

# THE ECONOMIC OUTLOOK GROUP



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## ECONOMIC TALKING POINTS

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### **The Strange Case For Monetary Tightening: The US and the Eurozone**

An increasingly vocal assembly of private and Federal Reserve economists have argued the time has come to raise interest rates, perhaps as much as 75 basis points, this year. The sooner the better, they say. This group points to the recent acceleration of inflation in both the headline and core numbers. For instance, core CPI at 1.1% is the highest in a year. Core PCE stands at 0.9%, the most since last September. A lack of action at this critical stage would fire up inflation expectations among investors and households and undermine the Fed's credibility as the nation's guardian against excessive price increases. The time has come, this group argues, to shift from monetary easing to one of tightening by raising the fed funds rate, or increasing interest on bank reserves, or ramping up term deposits--- or a combination of the three.

A similar discussion has taken place at the European Central Bank. In the last several weeks, ECB officials cautioned that inflation has exceeded the central bank's target of 2% for four months and they have strongly hinted that the benchmark rate needs to be raised to clamp down on consumer prices. The first such increase since July 2008 can occur Thursday.

But let's get real here. Is this the appropriate time to tighten in the US or the Eurozone? No! In fact, the debate itself is peculiar, since both regions have not

yet fully recovered from the financial crisis. Indeed, what's driving inflation higher has absolutely nothing to do with economic dynamics in the US or Europe.

## **A look at the US**

Does it make sense for the Fed to tighten monetary policy with unemployment still close to 9%? With wage inflation non-existent? With industry operating at only 76.3% of capacity (markedly below the 82% threshold that typically ignites inflation)? With housing still comatose? With the economy growing at a subpar 3%? With total construction spending now lower than any time during the last two recessions? With nonfarm productivity rates climbing a respectable 3%? With federal, state, and local government slashing spending by the most we have seen in history?

We certainly don't see a justification for it. Any attempt to tighten at this time will likely do more harm since the economy has become even more wobbly in the aftermath of the geopolitical eruptions in the Middle East and the subsequent jump in oil prices. Raising the fed funds rate would only impose more hardships consumers and businesses. Yields on Treasury securities, for example, would move up and drag other market rates higher, including mortgages, car and personal loans.

Moreover, there is evidence the headwinds of rising energy prices and the violent rebellions across the oil-rich Middle East are already dampening US economic growth.

So much so, economists are starting to lower their forecasts for GDP growth in the first quarter.

Here's why:

- Demand destruction from higher gasoline costs is well underway. Since the beginning of March, gasoline consumption in the US has fallen from 9.19 million barrels a day to, to 8.85 million, a 3.7% decline. This is just the beginning.
- Both the ISM manufacturing and services indexes dropped back last month, with new orders --- a barometer of future activity --- slipping as well!
- Business capital spending has been winding down too. Core (ex-aircraft and defense) durable goods orders dropped 1.3% in February--- and that decline followed a 6% plunge in January.
- Industrial production turned negative in February, with manufacturing output slowing for the second consecutive month.

- As we noted earlier, spending on total construction has now plummeted to the lowest level in more than a decade.
- Real disposable personal income just went negative in the latest month (February), because workers do not have the leverage to demand higher pay in this soft labor market. A jump in interest rates will not make matters easier for households.
- Both monthly consumer confidence measures fell sharply last month. The University of Michigan survey registered the lowest index in more than a year. The Conference Board's index dropped to the lowest of the year.
- New home sales in February was the worst in history!! (Or at least the smallest since the government began tracking this series in 1963.)
- Sales of existing homes turned down as well.

Clearly there is no justification to hit the monetary brakes now? The US economy is not overheating. There is no asset bubble emerging and certainly no excessive leveraging going on. In fact, there is precious little credit entering the private sector.

So the old analogy that the Federal Reserve removes the punch bowl just when the party gets going doesn't apply here because, well, there is no party! There's not even a balloon in site.

### **The Eurozone**

Similarly, there is no urgent reason why the ECB should rush to raise rates.

- Eurozone growth is unlikely to squeak past 1.5% this year.
- Why tighten when Ireland, Portugal, Greece, Italy, Belgium, Spain and others are undertaking fiscal austerity measures that will slow the pace of business activity.
- Key exporters, like Germany and France, will also see foreign demand weaken as the emerging countries stem more serious inflation by cooling their red hot economies.
- Germany's Ifo Business Climate Index, considered a reliable predictor of growth in its economy, fell last month for the first time since May 2010.

- The euro has just climbed to a 14-month high of 1.433 against the dollar. If the ECB were to begin a round of rate hikes, investors would bid up the currency even more and that will further crimp exports.

Regardless of these points, the ECB's trance-like obsession to hammer inflation down from a not quite terrifying 2.6% rate, to the 2% target may end up backfiring on the Eurozone. It threatens to codify the great divide between the healthier economies in the north (ex-Ireland) and the debt encumbered nations in the south.

Convinced that higher rates were on the way, Portugal finally admitted today that it will need a bailout too, thereby joining the ignominious gang of Ireland and Greece.

It seems odd that with the Eurozone still struggling to work through the greatest financial crisis in its history, the ECB appears impervious to the risks posed by making credit more expensive.

**Bottom line:**

Clearly those economies that have been overheating and where consumption is financed by excessive leveraging (such as Brazil and China), tightening credit is the right step to take.

But for the still hobbled economies of Europe and the United States, rising energy costs have already begun to take their toll by reducing consumer and business demand. There simply is no wisdom in commencing a round of interest rates hikes at this time.

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