Root Canal Economics

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The Fed lowered the boom on Friday as Chairman Powell committed to a policy of raising interest rates until inflation is tamed. The implication is that the fed funds rate would be increasing by 75 basis points for at least the next Board meeting in September or even more if the economy remains strong. He said, "we will keep at it until we are confident the job is done." Equity markets did not respond well to this announcement. After experiencing a positive week through Thursday, the Fed chief's remarks triggered a 1,000-point decline in the DJIA and a decline of 3.9% in the NASDAQ Composite.

The story is that inflation is defined as too much money chasing too few goods. The government goofed when it spent 5-7 trillion dollars on dealing with Covid, flooding the system with money and causing a run on goods and services which logically drove prices higher. By early 2022, the wealth accruing to the private sector was being reclaimed by the government reflected by higher tax revenues at the federal, state, and local levels. Moreover, the first of half of 2022 experienced a collapse of the stock market, especially the more speculative stocks that benefitted from outsized gains since 2020. Yet, just as the data was reflecting a wind down in the response to that government spending surge, both fiscal and monetary policy got ugly and looked like an attempt was being made to reclaim all that errant spending during the pandemic. What is unusual is that the Fed seems to be behind the curve when it comes to making policy decisions. A year ago, the Fed stated that we should not worry because inflation was only transitory. Now the Fed has ratcheted up the war on inflation just at a point when inflation seems to have peaked. The Fed has used the Personal Consumption Expenditures (PCE) measure as a good reflection of current inflation. The WSJ reports that the latest report on this measure was rising at a 4.6% rate (less the volatile food and energy components), down from 4.8% a year ago. "On a monthly basis, core prices rose a seasonally adjusted 0.1%, slowing markedly from June's 0.6% pace" according to the Journal. This is not the time to panic!

The problem as we see it is that the government is erring by responding to the money side of the equation rather than the goods side of the equation. The Fed is making borrowing difficult which is impacting the availability of credit, thus putting pressure on economic growth. The Administration is passing legislation that raises tax rates and increases regulations, both factors that also reduce economic output. The logical strategy would be to focus on fiscal policy that increases output to meet the challenge of fewer goods. Reducing taxes and regulations is a no-brainer when it comes to reducing inflation. Encouraging oil and gas production by lowering regulations on those industries also makes a lot of sense, especially when the global economy needs our energy exports to try to avoid an economic maelstrom.

Over the next few months errant monetary and fiscal policy may overshoot the target and contribute to a worsening economic situation than imagined. The financial markets are telling us that the government has taken the low road to managing the economy and we have currently stalled. We are just two months away from a national election that could prevent an economic disaster. Let's hope the folks in Washington DC will change course.