The Daily Dish

The Labor Market and the Importance of Expectations

DOUGLAS HOLTZ-EAKIN | NOVEMBER 11, 2013

Happy Veterans Day! Americans everywhere are thankful for the service of every veteran and we owe them all a great debt of gratitude.

The Federal Reserve chairman Ben Bernanke indicated Friday that quantitative easing would continue. Reuters writes, "Despite signs of improvement in the U.S. labor market, there is plenty of room for the jobless rate to fall further, Federal Reserve Chairman Ben Bernanke and two other top policymakers said on Friday."

The report continues "The three spoke at separate events on the same day that the U.S. Labor Department reported surprisingly strong jobs growth in October, though they all cautioned about drawing conclusions from economic data." AAF's Doug Holtz-Eakin called the report weak despite the high top line number, as income growth was weak and the labor force participation fell to the lowest level since March 1978.

Meanwhile, the Wall Street Journal writes on the latest round of budget negotiations that are set to begin this week. "Wednesday, a 29-member committee of House and Senate members will renew its efforts to bridge long-standing partisan divisions and write a budget for the rest of the fiscal year. A temporary measure now funding the federal government expires Jan. 15. The prospect of another government shutdown would grow if the group doesn't strike a deal by its Dec. 13 deadline."

Eakinomics: The Importance of Expectations

In a move that was widely noted in the U.S., the European Central Bank cut its key interest rate to fight potential deflation.

Falling prices are a symptom of weak demand. Worse, the expectation of falling prices can become self-reinforcing, as households defer purchases to take advantage of lower prices in the future. In short, the *expectation* of deflation is the key. Similarly, the Fed has argued that its massive quantitative easing is not inflation because "inflation expectations remain well-anchored." Central bankers everywhere recognize that households and businesses make important economic plans and that their expectations of future policy are an important element of the landscape.

This stands in sharp contrast to the sterile discussions that surround U.S. budget policy. The administration regularly urges Congress to ignore the unsustainable fiscal future and simply spend more now. As Congressional budget negotiations begin, it is important to recognize that a high and growing level of debt must ultimately be dealt with by either (a) reducing future spending or (b) raising future taxes. If Congress shows no willingness to undertake the entitlement reforms needed to accomplish (a), then the public will *expect* higher taxes in the future and be less willing to undertake the innovation and investment that are the foundations of better growth now.