

WEEK OF AUGUST 7, 2006—INFLATION WORRIES THE FEDERAL RESERVE

The jury is out on whether the Federal Reserve is done tightening credit after their August 8 pause in rate hikes. They left the overnight fed funds rate at 5.25 percent. This means the Prime rate remained at 8.25 percent, which spelled some relief for holders of credit cards and home equity loans that use the Prime as a rate index.

Why is the jury out, when Gross Domestic Product growth slowed to 2.5 percent in Q2 2006, down from a 5.6 percent annual growth rate in Q1, and job growth has slowed drastically? Payroll jobs increased just 112,000 per month in Q2 of this year versus 190,000 per month on average in 2005, excluding the 2 months depressed by hurricanes.

It would seem a no-brainer that with expanding Mideast wars, oil prices closing in on \$80/barrel, the dollar continuing to lose value (and so imports becoming more expensive), and the housing market losing its steam, that the Fed would think about boosting economic growth, not hindering it.

But the FOMC press release that announced the rate pause said inflation is still a problem, to wit:

“Economic growth has moderated from its quite strong pace earlier this year, partly reflecting a gradual cooling of the housing market and the lagged effects of increases in interest rates and energy prices,” said the release. (But) “Readings on core inflation have been elevated in recent months, and the high levels of resource utilization and of the prices of energy and other commodities have the potential to sustain inflation pressures.”

Inflation has been showing up in many ways. Rising energy-gas prices are just one example. Retail prices have risen 4.3 percent in the past 12 months when they were rising just 1 percent 4 years ago. Housing rents and health care costs are also increasing.

The Fed chose to pause anyway because its biggest worry is some kind of sustained slump in housing prices with so many jobs are dependent on real estate. Residential construction has lost 37,000 jobs in the past 5 months, for example, compared with a 200,000 job gain in 2005. This is a major reason for the 250,000 increase in number of unemployed, and rise to 4.8 percent in the July unemployment rate.

So why is inflation on the increase—at the same time that the economy seems to be slowing? CBS Marketwatch economist Irwin Kellner has an answer. The Federal Reserve’s 17 rate hikes over the past 2 years have not succeeded in shrinking the money supply, which is really what controls inflation. The Fed’s “M2” measure of money—the sum of all U.S. checking, savings, and money market accounts, in general—has grown 5 percent in 12 months. It grew just 3 percent 2 years ago, “when monetary policy was supposedly at its loosest,” said Dr. Kellner.

A money supply only shrinks when there is less need (i.e., demand in economic terms) for the money. But neither consumers nor the government have stopped spending, even though they had to borrow money to do so. In fact, the federal budget deficit, tax cuts, and homeowners borrowing against their equity have pumped too much money back

into the economy—at a time when many resources are now being diverted to grow the military. Almost \$4 billion per month is now needed just to fight in Afghanistan and Iraq, for instance.

This is when the Congressional Budget Office in its latest budget update announced that had the Bush tax cuts of 2001-2003 not been enacted, the federal budget would be in balance this year!

“Based on Joint Committee on Taxation estimates, the tax cuts enacted since January 2001 are costing a total of \$258 billion in 2006 (including the increased interest costs of the debt that result from the borrowing that is required to cover the lost revenues),” said the CBO report. “This means that even with the spending for the wars in Iraq and Afghanistan and the response to Hurricane Katrina, the federal budget would essentially be in balance this year if the tax cuts had not been enacted, or if they had been offset by either increases in other taxes or cuts in programs, as would have been required under the Pay-As-You-Go rules that tax-cut proponents first ignored and then allowed to expire.”

This economy is beginning eerily to look like the 1970’s, in other words, when the U.S. grew large budget deficits to finance the Vietnam War while funding the domestic War on Poverty. Could it mean another bout of stagflation around the corner?

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