Mitchell's Musings 7-4-11: Old Thinking

July 4th is supposed to celebrate "independence," a word which among other things connotes New Thinking. But on several critical issues, there seems to be lots of Old Thinking. Let's start with the macro and proceed to the micro.

Inflation or Unemployment?

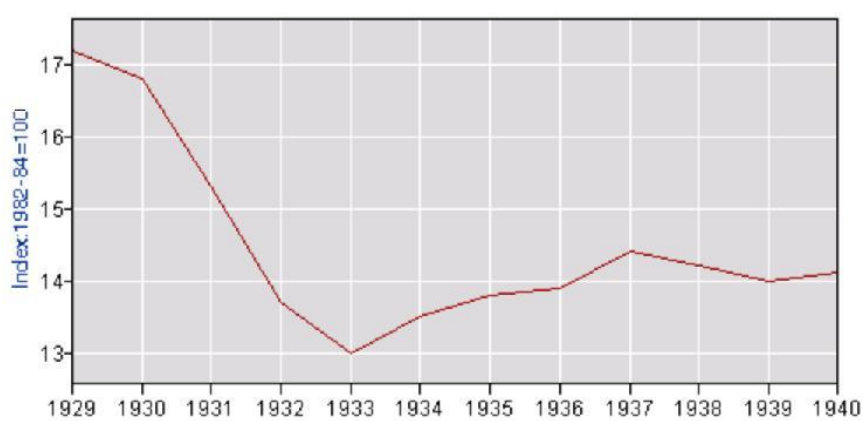
What should we be worrying about at the moment, inflation or unemployment? One of the paradoxes of the Great Depression was the concern back then about inflation. When measured by the Cost-of-Living Index (predecessor to the modern CPI) of that era, prices were in fact 18% lower in 1940 than they were in 1929, as can be seen on the chart below. And, to be fair, there were those academics - such as Yale economist Irving Fisher - who were concerned about "debt-deflation." It is true that prices could – and sometimes did - rise in the face of considerable economic slack. But inflation never reached as high as 4% per annum and the price trend returned to deflation in the late 1930s. Clearly, however, unemployment – which was largely unmeasured until 1940 when the Current Population Survey began – was THE problem of the day.

Inflation anxiety was Old Thinking. It wasn't just the Federal Reserve that worried about inflation in the 1930s, as this humorous recollection of that era suggests:

http://www.employmentpolicy.org/high-school-inflation-worries-during-great-depression-linked-mitchells-musings-7-4-11

All this history could be a quaint memory except that in the aftermath of the Great Recession of 2008, and with the latest release on GDP suggesting a stalling recovery, we seem to be repeating the Old Thinking. The Fed seems under attack from those who worry that its various policies, including the recent quantitative easing policy, will produce inflation. As has been noted in earlier musings, financial markets continue to forecast CPI inflation in the 2-3% range over the long run.

BLS Cost-of-Living Index



The initial hope was that policies adopted in late 2008 and early 2009, especially those involving “shovel ready” infrastructure projects, would take care of the unemployment problem – or at least reduce it substantially. While such policies helped stave off a decline into something truly resembling the Great Depression, the recovery path has been insufficient to lower unemployment at anything like the pace originally projected. Infrastructure is never really shovel ready, except for projects that were about to occur anyway.[1] Major infrastructure projects inherently involve complicated processes of planning and tend to trickle out as their various review and design phases are completed. As President Obama recently said, *"Shovel-ready was not as shovel-ready as we expected."*[2] So what can be done now? That question leads to the next area of Old Thinking.

Federal or Trade Deficit?

The New Deal administration of the Great Depression is often characterized as having followed “Keynesian” policies. The phrase “Keynesian” in such accounts is taken to be a synonym for deficit spending to stimulate the economy. In fact, the writings of John Maynard Keynes were barely coming on the scene when the New Deal began and the Roosevelt administration was quite concerned about running deficits – traditional Old Thinking. It looked for taxes to raise, such as the federal gasoline tax. The Social Security payroll tax was imposed in 1937, even though no pension benefits were to be paid out until the 1940s. In retrospect, these deficit concerns are seen as offsetting other efforts at job creation.

We again seem preoccupied with the federal deficit, now encapsulated in the conflict over raising the debt ceiling. Let’s put aside the obvious point that producing a default on the federal debt by not raising the debt ceiling would be a Bad Idea. The question to be asked is which deficit we should be worrying about – particularly given the slack labor market – the federal budget deficit or the U.S. trade deficit?

Last week, the latest Bureau of Economic Analysis release put the U.S. net international investment position at minus \$2.4 trillion at the end of 2010.[3] That net debt of the U.S. to the world is the result of continuous net export deficits, especially since the 1980s. “Net” means that the U.S. had gross liabilities of \$20.9 trillion and gross assets of \$18.5 trillion. Some of the gross liabilities are illiquid, e.g., physical assets such as real estate, factories, etc., and not easily sold off quickly. But much of it is liquid including \$4.4 trillion in federal obligations to foreign central banks and official institutions. Holders can abandon (sell) these assets. (Again, threatening to default by not raising the debt ceiling is a Bad Idea, precisely because a run on the dollar could produce another financial crisis.)

[1] As noted in earlier musings, local authorities may actually halt such projects temporarily in the hopes of obtaining federal financing for them, a perverse effect.

[2] Peter Nicholas, Obama Seeks Ways Around Congress to Boost Economy,” *Los Angeles Times*, June 14, 2011.

[3] Release BEA 11-34, June 28, 2011: http://www.bea.gov/newsreleases/international/intinv/2011/pdf/intinv10.pdf

The U.S. net export balance in 2010 was a negative $516.4 billion or about 3.5% of GDP. Simply bringing that balance to zero (to stop increasing the net debt) would be far more stimulative and job creating than any policy now in the works or likely to be in the works.

Unfortunately, pep talks about high-tech manufacturing, green jobs, and being more competitive won't do much to lower unemployment, certainly not in the immediate situation. If the U.S. wants to be competitive, it needs to deal aggressively with the dollar exchange rate problem. In earlier musings, I have pointed to the (Warren) Buffett plan that would swiftly bring trade into balance.[4] I have yet to hear of any other approach that addresses the exchange rate/jobs problems, especially in manufacturing. But Old Thinking prevails.

Top Down or Bottom Up?

Let's switch now from the macro to the micro. In a slack labor market where jobs are scarce, management can always say to workers that they should be lucky to have a job. *"If you don't like it here, try finding a job somewhere else."* In contrast, a buoyant labor market can be an equalizer. Workers can find a job somewhere else when there is a labor shortage. Their concerns, in the face of a labor shortage, have to be the concerns of management. Moreover, what they have to say about how things are run can be valuable to management. But there is little incentive to pay attention to what workers say in a period of high unemployment. Labor shortages are more conducive to listening to the help than the current labor surpluses.

I was reminded of that fact after several recent airline flights on a particular carrier. I won't name it here, but you can find the full story – which was featured in the *Los Angeles Times* – plus a document from airline management that was given to me by a flight attendant. The references can be found at another blog I do:

http://uclafacultyassociation.blogspot.com/2011/06/diversion-from-obvious-doing-what-they.html

To recap: the airline introduced a new system of boarding passengers. It appears, however, that the new system causes delays, a fact that flight attendants have pointed out – and to which this passenger can personally attest. But it also appears that no one at the top is listening since the system continues in effect. Perhaps that is because – in the current state of the labor market – no one at the top has to listen.

Management always knows best is Old Thinking. But at both the macro and micro levels, Old Thinking is in the ascendancy.

[4] The Buffett plan would provide those who sold a dollar of exports with a voucher entitling the holder to import a dollar's worth of imports. Vouchers could be exercised directly by recipients or sold to importers. In effect, the prevailing exchange rate plus the cost of the voucher would be the exchange rate associated with a zero net export balance.