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Why did Chairman Bernanke back off on monetary restraint CHATTER and what is behind it?

The recent pronouncements coming forth from the FED officialdom including Federal Reserve Board of Governors' Chairman Ben Bernanke are not inconsistent with that coming forth from the monetary policy makers throughout the developed world. Bluntly put: uncertainty and confusion reign. In the past, we could have relied on economic growth to bailout the economy from a multitude of errors by policy makers. When recessions came they seem to have been of shorter duration even when fairly severe, but recovery was quick to occur and a narrow V-shaped configuration usually put us back on the road to a reasonably rapid recovery.

The forecasters at the UCLA Anderson School of Business argue that we seem to have entered a new era of a very slow recovery from recessions that have become worse with time, at least for the last three recessions. This website's stressing of the collapse of the Labor Force Participation Rate that has occurred is one metric that is very consistent with the UCLA forecast.

Chairman Bernanke's statement made it clear that the FED would maintain its policy of relative ease and not move to one of more constraint.

Bernanke Plays Down Unemployment Rate's Weight

Federal Reserve Chairman Ben Bernanke played down the unemployment rate's weight in the central bank's calculation of when to start raising short-term borrowing costs.

July 17, 2013, 10:37 p.m. ET.

http://online.wsj.com/article/SB10001424127887323993804578612631506201970.html?mod=googlenews_wsj

"Since last December, the Fed has been saying short-term interest rates -- now near zero -- won't go up at least until the jobless rate drops below 6.5%, and as long as inflation stays near 2%.

But Mr. Bernanke suggested the Fed might keep rates near zero long after the jobless rate, which was 7.6% in June, falls below that 6.5% threshold. It is a point he has made before, but he placed new emphasis on it in the first of two days of congressional testimony about the economy and monetary policy -- possibly his last appearances before Congress since his term as chairman ends in January.

If very low inflation accompanies a drop in unemployment, Mr. Bernanke said, the Fed might feel less urgency about pulling back on cheap credit."

Some of the readers of this newsletter may think that we have been, and still are, too pessimistic about the state of the economy. Perhaps, but the Anderson forecasting group at UCLA is even more pessimistic as you can hear clicking on the following citation.

The Economic Recovery: A Novel Perspective from Ed Leamer
March 6, 2013

Hoover Institution
http://www.youtube.com/watch?v=aFN6X0O-wak

This pattern of increasingly weak recoveries from troughs of the last three recessions is reflected in several metrics. As we have been pointing out over the past few years on this website, the persistent drop in the Labor Force Participation Rate (LFPR) is one such measure. The discussants cite three reasons for this new pattern of stillborn recoveries that seem to have taken shape.

Professor Leamer cites three factors for the emergence of the lazy L shaped recovery. Two have to do with technological change and their impact on the employment of labor or rather the lack there of. The first is what used to be called deepening as opposed to widening investment in physical capital goods. It is now called automation. The capital to labor ratio in the production process increases along with a decrease in the labor to output ratio. Some see it as robotizing the production process. One of the extreme cases of such deepening investment or automation is the virtual elimination of longshoremen in our ports. With the move toward mechanization, such as massive overhead cranes, containers and container ships, etc., there are very few workers directly involved in the loading and unloading of cargo.

The new factories coming on line have been similarly automated. Physical strength and manual labor are less important than was the case in earlier years.

As we have explained in earlier newsletters on this website, the demand for labor reflects the tradeoff of labor involving worker compensation rates and job security, a variation of the law of demand or in this case, quantity demanded of labor being inversely related to the price of labor, i.e., its compensation rate. The greater is the demand for higher compensation rates by labor, the less will be the job security of labor. It is once again an example of that powerful but not well understood concept: substitution effect. Upward pressure on compensation rates without at least proportional increases in labor productivity, eventually gives rise to a very familiar form of the substitution effect manifesting itself in automation. When such technological changes are not available, bankruptcy of the firm can result. The cost of production lies behind the supply of goods and services. The demand for labor reflects an inverse relationship between labor compensation rates and the quantity demanded of labor. Ignorance of this can result in disastrous consequences for labor.

The UCLA Anderson forecasters cite another aspect of technological change, that of what they refer to as the negative impact on employment of the development in microprocessors. Simple and highly repetitive tasks can be done more cheaply and efficiently by computers than by manual labor. This has impacted the lower end of the labor market.

This last factor works in concert with what is referred to as globalization. The third major cause of the Lazy-L recovery pattern emerging exacerbates the loss of jobs at the lower end of the job market. This is probably one of the major causes contributing to our inability to reduce poverty rates recently pointed out by Congressman Paul Ryan.

Rep. Paul Ryan: The War on Poverty has 'failed miserably'
Thu Jul 25, 2013 3:33 PM EDT
NBC News

http://inplainsight.nbcnews.com/_news/2013/07/25/19681085-rep-paul-ryan-the-war-on-poverty-has-failed-miserably?lite

> "The Republican vice presidential candidate in 2012 and a potential GOP presidential contender in 2016, Ryan will hold a Budget Committee hearing next week to assess anti-poverty programs.
>
> "Next year marks the fiftieth anniversary of the War on Poverty. We've spent approximately $15 trillion and the question we ought to be asking ourselves is, 'where are we?' With a 15 percent poverty rate today -- the highest in a generation -- and with 46 million people in poverty, I would argue it's not working very well."
>
> He said, "We shouldn't be measuring our success in the war on poverty by inputs, by how much money we throw at programs, by how many people we enroll in programs; we ought to be measuring success in the War on Poverty by measuring how many people we get out of poverty….""

To summarize, these are the reasons for the lack of job creation – as pointed out by Ed Leamer in his online presentation:

1) Technological change in the form of robots viewed broadly as servo-mechanical machines.

2) Technological change in the form of microprocessors that have eliminated most of the so-called 'dumb' labor intensive repetitive jobs.

3) Globalization in the form of outsourcing of the remaining mundane jobs to lower labor cost areas in the second and third-worlds.

To which we're adding:

4) Improperly attributed productivity gains to labor, giving false readings on unit labor costs vs. unit capital costs

5) Collapsing birth rates (particularly in first-tier countries) leading to lack of consumer spending and with a lag, shortages of domestic labor often leading to significant immigration of foreign labor resulting in cultural clashes.

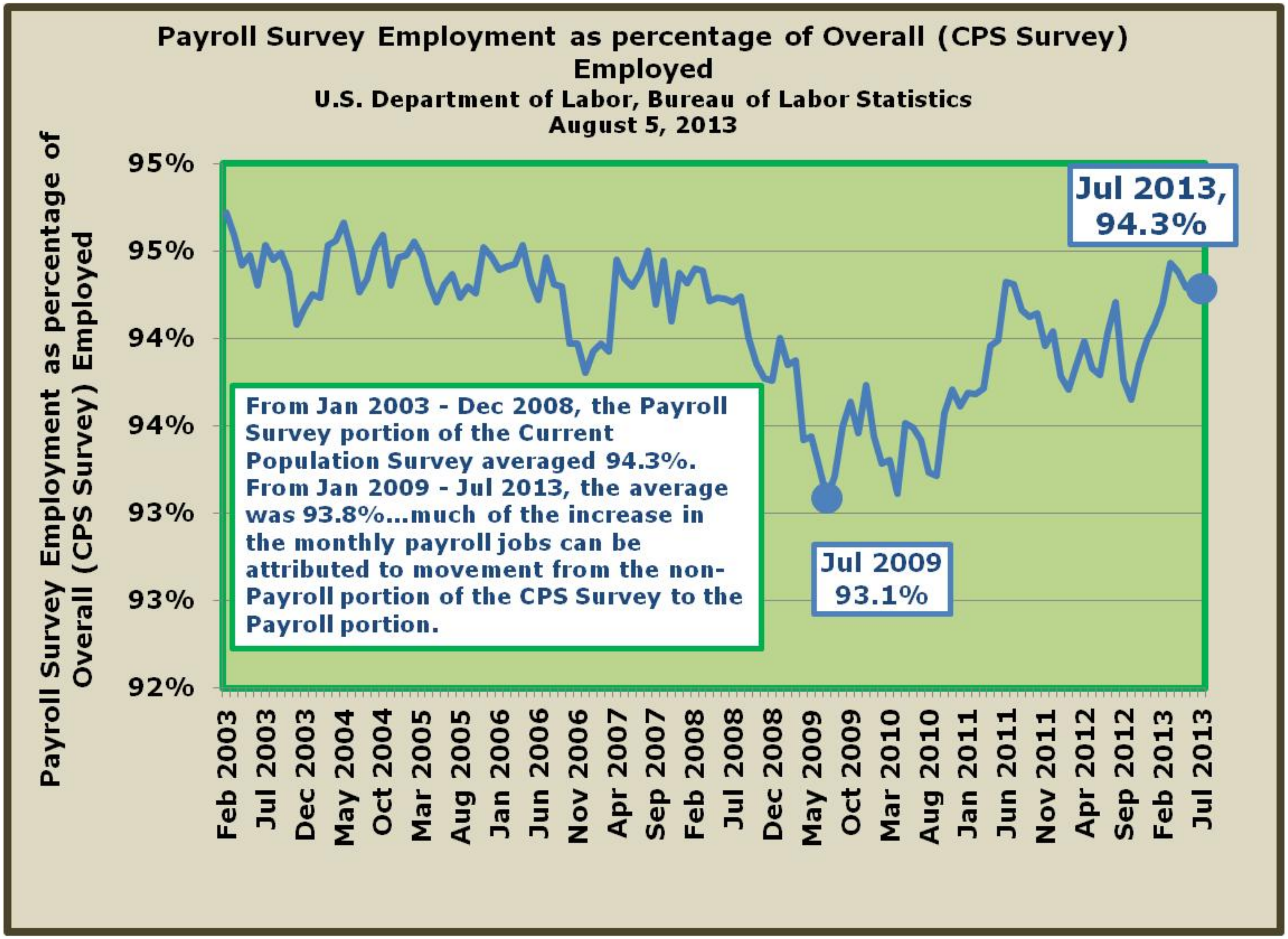
We would like to comment on the two additional factors we added to those cited by Professor Leamer. The first is the way in which changes in labor productivity are measured and its possible result in understanding unit labor costs.

One factor not mentioned in the articles cited above is the way in which increases in productivity are attributed to labor rather than capital. Undoubtedly, labor productivity is enhanced by many forms of education and training, now referred to as human capital. But the investment in physical capital such as in various forms of robotics that replace human strength and other forms of physical agility, do not require greater physical attributes of humans but rather less of such skills. Yet the increases in productivity from such investments in physical capital are attributed to labor, for the most part. Is this a Freudian type slip that is akin to versions of the Labor Theory of Value, ala David Ricardo or Karl Marx? It seems self-evident that the great increases in productivity at our seaports and new factories are clearly due primarily to physical capital and not human labor.

When higher nominal labor costs are adjusted for increases in labor productivity as is done in the periodic reports from the Department of Labor, are not the real costs of labor being understated? Maybe bureaucrats can pooh, pooh this subtlety, but the entrepreneurs responsible for bottom line performance understand the 'fog of data' very well. Their livelihood depends upon it. They must ask, is the cost of labor more expensive than official reposts are showing. If so, one of the most powerful economic forces enters into the decision, the SUBSTITUTION effect.

If official reports are understating the cost of labor and minimizing the impact of physical capital investments of the automation type on productivity, we do not need a concept such as mal-investment to explain the increasing capital intensity of the production process. A few years ago I had a graduate student whose family owned a firm with a proprietary heat treating process. It was a very competitive business and survival depended upon keeping efficiency up and costs down. He came to class and at the break chatted about what the firm had to do to remain competitive. His voice cracked and eyes teared-up as he explained that a new computerized machine, the CAM of CAD-CAM, was acquired. Six of the firm's longer termed employees lost their jobs and a new employee had to be hired since none of the six had the skill set required to operate the new machine.

The second addition we would like to add to The Leamer reasons for the seeming change in recent recoveries from the narrow V to a Lazy L configuration is the lack of population growth. This is one of the several areas beclouded by the 'fog of data' that has caused problems for the media and many economic analysts in their understanding of the relationship of the CES or Current Establishment Survey and the CPS or Current Population Survey. While technically the surveys are independent of each other, it helpful to consider the CES as being akin to a subset of the CPS. While the media highlights the CES report, they virtually ignore the CPS whose coverage is broader than the CES and upon which the unemployment rates are determined such as the sugar coated U-3 and the much more revealing U-6 measures of unemployment. As we have explained in several issues of this newsletter, the problem with the U-3 measure is that is defines away much of the unemployment problem by such things as excluding the discouraged worker from the labor force, employment or lack thereof in agriculture and household services, etc. 'Sweeping them under the carpet' would aptly describe the U-3 metric of employment and unemployment.


Payroll Survey Employment as percentage of Overall (CPS Survey) Employed
U.S. Department of Labor, Bureau of Labor Statistics
August 5, 2013
Payroll Survey Employment as percentage of Overall (CPS Survey) Employed
95%
95%
94%
94%
93%
93%
92%
Jul 2013, 94.3%
Jul 2009 93.1%
From Jan 2003 - Dec 2008, the Payroll Survey portion of the Current Population Survey averaged 94.3%. From Jan 2009 - Jul 2013, the average was 93.8%...much of the increase in the monthly payroll jobs can be attributed to movement from the non-Payroll portion of the CPS Survey to the Payroll portion.
Feb 2003
Jul 2003
Dec 2003
May 2004
Oct 2004
Mar 2005
Aug 2005
Jan 2006
Jun 2006
Nov 2006
Apr 2007
Sep 2007
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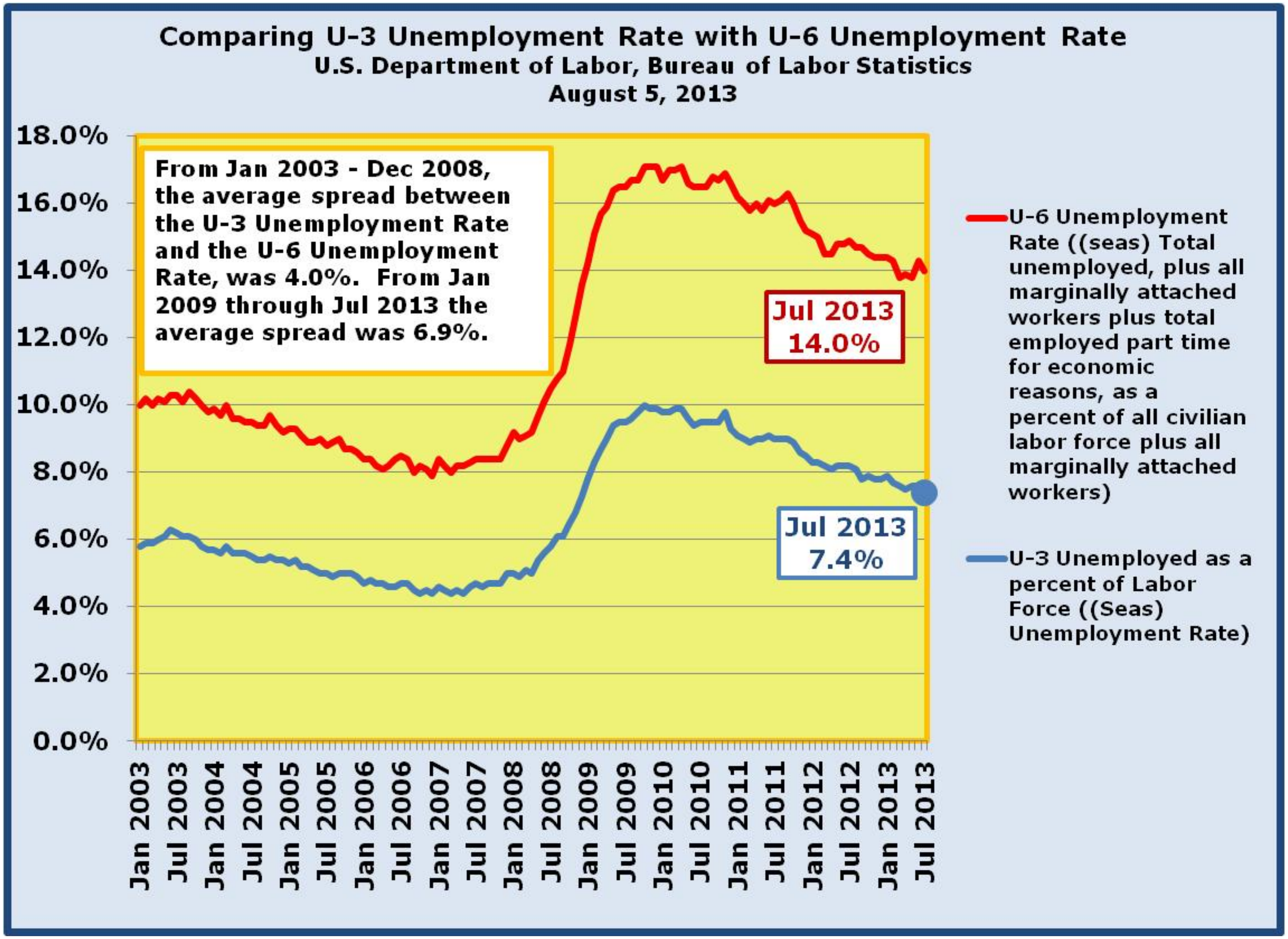
Apr 2012
Sep 2012
Feb 2013
Jul 2013



Comparing U-3 Unemployment Rate with U-6 Unemployment Rate
U.S. Department of Labor, Bureau of Labor Statistics
August 5, 2013
From Jan 2003 - Dec 2008, the average spread between the U-3 Unemployment Rate and the U-6 Unemployment Rate, was 4.0%. From Jan 2009 through Jul 2013 the average spread was 6.9%.
Jul 2013 14.0%
Jul 2013 7.4%
U-6 Unemployment Rate ((seas) Total unemployed, plus all marginally attached workers plus total employed part time for economic reasons, as a percent of all civilian labor force plus all marginally attached workers)
U-3 Unemployed as a percent of Labor Force ((Seas) Unemployment Rate)
18.0%
16.0%
14.0%
12.0%
10.0%
8.0%
6.0%
4.0%
2.0%
0.0%
Jan 2003
Jul 2003
Jan 2004
Jul 2004
Jan 2005
Jul 2005
Jan 2006
Jul 2006
Jan 2007
Jul 2007
Jan 2008
Jul 2008
Jan 2009
Jul 2009
Jan 2010
Jul 2010
Jan 2011
Jul 2011
Jan 2012
Jul 2012
Jan 2013
Jul 2013

One last point should be made. The Wall Street Journal had a recent article on the drop in college enrollments, especially incoming freshman. One of the several causes was attributed to a drop in population growth rates, especially in college age cohort.

Student Drought Hits Smaller Universities
At Loyola, Freshman Class Size Plunges
July 25, 2013, 7:28 p.m. ET

http://online.wsj.com/article/SB10001424127887323971204578628230654653180.html

“Enrollment rates for numerous smaller and lesser-known colleges and universities are falling this year, due to a decline in the U.S. college-age population, years of rising tuition, increasing popularity of Internet courses and a weak job market for recent graduates.”

The issue is much more serious than just college enrollments. Consumers are human beings, who account for over 60% of the economy’s aggregate demand if we include Personal Consumption Expenditures and expenditures on new residential construction which are lumped in with business investment to give us Gross Private Domestic Investment.

With a lag of 16 or so years, newborns are the additional productive resources needed for economic growth. These newborns eventually become the labor, debt and equity capitalists, entrepreneurs, and owners of land which includes our natural resources. Many countries which already have had or are starting to have problems of slow economic growth, fall into the category of low or negative population growth rates. We suggest as very helpful reading on this topic, a book by the late Julian Simon, THE ULTIMATE RESOURCE.

The Ultimate Resource II: People, Materials, and Environment
http://www.juliansimon.com/writings/Ultimate_Resource/

The Ultimate Resource
Julian Lincoln Simon

http://en.wikipedia.org/wiki/The_Ultimate_Resource

The last thing to be considered in this newsletter is a recent Forbes report as to the cause of a virtual jobless recovery, weak though the economic recovery is.
Note that it is related to a consideration we added to Professor Leamer's factors leading to the Lazy-L recovery pattern developing.

Forbes
June 24, 2013

The Fed's Zero Interest Rate Policies Amount To A War On Jobs

(http://www.forbes.com/sites/realspin/2013/06/04/the-feds-zero-interest-rate-policies-amount-to-a-war-on-jobs/)

> "To expand production employers either hire more workers or invest in new machinery and technology. The decision is influenced strongly by the relative cost of the two. If the relative cost of workers falls, the employer hires more people and spends less on investments. Conversely, a higher relative cost of workers encourages slower hiring."

The Forbes' article mentions a cause of the lackluster growth and jobs picture that sounds very Austrian in tone, i.e., MALINVESTMENT, but with a new twist. Low interest rates have stimulated investment in what we used to call deepening investment or automation as contrasted with widening investment. Recall that the Austrian School argued that mal-investment occurs when monetary policy causes interest rates to fall below market equilibrium rates that would have occurred in the absence of monetary policy intervention. In the jargon of financial theory, the cost of capital has become lower due to the policy intervention. The production process becomes more capital intensive than if the true market rates of interest prevailed. The apparent Forbes article twist is that automation occurs at a higher rate than if only market forces prevailed in the determination of interest rates, i.e., in the absence of monetary policy intervention. Many would say that the market rates of interest have been driven below the natural rate of interest.

Deepening capital investment meant that new technology was imbedded in the new capital goods. The production process would become more capital intensive and less labor intensive. The more popular term would be automation and reduce the labor to capital and labor to real output ratios.

The Austrian School has argued that activist monetary policies to attempt to fine tune the economy by changing the cost of credit, i.e. interest rates, made the level of economic activity more volatile, NOT less volatile. The FED's recent and ongoing policy of keeping interest rates low: on the short-term end by targeting the Federal funds rate at slightly above zero; and the intermediate and long term interest rates, by massive purchases of these longer maturities. This focus on longer term securities refers to the rounds of FED actions called quantitative easing (QE). QE 1-4 policy actions, which are still continuing in the form of MBSs and U.S. government marketable securities, have kept the cost of capital for firms at very low levels for the last five years.