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THE FED'S UNNECESSARY ASSAULT ON WAGES

By Jeff Faux

The Federal Reserve Board has raised its key interest rate a full percentage point since June 1999, and it has indicated that it will continue to raise rates until economic growth slows down.

It takes a while for interest rate changes to work their way through the economy. But sometime this year, the nation can expect to begin paying the costs. These costs will include:

- an increase in joblessness and a weakening of the bargaining power of low- and middle-income families, whose wages — after being stagnant for most of the 1990s — have been rising in the last several years because of tight labor markets.
- higher housing, consumer credit, and general borrowing costs.
- a worsening of the trade deficit, because raising interests rates will increase the near-term value of the dollar.

According to Fed Chairman Alan Greenspan, these costs are justified by the benefits of slower growth, which will: (1) prevent the current boom from "overheating," i.e., generating politically unacceptable levels of inflation that must then be brought down by engineering a deep recession, and (2) deflate the overpriced stock market, thereby preventing a future crash.

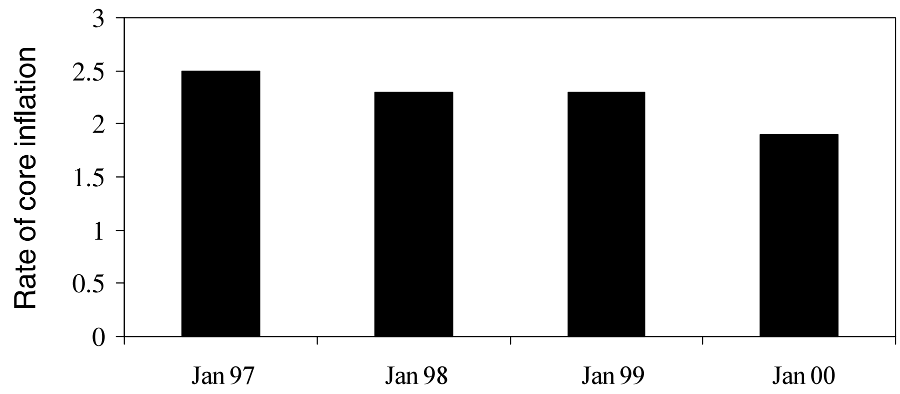
But the slowing of the economy is unnecessary. As Greenspan himself admitted in his February 17 semiannual report to Congress, "inflation has remained largely contained." Moreover, the historical evidence for Greenspan's inflationary scenario is weak. As for an overpriced stock market, the Fed has other policy options with which to deflate it. These realities suggest that the Fed's intervention has been aimed more at preventing wage increases than at preventing inflation.

If anything, lowering, rather than raising, interest rates is a more appropriate monetary policy for the current condition of the economy.

No inflation signals

There are no signs that the economy is approaching close enough to capacity to represent a serious inflationary threat. The latest data show that the January "core" inflation rate — consumer prices other than volatile energy and food prices — rose only 1.9% above the year before, compared with a 2.3% annual increase a year earlier (**Figure 1**).

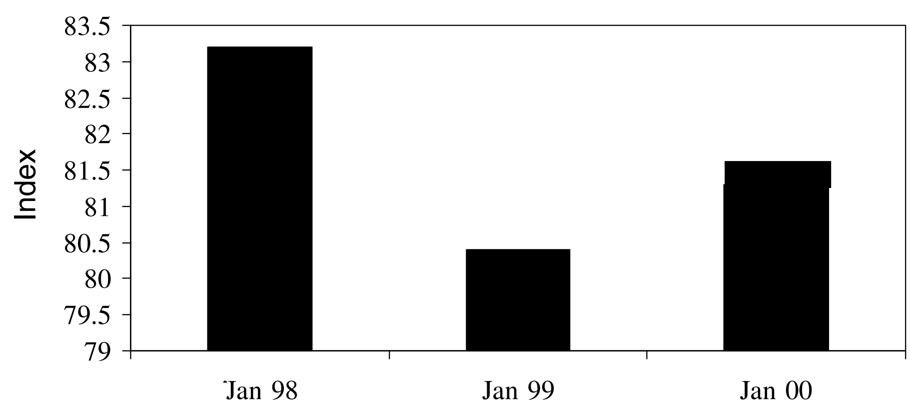
FIGURE 1: YEARLY INCREASE IN CORE INFLATION RATE (1997-2000)



Source: Bureau of Labor Statistics.

Nor is there any evidence that production is threatening to outstrip capacity. The Federal Reserve's own numbers show the capacity utilization rate at 81.6%, substantially below the 85.4% reached in 1988-89, at the peak of the last business cycle (**Figure 2**).

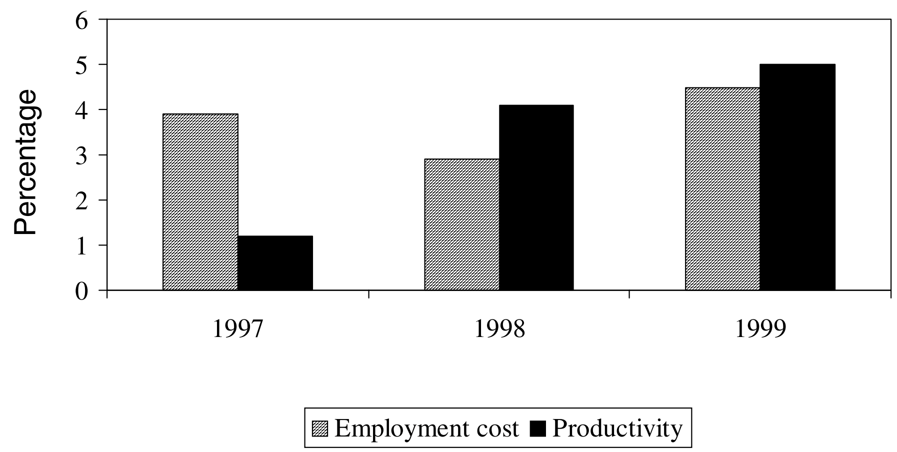
FIGURE 2: CAPACITY UTILIZATION INDEX, 1998-2000 (JAN.)



Source: Board of Governors, U.S. Federal Reserve.

The employment cost index — the statistic said to be most watched by the Fed economists — in the fourth quarter of 1999 was rising at an annual rate of 4.5%. But productivity was rising even faster — by 5% — leaving room in the economy for more noninflationary wage increases (**Figure 3**).

FIGURE 3: ANNUAL RATE OF FOURTH-QUARTER GROWTH IN EMPLOYMENT COST AND PRODUCTIVITY



Source: Bureau of Labor Statistics.

The disappearing NAIRU

It is of course *plausible* that at some point spending could outgrow the economy's capacity to produce, causing prices to accelerate to unacceptable levels. Economists have labeled the unemployment rate below which this inflationary spiral would theoretically ignite as the NAIRU, or the non-accelerating-inflation rate of unemployment.

In the early 1990s, the conventional wisdom among economists, including most at the Federal Reserve, was that the unemployment rate could not go below 6% without triggering an accelerating rate of inflation. The few economists who pointed out that there was little empirical evidence to support this theory and that the economy could achieve noninflationary unemployment rates of 4% or even lower[1] were derided by the profession and ignored by the business media.

The unemployment rate has now been below 6% since September 1994, below 5% since June 1997, and below 4.5% since April 1998. As we have seen, core inflation has not only *not* accelerated, it remains dormant.

The experience has taught us that no one, not even Dr. Greenspan, can calculate the NAIRU beforehand. Moreover, it has discredited the notion that low levels of unemployment will cause wages and prices to accelerate out of control. The NAIRU is revealed as useless as a guide to economic policy.

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[1] The late William Vickery of Columbia University, a Nobel Prize winner, said in 1994 that a 2% unemployment rate was feasible.

The wrong history lesson

Still, the threat of the kind of runaway inflation that caused such economic and political havoc in the 1970s has been enough to stifle objections to the Fed's current strategy, even in an election year.

The inflationary terror with which Greenspan threatens us is a scenario in which rising demand in a peacetime economy bursts through the limits of capacity to set off a wage-price spiral that feeds on itself, becomes politically unacceptable, and compels the government to bring it down by engineering a recession (reducing demand by reducing incomes). But, in fact, since 1914, when the U.S. began to measure consumer prices with a comprehensive index, a demand-driven peacetime economic boom has never generated the kind of inflation with which Greenspan frightens policy makers and the public.

A reasonable definition of "politically unacceptable" inflation is a condition in which rising consumer prices are used by the political opposition to successfully affect the outcome of elections. In this sense, price inflation was a significant national political issue on several 20th century occasions. One was the aftermath of World War I, when war-time inflation continued to increase through 1920. Prices rose 15% that year, and Republican Warren Harding, along with a GOP Congress, was elected on a platform of a "return to normalcy."

The next was 1946, when the end of World War II's price controls saw prices rise at a rate of 8.3% between 1945 and 1946. Rising meat prices were a particular sore spot with the voters, who elected a Republican Congress that November. Interestingly, prices rose at an annual rate of 11.3% over the next two years, but Democrat Harry Truman was still re-elected in 1948.

The next time that rising prices were a significant political issue was in the early 1970s. World oil prices were driven up by an oil-producing cartel, and a series of bad harvests in Russia and elsewhere caused global grain prices to rise as well. Price increases in these sectors then rippled through the U.S. economy. Between 1972 and 1980, consumer prices rose at an annual rate of 8.9%, and for three of those years the increases were in double digits. Political victims included Republican members of Congress decimated in the off-year election in 1974, President Gerald Ford in 1976, and President Jimmy Carter in 1980.

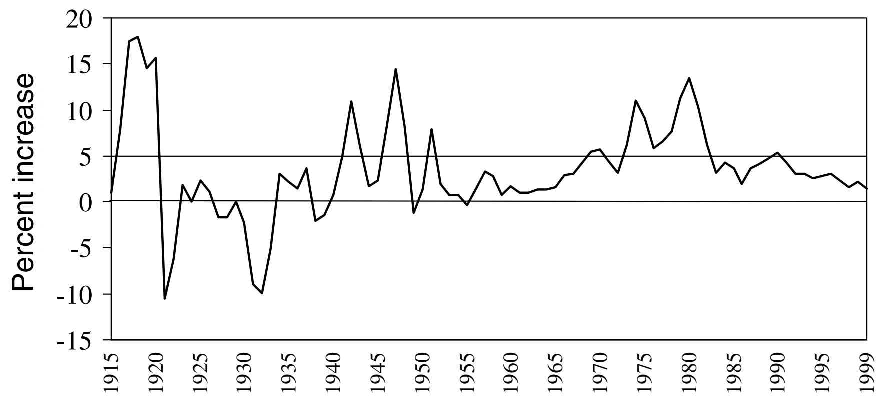
Thus, the general price increases that have reached politically troublesome levels have all involved several years of sustained inflation at rates that at some point reached double digits.

If we take a 5% increase in the consumer price index (CPI) as the point in which prices are moving toward this "politically unacceptable" range, we find that in no case since 1914 did price inflation reach even that level as a result of a peacetime economy growing beyond its capacity to produce. Every time the growth in the consumer price index reached 5%, the cause was exogenous to the domestic economy, i.e., war-related or energy and food price shocks emanating from outside U.S. borders.

Figure 4 shows the history of consumer price changes year-by-year since 1914. Working backward, the brief price spike in 1990 that put the CPI slightly over 5% was a result of a sharp, short run-up in oil prices during the Gulf War. As indicated above, the inflation of the 1970s was not a result of an overheated economy but was generated by world oil and grain price shocks. Nor was the previous bout of inflation in the late 1960s ignited by an insufficiently vigilant Fed; the culprit was Lyndon Johnson's refusal to raise taxes to pay for the Vietnam War. The inflation episode before that was fueled by the Korean War. And, as indicated, the other two bouts of inflation were the products of the 20th century's world wars.

In other words, the memories of inflation that give political support to Greenspan's policy of raising interest rates reflect past experiences that are irrelevant to the present condition of the American economy. In fact, one cannot find in modern history the inflationary scenario from which Greenspan is presumably protecting us.

FIGURE 4: ANNUAL CHANGE IN CONSUMER PRICES, 1915-99



Source: Bureau of Labor Statistics.

Dampening stock market exuberance

Recently, the stock market has been deflating on its own. Still, given the widespread casino mentality that pervades the markets, it is not unreasonable to attempt to bring down values more in line with economic fundamentals, i.e., the growth of employment, incomes, and production.

But it is not reasonable to undercut those economic fundamentals in order to bring down a speculative bubble in the stock market. Instead, the Fed should be trying to achieve balance by contracting the stock market and letting the productive part of the economy expand, gradually substituting *real* for *speculative* value in share prices.

Much of the recent overvaluation of U.S. stock markets has been fueled by excessive credit. The share of "margin debt" to the capitalization of the stock market is now at or above the heights reached just before the 1987 market crash. The ratio of margin debt to the gross domestic product (GDP) is now double what it was at that time.

A number of market observers, including financier George Soros and Stanley Fischer, deputy director at the International Monetary Fund, have recently advocated that the Fed let the air out of this credit boom by raising margin requirements. But Alan Greenspan has consistently refused. When asked about this at his confirmation hearing before the U.S. Senate Banking Committee, Greenspan said that he did not want to discriminate against individuals who were not wealthy enough to have other assets against which to borrow in order to play the stock market. Given that people who use margin leverage to buy stock are typically wealthy by any reasonable standard, this is a rather weak rationale for favoring higher interest rate policies whose costs will largely be felt by lower- and middle-income working people.

To the extent that Greenspan is concerned about irrational exuberance in the stock market, raising margin requirements should certainly be the weapon of choice.

Wages — the Fed's real target

Given the absence of inflationary signals, the lack of historical precedent, and the Fed's disinclination to target the stock market bubble directly, it does not appear that preventing an outbreak of inflation — at least as most Americans would understand the term — is the root motivation behind the Fed's recent interest rate increases. Rather, it seems to be aiming at preventing wage increases.

The Fed's defenders would of course argue that that is exactly how one prevents "wage-price" spirals from taking off. But as economist Jamie Galbraith has pointed out, every episode of accelerating inflation since 1960, with the exception of the lifting of Vietnam-era price controls after Richard Nixon's re-election, were led by prices, not by wages.

The current effort to slow down the economy, therefore, appears to be targeted at weakening the bargaining position of labor vis-à-vis capital. Indeed, throughout this economic expansion of the 1990s, we have seen a shift of market incomes from wages to profits. This shift has been so pronounced that economist Jared Bernstein has calculated that, even if labor costs were to accelerate to rising 1% faster than productivity (as opposed to their current slower growth rate), it would take four years before wages and profits went back to their respective shares in the decade of the 1980s.

It is reasonable to ask the following: if the expansion of profits and the subsequent reallocation of income from labor to capital that occurred throughout the 1990s did not by itself raise inflationary concerns, why should a potential swing back to labor's favor?

The Fed is unlikely to enlighten us. But it is obvious that Federal Reserve Boards have historically considered themselves defenders of the interests of those who invest for a living as opposed to those who work for wages. This one is no exception.

Greenspan deserves some credit for not having cut off this current expansion when the unemployment rate reached what the conventional wisdom assumed were NAIRU limits. On the other hand, he has responded much faster to problems in financial markets than to problems in labor markets. Thus, he was quick to intervene in the economy in the case of the stock market crash of 1987, the Asia financial crisis of 1997, and the Long Term Capital Management debacle of 1998. But he was so slow to react to a rising unemployment rate in the early 1990s that he allowed the economy to fall into a recession.

Greenspan himself has said on several occasions that job insecurity has been a significant factor in limiting labor's earnings during the expansion and thus adding to profits and the profit expectations that have fueled the stock market. From this perspective, raising interest rates to raise the unemployment rate, as opposed to targeting margin requirements, insures that labor's share remains depressed even as the financial markets are forced to undergo a correction.

Keeping the expansion going

The economic policy task now facing the United States is how to keep the current expansion alive by keeping it in balance, e.g., avoiding speculative markets, excessive debt, and high interest rates. This will require careful management by *both* the Federal Reserve and the Administration.

First, at the very least, the Fed should not raise interest rates any further. In fact, the Fed should gradually begin lowering rates to keep probing the economy's limits and to allow the dollar to fall and to make U.S. goods more internationally competitive. If and when signs appear that the domestic economy is overheating and price inflation threatens, there will be plenty of time to raise interest rates (or taxes) to reduce the growth rate.

Second, at the same time, the Fed should use its authority to raise margin requirements. In addition, both the Fed and the Clinton Administration should move to reduce excessive stock market and consumer credit use. Bank regulators should discourage the growing issuance of unsound mortgage lending and home equity loans and impose stricter regulation of credit card companies.

Tightening credit in speculative markets while allowing the rest of the economy to grow will bring more balance to the economy. In particular, it would help to raise real incomes and at the same time help reduce consumer debt, providing more stability and staying power for the household sector that has been the sustaining force for growth over the past decade.

Third, neither the Fed nor the Administration should attempt to slow economic growth if energy prices continue to rise. The lesson from the 1970s is that oil price cartels do not last. It helps that the U.S. economy is less energy intensive than it was in the 1970s and less vulnerable to energy price increases. The president's decision to increase subsidies to help low-income families to cope with temporarily higher heating oil prices was wise. If necessary, the Administration should use national oil reserves to counter any extraordinary short-term surge in prices that threatens to cut off economic growth.

This longest economic expansion in modern history has in the last few years finally begun to bring real income growth to low- and middle-income Americans. Maintaining that growth is essential for America's private sector to remain competitive and its public sector to have the revenues it needs to finance social investment.

The risk of jeopardizing these goals far outweighs any small risk of a sudden and historically unprecedented outbreak of demand-driven inflation.

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