Productivity, Goldilocks, and Inflation

The history of semiconductor manufacturing is peppered with one amazing story after another. The industry has overcome issue after issue to make chips smaller, faster and cheaper. Lately, insulation has become so thin that electricity leakage has been a real issue. But, once again, a solution is at hand.

Intel and IBM claim to be on the verge of manufacturing semiconductors with new metallic alloys. These new chips will have faster processors, but use less energy – an advancement that will allow cell phones (and other devices) to do more demanding tasks (e.g. play videos) with less battery drain.

This type of progress is symbolic of the entire New Era Economy. Productivity is booming. And rapid productivity growth explains why corporate profits, jobs and income growth have all accelerated at the same time.

Some forecasters have refused to accept this explanation and for the past few years have argued that rising oil prices, a housing slowdown, or some other calamity would bring the economy down very soon. These “fragile-economy” forecasters just can’t shake their pessimism.

Others have called this a Goldilocks Economy, because productivity not only pushes growth up, but pulls inflation down. What could be better than high growth, low inflation and low interest rates?

But there is a third view, which argues that much like the story Goldilocks, the bears of inflation and higher interest rates are on their way home.

Despite rapid increases in productivity, the Cleveland Fed’s weighted-median CPI (a measure which excludes the impact of big and small price increases) is up 3.7% during the year-ended December 2006. This is a sharp acceleration (a near doubling) from the 1.9% YOY growth rate in January 2004. While productivity helps contain prices, if monetary policy is too accommodative, inflation can still rise.

The fragile-economy crowd is too pessimistic on growth, while the Goldilocks crowd is blind to the inflation that is already here. The market, however, has recently pushed interest rates up sharply (the 10-year is up 44 basis points) and begun to price in greater odds of Fed rate hikes. The price of gold is back above $640/oz., and the dollar remains weak.

One last point: Inflation does not result from job creation, rising wages or strong growth, it’s caused by “too much money chasing too few goods.” Hiking interest rates a few more times to quell inflationary pressures will not hurt our high-productivity economy. Not hiking interest rates would be the real mistake and a very sad development when the Fed is on the verge of getting it just right.

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