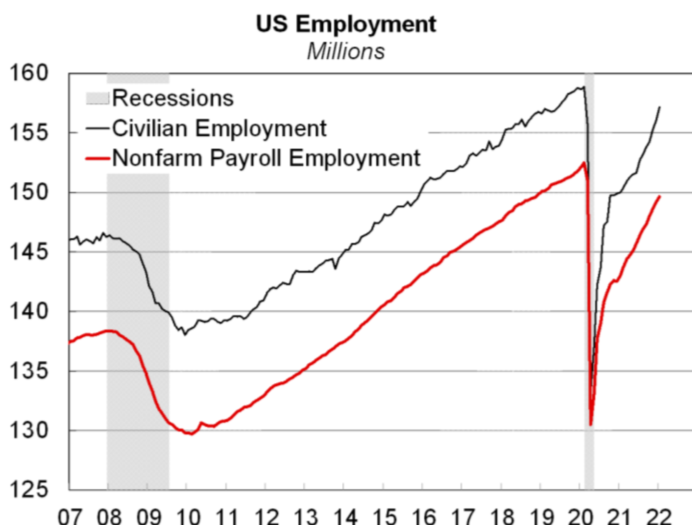
Current Economic Conditions

Robert C. Fry, Jr., Ph.D. February 18, 2022

OBJECTS IN MOTION TEND TO REMAIN IN MOTION

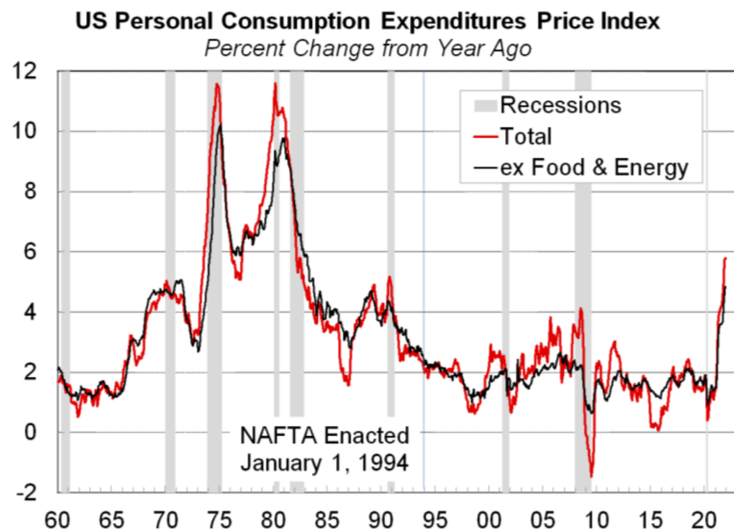
Sir Isaac Newton's first law of motion, also known as the law of inertia, states that if a body is at rest or moving at a constant speed in a straight line, it will remain at rest or keep moving in a straight line at constant speed unless it is acted upon by an external force. While this law is from physics and is meant to apply to physical objects, it also seems to apply to human nature and to economics. It is always easier to do the same thing today that we did yesterday, and it usually takes considerable energy to do otherwise. Perhaps that explains why economies and financial markets tend to keep doing what they've been doing until some external force causes them to do otherwise. Historically, the external force has usually come from a policy shift or an oil price shock. Inertia has two implications for the current economy. On the positive side, it means that growth is likely to remain strong for longer than pessimists expect. On the negative side, it means that inflation is likely to remain unacceptably high until a recession brings it down.

Last month, I wrote that the economy stumbled **into** 2022. In retrospect, I should have written that it stumbled **out of** 2021 (and that, aside from a big drop in retail sales, it didn't stumble very much). After a disappointing December, the result of the spike in COVID-19 cases caused by the Omicron variant, economic growth reasserted itself in January, showing a resumption of the strong growth that characterized 2021 (except for periods when COVID cases spiked due to the Delta and Omicron variants, which certainly qualify as "external forces.") Retail sales, which fell a downwardly revised 2.5% in December, rose 3.8% in January. While retail sales are reported in nominal terms, i.e., not adjusted for inflation, price increases can't explain the huge January increase. Light vehicles, which sold at only a 12.5 million seasonally adjusted rate in December, sold at a 15.0 million rate in January, the best since last June. Payroll employment, from a survey of employers, grew by a much-stronger-than-expected 467,000 in January, and big upward revisions to November and December data suggest that the labor market maintained more momentum into yearend than previously thought. Civilian employment, from a survey of households, grew by a staggering 1.119 million in January. Industrial production in U.S. manufacturing rose by just 0.2%, but production in mining rose by 1.0%, on top of a 1.5% increase in December. Building permits for single-family homes, the most important indicator in the monthly housing report, rose 6.8% in January, to a 12-month high.



The inflation news in January was as bad as the growth news was good. The Consumer Price Index rose 0.6%, pushing the year-over-year inflation rate to 7.5%, the highest since 1982. Excluding food and energy prices, the CPI also rose 0.6%, pushing "core inflation" to 6.0%. My favorite measure of underlying inflation, the Producer Price Index for finished goods excluding food and energy, rose by 1.0% in January. That was the biggest monthly increase since 1986. So far, there is absolutely no evidence that inflation is slowing, and my preferred inflation measure suggests that it is still accelerating.

The physics analogy isn't perfect. Growth must eventually slow to what can be supported by labor supply growth (due primarily to population growth) and productivity growth, even if no external forces are applied. But because different industries run out of spare capacity at different times, that slowdown is likely to be very gradual unless policy tightens or oil prices spike. The physics analogy is more appropriate in the case of inflation. Historically, there has been a tremendous amount of inertia in inflation. The Federal Reserve's preferred measure of inflation, the 12-month (year-over-year) percent change in the Personal Consumption Expenditures price index, excluding food and energy, remained between 0.6% and 2.7% from October 1993 through March 2021. (If you exclude periods that included a recession, it remained between 1.0% and 2.7%.) It rose to 3.1% in April 2021 and was up to 4.9% in December. When we get February data in late March, it will be well above 5%. It took extraordinarily stimulative monetary **and** fiscal policy – a force – to push inflation out of the narrow range it had occupied for more than 27 years.



It will also take a significant force, in the form of a very restrictive monetary policy, to get inflation back down from above 5% to the Fed's 2% target. Theoretically, this means that demand needs to grow more slowly than supply. In practice, it means the Fed is going to have to tighten monetary policy enough to cause a recession. Since 1960, the Fed's preferred measure of inflation has never fallen by three percentage points without a recession, although relative optimists can point out that inflation fell from 4.7% in February 1989 to 1.0% in June 1998 with only the very mild 1990-91 recession during that period.

Views about Fed policy continue to change in response to stubbornly high inflation and statements from Fed officials. The Fed is likely to end its purchases of Treasury and mortgage-backed securities in March, rather than in June as originally planned. Short-term interest rates are now expected to rise much more rapidly than they were a few months ago. Most forecasters, myself included, are now forecasting five quarter-point rate hikes this year. Many are forecasting either more rate hikes or one or more half-point rate hikes. I still think a recession will be necessary to bring inflation back down to the Fed's 2% target, but if the Fed does indeed raise interest rate more rapidly than was expected a few months ago, that recession will come sooner but be less severe than I would have otherwise expected. The Fed's rapid and ongoing shift towards a tighter policy increases the likelihood of a mild recession in 2023 or 2024, similar to the 1990-91 recession, and reduces the likelihood of a deep recession in 2025, similar to the 1973-75 and 1981-82 recessions that were needed to wring double-digit inflation out of the economy.

I think the Fed has finally realized that inflation will not slow on its own. Supply will not magically catch up with demand as the pandemic fades, and that's because demand is simply too strong and growing too fast. Tighter policy is needed to slow growth in demand and probably, eventually, to reduce the level of demand, triggering a recession. But slowing this economic freight train, which has quite a head of steam, will take a while. In the meantime, growth will remain strong. My forecast for growth in U.S. Gross Domestic Product in 2022 is the highest in the Consensus Economics survey. Tighter monetary policy might affect my forecast for 2023, but not for 2022. Weak December data had me questioning my strong forecast, but the strong January employment and retail sales reports and the sharp drop in COVID-19 cases since early January have convinced me to stick with my 2022 forecast. Only a big jump in oil prices, perhaps associated with a Russian invasion of Ukraine, is likely to change that. As for inflation, my forecast has been at or near the top of the Consensus Economics panel for some time. It will remain there. If anything, I will be raising my forecast by slowing the expected decline in inflation. Breaking/braking the momentum of inflation will take time . . . and considerable effort from a Fed that is playing catch-up.

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