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ECONOMIC TALKING POINTS

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Deflation Haunts Fed Policymakers and That Can Be Dangerous

The last revision for third quarter GDP growth was minimal, inching up from 2.5% to a 2.6% rate, largely as a result of higher inventories and more business investments. There was a downward change in the growth of personal consumption expenditures – but even the revised lower amount in spending to 2.4% (from 2.8%) still holds the distinction of being the biggest jump since the first quarter of 2007.

While we can scrutinize third quarter GDP numbers in depth, the fact is it bears little resemblance to the much more lively action seen so far in the final three months of the year. In fact, the third and fourth quarters will prove to be so different, they won't even rhyme.

What does stand out in the last GDP report is the absence of inflation and this appears to worry Fed policymakers. In addition to its stated goal of lowering unemployment, the Federal Reserve is determined to prevent deflation. A persistent fall in the general price level can be highly destructive. Chronically declining prices erodes corporate profits, which leads to more layoffs and eventually a sharp retrenchment in consumer spending. Debts become more costly in real terms and thereby pushes up defaults among individuals and businesses. Furthermore, in a deflationary environment, cash-strapped Americans will

postpone purchases into the future because they expect prices for goods and services will drop even more. It's all a vicious spiral that can condemn an economy to recession and stagnation for decades. Just look at the damage deflation has done to Japan the last two decades.

The Fed's vigilance against deflation is thus understandable. The third quarter GDP revisions probably added to those deflation concerns and emboldened Bernanke's commitment to proceed with QE2. Inflation, as measured by the core (ex- food and energy) personal consumption expenditures price index, rose at a 0.5% annual pace in the summer quarter from the previous period. That's the smallest increase ever recorded by the Federal Reserve since it began tracking this series in 1959.

But does this bring us closer to the precipice deflation? Of course not.

Just how great is the threat of deflation at this stage of the business cycle? The answer? None. Nada. It won't happen.

Let's review some of the economic forces now underway that ultimately makes deflation a virtual impossibility.

- 1. The economy has now been growing for five straight quarters, and it has done so at an average quarterly pace of 3% (2.92% to be exact). In fact, GDP growth over the last four quarters has been the strongest annually seen since early 2005!**
- 2. Consumer expenditures have been accelerating in each of the last four quarters.**
- 3. Business domestic investment has now been climbing at double-digit rates in every one of the last five quarters.**
- 4. This may surprise you. The U.S. economy is currently generating the same output as its previous peak. Yes, we have fully recovered all the ground lost from the recession.**
- 5. Wages are heading higher. The Employment Cost index rose 1.6% over the 12 months ending in the third quarter. The annual pace has been steadily rising the past year. Besides higher wages, employee benefit costs have been surging. It jumped by 2.8% in the third quarter from a year ago, nearly triple the annual pace seen in September 2009.**
- 6. Industrial output is at the highest in more than two years.**

- 7. U.S. industries are using more of their capacity than at anytime since October 2008.**
- 8. Commodity prices have been on a tear this year (especially in the second half of 2010) and, with world economic growth expected to move even faster in 2011, demand for commodities will be even higher. The Thomson Reuters/Jefferies CRB Index of 19 commodities this week climbed to the most since October 2008. The price of gold, silver and copper continue to surge ahead. By the way, copper prices, which are hovering around new highs, are highly correlated with global manufacturing activity. The price of oil just passed the \$90 a barrel mark and it is expected to exceed \$100 a barrel in 2010.**
- 9. US import prices have been rising faster than expected lately. November saw the fastest jump in a year. October's were revised higher. Think it was primarily led by fuel costs? If you take out the fuel component, import prices increased 0.8% in November, the fastest since April 2008.**
- 10. The producer price index has also been accelerating, up 0.8% on November, the most seen since last march. Take out fuel and it was still at a four-month high. For the year, PPI was up a fairly robust 3.5%.**
- 11. Confidence in the economy is improving in every sector. The University of Michigan, the Conference Board, National Federation of Independent Business (representing small and mid-size business), and the Business Roundtable (which surveys CEOs at the largest corporations) --- have all grown more confident about the 2011 economy. All three business size groups (small, medium and large) have reported that more members plan to increase hiring and spending next year.**
- 12. The expanding global economy has boosted US exports to the highest level since May 2008.**
- 13. New orders continue to stream into the manufacturing and services sectors, based on the monthly surveys from the Institute for Supply Management (ISM).**
- 14. The ISM has also reported that prices paid by manufacturers has been climbing for 17 straight months! Service sector firms say their prices have been climbing for 16 consecutive months!**
- 15. Let's not forget today's numbers on November existing home sales, which rose to a fairly impressive 4.68 million unit annual rate, the most seen since last June when buyers were taking advantage of the homebuying tax**

credit.

16. Last, but certainly not least, households have resumed taking on new debt the last two months, after swearing off borrowing for 19 previous months. Moreover, recent Federal Reserve data show that Americans have this month taken on more revolving home equity loans, credit card debt, and personal loans!

Look, we could go on and on with examples why the chance of deflation is miniscule. The retail price index is far more likely to move higher, than lower given the direction of the US and international economy. But by doggedly moving ahead with QE2 and adding more funds to the banking system, the Fed does risk eroding its reputation as the nation's main sentinel against inflation.

That could invite far more serious problems for the central bank later on should investors throw up their hands in disgust and begin to stampede out of bonds. Right now, the Fed's focus on deflation and with QE 2 reminds us of an admonishment from an old Chinese proverb: "It's not practical in the long run to go to bed early to save on candles, when the results are twins."

At the very least, the Fed should put QE 2 on hold a few months to better assess the performance of the economy and inflation

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