

MACROCOSM

Healing Old Wounds, Inflicting New Ones

Monday, March 15, 2004

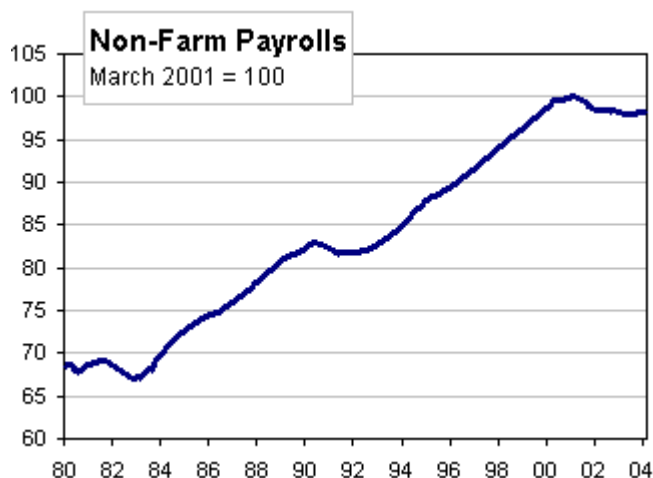
David Gitlitz

A too-tight Fed ended the boom. A too-easy one won't bring it back.

It is now an article of faith that **the Fed** will maintain its hyper-easy 1% overnight rate target until it is persuaded that job growth is strong enough to withstand an inevitable shift into rate-hiking mode. In the wake of the report earlier this month that February payrolls grew by a paltry 21 thousand jobs, tomorrow might even see the **FOMC** scale back its cautious assessment that the labor market is showing tentative signs of life. With the March 5 employment report having already pushed back the expected date of the Fed's first rate hike from August to November, tomorrow's post-meeting announcement could well extend the anticipated initiation of tightening beyond year end.

The developing political climate must also be counted among the mix of factors now bearing on the Fed's decision making process. The central bank's natural inclination to remain as inconspicuous as possible during an election campaign can only be reinforced with the **Democrats** intent on making the "jobless recovery" the rallying cry of their effort to defeat **President Bush** in November.

But while politicians can be expected to seize on any issue they perceive as a vote-getter no matter how thin the substantive rationale, the Fed gets no such pass. If, as seems more and more likely, a period of sharply higher inflation results from the Fed's overstayng an excessively accommodative stance, it will have little recourse to argue that it meant no harm. Fed history is littered with the debris of its failed efforts to manage labor market outcomes under the discredited notion that employment is a phenomenon properly subject to monetary control. Most recently, that brought us the deflationary recession of 2000-2001, precipitated in large measure by the Fed's wrongheaded fixation on the "shrinking pool of available workers" as an inflationary threat.



The result was a massively too-tight policy stance that finally crushed expected returns and sent risk premiums soaring, draining the capital markets of their formerly robust capacity to bear risk. That whipsaw experience, in fact, provides critical context in helping to explain the current sluggishness of payroll growth. The chart at left tracks total non-farm payrolls, indexed to their peak in March 2001. Non-farm payrolls currently are about 1.7% below their peak and on a par with their levels in late 1999. For all

the hand-wringing and finger-pointing over the state of the job market, then, it's worth bearing in mind that payrolls exceeded their current levels only during a relatively brief period now considered notable mostly for its wildly exaggerated expectations for continued elevated returns, virtually free capital, and boundless wealth creation. Indeed, job growth in that period was driven by the same manic expectations environment that produced NASDAQ 5000 and the flood of dot-com IPOs that now have less value than the paper their stock certificates were printed on. As many of the investments -- both real and financial -- supported by expectations that turned out to be illusory turned to dust, so did many of the jobs.

Some of the wounds of that period are taking longer to heal than others. Since around mid-2003, most indicators confirm that the economy has reentered a strong expansion phase, and although the equity markets have shown considerable volatility in recent weeks, the bulk of the gains of the past year are not seriously considered at risk. The balky pace of payroll job growth, however, is paralleled by a similarly uninspiring rebound in inventories. At this point, business inventories are falling well behind their normal pace relative to rising sales, and the reasons are probably similar to those holding down payrolls. After sales growth halted and suddenly turned south in mid- to late-2000, businesses eventually were compelled to liquidate surplus inventories at a record pace. The same could be said of surplus labor, although to a somewhat lesser extent. Once burned, twice shy still seems to be the motto of many cautious business managers, enough at least to restrain the growth of payrolls and inventories.

Even as employer payroll expansion has remained lackluster, meanwhile, sectors of the labor market not covered by the **BLS** establishment survey are exhibiting strong signs of recovery. For one thing, a boom in self-employment and LLC start-ups appears to be underway, an important part of the 1.9 million new jobs captured by the household survey since the recession officially ended in November 2001, as opposed to the 718 thousand net job losses reflected in the establishment data. The Fed, however, ignores this reality -- locked in to the conventional wisdom that denigrates the household data and holds out the payroll survey as akin to holy writ. And in the process of battling against what may turn out to be a phantom employment problem, **Alan Greenspan & Company** appear content to ignore the clear lessons of the central bank's history, which point to the probability of monetary error when the Fed attempts to engineer such real economic outcomes. **TM**