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Why Does The Fed Want Slower Growth?

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The Fed has raised interest rates six times in the past year to slow the economy in the belief that unemployment is too low. There is scant evidence, however, that low unemployment leads to inflation, that the economy is in danger of overheating, or that higher interest rates will reduce inflation. Instead, the Fed is merely hastening a downturn that will impose huge costs on society's most disadvantaged.

In june, newspaper headlines proclaimed good news all around: Largest employment losses in nine years! Retail sales down again! Home-starts collapsing! Manufacturing output down for third straight month! Debt service burdens up, delinquencies and defaults rising! Even imports are down!

Can we stand any more good news?

The Fed has raised interest rates six times over the past twelve months in an effort to slow economic growth, and mounting evidence shows that the economy has slowed perceptibly in recent months. Though the Federal Open Market Committee threatened to raise interest rates again if robust growth resumes (it chose to leave interest rates alone at its last meeting, June 28), it is likely that growth during the remainder of this year will be sufficiently sluggish to forestall another hike. However, it must be remembered that the Greenspan Fed continued to raise rates in 1989 even as the economy slowed into the last recession.

It is becoming increasingly obvious that the six rate hikes were the result of a colossal misreading of the economy. Inflation was never around some corner or other. The U.S. expansion was self-limiting because it was fueled by unsustainable private sector deficit spending--mostly by households, which were spending more than their incomes by a record amount. Early this year, households began to reduce borrowing and spending, an inevitable retrenchment that the Fed's rate hikes hastened by increasing debt service burdens. While most analysts believe the Fed can engineer a "soft landing" by gradually lowering rates as the economy slows, it is much more likely that we will suffer a Japanese-style "hard landing."

The Fed's Rationale

While the Fed has long been legitimately concerned with the stock market's "irrational exuberance," interest rates were likely not raised to cool equity prices. If anything, concern over effects of high interest rates on Wall Street have moderated Fed rate hikes. I believe Greenspan when he says he is worried about inflation and suspect that rate hikes will be discontinued if the Fed becomes convinced that inflation risks have subsided. This is not to deny that there are other forces pushing the Fed to action. An active Fed is a watched Fed. Since 1989, the Greenspan Fed has changed the fed funds rate 45 times--or an average of once every quarter. Frequent small interventions keep the Fed in the limelight and remind the press that the Fed's chairman is the Second Most Important Man in the World.

The Fed's model runs something like this: Fast aggregate demand growth eventually causes inflation because growth of potential supply is limited to growth of the labor force plus productivity growth. The current expansion has proceeded at an unsustainably high pace and inflation has not yet surfaced only because potential supply was until recently able to keep pace--in part because we began with a large number of unemployed and in part because productivity growth has been well above its post-1973 trend (the New Economy and all that). However, with aggregate demand outstripping supply, we are now living on borrowed time, as evidenced by unemployment rates that remain too low. While there is no strong evidence that inflation

is accelerating, because monetary policy works with a lag, it must be used preemptively. Interest rate hikes reduce borrowing and, thus, spending along a more or less smooth demand curve for loans. Moreover, the effects of a change in the interest rate are largely independent of the state of the economy and more or less proportional to the size of the change, otherwise it would be impossible to predict the effect of rate hikes.

This model has scant empirical support and stands on shaky theoretical ground. While there is probably some loose link between low unemployment rates and growth of wages, there is little reason to believe that low unemployment leads to inflation. Since 1970, every case of rapid acceleration in U.S. inflation has taken place during high unemployment periods. In contrast, low unemployment periods--the 1960s and late 1990s--have been times of robust growth and low inflation.

Inflation in the United States has always been driven by three components of the consumer basket: energy prices, food prices, and, most importantly, imputed housing costs (Papadimitriou and Wray 1996). Note the keyword--imputed. The housing component has a weight exceeding 40 percent of the CPI, but changes in actual housing costs are not accurately measured. That is because the rents the Bureau of Labor Statistics imputes to owner-occupied housing are based on the rents prevailing in the market for rental units; however, the BLS itself admits that rental units are not close substitutes for owner-occupied housing. There is no reason to suppose that these imputed rents vary systematically with tightness in the housing construction market or with anything else the Fed ought to be worried about. Many other important components of the consumer basket (from petroleum products to tobacco to medical care) are largely priced outside markets and are immune to Fed policy. For example, prices may be administered by cartels, influenced by government policy via taxation, or simply imputed by government statisticians. In short, the CPI provides little guidance for the formulation of anti-inflation policy precisely because it does not necessarily tell us much about what is happening in markets.

The notion that low unemployment and rising wages cause inflation has much intuitive appeal, but it ignores supply responses and price constraints. Low unemployment and strong economic growth mean firms operate closer to capacity, hence more efficiently. Firms adopt labor-saving techniques and technology. Labor productivity rises. Cheaper intermediate goods can be imported. Greater sales on a reduced markup allow firms to maintain profits and market share in spite of higher wage costs. Cheap imports, especially in the last two decades, prevent domestic producers from raising prices. Thus, it is not surprising that there is no strong empirical relationship between low unemployment and rising inflation (especially inflation as mismeasured by the CPI). On the contrary, the correlation often goes the other way because low demand pushes firms to operate inefficiently, putting pressure on prices. For these reasons, we cannot rely on low unemployment rates as a predictor of inflation, nor can we be certain that the rate of increase in the CPI actually says much about today's inflation.

Worse than that, the Fed's policy is based on a faulty understanding of the effects of rising interest rates. Interest is a cost imposed throughout the economy, much like an OPEC-induced increase of energy costs, and the initial effect is quite similar--inflationary. Business firms normally finance day-to-day operating expenses through short-term loans; when interest rates rise, their finance costs immediately rise and, to the extent that they are able, they pass these costs along in the form of higher prices. They will also try to cut other costs to compensate for rising interest costs. Their ability to raise prices, meanwhile, is mitigated by competition from foreign firms that are not affected by rising U.S. interest rates. Over the longer run, firms might decide to reduce some kinds of spending, although as long as demand remains high, it is unlikely that spending will be much affected. It is ironic that the Fed stands ready to fight rising wage costs because of their supposed inflationary consequences by raising interest costs, since the latter increase business costs in a much more direct and universal manner than do scattered wage increases.

Contrary to conventional wisdom, there is virtually no empirical evidence that higher interest rates lower investment. This is not surprising, since U.S. firms mostly finance investment with retained earnings (Fazzari 1993). Conventional wisdom also has it that consumers cut back spending on big ticket items as interest rates rise. While there may be a decrease in the origination of new mortgages, it is likely to be small when variable rate mortgages exist as an alternative. What matters to households is the amount of the monthly payment, not the interest rate. If incomes are rising or if debt loads are relatively small, rising interest rates have little effect on household spending. However, if rates rise enough and if households are sufficiently indebted, there is a large effect on household spending, the so-called net income effect. Hence, interest rate effects depend crucially on the debt load--when loads are small, interest rate hikes are inflationary and have little effect on spending, but when households and firms are heavily indebted, rate hikes can result in insolvency and default.

This means that there is no nice smooth credit demand schedule. The process is better understood as one in which interest rate hikes eventually push households to a debt service threshold, which varies depending on debt loads. The credit crunch, when it comes, will be much more severe if the debt load is high because default risk is then higher. As credit quality erodes, banks begin to retrench even as their own balance sheets erode, making recovery much more difficult. In recent decades the heaviest debt service load was reached in the late 1980s, and it is not surprising that the Fed's attempt to engineer a soft landing in 1989 led to a deep and prolonged recession accompanied by a credit crunch that hampered recovery. Although debt service ratios today are slightly lower than those reached at the 1980s peak, this is only because interest rates are lower today (debt ratios are much higher--indeed, they are easily at an all time high). As interest rates rise in coming months, debt service ratios will also rise until many households are no longer able to service their debt. The coming credit crunch could be more severe than that of the early 1990s, making recovery from the coming recession much more difficult.

Why Raising Unemployment to Fight Inflation Is Bad Policy

Greenspan argued in testimony to the Senate Budget Committee on January 21, 1997, that "heightened job insecurity explains a significant part of the restraint on compensation and the consequent muted price inflation." However, he went on to fret that tight labor markets must eventually cause job insecurity to diminish, which would lead to "compensation gains" and thus price inflation. In his testimony on February 26, 1997, before the Senate Committee on Banking, Housing, and Urban Affairs, he made a similar argument, adding that "the relatively modest wage gains we have experienced are a temporary rather than a lasting phenomenon because there is a limit to the value of additional job security people are willing to acquire in exchange for lesser increases in living standards." Accordingly, while wage gains have been small so far, in the presence of low unemployment this cannot last because tight labor markets will embolden workers to demand wage increases.

This old "reserve army of the unemployed" argument holds some appeal, but it is flawed. Monthly movements of the official unemployment rate make good press but provide little information. Most who would like to work do not get counted. Even Greenspan has argued that there are actually 10 million people who would like to get jobs--four million more than the official count (Monetary Policy Report submitted to the Congress on February 17, 2000, pursuant to the Full Employment and Balanced Growth Act of 1978). But that is still too low--the actual number of those who would like to get jobs is closer to 16 million (Pigeon and Wray 1998). If we take Greenspan at his word, something on the order of 10 to 16 million people must be prevented from working in order to keep inflation down. This is particularly disturbing because joblessness is disproportionately visited on the disadvantaged--low skilled, lowly educated, minorities, last-hired-first-fired.

It would be comforting if we could convince the jobless, and ourselves, that while it is a shame that they can't find jobs, their civic duty obliges them to go without jobs in order to keep the employed sufficiently insecure. But that is absurd. Today's jobless are not close substitutes for the highly educated, highly skilled workers that are in short supply. The United States may be facing a shortage of, say, experienced electrical engineers, but that cannot be remedied by raising the unemployment rate of inner-city teens or other disadvantaged groups who are enjoying, despite its shortcomings, the best job market in a generation and a half. Higher employment rates have helped to reverse declining wages at the very bottom of the labor market, but this is not going to spur general inflation. Nor can rising unemployment at the bottom help relieve bottlenecks at the top.

The costs of unemployment far exceed the lost income the unemployed suffer as long spells of joblessness generate large social costs: higher divorce, suicide, crime, and mortality rates (Pigeon and Wray 1999; Harvey 1999). It is a principle of public policy that government should not inflict concentrated burdens on a small subset of the population in order to generate benefits that are widely spread. If unemployment were equally shared across the entire population, it might be acceptable to raise unemployment to fight inflation, the benefits of which would be shared by those who bear the burden. However, until unemployment reaches levels not seen in the United States since the 1930s, it will be concentrated in certain easily identifiable, disadvantaged groups. It is thus not acceptable public policy to use unemployment to keep inflation in check.

Is Inflation Really Around the Corner?

According to the July 18 CPI report, the price of the consumer basket, excluding volatile food and energy

costs, rose by 0.2 percent in June--the same as in both April and May. Over the twelve-month period ending in June, the CPI was up 3.7 percent, although much of that was due to higher oil prices. (While gas prices at the pump have started to come down, energy prices were 21 percent higher than they stood a year earlier.) Excluding volatile food and energy prices, the CPI was up only 2.4 percent for the twelve-month period--approximately where consumer price inflation has remained over much of the Clinton-era expansion. It is interesting that the June index was pulled up by the prices of services, especially increases in shelter costs (a significant portion of which is imputed) and medical care costs, while prices of consumer goods have been absolutely flat for 1999 and 2000.

According to the June 9 PPI report, the index for finished goods prices in May was unchanged. However, if we exclude the large declines in the prices of food and energy, prices rose by 0.2 percent, or something on the order of a 2.5 percent annual rate--similar to the growth in the CPI. As the BLS said in the PPI release, measured inflation for May included "price increases for passenger cars, sanitary papers and health products, book publishing, light motor trucks, cosmetics, and women's apparel," which "outweighed declining prices for prescription drugs, alcoholic beverages, household appliances, passenger car radial tires, and for girls', children's, and infants' apparel." So sanitary paper prices rose while prescription drug prices fell. Is that a clear case that we risk runaway inflation if the Fed doesn't act now? If prices went up significantly across the board, we could probably all agree that there was inflation. But that is almost never the case. In reality, some prices are rising and some are falling, and the CPI and PPI weights these in particular ways. For example, the CPI uses relative weights based on a typical consumer basket whose components have historically been updated every decade or so and, as we move further from the updating, the weights used increasingly misrepresent actual consumption baskets.

The BLS has been sensitive to criticism about possible "biases" that cause the CPI to overstate inflation (the so-called Boskin Commission conservatively estimated the bias at 1.1 percent, although revisions made to BLS methodology are believed to have cut that). But it is not clear that proposed changes have or will improve the CPI for the purposes of formulating monetary policy. As discussed above, many prices are simply imputed, while others are substantially "massaged." In recent years "hedonic models," which attempt to adjust prices to take account of presumed quality changes, have become popular. Beginning this July, the BLS will apply its new hedonic model to refrigerator/freezers, microwave ovens, and college textbooks (the latter, in the case of economics, have fallen so rapidly in value that I no longer use them--I wonder how that is captured in the hedonic model!). At this time, the BLS will not apply hedonic models to washers and dryers, conventional stoves and ovens, or elementary and high school books. It deserves an "A" for effort, but as the BLS strives to obtain some ideal, theoretically correct measure of inflation, it necessarily moves the CPI ever further out of touch with price changes in the real world. It must always be remembered that the CPI and other measures of inflation are constructed indexes that are not designed to capture "market pressures" to which a central bank ought to react. Hence, changes in the CPI that are below 4 or 5 percent should probably be ignored--maybe not even reported--because the noise-to-signal ratio is too high to allow for a satisfactory interpretation. The lower the measured inflation rate, the greater the uncertainty regarding its meaning. A zero inflation target should be dismissed out of hand merely for those reasons.

However, it should be dismissed also because there is no theoretical or empirical justification for believing that moderate inflation is sufficiently costly to warrant concern. Certainly, there is no strong evidence that CPI-measured inflation of 5 percent or even 10 percent has real costs in terms of aggregates like GDP growth, investment, or consumption. Some careful cross-country analysis has shown that inflation rates of even 40 percent have no discernible impact on growth; a very recent study--by economists at the Fed Board of Governors, no less--found that moderate inflation in the United States is actually good for investment and output (Ahmed and Rogers 2000; Bruno and Easterly 1998). Leaving aside the long-term historical evidence, in today's conditions of massive excess industrial capacity all over the globe--especially in low-wage competitor nations--and a strong dollar, it simply is not plausible to argue that the United States faces accelerating inflation.

Finally, even if inflation is around the corner and even if it is costly, it is still not reasonable to combat it by raising unemployment. That is because the benefits of low inflation--if there are any--are presumably shared by the whole society, while the costs of fighting inflation by raising unemployment are borne by specific groups. If inflation is to be fought, it must be done in a manner such that costs are shared by the whole society--ideally by all who share in the benefits of low inflation. Economists are not close to formulating such a policy. Given the current state of knowledge, we should move carefully. In the meantime, empirical evidence for the United States does not support the case for raising unemployment to fight inflation; we have never experienced

accelerating inflation when unemployment was low. It is thus ironic that a quarter century after "fine-tuning" by government policy was rejected, most analysts support frequent, disruptive intervention by the Fed to change interest rates. Would anyone today support quarterly changes to federal tax rates in order to fine-tune the economy?

Raising interest rates to fight inflation is actually a pretty bizarre policy. It is like a tax on borrowing that hits indebted households and firms that use short-term loans to pay day-to-day operating costs. It increases government spending on interest, reducing the current budget surplus and increasing the income of the holders of financial assets. Thus spending by rentiers and the federal government actually rise, at least partially offsetting any reduction in spending by indebted firms and households. This is why interest rate effects must work mostly by causing insolvency and bankruptcy.

Conclusions

It has been clear for some time that the prospects facing the U.S. economy are mostly of the downside variety--and for the most part that is neither the fault of the Fed nor something the Fed can do much about. The stock market boom ended long ago: The Dow and S&P indexes have been essentially flat since last November, while the Nasdaq is down substantially since March. This is not necessarily a bad thing because the U.S. equity market is probably the biggest speculative bubble ever. More important, however, it was the stock market that was supposed to be driving consumption through a "wealth effect" as richer households borrowed against unrealized capital gains to fuel high living. What many fail to recognize is that if the market has "gone horizontal," there are no capital gains to borrow against and consequently the consumption boom should be over. Indeed, recent data indicate that spending trends are down. Projections now have GDP growth at just 4.5 percent for the year, far below the forecasts of only a month ago. Manufacturing output dropped for the third straight month in May, home sales fell significantly in April, and the unemployment rate rose to 4.1 percent in May from 3.9 percent in April. It is true that any employment losses in the private sector had something to do with the competition for workers by the Census Bureau and it is true that the unemployment rate did improve a bit in June. But the private sector's largest employment losses in nine years ought to give one pause.

Many welcome all this bad news. Wall Street temporarily rebounds on any hint that the economy is faltering. The Financial Times heralded the various reports in early June with the headline "Encouraging signs: The figures suggest that the Federal Reserve may finally have raised interest rates enough to slow the U.S. economy" (June 9). Earlier, the Financial Times had reported in another headline that "OECD looks to Fed for sharp rise in interest rates: Big increase is needed by August to avoid global downturn, report claims" (May 31). Not to be left behind, a Wall Street Journal headline on June 5 announced that the "Fed's rate increases seem to have vented the economy's steam." The text of the same story stated that steel industry prices are "softening, while inventories are starting to pile up." The common thread, of course, is the recognition that May fears of overheating were in error. More relevant for our purposes is the common assignment of credit for the slowdown to the Fed's six rate hikes.

In reality, the downturn was inevitable, with or without rate hikes. The basic problem is not monetary policy but a very tight fiscal policy in the context of a large and growing trade deficit. As a consequence of this policy, expansion could proceed only on the basis of unprecedented private sector borrowing. To some extent, this borrowing may have been fueled by the "wealth effect" that was induced by the unsustainable stock market boom. Stagnant wages over most of the past 30 years also made a contribution--households had to borrow in order to attain rising living standards. When the unemployment rate dropped and remained relatively low, consumer confidence rose and record borrowing was encouraged. However, there was little danger that this would overheat the economy. Given worldwide excess capacity and the weak position from which labor can bargain (due to competition from low-wage countries and loss of union power), both wages and prices have been severely constrained.

Further, the boom was self-limiting because fiscal policy had become so biased toward surpluses that low unemployment increased tax revenues, sucking away private sector income. The danger is that even if the economy turns down, the budget will remain in surplus, making recovery difficult. This is what happened in Japan, which maintained a government surplus for six years, even during its painful recession. Nor has maintaining the interest rate at zero for more than four years contributed significantly to an expansion. This ought to give Greenspan's supporters pause when they argue that the Fed can engineer a soft landing. We can only hope that our landing will not be as "soft" as Japan's.

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