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FEDERAL RESERVE

Fed's challenge: Balance the economy

The tug of economic forces toward both recession and inflation have the Federal Reserve in a regulatory bind.

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WASHINGTON --
Not since the 1970s has the U.S. economy faced such an ugly combination of a persistent energy shock, a looming recession threat, and menacing inflation that stays stubbornly high -- even in the face of a screeching slowdown in growth.

This combination has the Federal Reserve, entrusted by law with both sustaining growth and curbing inflation, in a bind. It must balance the needs of protecting the economy from a downturn while protecting it against an upward spiral of prices -- and doing either one can make the other far more difficult.

This dilemma also comes amid the worst housing slump in modern times, as well as an unprecedented crisis in credit markets whose positive outcome is far from certain. Adding to the troubles are the dive of the U.S. dollar against other currencies and rising global inflation that partly mutes whatever action the Fed takes.

"This thing has the potential to really unwind to create huge negative effects," said Lyle Gramley, a Fed governor from 1980 to 1985. "The Fed is walking a tightrope right now, that's for sure."

Laurence Meyer, a Fed governor from 1996 to 2002, sees some parallels between today and the late 1970s and early 1980s, when the oil-dependent U.S. economy saw double-digit inflation largely because of an unexpected energy shock. Growth fell while inflation rose, creating stagflation -- a stagnant economy and high inflation.

Today's problems, he said, reflect "the first really persistent [oil] shock we've had since the 1970s, and the inflation expectations are worse than we have had over the past decade. So we're kind of in a middle area."

Neither Meyer nor most other prominent economists expect a return to double-digit inflation. Policymakers learned from the Fed chairman back then, Paul Volcker. He pushed interest rates up so high that they crushed double-digit inflation. But it came at a huge price -- the job-killing 1981-82 recession, the worst since the Great Depression. To kill inflation, he first had to squash growth.

But once the inflation dragon was slain, the 1980s economy boomed, and Ronald Reagan won reelection in 1984 on the slogan that it was "morning in America."

PRESSURE ON FED CHIEF

Today there is no chance that Fed Chairman Ben Bernanke will ignore inflation; the question is how long its rise will be tolerated before he acts. Pressure on him to act soon is growing.

"We need to take steps to ensure that inflation does not get out of control. We need to act preemptively," Charles Plosser, president of the Federal Reserve Bank of Philadelphia, told CNBC television Thursday.

He said the Fed should raise interest rates soon to quell inflation. But that could tip the economy into recession if it's not already there, or make it worse if it is.

Yet failing to raise interest rates could make things even worse over time. It could permit an inflationary spiral to ignite as consumers and businesses demand higher wages and prices to compensate for the inflation they are already feeling. That, in turn, would fuel even higher inflation, which in turn would require even higher interest rates and a deeper recession, as happened in 1981-82.

In a June 9 speech, Bernanke said he would "strongly resist an erosion of longer-term inflation expectations, as an un-anchoring of those expectations would be destabilizing for growth as well as for inflation." That means that he'll raise rates quickly if consumers and businesses show signs that they are beginning to expect that inflation will keep rising.

"That's recognizing the important thing that went wrong in the '70s. But he's not saying it has happened yet," said Meyer, who expects rate hikes only after it is clear that the U.S. economy is on more stable footing and that recession threats have eased.

That view is shared by Alice Rivlin, a Fed vice chairman from 1996 to 1999. She is struck that inflation isn't worse. The May inflation report released Friday showed that the closely watched core inflation -- which excludes volatile food and energy prices -- grew only modestly.

"The amazing thing about this oil shock is it has not had very much impact on inflation," Rivlin said. "It's beginning to have some, but it's very mild compared to the last time."

"It is similar to the '70s," she said, "but it's been a long time since we have had the coincidence of rising prices and a softening labor market. "

That softening, Rivlin suggested, makes it unlikely that wages will chase rising prices -- the normal pattern of an inflationary spiral.

INTEREST-RATE CUTS

Bernanke has aggressively slashed short-term interest rates in response to a weakening economy. Since last August, the Fed's benchmark federal funds rate -- an overnight rate that banks charge each other -- has fallen from 5.25 percent to 2 percent.

Still, headline inflation -- the rise in prices that consumers see at the cash register -- is 4.2 percent since May 2007, and the core inflation rate, without food and energy prices, is 2.3 percent over the same 12 months. That's above the Fed's comfort zone of a 2 ercent annual rate.

The recent surge in oil prices threatens to raise prices of food and manufactured goods even higher. Dow Chemical recently announced 20 percent price hikes because of rising oil costs. That's why inflation hawks like Plosser call for a preemptive strike now.

Such a move seems a matter of when, not if. While a rate hike is not expected when the Fed's policy committee meets June 24-25, the odds will increase with every meeting after that.

"The big test will be, are they willing to be symmetrically aggressive. They were aggressive on the downside,and will they be aggressive on the upside?" said Vincent Reinhart, former chief economist for the Fed's rate-setting Federal Open Market Committee.