

Dr Marvin Goodfriend says US recession 'not inevitable'

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Despite renewed warnings from US Federal Reserve chairman Ben Bernanke about the central bank's determination to fight rising inflation, not everyone sees black days ahead.

Transcript

ALI MOORE: Well as we saw on our market today the jitters about credit concerns and global growth are alive and well.

But despite renewed warnings from US Federal Reserve chairman Ben Bernanke about the central bank's determination to fight rising inflation, not everyone sees black days ahead.

Professor Marvin Goodfriend is professor of economics at Carnegie Mellon University in Pittsburgh. He's been brought to Australia by the United States Studies Centre at the University of Sydney, and he says a recession in the US is not inevitable.

He joined me in the studio earlier this evening.

Marvin Goodfriend, welcome to Lateline Business.

MARVIN GOODFRIEND, CARNEGIE MELLON UNIVERSITY: Nice to be here.

ALI MOORE: Over the past few days those that were beginning to feel a little bit more optimistic have been hit by a number of things. We've had oil at US \$138 a barrel, we've had the Dow plunge 400 points and then come back just 70 points, more big losses from US investment banks and of course unemployment experiencing its biggest one month leap in 22 years in the US. Is this just a glitch on the road to recovery or should we all hold our breaths because there's worse to come?

MARVIN GOODFRIEND: I'd say this was a bad day for the data in the United States but when you look below these numbers that you just quoted there's reason to think that they're less serious than they appear on the surface in each case the Dow has been strong this year and the one day 400 point drop is bad news but it's also consistent with a pretty high Dow. The unemployment rate five per cent increase in the unemployment rate is actually a number that's not very reliable in the United States between April and July when young people come out of school and they enter the workforce. It's notoriously unreliable in fact so we need to wait a few months to get a fix on this thing.

ALI MOORE: Oil?

MARVIN GOODFRIEND: Oil is harder to argue away but on the other hand I think the nine days before this jump the price of oil had actually fallen by eight per cent. So what we're seeing really is volatility, not necessarily bad news but just incredible volatility in the markets and in the flows of employment and so forth.

ALI MOORE: I want to look at each of the issues in turn but in the context of that volatility in what lies behind it, what's your reading of the US economy? A lot of people were looking at those unemployment numbers and say it's in for a long, drawn out recession. Would you say even though the economy's growing it is to all intents and purposes in recession already?

MARVIN GOODFRIEND: I would say no. A recession is a contraction of employment that's greater than we've seen

so far. What we see is slow growth in the United States but not recession. I really don't believe we have a recession yet technically and I believe we may escape recession and have a long period of slow growth in the United States, most likely extending into next year.

ALI MOORE: What's going to be the triggers that allow you to escape recession?

MARVIN GOODFRIEND: I think we have on the table there's rebate cheques, for example.

ALI MOORE: This is the Government stimulus package?

MARVIN GOODFRIEND: The government stimulus package, the cheques have been sent out, they're in the process of being sent out and they're in the process of being spent. So we had retail sales report, I think a few days ago, that suggests that people are spending the cheques and the stores report that they're taking the effect that they should. They're holding up demands and so the rebate cheques should take us through the summer with some support and by then we hope that other more fundamental factors will kick in and try to revive the growth of demand.

ALI MOORE: Let me be the negative one for a minute. You've got \$170 billion worth of rebate cheques but you've also got not just oil but higher food prices. I mean inflation is a growing problem that the Federal Reserve chairman Ben Bernanke sees to increasingly be pointing to inflation and saying he's not going to stand for it, how does that sit?

MARVIN GOODFRIEND: You're making it very difficult for me but I think inflation is a fact of life. The real big picture of this is that what we're seeing globally is a rising scarcity of the goods that nature provides man, that is commodities, food, fuel, relative to the things that man's mind provides which are goods and services. And that's a kind of a relative price shift that we say as economists. It's likely to be here to stay. We're all going to have to learn to live with that. Those countries which primarily produce manufactured goods, which produce the goods of the mind are having to pay more for the commodities that are inputs to their goods that they produce. They're going to have a somewhat lower standard of living. Those countries which are producing nature's goods are going to have a higher standard of living. So Australia is doing well, the United States is on the other side of the coin to a large extent.

ALI MOORE: But if we have to put up with higher prices, where does that sit with a Fed that now seems to be inflation focused? You've made the point that in fact interest rates real interest rates are at negative at the moment?

MARVIN GOODFRIEND: The Fed has a very easy monetary policy at the moment. The Fed funds rate is at zero when you subtract off the rate of inflation which is slightly higher than the Fed funds rate. The Fed is trying to fight the recession at this point but it's at risk of creating inflation. The way the Fed wears the circle is to say to say it cares about core inflation, which excludes food and fuel and core inflation is doing pretty good, it's slightly above two per cent. It's the headline inflation number which includes the food and fuel that's one or two percentage points above the core.

ALI MOORE: But people can't live without food and fuel?

MARVIN GOODFRIEND: That's true. That's not an issue that monetary policy can do anything about. Nature is making food and fuel more scarce relative to manufactures, so headline inflation is inevitably rising relative to core. The Fed has to choose between targeting the headline number and the core number. It's chosen for long time to target the core and let these flexible prices move and for food and fuel.

ALI MOORE: The implication of that is we won't see higher interest rates, we won't see the Fed responding to those headline numbers?

MARVIN GOODFRIEND: You're asking a very difficult question. The Fed, I think, would like to have happen the following thing. That at some point the rising prices of food and fuel would stabilise and once they stabilised relative to other prices the headline inflation number will come back down to core and then the Fed would be happy. The

problem and the risk that the Fed faces is that we see a continuing rise and continuing increase in food and fuel prices so that the inflation and headline remains elevated relative to core for the next month and perhaps into next year. That's a problem for the Fed in the sense that the public's inflation expectations may begin to drift up and those inflation expectations could feed back into the core part of the economy.

ALI MOORE: And then they have to move?

MARVIN GOODFRIEND: Exactly and then they would have affect page wage and the Fed would have to move.

ALI MOORE: You think that's a likely scenario?

MARVIN GOODFRIEND: We just don't know. If you were at this federal open market committee meetings that's the kind of thing they would be debating.

ALI MOORE: Let's look at some of those prices in particular oil, because just tonight the International Energy Agency has warned that: "High prices are needed to choke off demand and balance the oil market". I wonder if you think they're right. Is what we're seeing now supply driven or is it more a speculative bubble?

MARVIN GOODFRIEND: I would say that the high price of fuel these days is the result of a high demand hitting a relatively inflexible supply.

What's interesting is that the world supply of oil now has almost completely exhausted by the demand. In large part because the rise of India and China has been faster and has gone further than I think people would have expected five years ago and it takes time to bring new supply on line. And we're seeing something that we've never seen before. The global demand for oil is just about up against the global supply and when that happens prices can spike very high because there is no where else to go.

ALI MOORE: So do you actually see oil going higher or do you see demand weakening off?

MARVIN GOODFRIEND: It's very hard to know but what we can say is there's tremendous the volatility that's possible is quite, quite high now. We just don't know. For example if the world hits a recession, the demand could slack off a little bit and prices could literally collapse but if the world doesn't hit a recession the Fed manages to steer free of recession and China continues to be strong, we can see prices spike up. There's just a big range of outcomes we're looking at now.

ALI MOORE: In that range of outcomes is stagflation on your potential list?

MARVIN GOODFRIEND: Sure, unfortunately it is because it's very possible for the Fed to get in the situation where perhaps because it guesses wrong about the elevation of headline inflation and rising oil prices it doesn't react soon enough and if that happens and inflation expectations move up, the Fed may have to react next year to higher inflation expectations and higher wage growth and higher core inflation and the Fed has no choice at that point to raise interest rates at great risk of rising unemployment and it's the combination of rising unemployment with rising inflation that we call stagflation.

ALI MOORE: So given there's a range of outcomes, as you say, are you optimistic or pessimistic about the immediate future?

MARVIN GOODFRIEND: I'm always, I'm an optimistic person and I have confidence that people who are looking at these numbers and making the judgements between the Federal Reserve if they have a chance to get it right they will get it right. There are a lot of people looking at this and talking to each other and debating the issues. We can't ever be sure what nature will do but I think we have every reason to think that the Fed will get it right.

ALI MOORE: Let's finish on an optimistic note. Professor Goodfriend, many thanks for joining us.

MARVIN GOODFRIEND: Thank you.