HIGHLIGHTS

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THE CASE FOR RATE HIKES

Did the Fed Prematurely Raise Rates?

L. RANDALL WRAY

The Federal Reserve has done the inevitable. For months, members of the Board of Governors have been warning anyone who would listen that "the federal funds rate cannot be held at its current level indefinitely" and must be raised "at some point to prevent pressures on price inflation from eventually emerging" (Federal Reserve 2004b; 2004c). The recent moves to tighten are only the first steps on an "inevitable" path to higher rates that will be played out over much of the next presidential term of office.

This brief examines the case for rate hikes, focusing on the Fed's two justifications: 1) that because of its repeated warnings that rates would rise, it would lose credibility if it did not raise them; and 2) that labor markets are tightening, a trend that is putting upward pressure on wages. If the Fed has misread prevailing economic forces, it will find itself raising rates to sustain credibility even as the economy deteriorates. And yet, as former Governor Lyle Gramley argues, the Fed must stay the course and continue to raise rates because if policymakers "chicken out at the first sign of weak numbers, that could end up bothering the bond markets" (Andrews 2004). In a display of machismo, the Fed tightened twice, even in the face of continuing downbeat numbers. Few doubt that additional rate hikes will be forthcoming.

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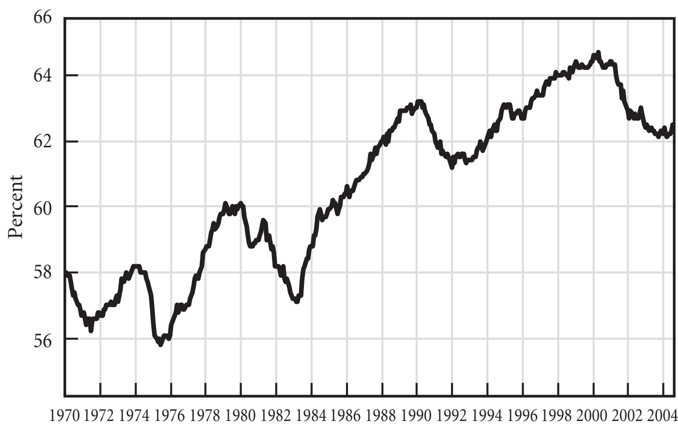
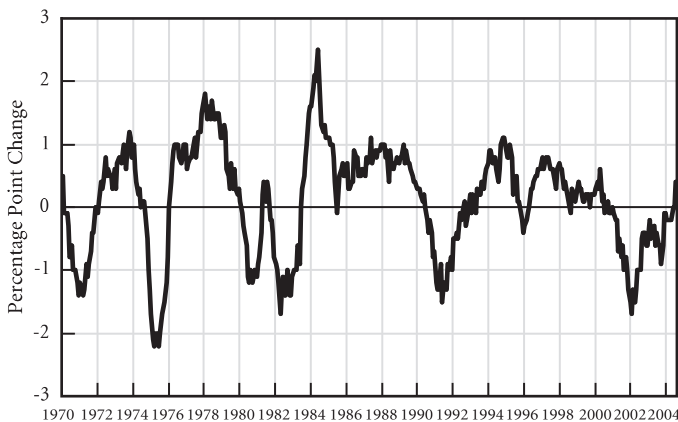
Figure 1 Employment-Population Ratio, 16 Years and Older



Source: Bureau of Labor Statistics (BLS) Series LNS12300000 (BLS data available at: data.bls.gov/cgi-bin.srgate)

Figure 2 12-Month Net Change, Employment-Population Ratio, 16 Years and Older



Source: BLS Series LNS12300000

Are Labor Markets Overheating?

It is no secret that the June and July jobs reports were disappointing, with monthly nonfarm jobs growth falling rapidly to just 32,000 in July. Additionally, April and May estimates were revised downward substantially (BLS 2004). As of midyear 2004, one million fewer Americans held jobs than when President George W. Bush took office. Further, the average hourly wage increased by only 2 percent over the previous 12 months, less than the rate of inflation, which was about 3 percent (Henderson 2004). Such a weak jobs and wages picture certainly does not lend much credence to the view that labor markets are overheating and driving inflation upward. However, optimistic commentators believe that June represents a momentary "blip," and they expect robust employment and economic growth to resume. In this section, we will take a detailed look at the labor market to examine the plausibility of this scenario.

At the end of the Clinton expansion, total employment reached nearly 138 million, with the employment-population ratio (age 16 years and over) peaking at 64.4 percent in 1999, then essentially holding steady into 2001. Between spring 1999 and spring 2000, the Clinton jobs machine was still adding four million new jobs per year—after adding about two million jobs per year for the previous seven years. The index of payrolls (which rises when wages increase and/or when employees are added) was growing at a healthy clip of 6 percent to 7 percent per year, while between 1996 and 2000, the real hourly wages of workers rose by 7.5 percent. The number of those working part-time for economic reasons (workers who wanted, but could not find, full-time jobs) fell continuously over the Clinton boom—from about five million in 1994 to just over three million in mid-1999. By most accounts, the labor market was tight by the end of the decade, though Consumer Price Index (CPI) inflation actually achieved a slightly lower average during the booming last half of the 1990s than it had attained during the more sluggish first half of the decade (see references below figures).

As the figures in this brief demonstrate, all of these labor market indicators worsened rapidly and markedly when the recession hit in 2000. By January 2002, the economy was losing jobs at a pace of 1.5 million per year. Figure 1 shows that the employment-population ratio turned sharply down as workers lost jobs while the population grew.

Further detail is shown in Figure 2, which graphs 12-month net changes to the employment-population ratio. This clearly

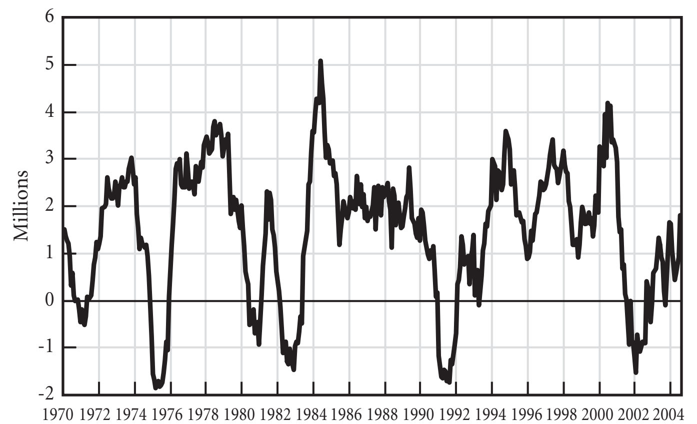
shows growth in all but one year during the Clinton presidency; by contrast, net change turned sharply negative after 2000—and remained negative until July 2004.

After the recession hit, the economy shed jobs at a rapid pace: the nation lost 750,000 agricultural jobs by June 2001, and about 1.5 million nonagricultural, private sector positions by July 2002. (See Figure 3, which shows the net change of nonagricultural, private sector workers.) Further, as shown in Figure 4, the number of workers in part-time jobs for economic reasons rose steadily to 4.8 million in late 2003. Finally, Figure 5 shows the 12-month percent change of the index of private sector payrolls, which turned down sharply during 2000.

The question is whether the jobs picture has recovered from its recession-period trough to the extent that policymakers ought to be worrying about labor market tightness. As of the latest data availability, that case is quite weak. The employment-population ratio is still falling, because jobs growth is not keeping pace with population growth. Indeed, while we were adding jobs at a pace of about 1.6 million per year in December 2003, the pace has fallen to less than a million a year—well under half the pace achieved during the Clinton years. Much of the apparent recovery of labor markets in 2001–2003 was actually due to government hiring, and when that turned around sharply this year, overall job growth dipped, because the private sector is not adding many jobs. Nonagricultural, private sector employment is essentially at midyear 2000 levels; if growth had continued on trend we would have approximately five million more nonagricultural workers in the private sector. In order to provide jobs to all those laid off during the recession and to those who have come of age since 2000 but have not yet found a job, we need to add 325,000 jobs per month for the next year. It was not uncommon to add this many jobs monthly during the Clinton years, but over the Bush recovery, most months have seen fewer than 100,000 jobs added.

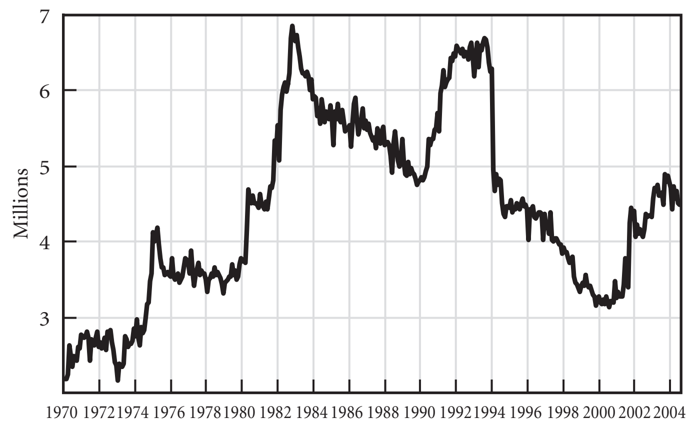
This puts into sharp perspective the claim that labor markets are in danger of overheating. Labor markets may be poised for recovery, but these data indicate that, at best, the economy is in the earliest stages of expansion. And if the past is any guide, we are years away from nearing anything like full employment.

Figure 3 **12-Month Net Change, Nonagricultural, Private Sector Workers**



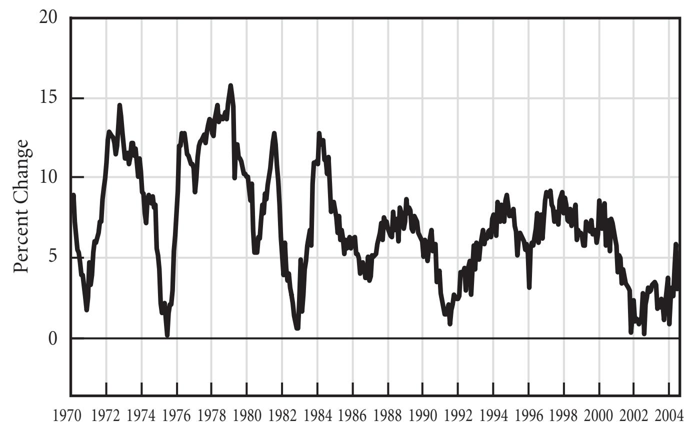
Source: BLS LNU02032189

Figure 4 **Part-time Workers for Economic Reasons, 16 Years and Older**



Source: BLS Series LNS12032194

Figure 5 **12-Month Percent Change, Private Aggregate Weekly Payrolls**



Source: BLS Series CEU0500000045

The Case for Inflation

The conventional view is that economic growth eventually stretches labor markets, which causes wages to rise and ultimately leads to inflationary price hikes. We must be cognizant of the Fed's view that monetary policy operates with long lags, and that once inflation is under way it is very difficult to eradicate. Hence, the conventional view is that the Fed needs to act preemptively against the earliest signs of inflation.

In fact, the Fed has already carefully analyzed the data and repeatedly announced its findings: there is currently no evidence that wage pressures exist, and no evidence that inflationary pressures are building. In his testimony before the Joint Economic Committee on April 21, 2004, Chairman Alan Greenspan said that "although the recent data suggest that the worrisome trend of disinflation presumably has come to an end, still-significant productivity growth and a sizable margin of underutilized resources, to date, have checked any sustained acceleration of the general price level and should continue to do so for a time" (Federal Reserve 2004c). Greenspan believed that job growth could continue without generating wage-price inflation because of labor market slack, productivity growth, and abnormally high profit margins.

Greenspan's views were echoed by Governor Donald Kohn in a June 4, 2004 speech (Federal Reserve 2004b), in which he said "inflation is most likely to remain at levels consistent with a continuation of effective price stability." He said that recent "shocks" to prices (coming in the energy and commodities sectors) were of a "limited nature" and correctly predicted that oil prices would soon moderate. Finally, Governor Kohn wondered why markets had so quickly shifted from worries about deflation to fear of incipient inflation. He attempted to reassure markets that "the economy has not entered a situation of steadily rising inflation."

Remarkably, less than a month later, Chairman Greenspan and Governor Kohn joined the rest of the Federal Open Market Committee (FOMC) in raising rates, as a chorus of voices claimed that the Fed was already "behind the curve" as an inflation fighter. While the proclamations of Fed officials are surprisingly untainted by evidence or argument in support of the belief that inflationary pressures are rising, it is possible that the FOMC knew more than it was willing to reveal, or that the data changed markedly after June 4. Let us examine those possibilities.

Data for the month of June (released in mid-July) on retail sales, factory production, new claims for unemployment benefits, energy prices, and the producer price index painted a uniformly downbeat picture of a slowing economy and moderating price increases. Retail sales actually fell by 1.1 percent, the largest drop in 16 months. Auto sales fell by 4.3 percent, and industrial production dropped by 0.3 percent (*Wall Street Journal* 2004; *New York Times* 2004). Wholesale prices fell by 0.3 percent in June, with gasoline prices falling by 5.2 percent and residential electric power prices declining by a record 2.9 percent over the month (*New York Times* 2004). Presumably, the FOMC had preliminary estimates of all these statistics at hand for its June 30 meeting. Hence, it does not seem likely that the decision to raise rates was based on data confirming price pressures that were not publicly apparent, nor was the decision based on a sudden upsurge of price pressures in June. The Fed must have known on June 30 that, if anything, inflation was moderating.

In short, there appears to be little evidence that the Fed raised rates because of actual or expected, current or future, wage or price inflation. The best case that can be made is that the economy had only just begun to recover and, hence, could finally bear a rate hike. In all likelihood, an expansion strong enough to produce labor market tightness is still years off, according to the Fed's own assessment.

An Alternative View: The Importance of Fiscal Stimulus

For some years, scholars at The Levy Economics Institute have promoted a sectoral-balance approach that emphasizes the necessary relations among the government, private domestic, and foreign sectors (Godley, Izurieta, and Zezza 2004). By an accounting relationship, the current account (foreign) deficit must equal the sum of the government and private sector deficits. According to the Levy Institute view, the Clinton-era expansion was doomed because of the surplus-generated fiscal headwinds, and the subsequent downturn had relatively little to do with the Fed's unnecessary rate hikes. Consumers would have eventually slowed the pace of consumption even if rates had not risen. Private sector saving was hugely negative, and any reversion toward normalcy would have opened a large demand gap. As it happened, recession did come, largely driven by a reduction of spending by firms, which lowered aggregate demand and led to layoffs.

With the recession that began in 2000, the federal budget deficit turned around sharply by a total of about 7 percent of GDP. Between 2000 and 2002, individual income taxes fell by 18.8 percent. Moreover, ramped up government spending, especially on defense, gave a much-needed boost to demand. In 2000, defense spending actually fell by 0.5 percent; in 2001 it grew by 3.9 percent, and then by 7.7 percent in 2002 and by 9.0 percent in 2003 (see table). Federal nondefense spending also grew rapidly, by 7.1 percent in 2002, adding fuel to the recovery. By the second quarter of 2003, federal government defense spending accounted for 1.5 percentage points of the 4.1 percent growth pace of GDP. In other words, growth of defense spending alone made up some 27 percent of economic growth by midyear 2003. Take that away, and the "hot" pace of recovery in 2003 becomes an anemic 2.6 percent growth rate (BEA 2004).

However, the fiscal stimulus coming from the Bush tax cuts plus the increase of spending for the military and for domestic security probably peaked in the last half of 2003. Between the third quarter of 2001 and the third quarter of 2003, personal current taxes fell from $1.11 trillion to $0.95 trillion (seasonally adjusted at annual rates, BEA 2004), and then began to grow quarter by quarter (to $1.03 trillion in the second quarter of 2004). And taxes on corporate income fell at a 23 percent rate in 2001 and at a 10 percent rate in 2002, but rose at a 27.8 percent pace over 2003. Thus, fiscal stimulus began to decline during 2003. Growth of spending for national defense fell sharply from a 10.6 percent pace in the first quarter of 2004 to 1.9 percent by the second quarter (see table). Hence, by a number of measures, fiscal policy has tightened noticeably since midyear 2003.

The apparent reduction of fiscal stimulus has taken its toll on consumption and on real GDP growth, generally, as shown in the table. Real GDP growth declined by a third between the first and second quarters of this year, with personal consumption expenditure growth falling by three-quarters. Motor vehicle sales plummeted, as did farm sales. The Commerce Department reported on July 28 that durable goods orders fell by 2.7 percent in April and by 0.9 percent in May before rising by 0.7 percent in June. However, excluding military orders (especially for aircraft and parts), durable goods orders would have fallen by 0.4 percent in June. The Fed's "beige book," released at the end of July, reported that growth was moderating in several districts, led by slowing consumer spending, and that there was relatively little retail price pressure except in energy products (Federal Reserve 2004a).

Further, the Labor Department reported on July 29 that wage and benefit growth had slowed in the second quarter to just 0.9 percent. Wages rose by only 0.6 percent over the period, the sixth quarter out of the past eight in which wages grew at 0.6 percent or less. Benefit costs climbed by 1.8 percent, down from a 2.4 percent increase in the previous quarter (Associated Press 2004). Overall, excluding energy and food, inflation proceeded at an annual pace of 1.8 percent in the second quarter, down from 2.1 percent in the first.

Greenspan and others have tried to put an optimistic spin on these data, saying they are evidence of a mere "soft patch." The chairman maintained that the economy is in a "self-sustaining expansion that no longer needed the strong monetary stimulus the Fed provided" (Reuters 2004). However, even if recovery does resume, and even if recovery does eventually become an expansion as strong as that achieved in the last half of the 1990s, it is difficult to see why the economy needs higher interest rates now, as fiscal policy tightens.

Table Real GDP Growth, Selected Components

Percent Change from Preceding Year (2000–2003); Seasonally Adjusted at Annual Rate (2004)	2000	2001	2002	2003	2004, Q1	2004, Q2
Real GDP	3.7	0.8	1.9	3.0	4.5	3.0
PCE	4.7	2.5	3.1	3.3	4.1	1.0
Motor Vehicles	-1.8	-4.7	11.6	4.2	8.8	-25.5
Farms	13.7	-8.3	6.5	4.0	-31.3	-21.8
Defense	-0.5	3.9	7.7	9.0	10.6	1.9
Nondefense	3.5	3.9	7.1	2.4	0.2	4.3
State and Local	2.7	3.2	2.8	0.7	0.0	2.1
Government	2.1	3.4	4.4	2.8	2.5	2.3

Source: BEA (2004)
PCE = Personal Consumption Expenditures
Motor Vehicles = Motor Vehicle Output
Farms = Farm Gross Value Added
Defense = Federal Government Defense Spending
Nondefense = Federal Nondefense Spending
State and Local = State and Local Government Spending
Government = Government Consumption and Gross Investment

Conclusion

It is rather easy to make the case that our economy is some four to six million jobs short of achieving the sort of labor market "tightness" that induced the Fed to hike rates at the peak of the Clinton expansion. There is little doubt that the recovery has been weak by historical standards, and there is some possibility that the economy is now "double-dipping," or at least hitting a "soft patch," in the chairman's own words. Hence, the most favorable view of the Fed's recent move to tighten is that it comes several years—or more—before there is any danger of widespread labor market tightening that would threaten wage stability. Further, both political parties plan to try to tighten the fiscal stance further (if possible), and there is certainly no political will to add fiscal stimulus in the near future. If the view held by many scholars at the Levy Institute is correct, the combination of attenuated fiscal stimulus plus rising debt service burdens due to higher interest rates could be deadly. The private sector already appears to be reducing its reliance on borrowing. Add oil-price uncertainty and security concerns to the mix, and it is difficult to make a strong case for preemptive strikes against pay raises that *might* be forthcoming several years down the road *when* we recover all those lost jobs and start creating new ones.

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About the Author

Senior Scholar L. RANDALL WRAY is a professor of economics at the University of Missouri–Kansas City and director of research at the Center for Full Employment and Price Stability. He is working in the areas of monetary policy, employment, and social security. He has used the ideas of the late Hyman P. Minsky to analyze current U.S. economic problems. Wray has published widely in journals and is the author of *Understanding Modern Money: The Key to Full Employment and Price Stability* (Edward Elgar, 1998) and *Money and Credit in Capitalist Economies: The Endogenous Money Approach* (Edward Elgar, 1990). He is also the editor of *Credit and State Theories of Money: The Contributions of A. Mitchell Innes* (Edward Elgar, 2004). He received a B.A. from the University of the Pacific and an M.A. and a Ph.D. from Washington University in St. Louis, where he was a student of Minsky's.

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