Fighting inflation with interest-rate increases alone is ineffectual; the Fed is constrained by laissez-faire economics.

By William E. Jackman, PhD

September 2023

Dear Mayor Thao,

Thank for your hard work during your first nine months as Mayor of Oakland as you have faced an array of challenging issues: inflation. the economy of Oakland's downtown including restaurants, homelessness, crime, employee strikes, broken streets and more. During this time, the Fed's series of eleven interest-rate increases in 17 months to fight inflation have been salient in daily news.

Earth Day and Memorial Day letters

I wrote an Earth Day letter to your predecessor Libby Schaaf each year of her eight years in office, and I wrote my first Earth Day letter to you in April of this year. Occasionally but not often, I wrote to Ms. Shaaf about economic growth issues. I wrote to her primarily about the environment and sustainable existence on our planet, not about the economy, because it is ill-conceived to focus on economic growth if it is wrecking our planet on which we and the economy depend. I wrote my last economics essay to Ms. Shaaf for Memorial Day 2021 (attached).

This is **my first economics letter to you**; it is entitled **"Fighting inflation with interest-rate increases alone is ineffectual; the Fed is constrained by laissez-faire economics."** This essay is pasted into this email and attached as a Word document which is **the recommended way to view it**. Pasting a Word document into an email is not a seamless process; for example, snipped photos are dropped.

The Fed's interest-rate increases to fight inflation have been in the news.

About ten months before you took office as Mayor of Oakland on January 9, 2023, the Fed initiated a series of eleven interest-rate increases, beginning on March 16,

2022. It made its eleventh interest-rate increase on July 26, 2023, raising the federal funds rate to the range of 5.25 to 5.5%, its highest level in 22 years. At its most recent meeting, the Fed did not raise interest rates but kept them where they have been since July 26. The Fed's decision to leave interest rates unchanged is the second time this year that the Fed has left interest rates unchanged as it assesses the impact of previous hikes on inflation and the wider economy.

Mayor Thao, you are the first renter to be elected as Oakland's mayor. You have probably dreamed of owning your own home. But the current cost of houses combined with elevated mortgage costs caused by the Fed's eleven interest-rate increases make owning your own home very difficult to attain.

The average rate for a 30-year, fixed-rate mortgage currently sits near 7%, according to Freddie Mac. In 2021, before the Fed began its series of eleven interest-rate increases in quick succession, the average rate for a 30-year, fixed-rate mortgage was 2.96%. An increase in mortgage rates from 2.96% to 7% can add thousands of dollars to the monthly cost of a mortgage, making buying a home out-of-reach even for the Mayor of Oakland.

The major points of this essay are:

- Except for new home purchases – and possibly, but probably not, consumer vehicle purchases – the Fed's eleven interest-rate raises in 17 months have **had a negligible effect** on consumer purchases.
- The drop in inflation from 8.3% in 2022 to 3.7% in September 2023 was **<u>not</u>** <u>due</u> to the Fed's eleven interest-rate raises in 17 months. It was due to the normal workings of the forces of supply and demand.

- The Fed’s ongoing campaign to bring inflation down from its September 2023 rate of 3.7% to the Fed’s target rate of 2% by further interest-rate increases **is ill-conceived and is wrecking the economy**, and the damage being done may last over a decade.
- The Fed is currently unable to respond to flagrant price increases that are much in excess of the current 3.7% rate of inflation (much less the Fed’s 2% inflation target).
- The Fed should take a lesson from the Department of Justice (DOJ). The DOJ’s **targeting of specific violators in the banking sector**, e.g., Wells Fargo Co. and UBS Group, levying heavy penalties on them, and publicizing the penalties as a deterrent to other potential violators have been effective.

Getting back to the Fed’s 2% inflation target could be tough.

The rate of inflation has come down from 8.3% in 2022 to 3.7% in September 2023 but is still considerably above the Fed's 2% target. The Federal Reserve has a target annual inflation rate of 2% which it believes best supports the goal of maximizing employment while also keeping prices stable. **But getting back to the 2% inflation target could be tough.**

- “We see some challenges in getting that all the way back to 2% quickly,” said Michael Hanson, senior global economist at J.P. Morgan.
- “The Fed has got lucky so far in what it’s gotten. Most of the decline in inflation was going to happen anyway.” They really own the part that’s to come” commented Steven Blitz, chief U.S. economist at GlobalData.
  (Both quotes are from an August 8, 2023 *Associated Press* report by Christopher Rugaber entitled “Inflation cools, but hitting Fed target could be tough.” It appeared in the *East Bay Times* on August 9, 2023.)

Interest-rate increases are ineffective for most consumer purchases.

Economist Blitz commented (above) "Most of the decline in inflation was going to happen anyway." The drop in the inflation rate to 3.7% in September 2023 from 8.3% in 2022 was **not the result of the Fed's interest-rate increases** because almost all the economic activities contributing to the sharp rise in inflation in 2021 and 2022 are not interest-rate sensitive; these purchases by consumers don't require getting a substantial loan. This point of view will be explained and elaborated on in the sections below.

The Fed Is powerless to act against flagrant price-increases.

Another factor that will make it tough for the Fed to get the U.S. back that to the 2% inflation level is that the Fed is powerless to act against businesses that raise prices considerably in excess of the current (September 2023) rate of inflation of 3.7%--much less the 2% inflation target. (The long-term average of inflation in the U.S. is 3.3%) Some examples:

- **"Big companies keep raising prices, complicating Fed's job"**

  (by J. Edward Moreno of *The New York Times*. It appeared in the *East Bay Times* on July 27, 2023, p. C9.)

  "Some of the largest consumer brands in the country have continued to raise prices aggressively this year while raking in large profits, posing a tough problem for the Federal Reserve as it aims to tame inflation.

  Coca-Cola, Pepsico and Unilever have each reported raising prices significantly in the second quarter, from about 8% at Univelver to 15% at Pepsi. The price increases powered sales growth last quarter, keeping earnings strong…"

  "We've been able to raise prices, and consumers stay within our brands," Ramon Lagarta, CEO of Pepsi, said on a call with analysts."

  Food prices are not sensitive to interest rates. Firstly, food is a necessity.

Secondly, we do not take out a major loan to buy food in good or bad times.

"The Fed really has no ability to resolve those issues [rising food prices]," said David Ortega, a food economist at Michigan State University.

"Big brands keep raising prices, with limited resistance"

"Unilever says it has raised prices for its products, which include Ben & Jerry's ice cream and Dove soap, more than 13% in its fourth quarter, the eighth consecutive acceleration in prices."

"PepsiCo raised prices 16% in the 4th quarter."

(by Isabella Simonetti of The *New York Times*. It appeared in the *East Bay Times* on February 11, 2023, p. C8.)

- **Tickets for rock/pop concerts are soaring** far in excess of the current (September 2023) rate of inflation of 3.7%--much less the Fed's 2% inflation target.

  In 2021 and 2022, the Fed's inflation-fighting focus was on goods. But for over a year, its focus has extended to services, and entertainment is a service. Tickets for rock/pop concerts, a service, are soaring, with price increases for Taylor Swift's concerts most salient.

  "The Fed is paying particular attention to a measure of services inflation that covers such items as dining out, hotel stays and entertainment that has remained chronically high for much of the past year."

  (By Christopher Rugaber of the *Associated Press* which appeared in the *East Bay Times* on May 11, 2023, p. C9)

<u>**Inflation in prices for Taylor Swift's concerts**</u>

How much did ticket prices for Taylor's current Eras tour increase from her previous Reputation tour? According to ticketing platform SeatGeek, the

average price for a resale ticket to Swift's Reputation tour was $279. As of Nov. 18, [2022], the average price of an Eras ticket on the secondary market was $2,424 (Dec 2, 2022).

So, tickets for Taylor's Eras tour cost almost 8 times more (7.69) than tickets for her Reputation tour.

$2,424 / $279 = 8.69, 8.69 – 1 = **7.69**

Taylor's Reputation tour occurred during 8 May 2018 – 21 Nov 2018. There were approximately five years between the tours. So, that's a 154% increase per year (7.79/5) = 1.538

Price increases of 154% per year are flagrantly higher the current (September 2023) rate of inflation of 3.7%--much less the Fed's 2% inflation target.

What can the Fed do about this? It can raise interest rates which makes loans more costly. But this tool of the Fed is ineffectual against soaring ticket prices for rock/pop concerts. Attendees of Taylor Swift's Eras tour are not dependent on getting a bank loan to attend her concerts.

The soaring prices of tickets for Taylor Swift's Eras tour directly drive inflation. But they also drive it indirectly because they encourage other pop/rock stars, e.g., Beyoncé, to replicate her financial success.

- **Prices for media publications are rising sharply, far in excess of the rate of inflation.** I have experienced this rapid price escalation personally. ***The New York Review of Books*** is a semi-monthly publication. When I first subscribed to it in 2021, it cost $34 per year. When I renewed it in 2022, it cost $49 per year, **a yearly increase of 44%**. To renew it in 2023 cost $100 per year, **a yearly increase of 104%**.

The ***East Bay Times*** is a daily newspaper I have subscribed to for many

years. (I receive the print and electronic versions, but read the former because I can read it much faster.)

It cost $352.67 per year in 2021. When I renewed it in 2022, it cost $446.80 per year, **a yearly increase of 26.7%**. When I renewed it in 2023, it cost $557.76, **a yearly increase of 24.8%**.

The Fed is trying to get inflation down to its target of 2% per year and is currently concerned about the rising prices of services which include media services such as newspapers.

What can the Fed do about these price increases far in excess of current (September 2023) rate of inflation of 3.7%--much less the Fed's 2% inflation target? As noted above, it can continue raising interest rates which makes loans more costly. But this tool of the Fed is ineffectual against steep increases in prices for media publications. Despite these steep price increases, I won't need to take out a loan to renew them, so Fed interest rate raises won't affect my purchase/renewal decision.

(Incidentally, over a third of the research for this essay came from articles I clipped from the *East Bay Times*.}

- **NFL Contracts for 2023 Hit Stratospheric Levels, surpassing even pop/rock stars.**

Professional football (NFL) is much in the news these days, and 49ers defensive end Nick Bosa has been particularly salient. Bosa held out for a new contract until four days before the 49ers first season game (Sunday, Sep 10. at Pittsburg; he missed almost all the 49ers 2023 NFL training camp in Santa Clara CA which began on July 25).

Bosa's lengthy holdout paid off for him: On Sept. 6, the 49ers and Bosa agreed to a five-year extension worth an incredible $170 million—a new record for a

defensive player. With an **average annual salary of $34 million**, Nick Bosa has set the new standard for contracts among non-quarterbacks in NFL history.

Bosa did exceedingly well in his negotiations with the 49ers for his 2023-2024 contract, but 15 other highly-remunerated NFL stars, all quarterbacks, did markedly better than Bosa.

Ranking the NFL's Top 28 Contracts for 2023

Ranked by the **average annual value** of their contracts

(Players with the same contract value are listed as "Tied".)

1 of 28

1) Joe Burrow (QB), Cincinnati Bengals - $55 million per season

2 of 28

2) Justin Herbert (QB), Los Angeles Chargers - $52.5 million per season

3 of 28

3) Lamar Jackson (QB), Baltimore Ravens - $52 million per season

4 of 28

4) Jalen Hurts (QB), Philadelphia Eagles - $51 million per season

5 of 28

5) Russell Wilson (QB), Denver Broncos - $49 million per season

6 of 28

6) Kyler Murray (QB), Arizona Cardinals - $46.1 million per season

7 of 28

7) Deshaun Watson (QB), Cleveland Browns - $46 million per season

8 of 28

8) Patrick Mahomes (QB), Kansas City Chiefs - $45 million per season

9 of 28

9) Josh Allen (QB), Buffalo Bills - $43 million per season

10 of 28

10-Tied) Dak Prescott (QB), Dallas Cowboys - $40 million per season

11 of 28

10-Tied) Daniel Jones (QB), New York Giants - $40 million per season

12 of 28

10-Tied) Matthew Stafford (QB), Los Angeles Rams - $40 million per season

Michael Owens/NFL

13 of 28

11-Tied) Aaron Rodgers (QB), New York Jets - $37.5 million per season

14 of 28

11-Tied) Derek Carr (QB), New Orleans Saints - $37.5 million per season

15 of 28

15) Kirk Cousins (QB), Minnesota Vikings - $35 million per season

16 of 28

16) Nick Bosa (DE), San Francisco 49ers - $34 million per season

17 of 28

17) Jared Goff (QB), Detroit Lions - $33.5 million per season

18 of 28

18) Aaron Donald (DL), Los Angeles Rams - $31.667 million per season

19 of 28

19) Tyreek Hill (WR), Miami Dolphins - $30 million per season

20 of 28

20) Ryan Tannehill (QB), Tennessee Titans - $29.5 million per season

21 of 28

21) T.J. Watt (OLB), Pittsburgh Steelers - $28.003 million per season

22 of 28

22) Davante Adams (WR), Las Vegas Raiders - $28 million per season

23 of 28

23) Joey Bosa (DE), Los Angeles Chargers - $27 million per season

24 of 28

24) Cooper Kupp (WR), Los Angeles Rams - $26.7 million per season

25 of 28

25-Tied) Geno Smith (QB), Seattle Seahawks - $25 million per season

26 of 28

25-Tied) A.J. Brown (WR), Philadelphia Eagles - $25 million per season

27 of 28

25-Tied) Myles Garrett (DE), Cleveland Browns - $25 million per season

28 of 28

25-Tied) Laremy Tunsil (LT), Houston Texans - $25 million per season

Top NBA contract surpasses top NFL contract.

As noted above, Joe Burrow and the Cincinnati Bengals agreed to a five-year, $275 million deal that will make Burrow the highest-paid player in NFL history; the deal will pay him **an average of $55 million per season.** But Anthony Davis of the Los Angeles Lakers (of the NBA) recently signed a contract for the next five seasons that will pay him **an average of $62 million per season, 12.7% more per year than Burrow.** Davis's average pay of $62 million per season surpasses the average $60.8 million per season that Boston Celtics wing Jaylen Brown got last month as part of his five-year supermax deal worth up to $304 million.

These stratospheric NFL and NBA contracts drive up inflation directly: ticket prices for the games go up to help defray the cost of these astronomical contracts. They also drive up inflation indirectly because they encourage other top football and basketball stars to try to replicate the financial success of the NFL **Top 28** and of Anthony Davis and Jaylen Brown of the NBA.

It also encourages others who are not professional athletes(entertainers) such UPS deliverers, United Auto workers, and American Airlines pilots to seek higher pay. They see Anthony Davis getting paid an average of $62 million per season to play basketball and Joe Burrow getting paid an average of $55 million per season to play basketball. These are games the rest of us play for fun.

Moreover, workers such as UPS deliverers perform vital economic functions. If UPS deliverers go on strike and you don't receive the goods you ordered online, it impacts your daily life. In contrast, football and basketball players are entertainers who don't perform vital economic functions. Whether the "home" teams wins or loses does **not** impact your daily life.

Professional Sports Drive Up Medical Costs and Inflation

Medical costs are increasingly a major driver of inflation. For example, prices for hospital services, the single biggest component of medical care, accelerated in December 2022 and even faster in January 2023 to an annual rate of 5.5%, according to personal consumption expenditures data, the Federal Reserve's preferred measure of inflation.

Football and quarterback sacks

Athletes of many professional sports, e.g., basketball, are particularly vulnerable to injuries which add to our country's medical costs and drive up inflation. These injuries do not usually occur because the opposing team is out "to sack" their opponents. For example, the Golden State Warrior's opponents do not intentionally try "to sack" point guard Steph Curry.

Football is different. A goal (for which they are highly remunerated) of players like 49ers defensive end Nick Bosa and Pittsburgh Steelers OLB (outside linebacker) T.J. Watt is **to sack quarterbacks**. Bosa, who recently became the NFL's highest-

paid, non-quarterback, **is expected to sack quarterbacks**. DraftKings sportsbook has set the over/under for quarterback sacks for Bosa in 2023 at 15.5. This past season is the first time that Bosa has ever exceeded 15.5. Prior to that, he had 15.5 sacks in 2021, then 9 in 2019. Bosa has set the bar extremely high, so getting over 15.5 is kind of expected of him. Bosa has had 43.0 career sacks.

Brock Purdy sacked by Haason Reddick, and the medical bills begin.

Sacking a quarterback is not a gentle process, especially when it is done by players like 49ers defensive end Nick Bosa who are expected to sack quarterbacks to justify their $34 million per season salary.

49er quarterback Brock Purdy took a hit from 240-pound linebacker Haason Reddick* during the first quarter of the Championship Game against the Philadelphia Eagles on January 29, 2023 and suffered a torn ulnar collateral ligament (UCL) in his right elbow. He underwent surgery on March 10, 2023 (which had initially been scheduled for February 22, 2023).
(*Haason Reddick sacked the quarterback 16 times in 2022, even more than Nick Bosa, the NFL's highest-paid non-quarterback, who had 15.5 sacks.)

Purdy became the 49ers' starter midway through his rookie season in 2022 after Trey Lance and Jimmy Garoppolo both suffered season-ending injuries, broken ankle and broken foot, respectively. Purdy had six regular season starts when he took the hit from linebacker Haason Reddick on January 29, 2023 that put him out for the season.

Expensive medical treatment

Football players suffer major injuries requiring lengthy and costly medical treatment at a much higher rate than the general population. Brock Purdy underwent successful elbow surgery during the 49ers offseason to repair his UCL with an internal brace. After surgery, the focus was on his recovery.

Recovery could be anywhere from six to eight months

At the time, whether he would be ready for the start of the 2023 season was unknown, and head coach Kyle Shanahan said the recovery could be anywhere from six to eight months. Purdy and Shanahan both said they would know more on Purdy's availability for the regular season once his recovery hit the three-month mark. "The protocol is you start throwing at three months, but it all depends on how your therapy and your range of motion and everything goes up until that point," Purdy said (via The Mercury News). "

Surgery followed by extensive physical therapy

Purdy's medical treatment included not just surgery by highly-skilled surgeons (MDs) but ongoing follow-up treatment by a medical team with highly-skilled physical therapists. "I'm with a specialist out here who's done this rehab on the elbow hundreds of thousands of times," Purdy said of his physical therapist, Keith Kocher. "He's a baseball guy and they trust in him and everything is going as planned."

As you can understand, Purdy's medical treatment was costly. If the general public were injured at the same rate as football players and required commensurate medical treatment, inflation for medical services would rise sharply, and our health system would conceivably be overwhelmed by the increased demands made on it. Given this, it is ironical that defensive ends, outside linebackers (OLB), and linebackers such as Nick Bosa, T.J. Watt, and Haason Reddick, respectively, **are paid more if they get more quarterback sacks** which can cause injuries like that of Brock Purdy which result in huge medical bills that drive inflation and increased demands on our medical system.

Brock Purdy returns as the 49ers' starting quarterback on September 10, 2023.

As stated above, Purdy was injured when he took a hit on January 29, 2023. He returned as the 49ers' starting quarterback on September 10, 2023 against the

Pittsburgh Steelers. So, he was unable to be the 49ers' starting quarterback for almost seven and one-half months.

Stratospheric levels of football and basketball contracts drive inflation. **What can the Fed do to counteract the inflationary effects of these astronomical football and basketball contracts?** It can raise interest rates which makes loans more costly. But this tool of the Fed is ineffectual against soaring ticket prices for football and basketball games. Fans want to be in the "home" stadium to root for the "home" team. They are willing to fork out the money for tickets and don't need to take out a bank loan* to buy them (*with high interest rates resulting from the Fed's eleven interest-rate increases in 17 months)

The Fed's single tool to control inflation: raising interest rates

The Fed has been relying on a single tool, raising interest rates, to bring down inflation. Supposedly, higher interest rates "cool off" the **entire** economy, ranging from consumer purchases to business investment.

This belief is false. Higher interest rates affect consumers trying to get a major loan to buy a home or possibly, but probably not, to buy a car or major appliance (more on this later) and they affect business formation and expansion which often requires substantial infusions of borrowed money. But higher interest rate have a **negligible effect on "cooling off"** most daily purchases by consumers and many daily purchases by businesses. These ongoing purchases by consumers and businesses are not interest rate-dependent; they don't require getting a loan to make them.

The Feds interest-rate increases have been highly-publicized in daily news which glibly assumes that these increases have had had a major role in bringing inflation

down from 8.0% in 2022 to 3.7 in September 2023. In fact, these interest-rate increases have had a **negligible effect on the rate of inflation**. Why? Because most factors driving inflation are not interest-rate sensitive.

Viewing inflation at the detailed level of daily consumer purchases

In the discussion above, we looked at some instances of large companies and music and sports stars flagrantly raising prices, knowing that consumers would still buy their products or services and that the Fed could not do a thing about their flagrant price increases. In this next section, we take a **more comprehensive and detailed look** at daily consumer purchases and analyze whether these purchases are affected by the Fed's interest-rate increases.

Here are two analyses of inflation at the detailed consumer level, one of inflation in 2022 by CBNC and the other of inflation in 2021 by Smartest Dollar.

CNBC
https://www.cnbc.com › 2023/01/13 › why-inflation-hit-...

School lunch, eggs, and airfare: Why inflation soared for 10 items in 2022

PUBLISHED FRI, JAN 13 20232:35 PM ESTUPDATED FRI, JAN 13 20235:52 PM EST

Greg Iacurci

KEY POINTS

- Inflation in 2022 hit its highest level in four decades, according to consumer price index data.
- Price increases were largely concentrated among food, fuel, and airfare.
- Some items, such as school meals, eggs, margarine, and fuel oil, saw more dramatic upswings in prices.

Some of those swings were due to outlying factors that extended beyond broad inflationary pressures such as snarled supply chains, labor shortages, burgeoning consumer demand and Russia's invasion of Ukraine.

Here's a look at the 10 items with the largest price gains, as measured by the annual inflation rate in December 2022. Percentages are from the latest consumer price index data, issued Thursday (January 12, 2023)

Top 10 inflation categories for December 2022

Year-over-year percent change in the consumer price index

Category	Change
Food at elementary + secondary schools	305.2%
Eggs	59.9%
Margarine	43.8%
Fuel oil	41.5%
Motor fuels *Excluding gasoline*	32.3%
Butter	31.4%
Airfare	28.5%
Lettuce	24.9%
Flour + prepared flour mixes	23.4%
Other dairy and related products *Excluding milk, cheese + ice cream*	21.4%

Table: Gabriel Cortes / CNBC
Source: U.S. Bureau of Labor Statistics
Data last published Jan. 12, 2023

<u>None</u> of the Top 10 inflation categories for 2022 in the CNBC analysis are interest-rate sensitive. That is, they are not affected when the Fed raises interest rates (which makes it more costly to borrow money) because consumers don't take out loans to buy these goods. If prices for these goods came down in 2023 from 2022, it is not because the Fed raised interest rates but because the supply of these goods increased or because demand for them decreased as consumers

substituted other less expensive goods, i.e., the interaction of the forces of supply and demand, or because consumers just did without them.

This is also the point of view of Steven Blitz, chief U.S. economist at GlobalData (repeated from above): “The Fed has got lucky so far in what it’s gotten. Most of the decline in inflation was going to happen anyway.”

The survey below shows how consumers contributed to bringing down inflation: they substituted less expensive goods for more expensive goods or just did without them. Fed interest rates increases had a **negligible effect** on their actions.

According to a recent survey, 88% of Americans say they are concerned about U.S. inflation. Here are the top five areas where consumers plan to cut back on their spending:

CNBC
https://www.cnbc.com › 2021/11/18 › inflation-has-88pe...

Inflation has 88% of Americans worried. Here's how they ...

18 nov 2021 — A new survey from Country Financial finds that 88% of Americans are highly concerned about **inflation**. That's as consumer prices soared to a more ...

Money saving action	% of respondents
Cut back on restaurant / take-out meals	48%
Keep my current technology (e.g. phone, tablet) instead of upgrading	30%
Budget food and cut back on grocery buying	29%
Purchase less clothing / accessories	29%
Put off home repairs, renovations, or home upgrades	23%

Cutting back on restaurants and takeout meals is the most popular way for respondents to save money. Image: Visual Capitalist

Products & Services Most Impacted by Inflation

Updated on April 26, 2022Jon Jones, 8 min read

February 2021 to February 2022

Rank/Category	Year-over-year change in price:
15. Fish and seafood	+10.4%
14. Coffee	+10.5%
13. Fresh fruits	+10.6%
12. Eggs	+11.4%
11. New vehicles	+12.4%
10. Poultry	+12.5%
9. Pork	+14.0%
8. Motor vehicle parts and equipment	+14.3%
7. Beef and veal	+16.2%
6. Utility (piped) gas service	+23.8%
5. Car and truck rental	+24.3%
4. Lodging away from home	+25.1%
3. Fuel oil and other fuels	+33.4%
2. Motor fuel	+38.1%
1. Used cars and trucks	+41.2%

Only one of the Top 15 inflation categories for 2021 in the Smartest Dollar analysis, Category 11, New Vehicles, was possibly influenced by the Fed's interest-rate increases. But there is **mixed evidence** about this.

- **<u>Not</u>** influenced by the Fed's interest-rate increases. This is what the most recent economic data indicates.
  "Plans to purchase autos and appliances continued to trend upward but plans to buy homes – more in line with rising interest rates – continued to trend downward," said Dana Peterson, chief economist of the Conference Board. (By Augusta Saralva of *Bloomberg*, which appeared in the *East Bay Times* on August 30, 2023, p. C7)
  Also, the New Vehicles category does not appear in the CNBC Top 10 Inflation Categories for 2022 (above).

- **<u>Is</u>** influenced by the Fed's interest-rate increases.

CNBC
https://www.cnbc.com › 2023/06/01 › how-inflation-and...

How inflation and higher interest rates changed car buying

1 jun 2023 — The Federal Reserve's battle to **taper inflation** by ratcheting up interest rates is limiting who can afford to purchase a new or used vehicle.

How inflation and higher interest rates have reshaped car buying for many Americans   PUBLISHED THU, JUN 1 20238:15 AM EDT

Michael Wayland@MIKEWAYLAND

KEY POINTS

•	The Fed's battle to taper inflation by upping interest rates is limiting who can afford to purchase a vehicle.

•	The rate hikes have many Americans lowering their buying expectations, opting for used vehicles over new, or fixing their current car or truck instead of purchasing a replacement.

- The trend is hitting lower-income consumers, with credit scores below 620, the hardest, according to data insights firm Cox Automotive.

Comment on this study: There have been newspaper reports*(see below) about how Americans are holding on to their current vehicle and having it repaired rather than replacing it with a new or used vehicle. But what has been driving their decision to keep their current vehicle has been the **very high price of new vehicles or used vehicles, not interest rates**. When Americans walk into a new car showroom or a used car lot, what they see and what influences their decision to buy or not to buy is the sticker price on the window of the vehicle, not interest rates.

* "Americans holding on to vehicles longer than ever", by Tom Krisher of the Associated Press, May 16, 2023

That the Fed's interest-rate increases do not significantly influence consumers' decisions regarding whether to purchase a new vehicle appears the most likely. The decision to purchase a new vehicle is different from the decision to purchase a new home. Firstly, the price of new vehicle, even an expensive one, pales in comparison to the price of a new home. Secondly, purchasing a new vehicle is less optional than purchasing a new home. We may not like living in our current home or apartment, but we can stay put in our current home for an indefinite period or get a new apartment. However, when our current vehicle is failing and it is no longer economic to try to keep it running, we don't have the option of keeping it. So, we are pushed to buy a new vehicle or a used vehicle, and we will do this regardless of the Fed's interest rates increases.

The **other 14 of the Top 15 inflation categories for 2021** in the Smartest Dollar analysis are clearly **NOT interest-rate sensitive**. That is, they are not affected when the Fed raises interest rates which makes it more costly to borrow money,

because consumers don't take out loans to buy these goods. If prices for these goods came down in 2023 from 2022, it is not because the Fed raised interest rates, but because the supply of these goods increased or because demand for them decreased as consumers substituted other less expensive goods, i.e., the interaction of the forces of supply and demand, or as consumers just did without them.

Business formation and expansion is impacted by the Fed's interest-rate increases.

As discussed in the previous section, **it is not clear** whether or how much the Fed's interest-rate increases affect new car purchases. But they **definitely** discourage home sales and business formation and expansion. Both economic activities entail large bank loans.

"The Fed's higher borrowing costs have been cutting into demand for cars and houses by making auto loans and mortgages more expensive, and they are probably discouraging business expansion and cooling the job market."
(by Jordan Holman of *The New York Times* which appeared in the *East Bay Times* on August 26, 2023.)

This is one of the main ways that Fed interest rate raises "cool the job market." High interest rates discourage business expansion and new hiring. They also discourage replacing worn or obsolete equipment, causing business contraction and layoffs. When consumers are unemployed, their ability to buy goods and services is greatly restricted, and their effects on inflation are greatly diminished. In short, if you are unemployed, your contributions to inflation are very low.

Jordan Holman wrote (above) that [the Fed's interest-rate increases] "are probably discouraging business expansion…" This is no longer "probably"; it is happening.

"BANKRUPTCIES, businesses seeking court protection has increased"
(by Steven Church of *Bloomberg* which appeared in the *East Bay Times* on September 6, 2023, p. C7)
"Business failures spiked in August as the number of companies seeking court protection from their creditors jumped in response to rising interest rates and pockets of economic headwinds."

Business failures reduce economic output, but it may not be easy to reverse this situation as a new study by the SF Fed shows.
"Rate hikes impact output for more than a decade, study finds"
(By Laura Curtis of *Bloomberg* which appeared in the *East Bay Times* of September 6, 2023, p. C7)
"Central bank interest-rate increases reduce potential economic output for at least 12 years, in contrast to traditional theories of national economies that assume policy is neutral in the long run, Federal Reserve Bank of San Francisco research found.

"We find that these long-run effects develop primarily through investment decisions that ultimately result in lower productivity and lower capital stock than would be available without policy intervention,"

"These productivity effects persist for at least 12 years following a period of monetary tightening."

Can the Fed reverse the situation by "running the economy hot", that is, by lowering interest rates? The study found that "a central bank might not be able to undo the long-run effects on the economy's potential by running the economy hot."

This essay has shown that

- Except for new home purchases – and possibly, but probably not, consumer vehicle purchases – the Fed's eleven interest-rate raises in 17 months have had a **negligible effect on consumer purchases**, the vast majority of which **are <u>not</u> interest-rate sensitive**; they do not require taking out a loan to make them.

- **The drop in inflation from 8.3% in 2022 to 3.7% in September 2023 was <u>not due</u> to the Fed's eleven interest-rate raises in 17 months. It was due to the normal workings of the forces of supply and demand**: the supply of goods that had been in short supply increased or demand for them decreased as consumers substituted other less expensive goods, i.e., the interaction of the forces of supply and demand, or as consumers just went without some goods and services.

- The Fed's ongoing campaign to bring inflation down from its September 2023 rate of 3.7% to the Fed's target rate of 2% by further interest-rate increases **is ill-conceived and is wrecking the economy**, and the damage being done may last over a decade.

- **The Fed is currently unable to respond to flagrant price increases** that are much in excess of the September 2023 rate of inflation of 3.7% (much less the Fed's 2% inflation target). This essay showed flagrant annual price increases in food (PepsiCo, 16%; Unilever, 13%), Taylor Swift concerts,154%, media publications (The New York Review of Books, 104%), and stratospheric, inflation-driving contracts in basketball ($62 million per season for Anthony Davis of the Los Angeles Lakers) and football ($55 million per season for Joe Burrow of the Cincinnati Bengals). The Fed is limited to responding by raising interest rates which are ineffectual against

these flagrant price and wage increases.

<u>Dealing with flagrant price and wage increases far in excess of the current rate of inflation</u>

The Fed's current dependence on interest-rate increases to fight inflation is not working. It should expand its arsenal of inflation-fighting weapons to include the capability to selectively address flagrant price and wage increases far in excess of the current rate of inflation. **<u>Selective enforcement of violations with penalties</u>** is a method that has worked effectively for the government in the **banking sector**. The government publicizes these penalties as a "**warning**" to other potential violators. This enables the government to effectively utilize its limited enforcement personnel. Some examples.

<u>Wells Fargo:</u> was accused over five years ago of opening unauthorized accounts for its customers to meet sales goals (imposed by former CEO John Stumpf). The government hit Wells Fargo with huge fines and, more significantly, put an unprecedented cap on its growth which has lasted over five years. A cap on growth has become banking's most-dreaded punishment. Moreover, Stumpf whose career had been ascending rapidly, was banned from the banking industry for life.

"Wells Fargo settlement is approved"
"COURTS. Bank will pay $1 billion to settle fake-accounts suit"
(By Chris Dolmetsch of *Bloomberg* which appeared in the *East Bay Times* on September 9, 2023, p. C7)
"Wells Fargo & Co's $1 billion settlement of a shareholder lawsuit over unauthorized customer accounts was approved by a federal judge, clearing the way for payments."

"Executive Charged

"US prosecutors said earlier this month that the company's former head of retail banking, Carrie L. Tolstedt, the only executive charged with criminal wrongdoing,

should spend a year in prison for impeding their probe.

"Tolsteadt pleaded guilty in May and agreed to a ban on working in the banking industry and to pay a $17 million penalty. She's scheduled to be sentenced on Sept. 15."

The thought of spending time in jail (and sharing a cell with common street criminals) strikes fear into the heart of high-level banking executives.

<u>A **warning** to other potential violators:</u> The government lacks the human resources to investigate all banks as they did at **Wells Fargo.** But its selective targeting of **Wells Fargo** serves as a <u>**warning** to other potential violators</u>.

"COURTS. <u>**UBS**</u> to pay $1.44B to settle DOJ lawsuit"

"Mortgage-backed securities agreement resolves all U.S. civil claims linked to the Swiss bank"

(By Patricia Hurtado of *Bloomberg* which appeared in the *East Bay Times* on August 15, 2023, p. C7)

"UBS Group said it agreed to pay $1.44 to settle a case with the U.S. Department of Justice regarding how it handled residential mortgage-backed securities."

"The scope of this settlement should serve as a warning to other financial institutions … of the significant penalties that can result when corporations mishandle vital information," says Ryan Buchanan, U.S. attorney.

As noted previously, the government lacks the human resources to investigate all banks as they did at **UBS Group**. But its selective targeting of **UBS Group** serves as a <u>**warning** to other potential violators</u>.

How can the Fed selectively address flagrant price and wage increases far in excess of the current rate of inflation?

The Fed's efforts to try to deal with flagrant price and wage increases by relying on interest-rates increases **have not been working.** The Fed needs the capability to selectively target flagrant price and wage increases, penalize the offenders, and

publicize their punishment as a deterrent to other potential offenders. This is what the Courts (Department of Justice) has done effectively with Wells Fargo Bank and UBS Group (see above).

Setting Price Guidelines

The U.S. government (e.g., the Fed) should set price guidelines commensurate with the level of inflation it hopes to achieve. Then it could selectively target flagrant price and wage increases, penalize the offenders, and publicize their punishment as a deterrent to other potential offenders.

Price **guidelines** are like price **controls** but more flexible. Price controls are restrictions set in place and enforced by governments on the prices that can be charged for goods and services in a market. Price controls have been used in modern times in less-planned economies, such as rent control. During World War I, the United States Food Administration enforced price controls on food. Price controls were also imposed in the US and Nazi Germany during World War II. Limited price controls are also present in the US economy today: Some cities cap rents or the amount landlords can hike them each year.

The market has a huge amount of detail: products, prices, locations, consumers, etc. With this enormous amount of detail, price guidelines or price controls were very difficult to use when transactions were written or typed on paper and kept in file cabinets as during WW II. However, we live in a **very different world today** in which computer systems have totally transformed administration. What was an administrative nightmare in WW II would no longer be an administrative nightmare today with the powerful computerized administrative systems we have.

Does the market with its "invisible hand" always know best?

Adherents of laissez-faire economics say that market prices efficiently allocate scarce resources. Price controls distort those signals, leading to the inefficient allocation of goods and services. **I am not going to get into this lengthy topic** in this hopefully-not-too-long essay on inflation. I will just return to one example

discussed earlier.

"Big brands keep raising prices, with limited resistance"

"Unilever says it has raised prices for its products, which include Ben & Jerry's ice cream and Dove soap, more than 13% in its fourth quarter, the eighth consecutive acceleration in prices."

"PepsiCo raised prices 16% in the 4th quarter."

These companies did not raise prices because the "invisible hand" was guiding them toward the efficient allocation of resources. They raised prices because

- They wanted to increase profitability.

  "PepsiCo, which makes Gatorade sports drinks, Lay potato chips and Quaker Oats reported this month that its second-quarter revenue grew 10% and that its profit doubled, to $2.7 billion, from a year earlier."
  (by J. Edward Moreno of *The New York Times*. It appeared in the *East Bay Times* on July 27, 2023, p. C9.)

- "Unlike other goods, food is something consumers cannot stop buying,.."

- PepsiCo knows that the Fed cannot do a thing about its price raises of 16% in the 4th quarter. The Fed fights inflation by raising interest rates, but higher interest rates don't affect demand for PepsiCo's products

<u>The Fed's Inflation-fighting efforts are constrained by laissez-faire economics</u>

Laissez-faire economics is a theory that says the government should not intervene in the economy except to protect individuals' inalienable rights. In other words, let the market do its own thing. If left alone, the laws of supply and demand will efficiently direct the production of goods and services. Laissez-faire economics embraces consumer sovereignty and producer sovereignty

<u>Consumer sovereignty</u>

Consumers are "sovereign" in the marketplace which means that they effectively "vote" for the goods they want with their spending power, causing firms to

respond to consumer preferences and produce the goods they demand. Consumers, not the government, determine what goods and services firms produce.

Producer Sovereignty

Producers are "sovereign" in the marketplace which means that they, not the government, have the ultimate power to decide what goods and services they want to produce, based on their costs, revenues, and profits.

A Mixed Economy

The U.S. has a mixed economy which is based on free markets but which allows for government intervention for the public good. Its mixed economy has the following characteristics of a market economy. First, it protects private property. Second, it allows the free market and the laws of supply and demand to determine prices. Third, it is driven by the motivation of the self-interest of individuals who presumably act rationally (rational market theory).

When the Fed raises or lowers interest rates, it is "intervening" in the economy, but, according to its beliefs, it is intervening **in a minimal way**. Setting interest rates – rather than letting the markets do this – is held to be a "neutral" intervention in the economy. That is, it affects the overall economy, but does not target specific products, services, producers, or consumers. In contrast, if the Fed were to target PepsiCo for its price raises of 16% in the 4th quarter, this would **not** be a "neutral" intervention but would be targeting a specific producer, would be a violation of PepsiCo's producer sovereignty, and would lead to the inefficient allocation of PepsiCo's products, according to the Fed's beliefs.

Fed must add other inflation-fighting tools to its arsenal.

The Fed has been using a single tool –raising interest rates – to try to tame inflation and bring it down to 2% per year. This single tool has **not** been working, is wrecking the economy, and is **not** adequate to complete the job.

Repeated from above:

- Except for new home purchases – and possibly, but probably not, consumer vehicle purchases – the Fed's eleven interest-rate raises in 17 months have had a **negligible effect** on consumer purchases, the vast majority of which **are <u>not</u> interest-rate sensitive**; they do not require taking out a loan to make them.
- **The drop in inflation from 8.3% in 2022 to 3.7% in September 2023 was <u>not due</u> to the Fed's eleven interest-rate raises in 17 months. It was due to the normal workings of the forces of supply and demand**: the supply of goods that had been in short supply increased or demand for them decreased as consumers substituted other less expensive goods or as consumers just went without some goods and services.
- The Fed's ongoing campaign to bring inflation down from its September 2023 rate of 3.7% to the Fed's target rate of 2% by further interest-rate increases **is ill-conceived and is wrecking the economy**, and the damage being done may last over a decade.

<u>The Fed should take a lesson from the Department of Justice (DOJ).</u>

The DOJ's targeting of specific violators in the banking sector, e.g., Wells Fargo Co. and UBS Group, levying heavy penalties on them, and publicizing the penalties as a deterrent to other potential violators have been effective.

- A cap on growth has become banking's most-dreaded punishment.
- The thought of spending time in jail (and sharing a cell with common street criminals) strikes fear into the heart of high-level banking executives.

William E. Jackman, PhD

Statistician/SAS & SQL Programmer

Oakland, California

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Note: I wrote this essay while in my wife's small hometown (pueblito) in Jalisco, México to celebrate México's Independence Day which is on September 16.