BET ON THE STEWARDSHIP OF THE FED

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Our experience in the 1970's showed that once inflation takes off, it will feed upon itself. Once this genie escapes, it is hard to put it back in the bottle. So the right policy response to an emerging inflation threat is to be pre-emptive by aggressively tightening in the early stage. The Fed has done just that with their seventeen 25-basis point hikes. Bank economists are even asking for a couple more just to be safe. So why doesn't the Fed take this insurance to protect us against such a malady? Isn't the unit cost of labor accelerating while productivity growth is slowing, fueling inflationary pressures in the future? Can we really bank upon the mild projected slowdown in growth to reverse the rising tide of inflation? This is precisely what Martin Feldstein debated in his August 7th op-ed piece in the Wall Street Journal (WSJ). He was questioning the wisdom of the Fed stopping now when the real interest rate is barely 1% when generally, the economy requires a much higher real rate to tame inflation. Volcker had to go as high as an 8% real rate in 1982 and even the cautious Greenspan went to a 3% real rate in 2000. So why stop now at 1%?

If I buy Feldstein's analysis in its entirety then the conclusion I draw is that we will need more than a hike or two to tame existing inflationary pressures. John Taylor, Stanford professor and former Undersecretary of Treasury, whose work on modern macro-modeling inspired me to pursue this field, also recommended in a July 13th op-ed piece in the WSJ that Bernanke go to at least a 6.5% federal funds rate based on the St. Louis Fed's version of his "Taylor Rule". Add a few more hikes to buy insurance and what is needed is a series of additional rate hikes totaling at least 200-basis points! Scary, isn't it, when you buy into the insurance argument.

I think Feldstein's argument is correct in theory but isn't applicable to the current setting. Inflation in the last 12 months, depending on the price index you choose, ranges from 4.8% (PPI for finished goods) to 2.5% (Core CPI). These numbers at present are definitely outside the comfort zone of the Fed. The PPI inflation rate has been elevated for the past few years and was this high even when the Core inflation rate dropped sharply in 2003 to below 1.2%. This made for a very nervous Fed that worried openly about deflation. Additionally, when Volcker stepped hard on the brakes back in 1981, both the PPI and the Core inflation rates were running above 10%.

The difference now is that we haven't seen much of a pass-through of inflation from PPI to Core. Whether it is due to the lack of pricing power from increased competition or to the nature of this new era is immaterial. However, I seriously doubt that firms are suddenly going to find their lost pricing power of the last decade in the next few months.

What really matters is the evolution of future inflation. There is a general consensus that inflation is a lagging indicator of the business cycle. But the length of the lag is a pertinent question. Empirical estimates range anywhere from as little as one quarter to about eighteen months. If it's a lag of few quarters, then questioning the Fed pause is a moot issue because they are done. But what if it is longer? Then the impact of past hikes needs to be evaluated. This is exactly what Bernanke emphasized in mid-July at the end of his testimony to the Senate. He said:

The lags between policy actions and their effects imply that we must be forward-looking, basing our policy choices on the longer-term outlook for both inflation and economic growth. In formulating that outlook, we must take account of the possible future effects of previous policy actions – that is, of policy effects still "in the pipeline."

That very day he had announced his pause in very clear English, henceforth dubbed as Ben-speak. The era of Greenspeak where we had to read between the lines to figure out what he really meant or didn't mean is over. Seventeen years has taken away one's trust in plain speak (Notice the coincidence….seventeen years, seventeen rate hikes!). However, Greenspan was very good at stage-managing official Fed appearances, whether in person or by his fellow Board members or the regional Fed presidents. This was his modus operandi after the 1994-95 rate hikes when the Fed felt that the market was taken by surprise at the start of their rate hike campaign in early 1994. To avoid repeating this scenario, of which Greenspan was very successful, he would crank up the speech routine before undertaking a major monetary policy change.

Bernanke inherited the hike campaign when it was nearing its probabilistic end. With Fed watchers accustomed to Greenspan's signals, we have a bit of "unlearning" to do. Bernanke is not going to play a saxophone to announce a permanent end to rate hikes. First, he doesn't play that instrument, and second, why pre-commit on rates? Just to make life easy for bank economists, hedge funds, and home equity addicts? That's not his legal mandate. The Fed needs to keep open its option to step in and resume rate hikes if the economy doesn't slow enough by fall to contain inflation. That is why, after acknowledging the inflation risk, the FOMC left the following clause in their August 8th statement:

The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

Given that the FOMC statements are terse due to space constraints, whereas I have the luxury of expounding on arguments, I will visit the issue of what causes inflation to rise. Apart from the fact that it is excess liquidity in the goods market, there has to be something more than too much money chasing too few goods. That relevant factor is inflation expectations and their evolution.

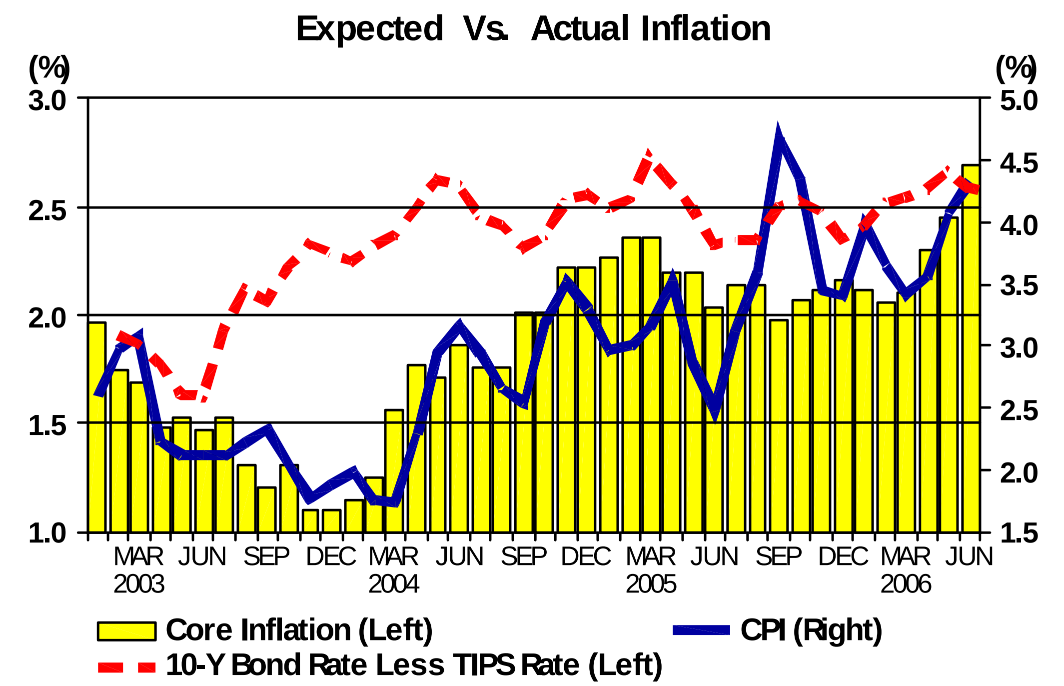
Paul Volcker was brought in to cure the inflation malady that was raging uncontrollably due to a wage-price spiral fueled in part by the Fed's stop-and-go monetary policy of the 1970's. Now, how does a wage-price spiral begin? Let's say my wage increase request today incorporates my expectations of a high inflation rate in the future. If I am granted this request and my wage increase gets financed by passing it on to the consumer in the form of higher prices, then the wage-price inflation spiral has begun. Why? Because my inflation expectations have now come true so in the next round I will ask for more based on my current experience. If the Fed is being accommodative by keeping the printing presses open (figuratively speaking, as the Mint is the preserve of the Treasury), then inflation becomes a self-fulfilling prophecy. Hence, the wage-price spiral requires three ingredients: bargaining or union power at the worker level, pricing power at the firm level and an accommodative Fed ala Arthur Burns that believes inflation is primarily due to one-time non-monetary factors. The last ingredient fortunately doesn't exist now and the other two have very little influence on prices.

Bernanke is very aware of this element and he made pointed comments about inflation expectations in his speech. He said:

The Federal Reserve must guard against the emergence of an inflationary psychology that could impart greater persistence to what would otherwise be a transitory increase in inflation. After rising earlier this year, measures of longer-term inflation expectations, based on surveys and on a comparison of yields on nominal and inflation-indexed government debt, have edged down and remain contained. These developments bear watching, however.

Figure A shows you the 10-year bond rate minus the TIPS rate, a quick and easy proxy for

Figure A



inflation expectations, CPI inflation and the Core inflation rate. Yes, they are higher now compared to early 2003, but look closely at the scale. Inflationary expectations rose from a low 1.6% in early 2003 to 2.6% by summer of 2004, which caused the Fed to begin their rate hike campaign. Since then they have plateaued at 2.6%. If this metric starts to climb again, the Fed will jump back into the arena. And that will only happen if the continuing moderation in housing stops or oil prices crash like they did in 1986, making for boom-like conditions that will then stoke the inflationary fire. I find this to be a very low probability scenario.

Last but not least is the behavior of the consumer in the ensuing months. In early 2005, I was beginning to have some doubts about our vaunted shopper's economic acumen, and I am sure the Fed was worried too. The fed funds rate had been raised by 200 basis points and it had hardly made a dent to the home equity borrowing growth rate, as shown in **figure B** on the next page.

I used to display this graph in my forecast talks to make fun of consumers, calling them home equity junkies because they didn't seem to care about the price of the product they loved so much to consume. Well, patience is a virtue, and finally the expectant moderation is beginning to show clearly. The home equity loan growth rate has finally entered negative territory. The great game of dipping into the housing ATM is finally over, thereby taking the fuel away from consumer spending. And with high energy prices also beginning to cut into people's discretionary spending, it is not too much of a stretch to expect moderation in the economy. Bernanke had this to say on the direction of this wealth effect:

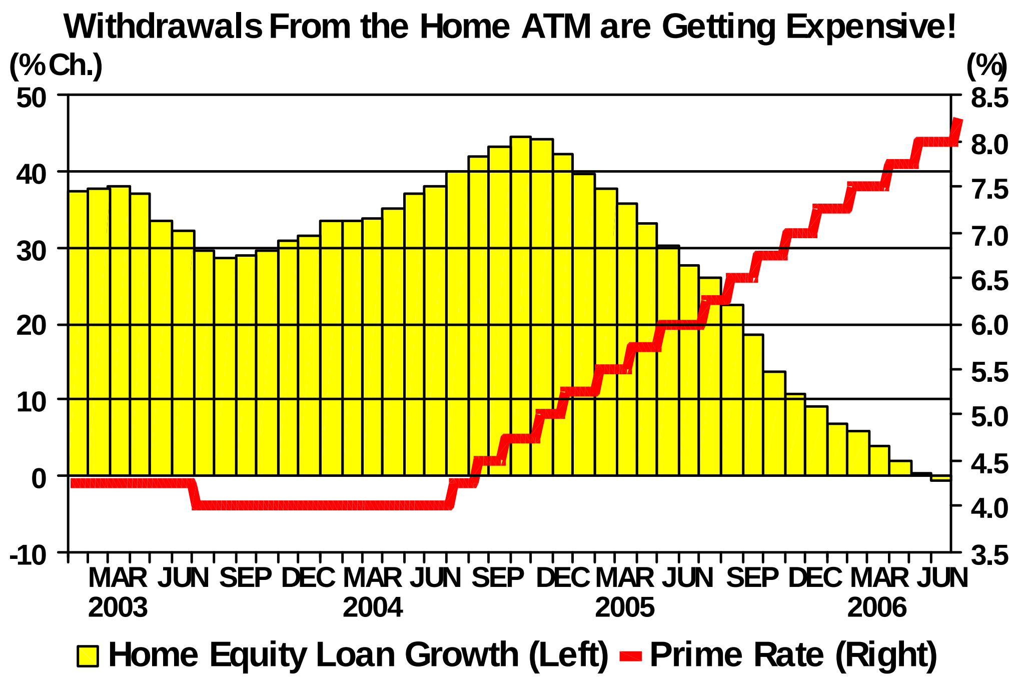
With homeowners no longer experiencing increases in the equity value of their homes at the rapid pace seen in the past few years, and with the recent declines in stock prices, increases in household net worth are likely to provide less of a boost to consumer expenditures than they have in the recent past.

But wait a second Rajeev, what about the impact of rising unit labor costs? This argument is not so easy to dismiss. Bernanke's speech contained his clear thinking on this issue. He said:

Profit margins are currently relatively wide, and the effect of a possible acceleration in compensation on price inflation would thus also depend on the extent to which competitive pressures force firms to reduce margins rather than pass on higher costs.

Businesses will eat up those costs! They lack pricing power and have ample, fat profit mar-

Figure B



Source: Federal Reserve Bank

gins to play with so stop fussing about labor costs that are still under control. The chances of them exploding depends upon labor's bargaining power, which given that only 12% of the work force is unionized, is minimal when compared to the unionization rate of 1960's and 1970's. Now I reproduce another one of those terse but succinct statements from the latest FOMC release to tie up this whole section:

However, inflation pressures seem likely to moderate over time, reflecting contained inflation expectations and the cumulative effects of monetary policy actions and other factors restraining aggregate demand.

By now it should be clear to the reader what these "other" factors are--high oil prices and a moderating housing sector.

Finally, John Taylor had this following two prong advice for Bernanke in his article:

#1 Talk about the evolution of the economy but refrain from doing cartwheels about the future direction of the federal funds rate.

#2 Stick to price stability without muddling it up with the talk of an inflation target.

The first point is nothing but the summary of what you have read in this section about the value of flexibility and keeping options open.

On the second point, I am very sympathetic to Taylor's suggestion. I am also in the camp that thinks talk of inflation targeting can be very constraining for the Fed because it may tie their hands unnecessarily. However, once the current episode is over, and normalcy has returned, then this issue will be tackled. Note that I did not say it <u>needs</u> to be tackled, as this is fait accompli. Didn't he write a whole book on this issue a few years ago? Didn't his coauthor just get nominated to the Board? Didn't I hear Janet Yellen, the president of the San Francisco Fed, give a very deft speech on this issue at the March NABE meetings in D.C.?

The train has left the station and there is a new conductor on board. It's time to hail to the new Sheriff in town!