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The Case for Rate Hikes: Did the Fed Prematurely Raise Rates?

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The Levy Economics Institute of Bard College

Public Policy Brief

No. 79, 2004

THE CASE FOR RATE HIKES

Did the Fed Prematurely Raise Rates?

L. RANDALL WRAY

Public Policy Brief

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Did the Fed Prematurely Raise Rates?

L. RANDALL WRAY

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Preface

For a time, the Federal Open Market Committee (FOMC) seemed to have learned from the mistakes of the past. Instead of taking good economic performance as a sign of incipient inflation, Chairman Alan Greenspan kept interest rates relatively low in the late 1990s, even as unemployment plummeted. Many commentators worried that the FOMC's unusually easy stance would usher in a period of runaway inflation, but inflation stayed in the 2 to 3 percent range.

Now, with scant evidence of an inflationary threat, Greenspan and his committee seem intent on raising interest rates. Greenspan argues that the current anemic expansion is "self-sustaining" and no longer needs the support of low interest rates.

In this new brief, Levy Institute Senior Scholar L. Randall Wray evaluates the Fed's concern about a coming inflation and its decision to begin raising interest rates. He begins with an examination of key market developments that might signal inflation. Most economists worry about inflation when labor markets begin to tighten and employees gain the bargaining power necessary to demand pay raises. Wray marshals an array of evidence demonstrating that workers can only wish for such conditions. The economy has created no net new jobs since the beginning of the current presidential term. To match the 64.4 percent proportion of adults who held jobs during the Clinton era, the economy would have to generate four million new positions. It is clear that the job market will not be a source of inflation any more than it was during the Clinton boom.

In the absence of any signs of life in labor markets, the main source of inflationary pressure would be rapid energy price hikes. Given increasing demand for fossil fuels and current security threats, the United States is vulnerable to adverse developments in energy markets. But the Federal Reserve has little direct influence over energy prices.

Confusion about interest rates goes beyond undue concern about the threat of inflation. Many observers simply overestimate the power of interest rate policy for good or ill. Much more important to the prospects for economic growth is the state of the sectoral balances, a point emphasized by the Levy Institute's macroeconomic team. These key balances include the current account balance, the government deficit, and the private sector balance. Unless policymakers can find some way to safely bring the economy down from its private-borrowing high wire, monetary policy will not save the day.

In short, there is much to worry about in these times. The FOMC is concerned about the wrong issues and is offering the wrong solutions. I believe this brief makes the case for this view and should be read by all those concerned with macroeconomic policy.

As this brief goes to press, the FOMC has just raised the federal funds rate once more. This increase appears to be as unjustified as the previous two and only increases the chances of a new recession. One could imagine a new brief on the latest rate increase, and it would make most of the same points as this piece. We hope the Fed soon recognizes that the case for rate hikes is weaker than ever.

As always, I welcome your comments.

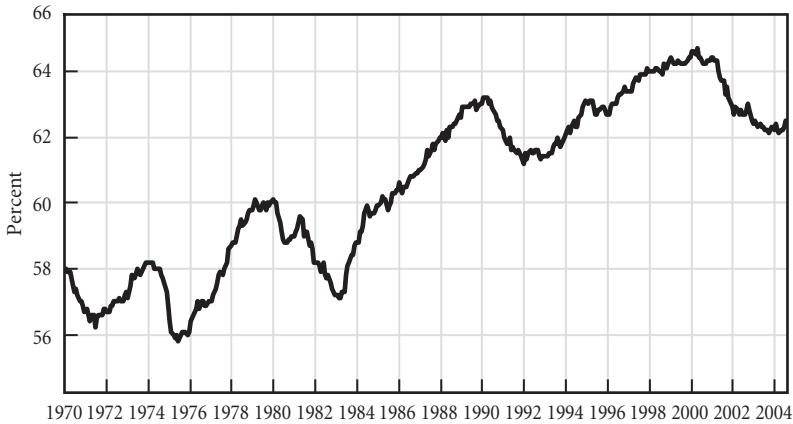
Dimitri B. Papadimitriou, *President*
September 2004

The Case for Rate Hikes

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 2004e; 2004f). Further, as the Fed has firmly embraced what Federal Reserve Board Governor Ben S. Bernanke (Federal Reserve 2004d) calls “gradualism,” according to which policy raises (or lowers) rates in a series of small steps over periods as long as three years, 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.

Searching through the various speeches, testimonies, and press releases that foreshadowed the recent rate hikes, one can identify only two plausible justifications for the policy reversal. The first is the most obvious: the Fed’s credibility had become linked to its repeated warnings that rates would rise; hence, it had to make good on its threat or suffer the fate of the boy who cried “wolf.” While this undoubtedly played a role, it is less than satisfying because the Fed created the expectation that it then needed to fulfill. The Federal Open Market Committee (FOMC) might just as well have preserved the option of discretion by keeping quiet until economic performance created conditions in which it believed policy would have to be reversed. This brings us to the second possible justification, which is the conventional view that robust economic growth tightens labor markets, thereby increasing wage demands and causing inflation. The Fed is supposed to “take away the punch bowl” before the party gets too raucous. Raising interest rate targets purportedly feeds through to rising longer-term market rates, which cools borrowing and spending and loosens up labor markets. The question, then, is whether “accommodative policy” at the Fed threatened to spur inflation.

Figure 1 Employment-Population Ratio, 16 Years and Older



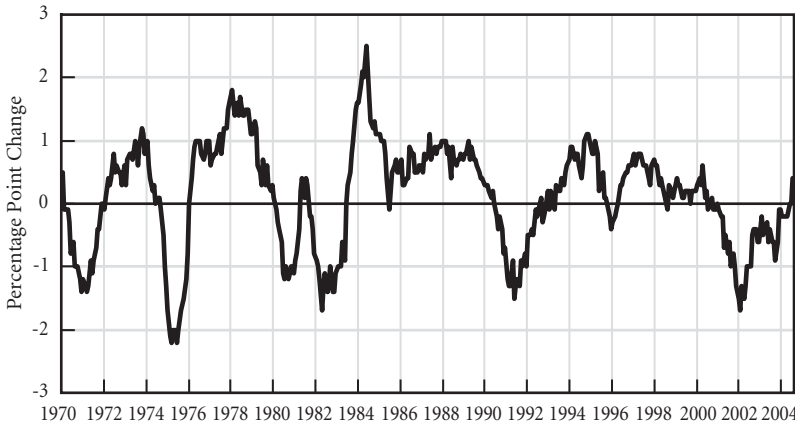
Source: Bureau of Labor Statistics (BLS) Series LNS12300000 (BLS data available at: data.bls.gov/cgi-bin/srgate)

This brief examines the case for rate hikes, focusing on these justifications. If the Fed has misread prevailing economic forces, it will find itself raising rates to sustain credibility even as the economy deteriorates. Such a scenario seems likely because, as we now know, both employment and retail sales data took a sharp turn for the worse during June—even before the Fed first raised rates on June 30. 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 a second time, even in the face of yet more disappointing numbers. Few doubt that additional rate hikes will be forthcoming.

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

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

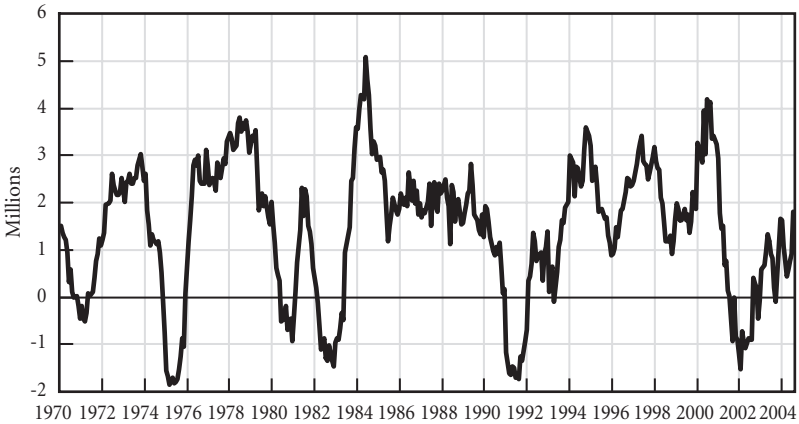


Source: BLS Series LNS12300000

than the rate of inflation, which was about 3 percent. Even overall personal income was flat after adjustments for taxes and inflation (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

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



Source: BLS Series LNU02032189

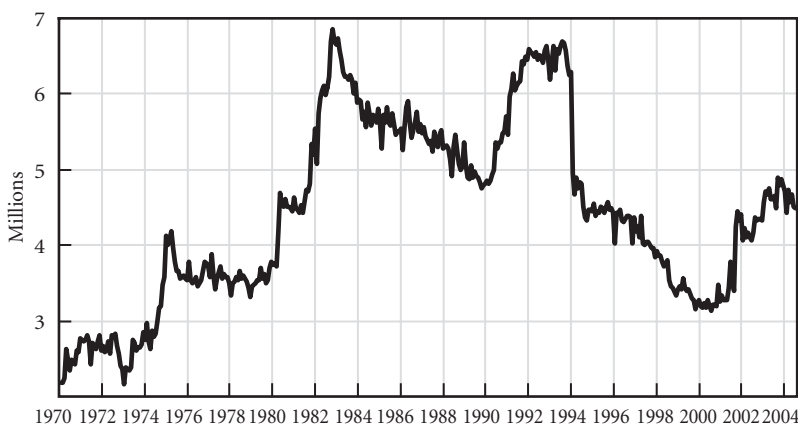
three million in mid-1999. By most accounts, the labor market was tight by the end of the decade, though Consumer Price Index (CPI) inflation actually achieved a slightly lower average during the booming last half of the 1990s than it had attained during the more sluggish first half of the decade.

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.

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.

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



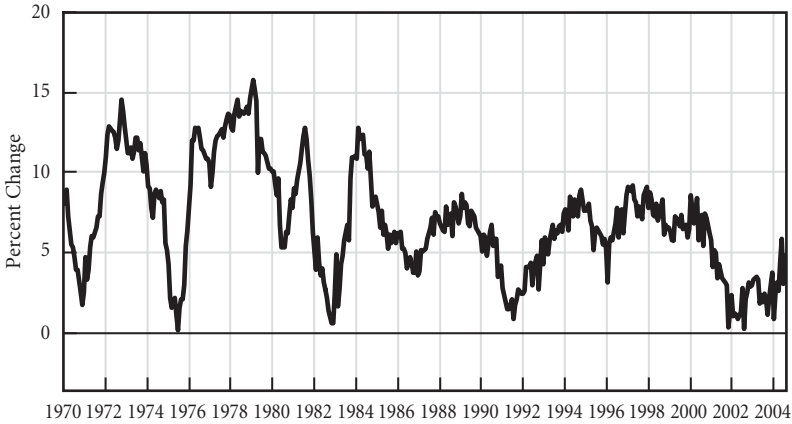
Source: BLS Series LNS12032194

Finally, Figure 5 shows the 12-month percent change of the index of private sector payrolls, which turned down sharply during 2000.

While things have improved somewhat over the past two years, all five figures show rather modest improvement so far. For example, weekly payrolls have been growing since 2002, but that growth is still quite anemic—at 2 to 3 percent—compared with growth rates well above 5 percent for all but one year during the Clinton presidency. Indeed, almost the only bright spot in the labor market is that the number of nonagricultural government employees has actually grown by nearly 1.3 million since bottoming out in August 2001 (see Figure 6).

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. We have gained 100,000 agricultural workers since the trough, but if job growth had continued on trend since 2000, we would have another 850,000 agricultural workers. 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. While the

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



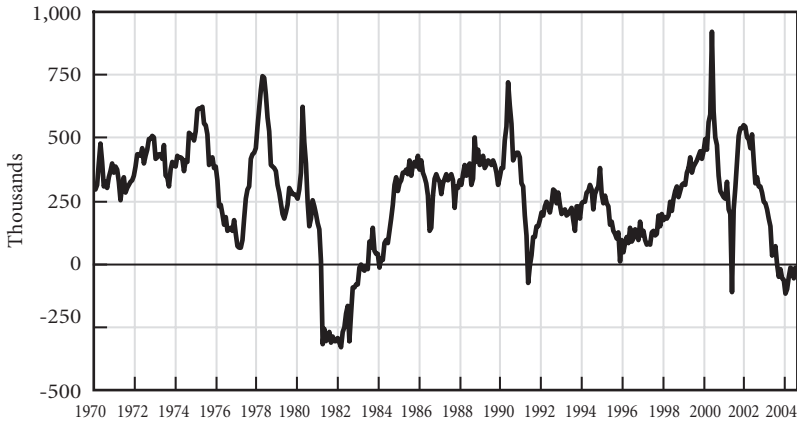
Source: BLS Series CEU0500000045

economy was adding jobs at a pace of about 1.6 million per year in December 2003, this rate had fallen to a million a year (at best) by summer 2004. Again, much of the apparent recovery of labor markets in 2001–2003 was due to government hiring. When that turned around sharply, overall job growth dipped, because the private sector is not adding many jobs.

If we apply the Clinton-era employment-population ratio of 64.4 percent to today’s population of working-age adults, we would have nearly four million more workers today. (If, on the other hand, the employment-population ratio had continued to grow as it did during the Clinton years, we would have more than six million additional workers and an employment-population ratio nearing 66 percent.) In order to bring the employment-population ratio back to 64.4 percent, the economy would have to add 325,000 jobs per month for the next year. Over the longer term, because the population aged 16 and above grows by approximately 3.5 million per year, another 188,000 jobs would have to be created every month to absorb future labor force entrants.

In other words, it is conceivable that we could add half a million jobs a month for the next year without stretching the labor market. This achievement would allow us to provide jobs to a growing population, to those who lost jobs in the recession, and to all those who have come of age

Figure 6 12-Month Net Change, Government Employees



Source: BLS Series CES9000000001

since 2000 but have not been able to find full-time work. After that, we would need to continue to add considerably more than 200,000 jobs per month to accommodate population growth and to allow for slight increases to the employment-population ratio. These are very high goals, indeed. During the Clinton expansion, it was not unusual to add 300,000 jobs per month. During the Bush recovery, most months have seen fewer than 100,000 jobs added. The point is not to argue that we must aim for 500,000 new jobs monthly—which could introduce bottlenecks, especially for skilled workers—but rather to put into perspective the claim that labor markets are in danger of becoming overly tight. Employment would have to grow for many months as rapidly as it did in April and May to make a dent in the backlog of disappointed workers.

Although the current recovery does not compare favorably with the 1990s expansion, one could object that the “New Economy” boom was unusual and set an unattainable standard. However, even casual inspection of the data presented in the figures above reveals that the current recovery has not yet attained the degree of labor market tightness that was common in previous recoveries. As Figure 1 demonstrates, employment-population ratios typically rise by three percentage points or more during expansions; Figure 2 shows that positive changes to that ratio typically persist for many

years as robust growth brings new workers into the labor force. Clearly, the current recovery stands out because we have yet to achieve *any* growth of the ratio, although the rate of decrease of the ratio has fallen. By this measure, there has been no recovery. Figure 3 shows that the Reagan expansion created two million (or more) nonagricultural, private sector jobs per year for eight years, and the Clinton expansion, which exhibited a bit more variability, easily averaged more than two million new jobs for eight years. In contrast, the current recovery looks more like the 1991–93 period—often characterized as a “jobless recovery”—than the Reagan or Clinton expansions. Furthermore, the “recovery” to date has not diminished the number of part-time workers who want full-time work; indeed, this number has risen in most months, as shown in Figure 4. Finally, the payroll index in Figure 5 also shows an unusual weakness when compared with previous expansions. Labor markets may be poised for recovery, according to these data, but the same figures 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.

The experience to date does not look like an expansion at all, much less like the later stages of expansion when wage increases supposedly set off a wage-price spiral. By most measures, the situation looks more like the “double-dip” and “jobless” recovery of Bush senior. From the vantage point of labor markets, we can conclude that the most charitable interpretation of the Fed’s policy change is that it appears to be premature.

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. While empirical evidence in support of such causal connections is rather weak, we can set such doubts aside and look for early evidence of wage and price increases. We must also 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 and with vigilance against the earliest signs of inflation. Let us examine the case for early 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 2004f). He went on to note that profit margins have been remarkably high, a situation he attributed to owners’ reaping of most of the benefits of productivity increases. Even slowing productivity growth or rising wages, should they develop, would not necessarily put pressure on prices, because profits can be reduced to more normal levels. In summary, the chairman predicted that “an easing of profit margins” rather than “an acceleration of prices” is probable.

Governor Donald Kohn echoed his chairman in a June 4, 2004 speech at the National Economists Club, arguing that “inflation is most likely to remain at levels consistent with a continuation of effective price stability” (Federal Reserve 2004e). He also mentioned the extraordinarily high profit margins, asserting that these could “absorb increases in unit labor costs for a while” before there would be any pressure on prices. He carefully examined all the other potential sources of inflationary pressure: (1) capacity utilization rates, which, at only 75 percent, were not a concern; (2) energy and commodity “shocks,” which have been of a “limited nature”; and (3) productivity growth, which “will remain strong on a sustained basis,” mitigating inflation pressures. He concluded that the economy is still operating with considerable slack and appeared to be somewhat puzzled by how quickly the fears of *deflation* morphed into talk of incipient *inflation*: “Had I been speaking to you just a year ago, you would have expected me to address the possibility of *deflation*. . . . In newspapers and in market reports, you would have read that the integration of China and India into the global trading system meant persistent excess supply of labor and products that would place downward pressure on wages and prices in the developed world for years to come. Now the concern has shifted to whether inflation is rising, and those earlier stories are frequently turned on their heads.” He

tried to reassure the audience that “the best indications are that some economic slack persists and that long-term inflation expectations are stable, which bolsters the inference that the economy has not entered a situation of steadily rising inflation.”

Of course, conventional wisdom holds that the Fed must act preemptively, long before inflation becomes a problem. As Governor Kohn noted on June 4, however, surveys of inflation expectations “suggest that the recent uptick in total and core inflation has not materially affected expectations of inflation over the longer term”; rather, the “stability of long-term inflation expectations is evident” in the case of both professional forecasters and households (Federal Reserve 2004e). In other words, market participants seem to agree with Governor Kohn that rising prices in late spring had more to do with temporary “shocks” (especially energy prices) than with pressures on capacity or in labor markets. Further, both Greenspan and Kohn believed that job growth could continue without generating wage-price inflation because of labor market slack, productivity growth, and abnormally high profit margins.

Remarkably, less than a month later, Chairman Greenspan and Governor Kohn joined the rest of the 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, when Governor Kohn gave his speech. 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—just as Governor Kohn had predicted nearly a month earlier.

Further, in his testimony before the Senate on July 20, 2004—after the release of many of the disappointing June figures—Chairman Greenspan insisted that “between the first quarter of 2003 and the first quarter of 2004, all of the 1.1 percent increase in the prices of final goods and services produced in the nonfinancial corporate sector can be attributed to a rise in profit margins rather than rising cost pressures.” He noted that most cost pressures, such as those coming from the energy sector, are transitory, while average hourly earnings of nonsupervisory workers had “barely budged.” He emphasized that “the modest upward path of unit labor costs does not appear to threaten longer-term price stability.” However, he warned that the economy appeared to have attained a “self-sustaining” expansion such that “monetary accommodation” had become “increasingly unnecessary.” In other words, even though the economy had slowed noticeably in June, and there was a lack of evidence that wages were heating up, “monetary policy neutrality” should be restored “at a measured pace” through rate hikes (Federal Reserve 2004g).

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. Clinton’s budget surpluses in the presence of current

account deficits implied large and unsustainable private sector balances. According to this view, the 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. It is probable that the rising interest rates did spook financial markets, with the stock market bust adding some deflationary pressures through its negative impact on consumption. However, consumers would have eventually slowed the pace of consumption anyway. Private sector saving was hugely negative, and any reversion toward normalcy would open 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. As the economy slowed and the Internet-led boom turned to bust, household income fell. Indeed, a recent release by the IRS shows that total adjusted gross income on tax returns fell for two consecutive years (for the first time in the postwar period) by a total of 5.1 percent in nominal terms, or 9.2 percent in inflation-adjusted terms (Johnston 2004).

With the recession that began in 2000, the federal budget turned around sharply by a total of about 7 percent of GDP. Between 2000 and 2002, individual income taxes fell by 18.8 percent—again, an unprecedented postwar decline, and a far bigger decline than the loss of income. The IRS study makes it clear that much of this decline of taxes came at the top of the income distribution (not surprising, as most individual income taxes come from the highly paid; most workers pay more in payroll taxes than in federal income taxes). This is significant because it means that much of the falling tax revenue was due to economic performance rather than to President Bush's tax cuts (the benefits of which did not really kick in until 2003 for the highest income levels). However, 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 2 and related discussion below). Federal nondefense spending also grew rapidly, by 7.1 percent in 2002, adding fuel to the recovery. As we saw above, the number of government employees grew, helping to turn consumer spending around. 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 mid-2003. Take that away, and the “hot” pace of recovery in 2003 becomes an anemic 2.6 percent growth rate (BEA 2004).

Another way of looking at the fiscal stimulus originating from the federal government is through the Bureau of Economic Analysis’s (BEA) quantity indexes, which set real spending equal to 100 for the year 2000 (BEA 2004). The quantity index for GDP reached 109.8 by the second quarter of 2004, meaning real output grew by almost 10 percent over the approximately three and a half years of the Bush presidency. Personal consumption reached an index of 112.2, so it actually grew by more than GDP. By contrast, private investment reached only 104.8, in spite of relatively strong growth of investment in the last few quarters. However, because investment had plummeted to less than 90 in the aftermath of the recession, it was growing from a depressed base. By contrast, the federal government index stood at 124.1 in the second quarter of 2004—meaning federal government spending grew by nearly 25 percent in quantity terms. It is also interesting to note that this strong growth of federal spending is reflected in price indices (BEA 2004). Again using the year 2000 as the base (with all price indices set to 100), the overall GDP price index reached 108.2 in the second quarter of 2004. The price index for personal

Table 1 Price and Quantity Indexes (Base Year 2000=100)

| | 2001 | | 2002 | | 2003 | | 2004, Q2 | |
|---------|----------|--------|----------|--------|----------|--------|----------|--------|
| | Quantity | Price | Quantity | Price | Quantity | Price | Quantity | Price |
| GDP | 100.75 | 102.40 | 102.63 | 104.10 | 105.75 | 106.00 | 109.78 | 108.16 |
| PCE | 102.54 | 102.09 | 105.70 | 103.55 | 109.14 | 105.51 | 112.21 | 107.72 |
| Inv. | 92.10 | 101.01 | 89.93 | 101.22 | 93.85 | 102.30 | 104.78 | 104.43 |
| Gov. | 103.41 | 102.54 | 107.92 | 105.31 | 110.91 | 108.70 | 113.08 | 111.61 |
| Federal | 103.91 | 101.91 | 111.73 | 105.29 | 119.14 | 109.08 | 124.07 | 112.00 |
| State | 103.16 | 102.87 | 106.00 | 105.32 | 106.74 | 108.59 | 107.51 | 111.39 |

Source: BEA (2004)

PCE = Personal Consumption Expenditures

Inv. = Gross Private Domestic Investment

Gov. = Government Consumption and Gross Investment

Federal, State = Federal and State Components of Gov.

consumption reached only 107.7, meaning that consumption prices actually grew more slowly than prices for output as a whole. The investment price index reached only 104.4, which appears to be consistent with sluggish growth of investment spending. However, the federal government price index had risen to 112, far above the general price increases. Thus, both in terms of quantities purchased and prices paid, government spending was leading the way to recovery.

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). Contributions for government social insurance (payroll taxes) grew slowly until mid-2003, after which the pace of growth accelerated. 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 as taxes started to grow rapidly. 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 2). Indeed, the latest figures show national defense spending contributing only 0.09 percentage points to the much lower 3 percent GDP growth rate reported by the BEA on July 30—compared with its contribution of 1.5 percentage points in mid-2003 to the higher 4.1 percent growth rate of that period. Hence, by a number of measures, fiscal policy has tightened noticeably since midyear 2003. This tightening is also reflected in the administration's newest revisions to its budget projections, lowering the anticipated deficit by about \$100 billion.

The apparent reduction of fiscal stimulus has taken its toll on consumption and on real GDP growth, generally, as shown in Table 2. 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

Table 2 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

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). This deceleration is important, because the Fed had previously cited accelerating benefit costs as evidence that labor markets were on an inflationary path. Overall, excluding energy and food, inflation proceeded at an annual pace of just 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.

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. Many have credited the Fed with its swift move to lower rates during the recession that followed, and most have credited the Fed’s accommodative stance for the recovery of the past three years. However, 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. A less sanguine view is that the Fed’s move to tighten is wrongheaded, especially given that the fiscal stimulus appears to have peaked. 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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