Global Economic Solutions

Borders Create Opportunities

IT'S INFLATION STUPID!

Marc A. Miles, Ph.D.

A Report Prepared for

American Principles Project

Washington, DC

April 2013

It’s Inflation Stupid!

Marc A. Miles, Ph.D.

EXECUTIVE SUMMARY

There is a disconnect between the concerns of voters and policy focus of politicians. Exit polls from last November and a recent Ohio focus group show the average American is concerned primarily with inflation and unemployment, while Congress and the President focus on the current fiscal year federal deficit. This paper illustrates what the policy discussions are missing.

The conclusions are that:

- Inflation is a real phenomenon for Americans.
- The apparent low rate of overall inflation is really the interaction of two negatives that simultaneously squeeze voters – the price rise in everyday purchases like food, clothing, transportation and medical care and the fall in value of the average American’s main asset, housing.
- The Federal Reserve is therefore misreading the true rate of inflation experienced by Americans.
- Politicians can better connect with voters by focusing on inflation.
- There should be less emphasis on the current year federal deficit.
- The Fed’s policy of maintaining historically low interest rates is not helping the rebound: it is actually slowing the creation of jobs and reducing the wages of workers despite increasing labor productivity.
- Moreover, the means of achieving this interest rate policy, purchasing more and more long-term securities, is making the Federal Reserve increasingly vulnerable to balance sheet losses and the economy increasingly vulnerable to high inflation.
- The Fed, rather than commercial banks, is in greater need of a stress test this time to measure the impact of rising rates.
- Political policy discussions must shift focus. Inflation and the impact of Fed policy on employment wages would more directly address the concerns of voters than the deficit.

April 2013

It's Inflation Stupid!

Marc A. Miles, Ph.D.

The November 2012 NBC Presidential exit poll measured which economic issues weighed most heavily on the minds of voters (Table 1). The two biggest: unemployment closely followed by inflation.

Table 1[1]

Which ONE of these four is the biggest economic problem facing people like you?

Category	Obama	Romney	% Total
The housing market	63	32	8
Unemployment	54	44	38
Taxes	32	66	14
Rising prices	49	49	37

With unemployment almost 8 percent, it is not surprising that it topped the list (last column). Yet in the twelve months prior to the election, the all urban consumer price index (CPI-U) had risen merely 1.8 percent. Despite such an apparently tame rate, inflation weighed heavily on voters' minds.

More than five months later, inflation still hardly registers on the radar screens of Republican politicians. Instead, they continue to focus primarily on the current budget deficit.

These facts raise two important questions. First, why is there a disconnect between voter concerns and the Republican agenda? Second, why are voters troubled by inflation at a time when reported inflation averaged about 2 percent?

This research report explains the apparent anomaly and why the impact of inflation is more onerous than the summary statistics would suggest. It further demonstrates both why the prevailing feeling that Americans are falling behind financially is a very real phenomenon, and why current Federal Reserve policy is actually exacerbating the level of unemployment, causing voters to feel even worse.

[1] Presidential Election Results: Exit Poll.
http://elections.nbcnews.com/ns/politics/2012/all/president/#.UW25KeLD9LM

The conclusion: To better connect with the major concerns of voters, Congressional Republicans should drop their focus on the current budget deficit, and turn their sights to inflation and Federal Reserve policy.

Why Inflation Feels So Oppressive

The key to why the overall inflation rate does not reveal the true impact of inflation lies in the CPI's components. The largest component is housing, comprising over 41 percent of the index[2]. Four other major components (food and beverages, apparel, transportation and medical care) account for approximately the same weight (42.8 percent) of the index.[3] Figure 1 shows the change in these five categories from January 2011 to December 2012.

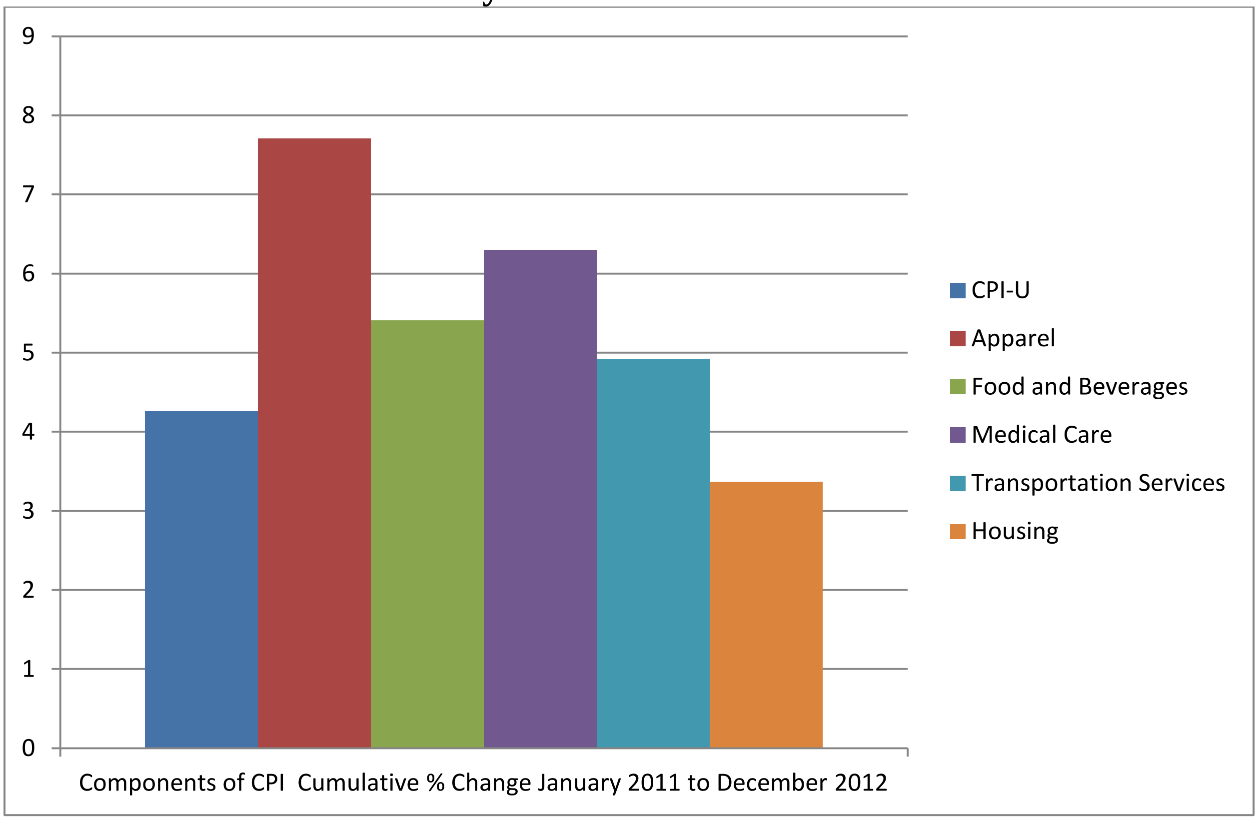
During this 2-year period the overall CPI rose just 4.3 percent, or a little over 2 percent per year. However, the prices voters were facing daily at the cash register (food and clothing) increased significantly more (5.4 and 7.7 percent). Medical care jumped 5.4 percent and the cost of commuting or getting around was up almost 6 percent.

No wonder the average American was feeling pinched! He found every time he went to a store, filled up at the pump, or went to the doctor that the purchasing power of his income was shrinking much faster than the CPI indicated. To him inflation was a real, everyday problem[4].

Housing, on the other hand rose by only 3.4 percent. **So, the moderation in the overall index existed primarily because the slower increase in housing and related products and services was offsetting the jump in everyday purchases.**

[2] The category "Housing" contains more than shelter. Shelter comprises 31.6 percent of the overall CPI-U and includes rent on one's primary residence or a homeowner's equivalent imputed rent, secondary residence rent and renters' and homeowners' insurance costs. Fuels and utilities comprise 5.3 percent. Household furnishings and operations account for the remaining 4 percent.
[3] The precise sub-category weights are food and beverages 15.261 percent, apparel 3.564 percent, transportation 16.846 percent and medical care 7.163 percent.
[4] There have been attempts to construct price indices that more closely reflect the daily purchases of Americans. One is the Everyday Price index (EPI) constructed by the American Institute of Economic Research (AIER). Their index differs in two ways. First, they attempt to create more dynamic (constantly adjusting) index weights to account for price change induced constantly adjusting consumption patterns. Second, they exclude most of the products (primarily those embodying technological change) whose quality-adjusted prices have been falling. It is therefore not surprising that the EPI has diverged significantly from the CPI over the last decade. For example, in 2011 the EPI measured 8 percent inflation versus only 3.1 for the CPI. For more information, see https://www.aier.org/article/7557-epi-reflects-basic-economic-change.

Figure 1
Comparison of Changes in Five Major Components to the Overall CPI-U
January 2011 to December 2012



Source: US Bureau of Labor Statistics

A Further Housing Squeeze

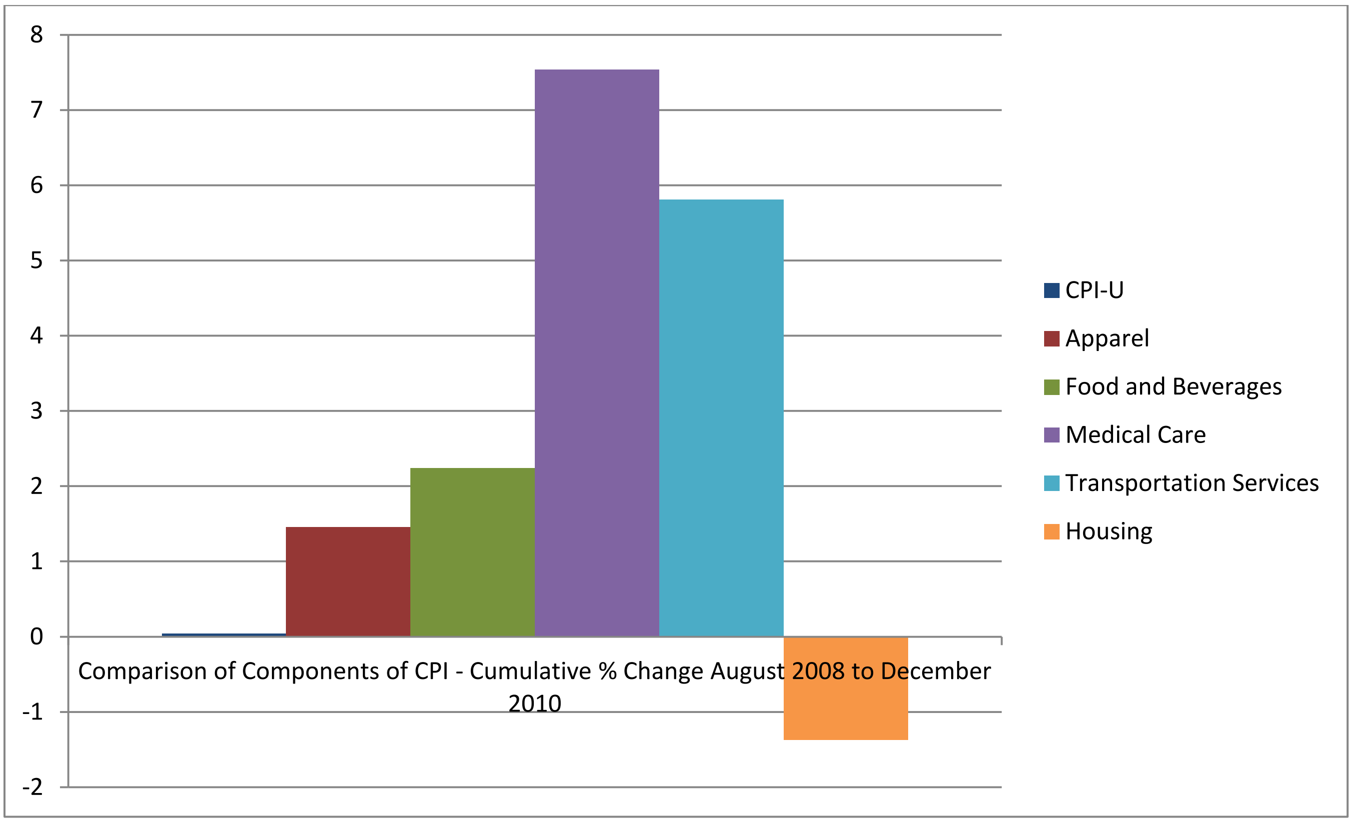
One might think that the moderate rise in housing-related prices would be a good thing. In fact it represented just the opposite - a phenomenon further exacerbating the plight of Americans. The impact of housing can best be seen in the period August 2008 (right before the Lehman Brothers collapse[5]) to the end of 2010 (Figure 2). Over that period the CPI-U hardly changed. However, this lack of change was not because the prices of apparel, food, medical care or transportation were stable. These items rose by 1.5-7.5 percent. Instead the apparent price stability was caused by the significant decline in housing-related prices (fell almost 1.5 percent).

[5] **Lehman Brothers** filed for Chapter 11 **bankruptcy** protection on September 15, 2008.

This was the period of the housing price collapse. The decline in the housing component of the CPI simply reflected (with a delay) the decline that, according to the S&P/Case-Shiller National Home Price Index[6], started in 2007 and lasted through 2011 (Figure 3).

Figure 2

Comparison of Changes in Five Major Components to the Overall CPI-U
August 2008 to December 2010



Source: US Bureau of Labor Statistics

Over that period national home prices declined approximately one-third. In other words, the average American's major asset shrank one-third in value.

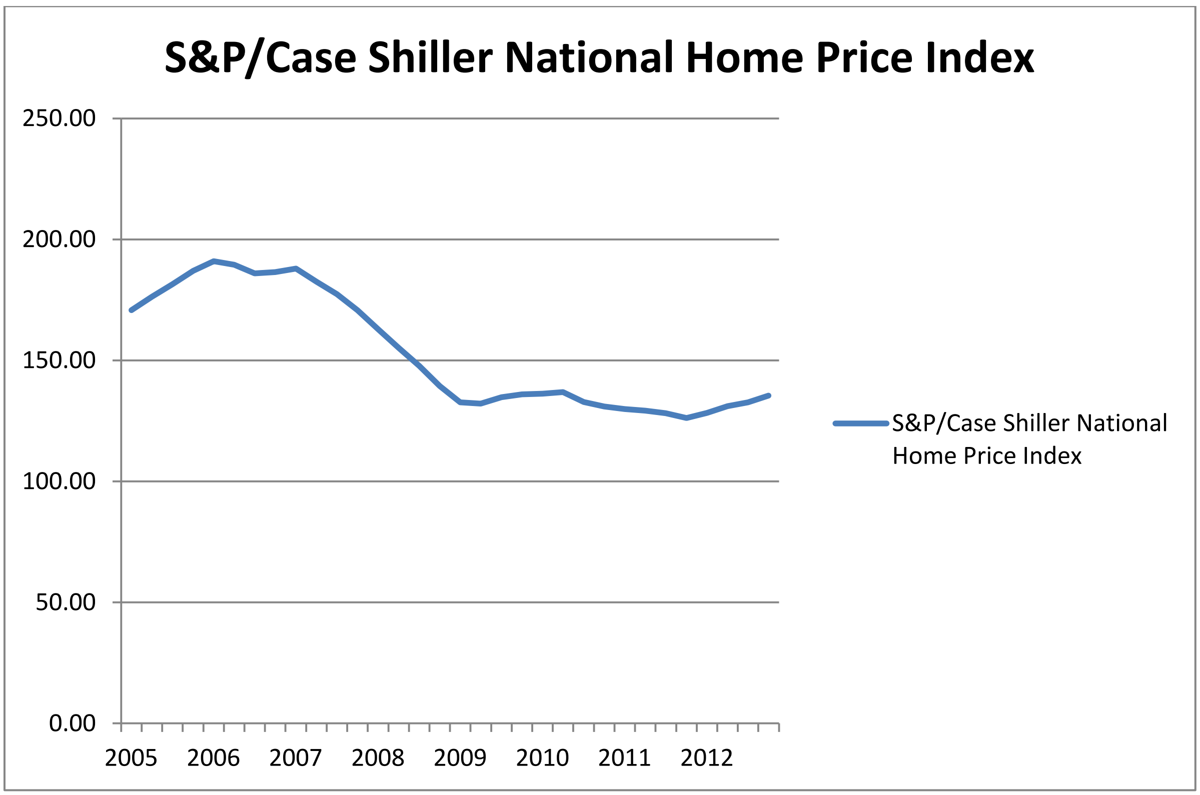
[6] S&P/Case-Shiller Home Price Indices, http://www.standardandpoors.com/indices/sp-case-shiller-home-price-indices/en/us/?indexId=spusa-cashpidff--p-us----

The total decline in the wealth portfolio of Americans was actually considerably more than the drop in housing prices indicate. The S&P 500 peaked in early October 2007 and fell until the first week of March 2009. Over that period it lost over 50 percent in nominal value. So Americans' savings and retirement funds took a big hit. According to one researcher, between 2007 and 2010 the real value of housing prices fell by 24 percent and the real value of stocks by 26 percent. The proportion of American households with zero or negative net worth rose from 18.6 to 22.5 percent, and those with zero or negative non-housing wealth rose from 27.4 to 30.9 percent[7].

So every time Americans went to the store, drove to work or needed medical attention, they felt the simultaneous squeeze of dramatically less wealth and rising everyday prices.

Figure 3

How US Home Prices Varied 2005-Present



[7] Edward Wolff, "The Asset Price Meltdown and the Wealth of the Middle Class," NBER Working Paper No. 18559. According to a recent Pew Research Center report, between 2009 and 2011 wealthy households boosted their net wealth 21.2 percent, whereas household wealth fell by 4.9 percent for the rest of Americans.

The Federal Reserve's Reaction

Enter the Federal Reserve. In an attempt to stimulate the economy, the Fed initiated its traditional policy of targeting significantly lower interest rates on short-term T-bills. Between August 2007 and August 2008 (right before the Lehman Brothers collapse) the monthly average T-bill rate fell from 4.20 percent to 1.72 percent. The intervention, however, did not stop there. By April 2011 the short rate had fallen below 0.1 (one-tenth of one percent), an all-time low. The monthly average rate has since stayed in the range of 0.01 to 0.11 percent.

Despite such record low short-term rates, unemployment stubbornly continued to climb, reaching 10 percent in late 2009, and then tenaciously remaining above 8 percent for two additional years. Nor did the rates generate the usual post-recession rebound in GDP growth. In response the Federal Reserve Board of Governors reached into their bag of tricks and started pulling out new tactics.

In late 2008 the Fed Governors decided the path to recovery lay in a revival of the housing market. The course of recovery – buy mortgage backed securities (MBS) and the securities of federal mortgage agencies Fannie Mae and Freddie Mac to cause mortgage rates to plummet and to make housing more affordable. This policy became known as Quantitative Easing 1 or QE1. Between the fall of 2008 and the summer of 2010, the Fed's holding of these two sets of securities grew by $1.25 trillion. Conventional mortgage rates fell from about 6.50 percent in August 2008 to about 4.25 percent in October 2010[8]. However, even that approach failed to produce a typical post-recession spurt in GDP growth or decline in unemployment.

In late summer 2010 economic growth remained mired below 2.5 percent and unemployment was stuck at over 9 percent. Once again it was time for a new tactic. This time the Fed Governors reached into their bag of tricks, deciding to sell holdings of the agency and MBS in exchange for long-term Treasuries. Under this QE2 policy, 10-year Treasury rates fell less than 50 basis points to about 2.3 percent.

Once more the policy failed to generate either faster economic growth or a significant drop in unemployment. So the Fed again changed tactics, initiating "Operation Twist," in September 2011. This policy was so-named because now the Federal Reserve was trying to "twist" or flatten the yield curve by buying long-term Treasuries in exchange for short-term T-bills[9]. Yields on 10-year Treasury rates quickly fell through 2 percent, reaching an all-time monthly average low of 1.53 percent in July 2012.

[8] Source: Freddie Mac, "30-Year Fixed-Rate Mortgages Since 1971," http://www.freddiemac.com/pmms/pmms30.htm

[9] The original "Operation Twist" was attempted by the Federal Reserve in 1961. That year coincided with the "The Twist" dance craze and Chubby Checkers' recent #1 ranked recording of the same title. Hence the origin of the policy name.

In September 2012 the Fed again switched policies, this time to an open-ended purchase of long-term securities. Initially they approved purchasing $40 billion per month of securities. The new policy became known as QE3. On December12, 2012 the Federal Reserve increased the monthly amount and has since followed the open-ended policy of purchasing about $85 billion a month in long-term securities, $45 billion in Treasuries and $40 billion in MBS. The larger buying policy is known to some as QE4.

All the buying of securities on the open market did have one effect – the balance sheet of the Fed ballooned to $3 trillion. The Fed justifies this balance sheet expansion, because measured inflation and economic growth remain low and unemployment remains unusually high. However, as we have seen, the inflation argument is like the proverbial man who drowned in water that on average was only 4 inches deep – that low average inflation hides the fact that Americans' budgets have been squeezed by high inflation in some items and low inflation in others.

The Many Ways Federal Reserve Policy Hurts the Average American

Defenders of the Fed's policy argue that it has been associated with at least two positive changes in the economy. The stock market is up sharply, surpassing the October 2007 nominal levels and hitting new nominal highs. The housing market has also sharply improved. Unsold inventory of foreclosed homes even in hard hit areas like Phoenix are disappearing, and home prices according to the Case-Shiller Index were up 8,1 in January 2013 from a year earlier, the biggest national gain since 2006.

The defense is that not only do both outcomes increase Americans' wealth, but they reflect a stronger rebound in the overall economy than the economy's growth would indicate. However, there is controversy over even this seemingly obvious conclusion. The controversy revolves around whether the price increases are driven by some broad-based improvement in the economy's fundamentals, or simply reflect the increase in the capitalized value generated solely by lower interest rates (lower discount rate for future earnings/benefits). For example, a recent Federal Housing Finance Agency report points to the latter conclusion. It finds that the recent run-up in housing prices cannot be attributed to higher income. The average wages of Americans has risen only by the rate of measured inflation over the last year. Rather, the rise is more closely tied to lower interest rates and the greater availability of government financing[10].

Instead a closer analysis of recent Fed policy reveals unintended, clear, negative impacts on American workers. For instance, the low interest rate policy aims to stimulate the economy and reduce unemployment. In fact it has had precisely the opposite effect.

[10] For a discussion of this issue see Edward Pinto, "Is the Fed Blowing a New Housing Bubble?" *The Wall Street Journal,* April 10, 2013.

Understanding the source of this perverse outcome requires simply understanding the incentives of employers deciding how to achieve their target level of production or services. The employers can choose to hire more workers or to invest in new machinery and/or technology. The technology might be as simple as buying computers and printers that allow employees to print out their own letters and envelopes, thus minimizing the need for secretaries and administrative assistants. Or it could be something far more complex.

Either way, the employer's decision will be influenced strongly by the relative cost of workers and capital investments. If the relative cost of workers falls, the employer more than likely will hire more people and spend less on investments. Conversely, if the relative cost of workers rises, hiring will slow down. The relative labor cost rise can occur if either the cost of capital (the interest rate) falls or the costs of hiring rise[11]

The contribution of interest rates to the investment/worker decision is illustrated in Figure 4. The blue line illustrates how the ratio of the US capital stock to labor force has changed between 1960 and 2010. Capital is measured by the year-end Bureau of Economic Analysis estimates of the country's real value of the net stock of fixed assets and consumer durables (in millions of dollars)[12]. The labor figure is the annual average of workers captured in the Bureau of Labor Statistics' total nonfarm employment[13].

This ratio has varied considerably. Each time the capital/labor ratio rises, workers on average have more capital with which to work. Hence, the marginal productivity of workers rises. Conversely, if the ratio falls, capital at the workers' disposal falls and workers are less productive.

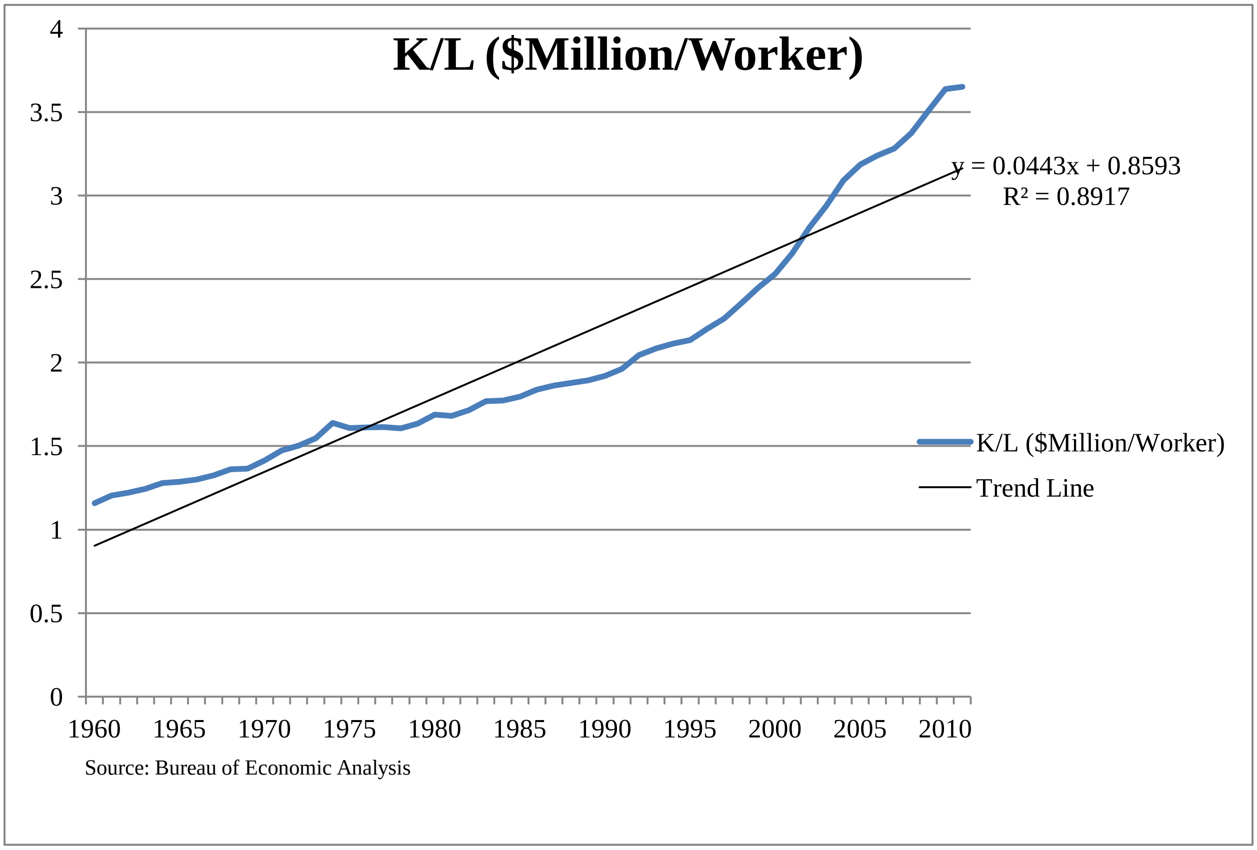
The straight line in the Figure 4 measures the trend in the ratio over the entire 50+ year period. The trend is positive, which implies that as the country has become more prosperous the real capital stock of the US has increased. However, the point currently under examination is how the actual ratio has fluctuated around this trend, for it provides more insight into the changing behavior of employers and Americans' wages.

As Figure 4 illustrates, the late 1970s and early 1980s were not good times for workers. The capital-labor ratio was falling, workers' productivity was falling, and the real value of workers' wages declined. What caused this hit to the real purchasing power of workers' wages? Recall

[11] This section concentrates on the fall in interest rates. However, recent and future increases in the cost of hiring including tax increases and the mandates of Obamacare are also exacerbating the relative cost of hiring workers.
[12] "The Current-Cost of Net Stock of Fixed Assets and Consumer Durables," http://bea.gov/iTable/iTable.cfm?ReqID=10&step=1#reqid=10&step=1&isuri=1. The current dollar figures were then deflated by the Gross Private Domestic Investment: Chain-type Price Index. Investment is scheduled to undergo a comprehensive revision in July 2013. The definition will be expanded to include among other things military R&D, intellectual property rights from movies, long-lasting television programs and books, plus R&D in developing PCs, smart phones, laptops and iPads. This revision might fill in part of the gap in Figure 5 between 1985 and 2005. See "Preview of the 2013 Comprehensive Revision of the National Income and Product Accounts: Changes in Definitions and Presentations," March 2013, http://www.bea.gov/scb/pdf/2013/03%20March/0313_nipa_comprehensive_revision_preview.pdf.
[13] http://data.bls.gov/pdq/SurveyOutputServlet?request_action=wh&graph_name=CE_cesbref1

Figure 4

The US Capital-Labor Ratio 1960 - 2010



that the late 1970s were a time of rising inflation and rising interest rates. By 1981 yields on 3-month T-bills reached over 15 percent and inflation exceeded 10 percent. In order to justify capital investment, companies needed machines with a marginal productivity greater than the ever higher cost of capital. Hence, capital investment fell. By the same token, the relative cost of workers was falling, and employers hired relatively more workers. Companies, nonprofits and government became increasing labor-intensive. Relatively capital-intensive industries like autos and steel found it harder to compete and contracted or even went out of business. Relatively labor-intensive services expanded.

As interest rates trended down in the 1980s, the process slowed and eventually reversed. Falling interest rates meant that investments were profitable at lower marginal productivity. Workers became relatively more expensive. Employers' incentives switched to hiring fewer workers and investing more in machinery and technology.

Recall the lament of workers in the early 1990s. Companies were becoming "lean and mean". Middle management workers became expendable. Manufacturers found they could produce with fewer workers. Even governments discovered that their payrolls were too high, and they commenced thinning the ranks. These phenomena were part of the process of raising the capital-labor ratio throughout the economy. As interest rates continued to fall over the next two decades, that process continued. The use of computers became increasingly common throughout the economy. Writers learned to compose from a blank screen instead of creating their stories or reports in long hand. Computer controls began to dominate machinery. Police relied increasingly on devices and software that could perform more efficiently tasks that were previously the purview of patrolmen and desk clerks. The capital-labor ratio rose towards the trend line and then surpassed it.

Figure 5 isolates the amount by which the ratio exceeded or fell short of its trend line in Figure 4, providing a clearer view of how interest rates and the capital to worker ratio rose and fell together.

The chart's blue line is the difference between the capital-labor ratio and the trend line in Figure 4. Notice how that difference dropped sharply and became negative in the late 1970s. This movement reflected the rising relative cost of capital just discussed. The distance below the trend line bottomed in the early 1990s, and has since risen sharply[14].

The red line measures the average annual yield on 10-year constant maturity Treasuries. The interest rate values have been inverted in order to make the relationship easier to assess. In other words an upward movement in the red line represents a *decline* in interest rates, and a decline in the line means interest rates are *rising*. So interest rates rose sharply from the mid-1970s until 1981-82 and have mostly fallen since.

The two lines in Figure 5 generally move together, as the theory would predict. With rising interest rates the capital-labor ratio declines and the marginal productivity of labor falls. Falling interest rates are associated with rising labor productivity and a higher proportion of capital to labor.

Of particular interest is how the two lines have behaved in recent years. The continued efforts of the Federal Reserve to push interest rates lower and lower have pushed the capital-labor ratio higher and higher. But rates have been pushed so low that we are now at a point where the ratio of capital to labor is much higher than the historical trend line would predict.

This excess rise in the capital-labor ratio highlights the negative effect of Federal Reserve policy on wages and unemployment. The persistent, extremely low interest rates are keeping real wages from climbing and retarding the rate of hiring. The Federal Reserve is making unemployment worse than it has to be.

[14] Watch the July 2013 comprehensive data revisions mentioned in footnote 11 to see if this area of the curve in particular shifts upward.

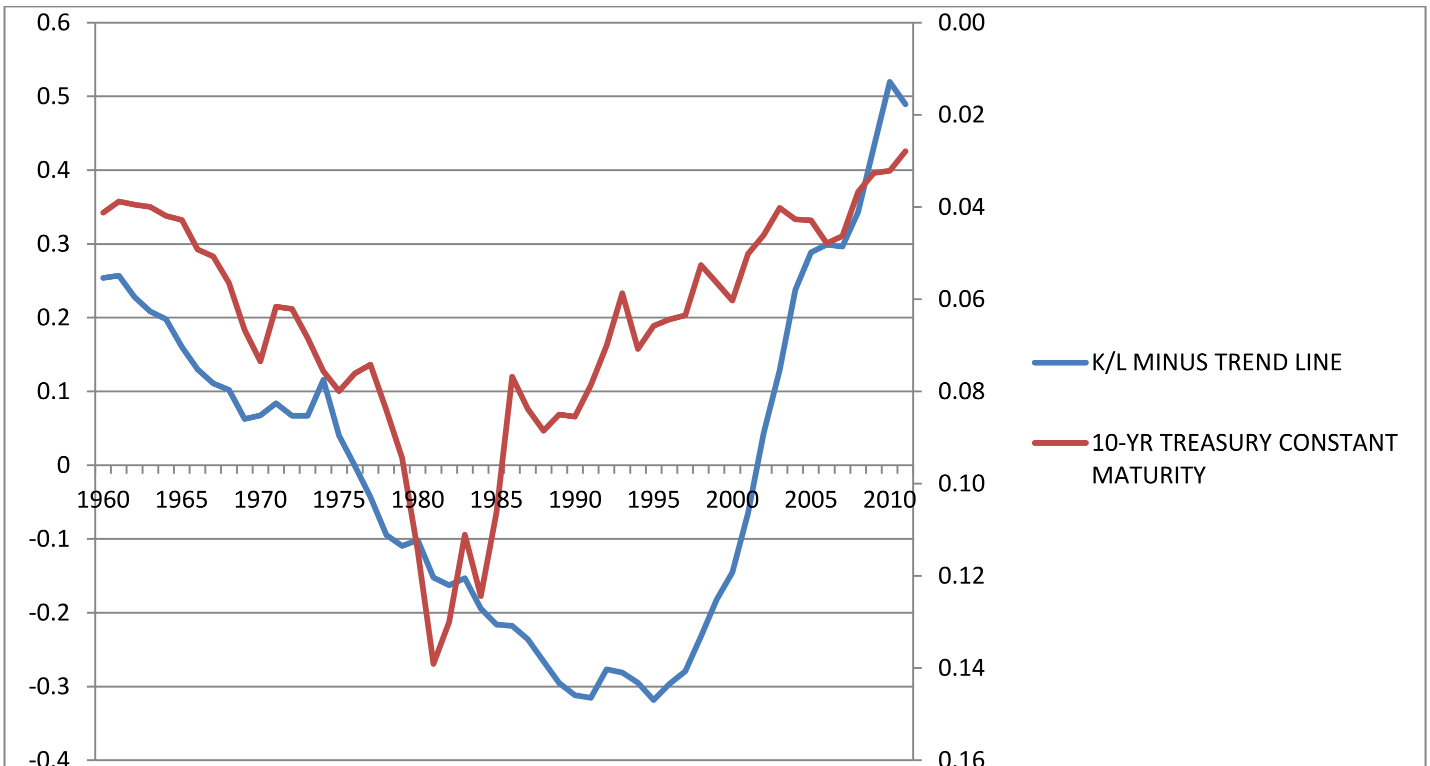
To understand why the Fed's actions are so anti-employment, remember the incentives facing potential employers. They are going to choose the proportion of investment and workers that can achieve their desired level of production or services at the lowest price.

With record low interest rates, investment is unusually attractive for keeping costs low. Naturally owners and managers will want to invest more and hire fewer workers than if interest rates were not so artificially low. As the economy grows, hiring will increase, but not as fast.

No wonder unemployment has been so slow to fall, and more and more workers are simply dropping out of the labor force. The economy may be expanding (at a relatively slow rate), but job opportunities refuse to keep up.

Figure 5

Interest Rates and the Capital-Labor Ratio Move Together



Sources: Bureau of Economic Analysis and St. Louis Federal Reserve Fred Database

Evidence of the desire to invest rather than hire workers in this low interest rate environment is borne out at the company level in a recent poll conducted by Duke University and CFO

Magazine[15]. The poll asked 450 American CFOs about the effect of low interest rates on their company's behavior over the previous 12 to 18 months. The poll concluded on March 8, 2013.

The poll found that low interest rates had caused 202 CFOs to increase their borrowing. What they did with the borrowed funds was even more interesting. Each CFO could check more than one use for the borrowed funds on the poll question. Fifty percent said they used the funds to increase capital spending. Twenty-seven percent used them to increase their mergers and acquisitions. However, only ten percent indicated that the borrowing had resulted in increased hiring.

Further interviews revealed that the increased borrowing sometimes led to hiring more employees. **Yet the relationship is clear. Investment is expanding more rapidly than hiring. The capital-labor ratio is increasing.**

Simultaneously wages are stagnating. With the increasing amount of capital per employee, labor productivity is rising. **But this increasing value of employees is not reflected in their wages. Wages are stagnating in real terms.**

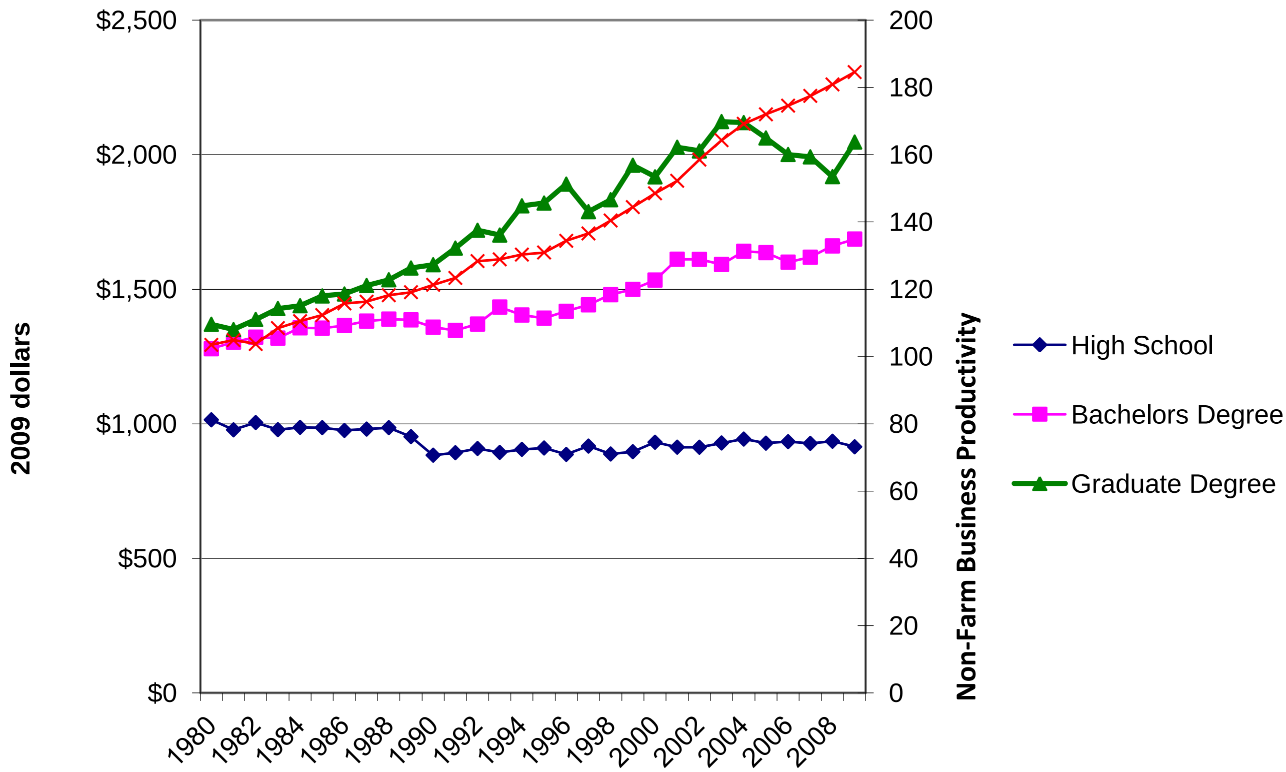
Levy and Kochan demonstrate this point[16]. Examining the growth of real wages including fringe benefits to the growth of real labor productivity, they find that wages have not kept up. "From the mid-1940s through the 1970s, median wages and productivity growth rose in tandem. Since the 1980s productivity continued to grow steadily while wages stagnated."

Their evidence is summarized in Figure 6, which compares the growth of wages for 35-44 year-old males to the growth in nonfarm labor productivity over the post-1980 period. The wage growth is further divided to show the differences by the level of education.

[15] For a description of the poll results see, Victoria McGrane, "Easy Money: Fed Policies Spur Corporate Spending," The Wall Street Journal, April 8, 2013, http://online.wsj.com/article/SB10001424127887323916304578400562843778162.html?mod=ITP_marketplace_0

[16] Frank Levy and Thomas Kochan, "Addressing the Problem of Stagnant Wages," *Comparative Economic Studies* (2012) 54, 739–764. http://www.palgrave-journals.com/ces/journal/v54/n4/full/ces201228a.html They estimated fringe benefits by multiplying median earnings by the ratio of supplements to wages and salaries to/wages and salaries as reported in the NIPA

Figure 6
Median Weekly Compensation of 35-44 Year Old Men who Work Full Time:
Non Farm Business Productivity (Right Hand Axis)



They conclude from the evidence that "between 1980 and 2009, labor productivity increased by 78% but:

- The median compensation of 35–44 male high school graduates (with no college) declined by 10%.
- The median compensation of 35–44-year-old male college graduates (without graduate degrees) grew by 32%, less than half as much as overall productivity growth.
- Only the median compensation of 35–44-year-old men with post-graduate training came close to keeping up with labor productivity growth increasing by 49%."

Even more interesting is the fact that the divergence between labor productivity and wages in the graph appears to accelerate in the mid-2000s. This larger divergence is particularly noticeable for those with the highest education level, the one group that had previously been able to keep up.

They present the same graph for women. The results are more positive in that women with a BA or post-graduate education kept up with productivity growth. "But only one-third of working women in this age group have a BA or more while the compensation for the other two-thirds of working women generally lags behind productivity growth." Furthermore, starting in the mid-2000s there is the same increase in the divergence between wages and productivity for highly educated woman that was observed for the men.

In other words, during this period of declining interest rates as the capital-labor ratio has increased, the proportion of additional labor productivity going to workers has declined. A greater and greater share has gone to the investors in machines and technology. This trend is particularly evident during the last few years as the Federal Reserve has pushed rates ever lower.

It May Get Worse

Recall that the Federal Reserve pushed interest rates, especially long-term rates, lower by buying more and more Treasuries and mortgage-backed securities. This policy dramatically changed not only the size but the composition of the Fed's balance sheet. This transformation of the balance is shown in Figure 7.

Over the period shown (January 2007 through March 2013) the total size of the Fed's balance sheet more than tripled. Most of that change, however, occurred after Lehman Brothers debacle in September 2008. The *composition* also changed dramatically. At the start of October 2008 long-term Treasuries were about 30 percent of the portfolio. At the end of the chart they compromise almost twice that proportion (56 percent). The proportion of mortgage-backed securities also soared. In October 2008 the Fed's balance sheet had few if any mortgage-backed securities. By March 2013 MBS are one-third of the total. In other words, today long-term assets make up nearly 90 percent of the portfolio.

These dramatic changes pose at least two threats. First, tripling the size of the balance sheet represents a significant threat of even more inflation that could eat away at the purchasing power of American paychecks. There are two sides to the balance sheet, and for every dollar increase in assets there is a dollar increase in liabilities in the form of monetary base. This immense base potentially could support inflation resembling more the 1970s' inflation rates than inflation today. Inflation of that magnitude undoubtedly would disrupt the plans, dreams and savings of the average American as he or she scurries to make up ground lost to diminished purchasing power. With the dashed dreams comes anger at those who failed to warn.

Second, the fact that the balance sheet is almost entirely long-term assets makes the Fed extremely vulnerable to changes in interest rates, presenting a threat to the Fed itself. Today the bond market is essentially a one-sided bet. There is little room for interest rates to fall further. The next major movement has to be up. When that happens, the value of all those long-term securities will plummet! The value of the asset side of the Fed's ledger will contract without an immediate reduction in the liability side. Investors will begin to question the Fed's ability to stand behind the dollar. The value of the dollar on international markets likely will fall, triggering even more inflation.

How large could that reduction of Federal Reserve assets be? In a January 2013 report, 5 staff members of the Federal Reserve estimated that the weighted average maturity of the Fed's balance sheet is now over 10 years[17]. Given today's 10-year interest rates, a 2 percentage point rise would produce over a 15% fall in the value of the securities. With the Fed holding almost $3 trillion in securities, the decline would be $450 billion or more. To put this amount in perspective, the Federal Reserve currently buys $85 billion per month in Treasuries and mortgage-backed securities. Were it to lose $450 billion, it would be equivalent to wiping out the value of about five and a quarter months of purchases[18].

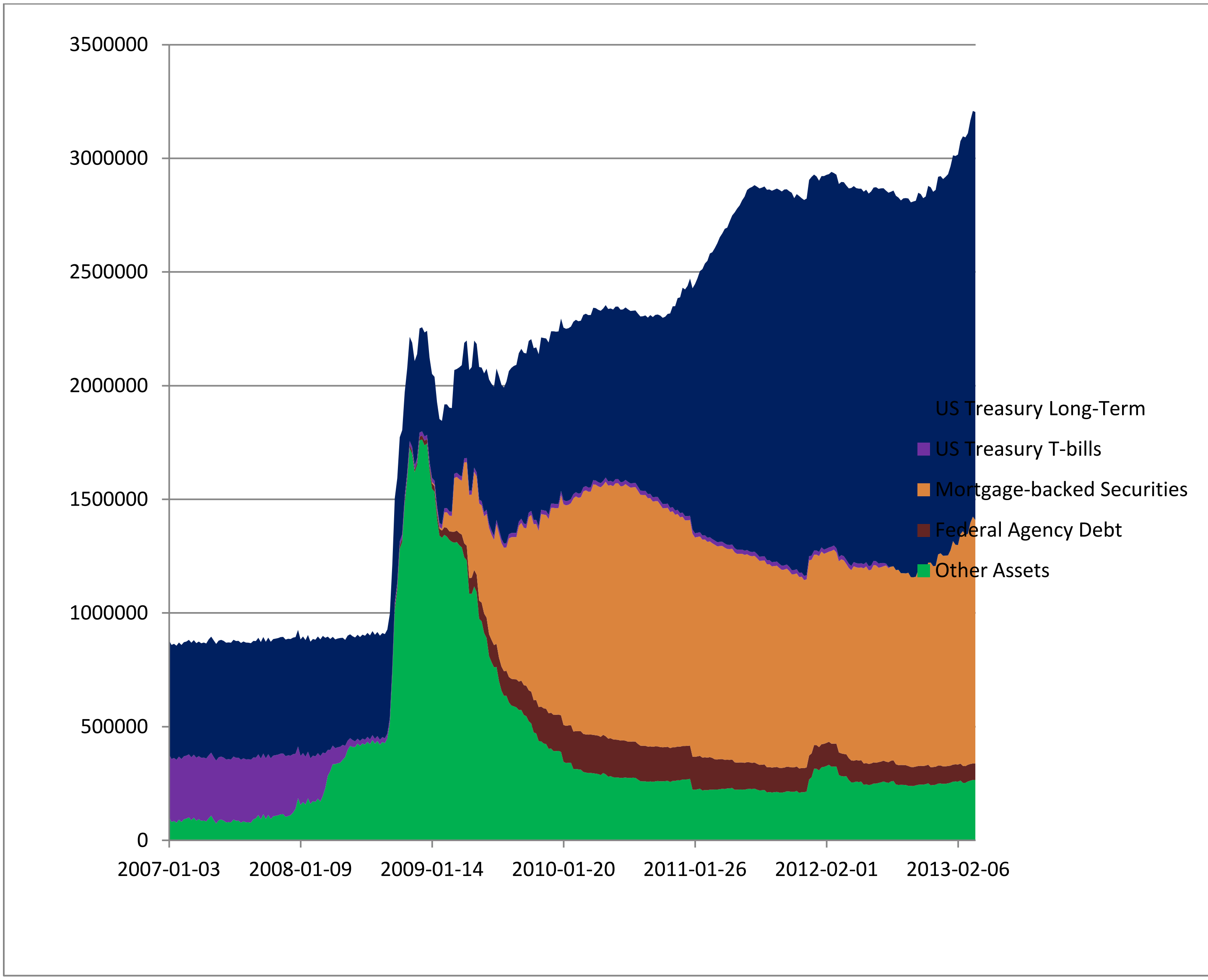
[17] Seth B. Carpenter, Jane E. Ihrig, Elizabeth C. Klee, Daniel W. Quinn, and Alexander H. Boote, "The Federal Reserve's Balance Sheet and Earnings: A primer and Projections," Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington, D.C., January 2013, http://www.federalreserve.gov/pubs/feds/2013/201301/201301pap.pdf P. 54.

[18] Another implication noted by the authors is that there could be an effect on the budget deficit. Each year the Federal Reserve remits to the Treasury its income in excess of its operating expenses and dividends to member banks. These remittances are considered government revenue and become part of the Federal Budget. Over the last three years, these annual remittances have averaged over $80 billion. Depending on the assumptions made, the authors see these remittances dropping to zero around 2015, and even a 100 basis point rise in rates could extend that drought to as much as 6-7 years (see pages 5-6 of report).

Figure 7

THE CHANGING COMPOSITION OF THE FEDERAL RESERVE BALANCE SHEET

THOUSANDS OF US DOLLARS



A Stress Test for the Fed?

The Federal Reserve has been actively applying "stress tests" to the nation's banks. Surprisingly no one has suggested a stress test for the Fed.

More to the point, no one has even suggested the appropriate type of stress test. As often happens, the Federal Reserve is busy fighting the last war. Its tests of banks have focused on whether they now could survive a repeat of a sudden, serious recession with significant unemployment. Realistically, however, that is not the most likely scenario. The next looming threat is a sudden rise in interest rates and the sudden loss of capital on balance sheets. With an average portfolio maturity of over 10 years, and long-term Treasuries and MBS comprising about 90 percent of the Fed's balance sheet versus about 14 percent in private banks, the Fed has by far the biggest exposure to this threat[19].

How To Connect More Effectively With Today's Voters

Gather a group of today's likely voters and ask them for a show of hands. Ask the voters which they worry about most: this year's deficit or the impact of inflation on their family's budget? Chances are many more hands will be raised about the threat of inflation. The reason is that the families feel the painful pinch of inflation quickly and dramatically. As prices rise, wages immediately purchase less and less. Families have to do without more and more. The strain around the kitchen table during meals and late night discussions becomes more intense. Can we afford to go see Grandma? Can we afford that summer vacation? How are we going to make our income last until the end of the month? Johnny needs a new pair of shoes, what are we going to do? Can we afford another child? These are everyday, gut issues.

In contrast the deficit's negative impact seems far away. Voters know that it is not good, but they do not understand precisely why or how it directly impacts them. The impact seems too distant and too vague.

The importance of the inflation issue was reinforced by a recent focus group of Ohio voters[20]. The ten participants were Democrats and Independents (no Republicans) with incomes below $100,000 and no post-graduate degrees. Hence they were solidly middle class. To quote the summary of the findings, "There is a strong desire for a narrative which explains why the American economy is so anemic in its growth, and so punishing in its escalating prices. In fact, there is evidence of a nascent perception that the 'declining value of the dollar' (in terms of

[19] In its annual report released April 25, 2013, The Financial Stability Oversight Council for the first time cited interest rate risk as a vulnerability of financial institutions. Fed Chairman Ben Bernanke is a member of the FSOC, and the Fed has finally started stress testing banks for this risk. See, "Fed Zeros In on Vulnerability to Rate Rise," *The Wall Street Journal*, April 26, 2013. However, there is still no suggestion to test the Fed for this vulnerability.
[20] QEV Research Analysis: A Focus Group Discussion Regarding the Economy Convened in Columbus Ohio, Washington DC, April 3, 2013.

domestic buying power, not international exchange rates) is behind the difficulty of our participants to maintain the purchasing power of their household budgets."

Showing concern about their suffering from inflation, and presenting a logical plan to do something to protect them, is therefore far more likely to resonate.

Should The Deficit Be Ignored?

No! Reducing the focus on the current year deficit does not diminish the need to focus on the long-term deficit. Workers increasingly understand the impact of unfunded long-term liabilities. Their lives are directly affected by them. Their defined benefits are being cut. Workers have to scramble to cut their annual spending to assure they can support themselves in retirement. They are angry about promises employers have made that have been broken.

The unfunded liabilities are simultaneously hitting workers in the pocketbook and when they pay their taxes. As the generous retirement promises made to state and local government workers over the last four decades come due, cities and states try to make up for the existing shortfall by raising taxes. Other states like Illinois try to simply ignore the issue, causing the state's credit rating to fall and the cost of debt serving to rise. Again, taxes rise.

Nor does the current fiscal year deficit become irrelevant. Through the Federal Reserve's policy objectives, the fiscal year deficit feeds the threat of inflation. The Fed is monetizing $85 billion of long-term securities each month. That's approximately $1 trillion of debt annually, roughly what the federal deficit has been the last few years (though about $200 billion more than the projected current fiscal year shortfall). This extra debt is exacerbating the Fed's already bloated balance sheet. Reducing the deficit would reduce the rate at which the balance sheet balloons.

Notice, however, that the direct source of the problem is not the current fiscal year deficit per se, but rather the Fed's policy of extremely easy money. The Fed seems committed to monetizing the federal deficit. The Fed believes it is trading an amelioration of near term problems for uncertain long-term ills. As we have seen, however, while the fears of the future are quite real, the short-term benefits are widely overrated.

Why A Policy Shift Makes Sense

- **These facts argue for a policy focus shift to more directly align the Party's policy concerns with the concerns of the voters.**
- **The fact that the overall low inflation rate in the last couple of years does not accurately reflect what is happening to food, clothing,**

transportation and medicine affirms that the inflation concerns of voters have been more real than previously thought.

- **Voters have realized far better than economists that the Federal Reserve's "easy money" policy is not making their lives better.**
- **Quite to the contrary, the Fed's singular focus on keeping short- and long- term interest rates low is one more barrier to the swift creation of new jobs.**
- **Moreover, this policy has contributed to the stagnation of American wages.**
- **The policy has also made the American economy more vulnerable. The ballooning of the Fed's balance sheet and the shift of the Fed's assets to longer term securities makes the Federal Reserve extremely vulnerable to a sudden rise in interest rates. When that rise occurs, the soundness of the Fed itself comes into question, potentially undermining the dollar and producing….more inflation!**
- **Republicans should be out front on the inflation issue. It resonates with voters now and will likely dominate in the next economic crisis.**
- **A sound platform for a sound dollar will yield political dividends now and years down the road.**