

Financial FAQs

When is Inflation a Problem?

By Harlan Green

A recent column by MarketWatch columnist Rex Nutting shows us why inflation won't be a problem for maybe years to come. U.S. businesses have become "world class" in squeezing the most from their existing workforce, rather than hiring more workers. This is in part because of the availability of technology to replace workers, but also a mentality that puts profits (and CEO salaries) first. CEO incomes now average more than 400 times the average worker's salary with stock options and benefits, vs. just 40 times workers' incomes in past decades.

And so labor costs continue to trend downward, which is why inflation is no problem. In 2010, for instance, the first full year of growth after the recession, U.S. total output increased 3.7 percent, reported the Bureau of Labor Statistics reported. But to produce all those extra goods and services,

American workers put in just 0.1 percent more hours on the clock. And so labor productivity increased 3.6 percent.

What did we get for that extra effort, asks Rex Nutting? Just a little extra hay: Wages rose 2 percent, but most of that was inflated away. After adjusting for higher prices, real compensation rose just 0.3 percent. If you earned \$1,000 a week in 2009, you got the equivalent of \$1,003 in 2010, enough for an extra doughnut at the coffee shop.

What is making the deficit hawks nervous is that headline inflation—i.e., overall inflation including food and energy prices—has been steadily rising since July, 2010. This is using the Personal Consumption Expenditure price index, which is the best overall measure of domestic prices. But the core rate without food and energy prices hasn't budged. Why? Because there aren't enough consumers buying the products and services affected by food and energy prices—such as

motor vehicles (though demand for vehicles is rising).

Therefore, the overall inflation trend is still downward, as we said last week. The core rate came in unchanged after edging up 0.1 percent in November. On a year-ago basis, headline PCE prices are up 1.2 percent, compared to 1.1 percent in November. Core inflation eased to 0.7 percent year-on-year versus 0.8 percent in November.

What does this have to do with inflation? Everything, says Nutting. Businesses' costs are the main driver of inflation, and labor is the main cost of doing business. Due to the rapid increase in productivity in 2010 and the pathetic increase in wages, the cost of the

labor needed to produce a ton of steel or a loaf of bread fell by an average of 1.5 percent in 2010 after a 1.6 percent drop in 2009.

So inflation is still way below the Fed's 'implicit' target range of 1.5 to 2 percent. That is why the Fed wants to continue with QE2. Right now, the emphasis has to be on creating jobs, and keeping the inflation rate from falling further. For, falling prices mean lower profits for employers, which mean shedding jobs rather than adding them.

There is some good news on the hiring front, as weekly initial unemployment claims continue downward. In the week ending Feb. 5, the advance figure for seasonally adjusted initial claims was 383,000, a mammoth decrease of 36,000 from the previous

week's revised figure of 419,000. The 4-week moving average was 415,500. It was the lowest weekly claims total since 2008.

The decline in unit labor costs means that businesses aren't being pressured to raise

prices to maintain their profits. In fact, they can cut prices compared with a year earlier and still earn higher profits. They can even afford to give their hard-working employees an extra crumb as a reward.

Most people tend to think inflation comes from higher prices for oil or other commodities, as we said last week. But that's wrong: Inflation isn't an increase in a few prices, but rather it's a general increase in almost all prices across the board. Why don't we

have an inflation problem? Because American businesses are world class at squeezing labor costs — that is, wages, says Mr. Nutting. Unfortunately, the rapid increase in productivity in the American workplace is also keeping millions of willing and able people on the unemployment lines.



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