Musings & Amusings:

Conan O’Brien
The automakers have greatly reduced their number of customer complaints. They did this by greatly reducing their number of customers.

President Obama’s new health care plan is so expensive, Democrats are looking for ways to trim it back... it will only offer coverage for Jon and Kate plus three.

The bad economy is affecting the numbers of available jobs. So many new college graduates are volunteering at a nonprofit organization. These include Chrysler and GM.

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Between Scylla and Charybdis? The highlight of my summer was an unforgettable trip to southern Italy. As we crossed the straits of Messina to go from Sicily to Calabria (my father’s birthplace), I recalled that this was where Greek mythology placed the two monsters that preyed on sailors venturing too close to either shore. For those without a scorecard, Scylla had the six heads and three rows of teeth. Charybdis was the all-powerful whirlpool. (By the way, our crossing was uneventful.)

Some recent exchanges in the media make it seem as if the U.S. economy is, indeed, “between a rock and a hard place.” There are those who contend that the Federal Reserve’s opening of the monetary floodgates to combat the financial meltdown and deep recession will soon lead to rampant inflation. Hence, they urge the Fed to start tightening soon.

On the other hand, there are economists who say that inflation fears are way overblown. The real risk is that a premature tightening by the Fed will abort the soon-to-be recovery and cause a relapse into recession ... or worse. When the time is right, the Fed has the ability to drain reserves that could eventually pose an inflation problem.

The inflation-phobes, such as Arthur Laffer (of Laffer Curve fame) are alarmed by the unprecedented growth of the nation’s monetary base as a result of the Federal Reserve’s massive purchases of government and other securities such as the mortgage-backed variety. Most of the proceeds of these purchases end up as deposits in banks. The monetary base is defined as currency in circulation plus bank reserves on deposit at the Fed. The base is the feedstock for the money supply. It gets multiplied into the money supply through the lending and deposit activities of the banking system. And according to the Monetarist school of economics, the money supply is the ultimate source of inflation.

One of my favorite graduate school professors, Nobel Laureate Robert Solow, once quipped that Milton Friedman (patron saint of the Monetarists) saw money supply in everything.

In his recent Wall Street Journal op-ed, “Get Ready for Inflation and Higher Interest Rates,” Laffer says that the rise in the base is the largest increase in half century by a factor of ten! As this huge pool gets lent out by the banks, it will generate a large rise in the money supply and, therefore, a bout of inflation topping even the 1970s.

At the opposite end of this debate is Nobel Laureate, Princeton professor and New York Times columnist, Paul Krugman. He says that the rise in the monetary base is not alarming, indeed, it is necessary when the economy is caught in a “liquidity trap.” (A liquidity trap is sort of like saying “You can lead a horse to water, but you can’t force him to borrow.”) Such traps occur during deep financial crises when business and financial confidence is very low, such as the 1930s and again in Japan during the 1990s. Krugman argues that when the U.S. during the 1930s and Japan during the 1990s tightened economic policy in the wake of rapidly rising monetary bases, both suffered severe economic relapses that prolonged the malaise.

Wow! This is heavy stuff even for a seasoned economist like myself. Since I update my U.S. forecasts every month (available in the Wall Street Journal), there’s no way I can avoid taking a position on this one. Forecasts simply do not see explosive inflation ahead. Recent surveys of economists expect the Consumer Price Index (CPI) to rise about 2 percent next year.

The reasons for this much more comforting outlook are numerous. For starters, with the U.S. unemployment rate likely to top 10 percent and stay elevated for some time, there’s little potential for large wage increases. Labor costs are two-thirds of economy-wide costs and much more important than raw materials prices, including the cost of oil. Plus, the global recession means there’s plenty of excess capacity around the world.
Furthermore, the connection between monetary base growth and inflation is very tenuous, especially during times of acute financial stress. Krugman has pointed out that double digit base growth during the 1930s Depression in the U.S. and the 1990s “lost decade” in Japan was associated with falling prices, i.e., deflation and not inflation. And while the money supply-inflation connection is true in the long run, there’s plenty of slippage when we’re talking about years rather than decades.

Finally, the financial markets that would be highly affected by inflation seem to be dismissing the alarmists. This is best seen in the spread between TIPS (Treasury Inflation-Protected Securities) and the familiar Treasury coupon bond. As we’ve mentioned a number of times, holders of TIPS are fully compensated for future increases in the CPI while those who own coupon bonds are not. Hence, changes in the spread between the two yields are a decent gauge of what’s happening to inflation expectations. The table shows that the spread has not widened. Indeed it has fallen over the past year, suggesting a long term inflation expectation of around 2 percent.

### 10 Year Treasury Note Yields (%)

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<th>6/08</th>
<th>12/08</th>
<th>6/09</th>
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<tr>
<td>Coupon Note</td>
<td>5.10</td>
<td>4.10</td>
<td>2.42</td>
<td>3.74</td>
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<tr>
<td>Minus: TIPS</td>
<td>2.69</td>
<td>1.63</td>
<td>2.17</td>
<td>1.87</td>
</tr>
<tr>
<td>= Expected Inflation</td>
<td>2.41</td>
<td>2.47</td>
<td>.25</td>
<td>1.87</td>
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What made the spread get so narrow last December? There was probably some fear of deflation, but I think the main reason was that financial markets under great stress, investors were fleeing to the safest, most liquid instruments they could find. These are U.S. Treasury coupon bonds. TIPS are equally safe from default, but less liquid since the TIPS market is much newer and smaller.

So how can you protect yourself if I’m wrong and inflation does return? One strategy to explore is purchasing TIPS, which give you 100 percent protection from future increases in the CPI. If you bought 10-year TIPS in June, you’d be paid a real annual yield 1.9 percent. In addition, the value of the bond would be increased automatically by the rise in the CPI. The inflation adjustment is paid when you sell the bond or when it matures.

You should seek advice from your professional financial advisor to see how TIPS might fit your circumstances. It should be noted that if held in a taxable account, federal income taxes are due annually on the inflation adjustment to the principal even though that portion of the return isn’t paid until you sell or redeem the bond.

**Region: glimmers of hope?** During some of the rainiest weather in memory, there was a silver lining in one of the clouds that covered the region. According to the government statisticians, jobs rose during May in both Massachusetts and Connecticut, the first improvement since early last year. In the several prior months, the declines seemed to be getting smaller. Unfortunately, jobs are still declining at a fairly rapid pace in Rhode Island.

Does this mean the recession is over in the region? Most likely not. The jobs rise doesn’t seem sustainable because of several factors. The housing sector has not yet begun to turn around. And there’s more economic drag in store from the spending cuts and tax hikes being implemented to balance state budgets for the fiscal year that started on July 1.

However, the May data are a good sign that the worst of the recession is behind us and that the employment declines are getting smaller. This view is consistent with the most recent forecasts from the New England Economic Partnership (NEEP), which is a non-profit consortium of academics, public institutions and private businesses that has been issuing twice-yearly regional forecasts for more than two decades.

NEEP has predicted that the rate of employment decline would slow right around now and that seems to be happening. However, NEEP doesn’t believe the slide will end until the second quarter of next year. That might be a bit pessimistic. As with the national economy, regional GDP is expected to start rising before jobs do.

Of course, the region depends very heavily on national and global economic developments. There’s still enough uncertainty that we could be sucked into Charybdis’ vortex or devoured by one of Scylla’s many mouths.