# Current Economic Conditions

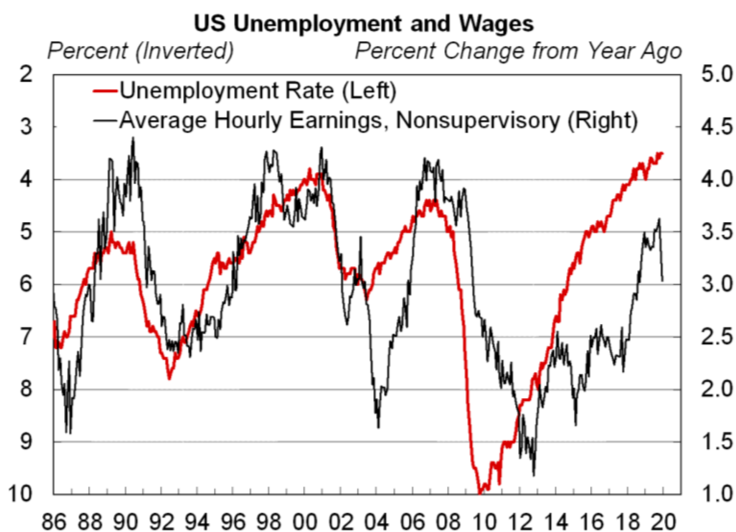
Robert C. Fry, Jr., Ph.D. January 17, 2020

## SOME THOUGHTS ABOUT INFLATION

The Federal Reserve seeks to keep inflation, as measured by the year-over-year (12-month) percent change in the Personal Consumption Expenditures Price Index, close to 2%. People on pensions that are not adjusted for inflation and public-finance economists who understand that the U.S. tax system taxes nominal interest, dividends, and capital gains without adjustment for inflation know that even a little inflation is a bad thing. But I don't expect to convince the Fed to lower its target, and I know that by reducing uncertainty, having a non-zero inflation target and sticking to it is better than having no target at all. (Full disclosure: I'm a public-finance economist on a pension.)

In December, the PCE price index was up 1.5% year-over-year, well below the Fed's target. The so-called "core" PCE price index, which excludes volatile food and energy prices, was up 1.6%. Although the Fed has never specified whether its 2% target applies to the total PCE price index or the core index, most Fed watchers focus on core. The Consumer Price Index, which puts more weight on shelter and less on medical care than the PCE price index, was up 2.3% year-over-year in December, total and core. The gap between CPI and PCE inflation is unusually wide now; it's usually about 0.3 percentage points.

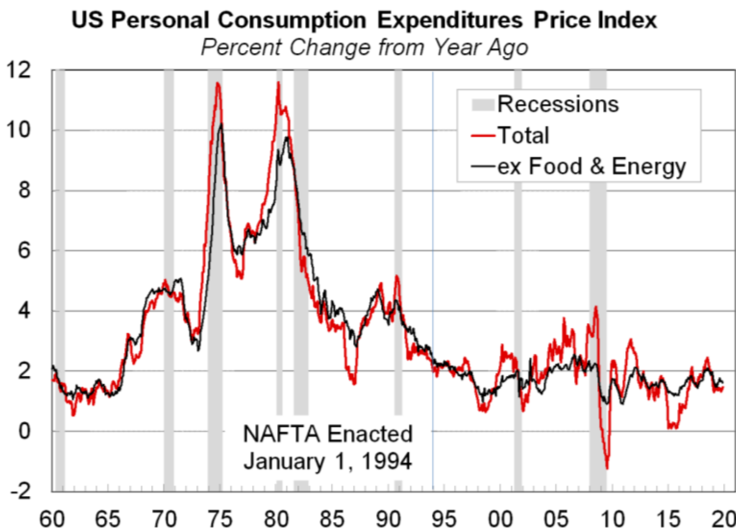
Inflation has remained below the Fed's target even though the unemployment rate is 3.5%, a 50-year low and well below the Congressional Budget Office's 4.6% estimate of the natural rate of unemployment. This flies in the face of the Phillips curve theory that holds that inflation rises when unemployment is below the natural rate. The Phillips curve has always been more casual empiricism than sound economy theory; in theory, real (inflation-adjusted) wages should rise when labor markets are tight, but if markets for goods and services aren't tight enough to allow price increases, higher wages will translate into lower profit margins, not higher prices. The breakdown of the Phillips curve relationship stems largely from globalization. Even if U.S. markets are tight, it's hard to raise prices of goods and (increasingly) services if there is slack anywhere in the world. As more jobs can be outsourced abroad, a tight labor market might not even translate into accelerating wages. (The original Phillips curve posited a relationship between unemployment and wage inflation, not price inflation. That makes more sense, but even that relationship looks shaky now. Average hourly earnings decelerated sharply at the end of 2019.)




Largely because of the persistent shortfall in inflation vis-à-vis its 2% target, the Fed cut its federal funds rate target by 0.75 percentage points last year. They also stopped shrinking their balance sheet and have allowed it to expand rapidly in recent months. Year-over-year growth in the M2 money supply has accelerated from 3.3% in November 2018 to 7.2% in December 2019. Historically, such a loosening of monetary policy has resulted in higher inflation, but that needn't be the case. An expansion of money and

credit is only inflationary if its boosts aggregate demand more than it boosts aggregate supply. If the money is used to buy consumer goods and houses, it will be inflationary. But if it is used to drill more oil wells in the Permian Basin, build more excess capacity in China, and allow Amazon to expand into more lines of business, it can be deflationary. (Demographics determine how much an expansion of money and credit stimulates demand. In a population with many young adults, low interest rates will stimulate purchases of houses and motor vehicles. In a population with more mature adults, low interest rates won't do much to stimulate housing demand and will reduce interest income from savings accounts and CDs.)

Even if the Fed is successful in raising inflation to its 2% target, it will probably take a while. That's because there is tremendous inertia in inflation. Since NAFTA opened an important relief valve for inflation in January 1994, core PCE inflation has remained between 0.9% and 2.6% and has neither risen nor fallen by more than 1.3 percentage points over a 12-month period. The rapid increases in core inflation in the 1970s, as much as 5.0 percentage points over a 12-month period, reflected the greater energy intensity of the economy and bigger impact of energy prices on non-energy prices, the expiration of price controls, which had held down inflation even as inflation pressures were building, and the most irresponsible monetary policy of my lifetime. (The latter began in December 1965 when President Johnson physically assaulted Fed Chairman William McChesney Martin to intimidate him into opening the monetary spigots when Johnson was fighting two wars – a war in Vietnam and a war on poverty – without paying for either of them.)




My forecast is for inflation to rise, but very slowly. Even if U.S. growth accelerates and unemployment goes even lower, faster growth and tighter markets **globally** are needed to get inflation up to the Fed's target. I don't expect the year-over-year increase in the core PCE price index to get to 2% until the second half of 2021. (Higher inflation will show up sooner in monthly and quarterly data; focusing on year-over-year changes always leaves you behind the curve.) Given the declines in inflation and stock prices in late 2018, after the Fed's September 2018 rate hike, and the Fed's insistence that its 2% target is symmetric, the Fed will be reluctant to raise the federal funds rate until inflation rises above 2%. That has two implications. First, it means the Fed will keep interest rates low for a long time. That bodes well for housing starts and home sales, other interest-sensitive segments of the economy, and stock prices. It also implies that the next recession is a long way in the future. Second, it means that inflation could remain above 2% for a while, since the interest rate hikes I expect in 2021 and 2022 will bring inflation down only after a long lag. But given current demographics, the extent of global competition, and the Fed's difficulty in getting inflation up to 2%, I don't think inflation will rise very far above 2% or stay there very long.

Even if inflation quickly falls back to 2% (or never rises to that level), that doesn't mean that low interest rates, an expanding Fed balance sheet, and rapid money supply growth don't pose risks to the economy. Stock market bubbles and real estate bubbles can still inflate and burst. (Bubbles in other assets pose little threat to the economy.) Identifying bubbles is extremely difficult, but if the Fed sees bubbles developing, it should (but probably won't) raise interest rates even if inflation is below its 2% target.

In the meantime, inflation is low, consumers are in good shape, housing starts have surged in response to lower mortgage rates, and trade deals with China and with Canada and Mexico offer hope that business investment will pick up in response to a lessening in trade policy uncertainty. Problems at Boeing will hold down first-quarter growth in Gross Domestic Production and especially in industrial production, but once those problems are resolved, U.S. economic growth could break out of its 2% rut.

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