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The Fed's Difficult Task

By Martin Feldstein

A soft landing is a natural aspiration for any central bank confronting an unacceptably high rate of inflation. For today's Federal Reserve, that means bringing inflation down to less than 2% without the fall in output and employment that would constitute a recession.

The Fed governors and Reserve Bank presidents appear to believe this will happen. Their "central tendency" economic projections, summarized in the July Monetary Policy Report, state that the Fed's favored measure of inflation, the PCE price index excluding food and energy, will decline from the 2.9% rate in the most recent quarter to between 2% and 2.25% in 2007, presumably on its way to Ben Bernanke's "comfort zone" of 1% to 2% in 2008. They project this to occur with real GDP growing above 3% and the unemployment rate remaining under 5%. Indeed, not a single one of the 19 FOMC members projected growth of less than 2.5% in 2007 or an unemployment rate above 5.25%.

Although this optimistic outlook is possible, experience suggests that it is unlikely. A mild slowing of economic growth is generally not sufficient to reverse rising inflation. That generally requires a sustained period of excess capacity in product and labor markets, with GDP growth falling significantly or even turning negative.

The Fed's projected combination of strong growth and declining inflation requires either a rise in the rate of productivity growth that slows the rise in unit labor costs, or some favorable spontaneous decline of the external drivers of inflation that is unrelated to unit labor costs. Neither seems likely. Productivity growth appears to be slowing, and external drivers are pointing to a continuation of high or rising inflation.

The official estimates of productivity growth showed a gradual decline of productivity growth in the nonfarm business sector from 3.9% in 2003 to 3.4% in 2004 and 2.7% in 2005. The result of the slower productivity growth and rising compensation per hour (from a 4% rate in 2003 to 5.1% in 2005) caused the increase in unit labor costs to accelerate from 1.3% in 2003 to 2.1% in 2004 and 2.8% in 2005. Taking the new GDP estimates into account is likely to lower the calculated productivity growth rates and cause estimated unit labor costs to have risen faster than 3% in the most recent quarter. There is no reason to anticipate a favorable productivity surprise of the type that contained inflation in the 1990s.

The rapid rise in the overall cost of living creates wage pressures that make it harder to limit the rise in unit labor costs. The CPI in June was 4.3% higher than a year ago. Since wages and salaries have not kept pace, real wages were actually declining over the past year. That came to an abrupt end in June when they jumped at a 5.7% rate.

The external drivers of inflation imply that actual inflation is likely to rise even more rapidly than the unit labor cost numbers would otherwise imply. The doubling of the price of oil is being reflected in transportation costs and in the costs of goods that use petrochemical inputs. The gap between the sharp rise in real-estate prices over the past few years and the much smaller rise in rents is now causing a catch-up in rents, and in the implicit rental prices that the government statisticians impute to owner-occupied housing. The decline of the dollar in the past year, and its likely further decline in the year ahead, will boost the prices of imports and of domestic goods that compete in global markets. The expected rate of inflation implied by comparing the yields on Treasury Inflation Protected Securities and ordinary Treasury bonds has increased during the year to 2.6%.

But while a decline in the core inflation rate may not be compatible with the FOMC's "central tendency" growth projections, the interest rate hikes of the past two years could soon cause a significant and sustained economic slowdown, bringing down future inflation without the need for further rate hikes. Although it is too soon to tell, some FOMC members may oppose a rise in the interest rate at tomorrow's meeting because of this possibility, and because of their fear that another rate increase could lead to an unnecessarily deep economic decline.

The published forecasts of the FOMC members do not capture the full range of each individual's views. While stating that the most likely growth is 2.5%, an FOMC member may also believe that there is a risk that the growth and employment picture could be substantially worse than his or her forecast. As Alan Greenspan emphasized, monetary policy is a balancing of risks and cannot be made on the basis of the most likely projections alone.

The consequences of the past interest rate hikes are difficult to predict. The fall in the real level of house prices has caused residential construction to plummet, with housing starts off 14% from 12 months ago. The combination of lower housing wealth and a sharp fall in mortgage refinancing may cause the household saving rate to return to a positive level, bringing down consumer spending. Business expenditures on equipment and software slowed sharply in the most recent quarter. So a much sharper slowdown than the central tendency forecasts is certainly possible.

While this risk provides a rationale for a pause at tomorrow's meeting, it would be wrong to focus just on this downside risk. The probability that inflation will rise above the FOMC forecast is at least as great. The unemployment rate of 4.8% still represents a tight labor market. Waiting for more data before deciding to raise rates is not costless. If the Fed does not act and core inflation continues to rise, expected inflation may rise further. Higher expected inflation would cause faster increases in wages and prices. If the

core PCE inflation rate rises above 3% in 2007, it would take a very substantial slowdown and a large loss of GDP and employment to bring it back under 2%.

In assessing the current interest rate decision, the FOMC members should recall that during the Volcker and Greenspan years the Fed pushed the fed funds rate to 8% above the concurrent rate of CPI inflation in the early 1980s, to 4% in 1989 and to almost 3% in 2000. That measure of the real fed funds rate is now less than 1%.

The Federal Reserve has a difficult task ahead. It is understandable that it would like to achieve the soft landing of low inflation with continued solid growth. But that may not be possible. And if the Fed wants to convince the markets that inflation will be contained in the future, it must show that it is willing to take the risk of tightening too much.

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