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Impatience at the Federal Reserve: The New Productivity Paradox and Fed Monetary Activism

Introduction

On June 25, 2003, the Federal Reserve announced they were cutting rates by 25 basis points; This 13th and (possibly) final cut was the most telegraphed easing since this rate cutting cycle began on March 20th, 2001.

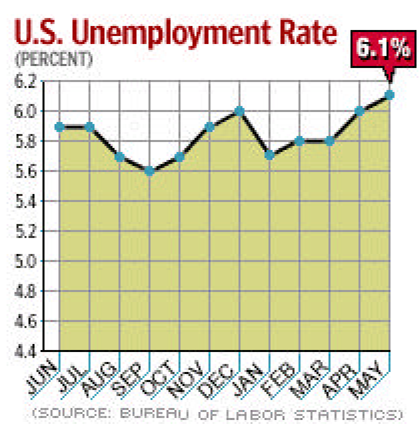
Of the past 13 eases, today's is the most difficult to justify, at least on a purely economic basis. Since the war in Iraq ended, consumer confidence has rebounded, retailing has improved and oil prices have come down. The Wall Street Journal noted that "Corporate bond issuance is booming, and mortgage-refinancing applications exceed the capacity available to handle them. Total commercial bank assets have climbed by 11% in the past year and bank profits have soared – a clear sign that the financial system is not starved of liquidity . . . Purchasing managers' indices are rising, deal-flow is improving again on Wall Street, corporate bond spreads have narrowed sharply, and the stock market is up."

All this begs the question: *Was this cut necessary?* Considering the tax cuts, already low interest rates, weak dollar and increases in money supply, "putting an exclamation mark" on the end of this rate cutting cycle hardly seems necessary.

Our curiosity has gotten the better of us: *What is it that is motivating the Fed?*

Jobless Recovery?

The most obvious weakness in the economic rebound has been the employment picture. This has been a mostly jobless recovery, with unemployment still over 6.1%. The jobless numbers have stubbornly stayed over 400,000. Nine million people were unemployed in May, compared with 8.8 million in April.



Yet the Federal Reserve's impatience with the employment picture is puzzling. The labor market is a lagging indicator; It's usually the last part of the economy to show marked improvement in any recovery. "As long as employment doesn't collapse, the recovery will continue to gain strength. As it does, slowly jobs will be added and they will be the fuel that kicks the economy into a higher gear," observed Bill Cheney, chief economist at John Hancock Financial Services in a CNN interview.

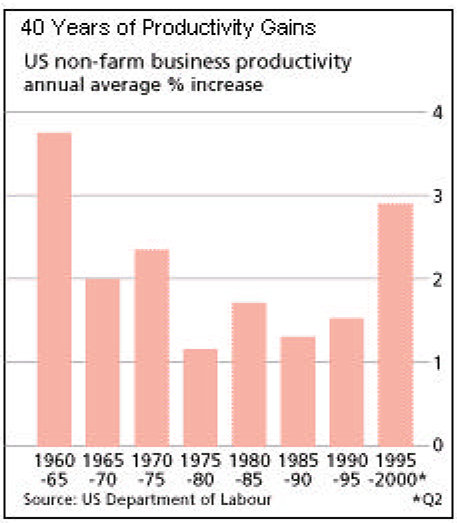
We agree. The Fed's impatience is an enigma. Unless the system receives another external shock (i.e., war or terrorist attack), it's reasonable to expect a slow but continuing recovery. Indeed, the possibility of a "shock event" is itself reason to keep some powder dry, just to be able to determinedly respond if such an untoward episode were to occur. This makes today's cut all the more intriguing.

The New Productivity Paradox

In 1987, Nobel laureate Robert Solow famously observed: "You can see the computer age everywhere but in the productivity statistics." Despite massive investment in IT infrastructure, productivity growth was nonexistent. At the time, this was known as the "Productivity Paradox."

It's not too difficult to see why productivity increases remained so elusive during that era. In 1987, PCs were klunky and awkward to use; Command codes via DOS were not the path to improved worker efficiency. As companies struggled to incorporate PCs into their workflow, they upset existing efficient routines. Firms had to create new infrastructures, hire consultants, and add IT staff. The subsequent integration was both painful and costly.

Productivity Spike in late '90s



Starting in 1995, non-farm worker productivity doubled. Looking back from our present vantage point, it's easy to see the how a few incremental improvements added up to a massive increase. By 1995, most office applications had become standardized. New hires no longer had to learn a unique set of tools. The learning curve for existing workers dramatically flattened. With the introduction of Windows 95, DOS became buried under a graphical user interface (GUI). The tools themselves were getting better and easier to use.

Additionally, new workers had *grown up* using PCs; They required little if any formal training. Using computers was not a learned skill to these new hires; For new employees from the "Class of 1995" onwards, the PC was a tool internalized as much the telephone or pen and paper. Standardization – plus these new, highly computer literate workers – helped boost productivity dramatically.

Thus, the Productivity Paradox appeared to have been solved. Growth of U.S. productivity surged on an annual basis. Since 1995, labor force productivity has been increasing at an annual rate double that of the previous two decades. This "productivity feast" (as its been called by Greenspan) is the largest increase in non-farm business output per hour in 30 years.

Since 1995, Productivity has been increasing on an annual basis of about 2.25% per year. At the same time, the labor force itself has been growing at 1% per year.

That simple math of 1% + 2.25% lies at the heart of the "***new* Productivity Paradox**:" As long as productivity continues to increase year after year at the present rate, the traditional notion of 3% GDP creating jobs no longer applies. *Real GDP must increase at the annual rate of at least 3.25% per year just for the economy not to lose any more jobs*.

The conservative American Enterprise Institute (AEI) noted that "right now, we're in a 'jobless recovery' – the economy is growing, but so is unemployment. The reason is that productivity is increasing. If new technologies enable each worker to produce more, the economy can grow without increasing the number of jobs."

This simple revelation engenders a host of issues not publicly addressed by the Fed Chief. During the boom times, Greenspan lauded productivity as the source of all that was right in the world. Productivity increases got the credit for a myriad of positives: increased living standards, higher corporate profitability, boosted tax revenues, and better funded pension plans. At the time, it seemed that the benefits of technological induced efficiencies knew no bounds.

The Dark Side of Productivity

Since the stock market bubble popped, the markets have been confronting the dark side of productivity: Companies now need less laborers to produce even more goods and services; On a macro-economic level, less workers means less consumer spending, lowered tax receipts and weaker corporate profitability. Firms have little pricing power; The National Review noted that "productivity stemming from technology advances and applications also creates inexorably downward price pressures. Technology breakthroughs make it a lot cheaper to produce commodities, finished goods, and all manner of services."

This ***new* Productivity Paradox** has the potential to cause significant dislocations in the labor market – one that might not be as easily solved as the last major shift. When the nation changed from a mostly manufacturing to a primarily service economy, it caused similar dislocations. The response by displaced workers was to retrain themselves for employment in other sectors, using the new tools of the trade. That response – *learning how to use new technological based productivity tools* – will not work at present. Indeed, it's what's to blame for these new productivity issues.

The jobs being lost presently via enhanced productivity will not be so easily replaced. Unlike the last seismic shift, there is no new "new economy" on the horizon to absorb newly displaced workers.

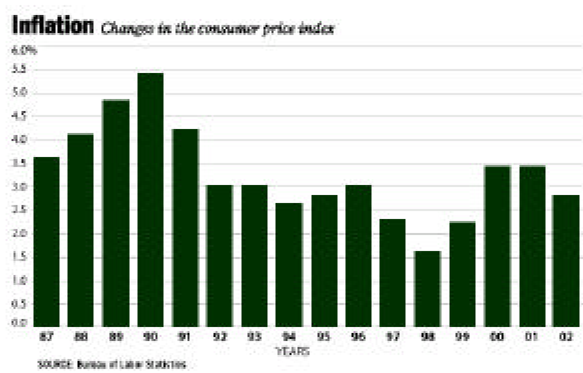
In order to stem the tide, one of two things needs to occur: Either *GDP must improve dramatically*, or *productivity gains must tail off*, if not outright reverse. Indicators suggest GDP is on the upswing (*see below*); But if neither of these occur, the U.S. may not start creating jobs for the next few quarters – if not years. Indeed, any *backslide* in the economy would see job losses resume at a disturbing pace.

The *New* Monetary Activism

Its hard to call a 13th rate cut "new;" Its only within the framework of the present environment that what was once a gradualist form of intervention has morphed into something much more *radical*. The Fed has subtly changed from being "social rate cutters" into "problem interventionists." I suspect they are thinking: "*We can stop anytime we want . . .*"

The weak but improving economy certainly doesn't demand further cuts. Its not as if there's been a "ground swell of complaints about high interest rates or tight money," observed the Wall Street Journal. The American Enterprise Institute similarly noted that "GDP growth will rise to 4 percent and probably overshoot to 5 percent for one or two quarters in 2004, in a long-awaited, normal cyclical recovery pattern, on the way to sustainable growth of 3.5 to 4 percent." With the economy on the mend, GDP should start creating jobs over the next 24 months. Today's 1/4 point cut reveals more about the *Fed's impatience* than it does about the state of the economy.

CPI change (since 1987)

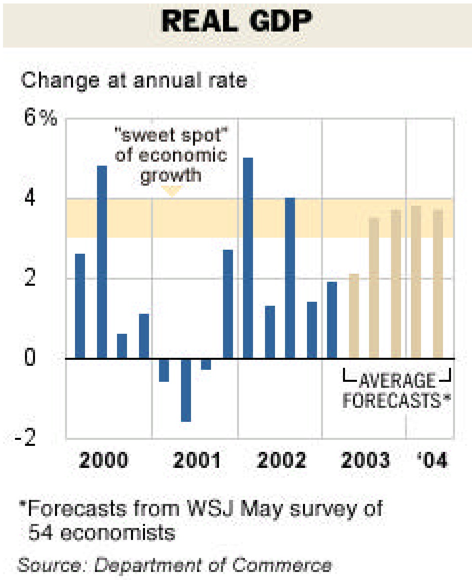


Nor does the recent Fed jawboning about deflation ring true. Some strategists have taken to referring to the specter of falling prices as "*the deflation ghost*." None other than former Federal Reserve Chairman Paul Volcker addressed the subject earlier this week. Speaking Monday at a forum on the state of the global economy at the London School of Economics, Volcker commented "*If I were setting odds on deflation in the U.S., the probability wouldn't reach 0.1 percent. I see no prospect of real deflation like we had in the U.S. and other countries in the 1930s*." The widely respected Volcker's comments effectively repudiated deflation as a factor in making further rate cuts.

With both deflation and economic recovery eliminated as possible reasons, the question remains: What else is left? The biggest issue of concern is unemployment and/or the job creation rate. But, as the AEI noted, GDP should hit a sustainable job-creating rate of 3.5 - 4% by 2005.

With so little evidence in favor of today's cut, Fed watchers are left to philosophically wonder "*why*." As we have pointed out in earlier reports, the Fed seems to be newly impatient, more concerned with the *timing* of their impact than their actual impact on the economy.

The Fed's role has apparently changed from "cushioning the pain in a downturn, towards creating a new expansion cycle." This is a radical change.



The new objectives of monetary policy, as well as the methodologies employed, reflect a newly radicalized Fed: "This policy cycle can arguably be seen as revealing a more powerful and preemptive use of fiscal and monetary stimulus than any prior post-World War II cycle," observed Michael Englund, chief economist for MMS International Analysts. In a recent Business Week article, Englund further added, "much of the economic stimulus in the pipeline is only now taking effect, as yields on longer-dated securities have just recently pulled back a significant degree, and a big portion of the combined tax cuts of the last three years is expected to kick in during June and July. All this is occurring while "real" interest rates (as adjusted for inflation) have fallen from cyclically firm levels to historic lows that now reflect extraordinarily depressed nominal levels overall."

Indeed, this radically *new* **monetary activism** – and its broad intervention in the markets – is now in uncharted waters. "*We have an amount of stimulus beyond anything I've heard of in history*" were the not so subtle observations of former Fed Chief Paul Volcker.

Relationship between the Productivity Paradox and Monetary Activism
The economy has reached the point in the cyclical recovery where the Fed's considerable economic stimulus is *finally* having an impact. All manners of economic activity have shown a modest rebound. And, much of the stimulus is still "in the pipeline."

The biggest laggard remains employment – historically, the last data point to see a rise in any economic recovery. As the excesses of the bubble get worked off, employment should see a gradual improvement. But this development will be a *function of time*, not *monetary policy*. Indeed, some have argued that the extremely cheap cost of capital allows companies to "hang around," instead of weakening to the point where the normal consolidation processes can occur.

The combination of this excess capacity and increased productivity suggests that employment will continue to lag the broader recovery, only gradually rising when GDP growth finally tops 3.25%. Barring unforeseen circumstances, that's not likely to occur until later this year at the earliest, and more likely sometime in 2004. But it should happen eventually.

Hence, the Fed's impatience and monetary activism appears to be unusually tied to the calendar. Unwilling to allow their already substantial stimulus to gradually work its way into the system, the Fed has opted to engage on a surprisingly activist agenda.

The most obvious event in 2004 possibly motivating the Fed's latest intervention is the Presidential election.

CONCLUSION: The Dangers of Excessive Intervention
The Fed's impatience and their surprisingly activist stance raise several danger signals:

First, rates will not stay this low indefinitely. What the Fed giveth, they must ultimately taketh away – and then some. "As always, the end result of excessive ease by the Fed will be higher rates in the years ahead" noted Brian Wesbury, chief economist at Griffin, Kubik, Stephens & Thompson.

Secondly, the question of the Fed's focus also is subject to criticism. "If the Fed is going to underscore its commitment to anything, it shouldn't be to an interest rate. It should be to macroeconomic stability, which doesn't include fostering another asset bubble. The U.S. is still recovering from the last one," noted Bloomberg columnist Caroline Baum.

Finally, the consideration of the Fed's activities as it relates to the Democratic process is yet another issue. We are not so naïve to believe that the Fed is totally insulated from politics; Indeed, Greenspan has shown himself to be a rather astute politician. (One does not get to be the Fed Chief without at least a passing understanding of what it means to be a player in DC). However, the Fed's activist stance smacks of partisanship:

David Gilmore, an economist at Foreign Exchange Analytics, details the overtly political factors in the Fed Chief's actions: "President Bush gave the aging Greenspan an unexpected, early reappointment as chairman." With an election less than 18 months away, "Bush is betting his generosity will get Greenspan on track for stimulating the economy **by all means necessary**" (emphasis ours). Timing, apparently, is everything.

Aggressive market interventionism is invariably accompanied by unintended consequences. We suspect that – eventually – the result of the Fed's impatience will be felt long after the present Fed Chief has retired

In the 1960s, then Federal Reserve Board Chairman William McChesney Martin made the famous quip that it was the Fed's job "to take away the punch bowl just when the party is getting going." Alan Greenspan tends the economic bar differently: He is freely offering drinks to the already inebriated; We should not be surprised by the consequences.

Explanation of Holding Periods

Long Term - Price movement expected in months to years.
Intermediate Term - Price movement expected in weeks to months.
Short Term - Price movement expected in days to weeks.

Explanation of Ratings

Buy - Expected relative performance of greater than +20% in the intermediate term.
Trading Buy - Expected relative performance of greater than +20% in the short term
Hold - Expected relative performance of -10% to +10% in the intermediate term.
Reduce - Expected relative performance of -10% to +10% in the short term.
Avoid - Expected relative performance of -10% to -20% in the short term.
Sell - Expected relative performance of less than -20% in the intermediate term.
Short Sale - Expected relative performance of less than -20% in the short term.

Ratings are benchmarked relative to the S&P 500

*In addition to the above listed rating there is a category called Remove that is not considered a rating. The term Remove means that the position is recommended to be eliminated and coverage is suspended.

Coverage Universe

Rating	Percent
Buy	38.1%
Trading Buy	9.5%
Hold	42.9%
Reduce	9.5%
Avoid	0%
Sell	0%
Short Sale	0%

Coverage universe as of March 31, 2003.

Valuation Methods

One or more of the following valuation methods are used in making a price projection: Analysis of the supply and demand for a security to ascertain how high or low a stock price may move before either overhead supply or underneath demand develops. Analysis of a companies P/E ratio, price/book ratio, price/cash ratio, earnings expectations or sales growth as they relate within an industry group or to the broader market. Dividend yield of the S&P 500 vs. the dividend yield of the 10-year government bond. Individual sector analysis along with investor sentiment and Federal Monetary policy.

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