



Anne: "Everything ok with your car now?"

Dana: "Yes, thank goodness. I was worried that my mechanic might try to rip me off, so I was relieved when he told me all I needed was \$12 worth of blinker fluid."

A guy went into an auto parts store and said to the clerk, "Can I get a new gas cap for a Yugo?"

The clerk said, "That seems like a fair trade."

with Nicholas S. Perna, Ph.D., Webster Bank Economic Advisor

Ask the Money Doctor.

Occasionally, I devote an entire issue to answering questions that are on peoples' minds. As you may recall, the "Money Doctor" title was bestowed on me many years ago by my son when he was in kindergarten. For fans of Ray and Tom Magliozzi on NPR's *Car Talk* radio show, this is my version of their "Stump the Chumps" routine.

Q: Why the big ruckus over picking the next Fed chairman?

This is one of the world's most powerful positions. President Obama's first choice, former Treasury Secretary Lawrence Summers, withdrew his name from consideration. He was quite controversial and serious doubts arose that he could be confirmed by the senate.

Janet Yellen now seems to be the most likely appointee. I've known her for years and she'd make a great leader of the Federal Reserve. Janet has strong academic credentials (Yale Ph.D. and U.C. Berkeley faculty member) and has held major positions with the White House and Federal Reserve, the latest being the vice chair under Ben Bernanke.

Yellen is likely to be a gradualist in raising short-term interest rates and winding down Quantitative Easing (QE). And she would also continue many of the practices pioneered by Bernanke, especially greatly increased "transparency" that includes releasing economic forecasts made at the Federal Reserve. She is also likely to enforce regulation of financial institutions, having stressed that inadequate regulation was a major cause of the financial crisis.

Nonetheless, her confirmation hearings could be bumpy. She might seem too liberal to some and too closely identified with Bernanke's approach.

I am reminded of the fascinating experience of Peter Diamond, the MIT professor who had won the Nobel Prize for his work on unemployment and labor markets. He withdrew from consideration for a Federal Reserve governorship in June of 2011. Although

approved by the Senate Banking Committee, he was blocked from a vote by the full senate because – according to one influential senator – Diamond was "an old fashioned, big government Keynesian" and did not have "the appropriate background or experience" in "conducting monetary policy, supervising our financial system, and responding to financial crises." And this was when Washington politics were less partisan!

Q: Does the Federal Reserve really believe that inflation is too low? Prices seem to be going up all the time!

Great question. Overall inflation is actually quite modest, only 1.5 percent over the past year, as measured by the comprehensive Consumer Price Index (CPI) Sure, natural gas is up 5 percent, but food prices rose only 1 percent. And used cars and appliances cost less than a year ago.

Remember, the Federal Reserve has been given two mandates by Congress: price stability and reasonably full employment. The Fed's stated inflation target is around 2 percent as measured by the Personal Consumption Expenditures Deflator (PCED) which is a very close cousin of the CPI and tends to rise about half a point slower. The Fed has also hinted strongly that it considers the unemployment rate at full employment to be in the range of 5 to 6 percent – well below the present level of more than 7 percent.

What the Fed is trying to tell us is that there's room to stimulate the economy to get unemployment down. And with so much slack in the economy, inflation could easily morph into deflation if GDP growth slowed further. Japan's experience over the past couple of decades clearly indicates that deflation is not only bad for the economy, but very difficult to eliminate. This means that the central bank is in no rush to raise interest rates – as seen in its recent decision to refrain from cutting back on bond purchases under the Quantitative Easing program.



Q: Should I worry about the debt ceiling? I fretted the last couple of years but nothing happened as the folks in Washington struck a deal.

Well, it could well be different this time. Without additional borrowing authority, the Treasury will run out of money in mid-October. Not only will it be unable to issue new debt but it will not have the funds to finance all of the spending that Congress has legislated.

Some ultra conservatives in Congress have threatened to vote against raising the borrowing limit unless funding for Obamacare is cut. This could lead to a stalemate and a government default. One really bad scenario is a debt ceiling deadlock combined with an inability of the Senate to confirm President Obama's nominee for the Federal Reserve chairmanship.

While such dire outcomes are possible, I don't think they are likely. Failure to pay U.S. bondholders would cause global economic and financial chaos at precisely the time that the Federal Reserve would be leaderless. This would be political suicide for many elected officials – not just the hard liners.

Q: Why are people worried about currency devaluations in countries like India, Brazil and Indonesia?

Businesses and governments borrowed heavily from foreign lenders and promised to pay the debts back in dollars or euros. Much of this occurred when U.S. interest rates dropped so low that capital flowed to other nations in search of higher returns. The recent rise in U.S. bond yields has made these developing countries less attractive.

As capital flows out, their currencies fall. The Indian rupee has hit new lows, thereby increasing the burden of servicing those debts climbs because it takes more rupees to repay each dollar or euro of debt.

Those huge U.S. borrowings from abroad are in dollars so that the foreign lenders bear the exchange rate risk a falling dollar. However, the U.S. would be hurt by the sharp rise in interest rates that is likely to accompany a steeply depreciating currency.

Back to India and the other developing nations: A declining exchange rate also has its plusses by making their exports more competitive. But it also makes imports more expensive which is a concern for India which imports large amounts of food and energy. Hence, the problem is partly one of timing and magnitude of response: which hits first and how big is the export response.

This is reminiscent of the Asian financial crisis of the late 1990s where Koreans and other borrowed large amounts in dollars and then the lenders started to worry.

Economist Paul Krugman thinks current worries are overdone because exports will rise in these nations. He is much more concerned about China, but for very different reasons. China is a foreign lender and not a borrower. Its problem is the daunting challenge of transitioning from an investment-driven to a consumer-oriented economy. The Chinese must do this because they are running out of cheap labor at the same time that many new investment projects seem to have little or no return.

Q: What's happening to our region?

We're growing, but we seem to be experiencing what the stock market folks call "rotation" in which the relative performance of sectors is shifting. Rhode Island and Connecticut are expanding again while Massachusetts is decelerating a bit. Metro New York continues to do well.

Rhode Island's unemployment rate has fallen from a high of 11 percent to about 9 percent. Employment is gaining, albeit slowly with strength concentrated in financial and business services. Manufacturing jobs are rising as demand for exports increases.

Connecticut has had a very uneven recovery from the Great Recession that ended in mid-2009. During the first two years or so, Connecticut performed in line with the nation. Then it lost steam, only to regain it recently. One caveat: the latest monthly jobs data have been unusually volatile. Through July, employment has risen about 1 percent from 12 months earlier – a bit slower than the nation.

Massachusetts job gains have slowed, but are still decent. The deceleration has been spread across most industry sectors. Unemployment has drifted up a bit to 7 percent.

Metro New York is doing quite well. Jobs have increased more than 2 percent, which is ahead of the nation. Gains are notable in construction, education & health, and leisure & hospitality.

Q: Any final words of wisdom?

The Money Doctor has been reading a book about the long-term decline of the Western economies. It is depressing and I don't agree with many of its arguments. I much prefer Tom and Ray's diagnosis: "The decline of Western Civilization is due to the automatic transmission. That's when we all started to become shiftless."