversed that policy as it seeks to right our huge balance of payments problem, now approaching 7 percent of GDP. A cheaper

dollar makes U.S. products more competitive overseas and imports more expensive, thus narrowing the trade gap between imports and exports.

Globalization has therefore become a two-edged sword. On the one hand, freer trade has made goods cheaper, though also causing U.S. jobs to migrate overseas. This has kept a lid on inflation to date (because of lower wages and cheaper imported goods).

On the other hand, foreign money (from our oil and other consumer purchases) has been able to flow freely back into this country. This is one factor that has kept interest rates below historical levels and made the Fed's inflation-fighting job harder. The Fed has not really found a way to shrink a money supply that comes from overseas. And it is excess monies in circulation that causes higher inflation. In fact, the Fed's 16 interest rates hikes since 2004 have really been counterproductive, since higher interest rates have helped to lure more money (hence liquidity) into our banking system from abroad!

So, on balance, such a swiftly changing economy has created a growing income inequality, as only the most educated and affluent (roughly 20 percent of our workforce) have been able to take advantage of the new global economy. The rest of our workforce has had to borrow to maintain a rising standard of living.

And inflation hawks like PIMCO Bond fund's Bill Gross have cried fire in the building. For once the easy credit that has enabled the spending spree (and inflationary pressures) is gone our red-hot economy will be reduced to ashes.

What to do? The growing income inequality brought on my globalization has not only endangered our standard of living by creating a negative savings rate for both private and public (government) sectors, but our social safety net as well. For as global competition heats up, both our private pension system, as well as social security and Medicare are endangered as employers and governments attempt to cut costs and benefits.

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