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Evidence of inflationary pressures argue for hike

The case for raising rates

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"The Fed uses a range of measurements to discern signs of incipient inflation. We would point to the fundamental signals of both wage and price pressures now telling the Fed it is time to act."

Although the Federal Reserve made no decision to change interest rates at their meeting in May, they did issue a statement saying that they were more likely to raise interest rates than to lower them. This so-called "upward bias" has lent an extra edge to the usual speculation about interest rates that builds before each meeting of the Fed*s Open Market Committee that makes the critical interest rate decisions.

We believe that there is now enough evidence of inflationary pressures to support a small increase in interest rates when the Open Market Committee next meets at the end of June.

This would be the first increase in interest rates since the spring of 1997. While the outlook for inflation remains uncertain, a small degree of tightening now would reduce the risk that inflation will pick up rapidly and therefore would reduce the need for a future sharp increase in rates.

The Fed, of course, uses a wide range of different measurements to discern signs of incipient inflation. At the risk of oversimplification, we would point to the fundamental signals of both wage and price pressures now telling the Fed it is time to act.

Since wages are the largest component of the cost of production, rapid increases in wages have traditionally been the principal source of inflation. When unemployment is low and it is difficult to find new workers, wages are likely to rise more rapidly, triggering an increase in inflation.

Tracking the trends in wages over the past few years leaves little doubt that wage increases have been accelerating since 1995, albeit at a fairly modest pace. Wages increased at 2.4 percent in 1995, by 3.5 percent in 1996 and by 4.3 percent 1998. And since unemployment rates have fallen to levels that haven't been seen in over three decades, this trend in wages should continue as long as the economy maintains its recent strong growth.

It is not pure luck that the acceleration in wage increases hasn*t already created inflationary pressures. The actual link between rising wages and an increase in the cost of production that might lead employers to raise prices depends on productivity, or hourly output per worker. When productivity is rising more rapidly than usual, labor cost per unit of output will increase correspondingly more slowly. And that*s just what has been happening. After decades in which worker productivity rose at only about 1 percent per year, since about 1995 productivity has been rising at about 2 percentage points a year, permitting the faster increase in wages without a corresponding increase in unit labor cost. While the increase in productivity is still not fully understood, the rapid pace of change in computer and telecommunications technology is the most likely explanation.

Consumer prices have been slow to increase both because of these productivity gains and also because producers have had to compete with low import prices, as many of our trading partners have seen their currencies decline relative to the dollar. Last year import prices actually fell by 5 percent. The net result of increasing productivity and favorable import prices is that the rise in consumer prices (the CPI) in 1998, at 1.6 percent, even lower than that in 1995.

But looking ahead, the wage effect of an increasingly tight labor market is likely to outweigh the high rate of productivity increases.

In addition, oil prices have turned around, raising another important cost of production, and as the Asian financial crisis eases, the dollar is less likely to continue strengthening against the currencies of our trading partners. Facing higher costs of production and less competition from foreign prices, producers are beginning to be less constrained about raising prices to consumers.

Turning from the cost of production to the role of the consumer in the economy, recent quarters have seen very strong growth in consumer spending. In the first quarter of this year, consumer spending surged at a 7 percent annual rate. While some of the increased spending is on imported goods, this spending splurge can only mean a further tightening of the labor market as producers seek to meet the strong demand.

It is no surprise that these factors are beginning to be reflected in higher price inflation. The CPI shot up sharply for April at an annual rate of 8 percent. Even without the volatile food and energy components, consumer prices rose at a 5 percent rate. Although prices for May were nearly stable, the overall price trend is up.

Lest the conclusion seem to obvious, there are some anomalous factors for the Fed to consider before deciding to raise interest rates. In the last quarter of 1998 and the first quarter of this year, wages have actually been growing more slowly than during the accelerated trend from 1995-1998 -- this despite that productivity growth accelerated in these two quarters. If this surprising development were to continue, a rise in inflation might be put off for a substantial period of time.

This is the dilemma for the Fed: to hold steady on rates and wait for more information or to increase rates slightly and head off a more serious rise in inflation. We believe the balance should fall on the side of a preemptive strike against inflation.

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