First Trust
Monday Morning OUTLOOK
November 7, 2011

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Time to Raise the "Natural Rate"

So far this year, inflation has been much higher than the Federal Reserve has expected. Back in January, the Fed expected the PCE Deflator (a broad measure of consumer prices calculated for GDP accounts) to rise 1.5% in 2011. But so far this year, these prices are up at a much faster 3.2% annual rate. A better known measure, the Consumer Price Index, is up at a 4.1% annual rate in the first nine months of the year.

The Fed argues that it really hasn't been wrong. It thinks temporary issues (mostly with commodity prices) are artificially holding up inflation. For next year, the Fed says the PCE Deflator will rise 1.7%, a higher forecast than it had for 2011, but still significantly lower than the current pace of inflation.

We think the Fed is making the same mistake again. The Fed, like all Keynesians, believes higher unemployment means lower wages, which, in turn, means downward pressure on inflation. But this was proven wrong in the 1970s, when high unemployment and inflation existed at the same time.

Instead of fixating on the unemployment rate, we see inflation as a monetary phenomenon. Inflation is "too much money chasing too few goods." So, inflation rises when the Fed is loose and falls when the Fed is tight.

Government policy, which enhances or detracts from real economic growth, also has an impact. In the early 1980s, Fed Chairman Paul Volcker's tight money was accompanied by President Reagan's tax cuts. Both helped tame inflation. And the same goes in reverse. Bad fiscal policies that deter growth can make a given monetary policy more prone toward inflation.

Right now the Fed is way too loose. We use nominal GDP growth as the appropriate target for the federal funds rate. In the past two years nominal GDP – real GDP growth plus inflation – is up at a 4.5% annual rate. Some view this growth as a rebound from crisis, a temporary upward blip that overestimates economic strength. But, even if we look at average growth back to Q1 2008, nominal GDP is up at a 1.8% average rate. Either way, a 0% federal funds rate is too low.

With nominal growth accelerating, either real GDP growth must rise to absorb excess monetary liquidity, or inflation will continue to accelerate. Or, a combination of rising real growth and rising inflation could occur.

That last scenario seems most likely. Real GDP growth *should* accelerate in 2012, to a 3% gain from about 2% this year. Given lower gas prices, the CPI probably took a breather in October (official data will arrive November 16) and our best guess is that we finish the year up 3.6%. Next year, consumer prices are likely to be up 4%+. To be clear, we think inflation would accelerate even more next year if not for the improvement in real economic growth.

One reason that Keynesian models make mistakes is that they miss underlying shifts in economic potential. For example, the Fed still thinks the future long-term average jobless rate should be roughly 5.6% - what economists call the "natural rate" of unemployment. In other words, the Fed doesn't think inflation can persist unless the unemployment rate falls below this natural rate.

But what if the natural rate is higher than this? Federal spending has climbed to near 25% of GDP – its highest levels in thirty years, reminiscent of a time when most economists thought the natural rate was 7%. Like 30 years ago, government spending has increased the natural rate of unemployment and the Fed has missed it. As a result, Fed models will continue to underestimate inflation.

We think the jobless rate is headed down in the next few years and think it will decline a bit faster than the Fed believes. But the only way to get it down to 5.6% is to dramatically reduce the size of government or to push so much money into the economy that it artificially pushes unemployment below the natural rate. But that second method can only work for a short period of time. Eventually, a monetary policy loose enough to lower the unemployment rate that much would create a 1970s-style inflation. That would make today's inflation problem look minor in comparison.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
11-7 / 2:00 pm	Consumer Credit - Sep	+$5.2 Bil	**+$2.0 Bil**		-$9.5 Bil
11-10 / 7:30 am	Int'l Trade Balance - Sep	-$46.2 Bil	**-$46.3 Bil**		-$45.6 Bil
7:30 am	Import Prices - Oct	+0.1%	**+0.2%**		+0.3%
7:30 am	Export Prices - Oct	+0.3%	**+0.5%**		+0.4%
7:30 am	Initial Claims - Nov 5	400K	**398K**		397K
11-11 / 8:55 am	U. Mich. Consumer Sentiment	61.5	**61.0**		60.9