TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist

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Jobs, Uncertainty and the Fed

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David Gitlitz

Will the Fed fall into the inflationary trap of using monetary policy to deal with non-monetary problems?

On the face of it, Friday's report of a decline of 308,000 in non-farm payrolls in February was a stunner. After several months of apparent labor market stabilization, there's no question that -- in isolation -- the contraction of payrolls last month at the highest rate since the immediate aftermath of the 9/11 terrorist attacks justifies considerable skepticism about the staying power of an already sub-par recovery. These jobs numbers, though, should be viewed in the context of a month marked by brutal winter weather, surging energy prices, heightened terrorism alerts, and rising risk of war in **Iraq**. More likely than not, this employment report overstated the degree of underlying economic weakness.

We have argued that the war-risk premium discounted by the markets is more a matter of irresolution than a fear of military action per se. Still, there's not much question that, one way or another, geopolitical uncertainty is taking a toll on business confidence and, by extension, the willingness of employers to hire labor. But given recent readings from other indicators -- including durable goods orders and the **ISM** manufacturing- and service-sector surveys -- the expansion is continuing, albeit at a somewhat-less-than-vigorous pace.

It's understandable, we suppose, that the initial, knee-jerk response to the jobs data focused on the probability of further **Fed** easing action, with fed funds futures now priced odds-on for a 25 basis point cut by no later than May. The Fed, after all, is widely assumed to control the throttle on all economic activity. If the jobs report indicates the economy is running too slowly with a funds rate of 1.25%, the Fed must need only to cut the rate to 1% -- or maybe 0.75% -- to get it moving faster. In fact, though, the factors currently posing the most significant obstacles to more robust growth are not monetary in nature, and would not likely be amenable to further policy action. For the past four months, the Fed has pursued a decisively anti-deflationary policy orientation, as seen in the 10% reflation of the dollar against gold and the continued softening in the dollar's foreign exchange value. Confirmation that these indicators reflect a monetary posture providing more ample supplies of dollar liquidity is found in data showing the Fed's balance sheet holdings now expanding at a year-over-year rate of about 10.35%, versus 7.5% as of mid-November.

By and large, we have welcomed these developments as reflecting long-overdue relief from an excessive liquidity scarcity. But we first noted in late January that the risk of inflationary overshoot should not be overlooked during this period, and we underscore that again now with signs of economic sluggishness fallaciously interpreted as calling for a monetary policy response. The Fed has a long and unhappy history of responding to non-monetary influences restraining economic activity and, in the process, creating a glut of liquidity that only produces accelerating inflation. One might be tempted to believe that Alan **Greenspan** knows better than to fall into this trap. But, then again, Greenspan has proven over the years that it can be extremely short-sighted to put undue faith in his capacity to avoid seemingly obvious errors. TM

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com

325M Sharon Park Drive #325
Menlo Park CA 94025
Phone 650 429 2112
Fax 650 429 2112

42 Forest Drive
Parsippany NJ 07054
Phone 973 335 5079
Fax 973 402 5074