Current Economic Conditions

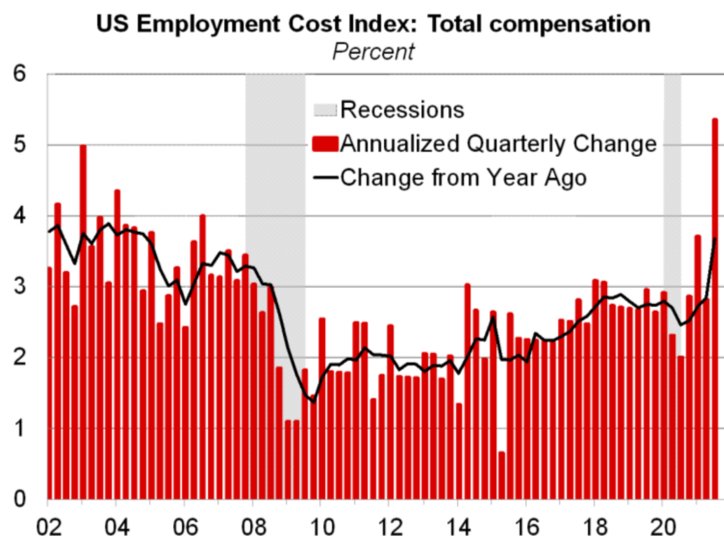
Robert C. Fry, Jr., Ph.D. November 18, 2021

EXCESSIVE STIMULUS CAUSING STUBBORNLY HIGH INFLATION

The U.S. Consumer Price Index rose 0.9% in October, taking its year-over-year (12-month) percent change to 6.2%. That's the highest reading for CPI inflation since 1990. Excluding food and energy prices, the CPI rose 0.6%, leaving it up 4.6% year-over-year, the highest since 1991. The hot CPI report echoed the previous day's Producer Price Index, which showed the PPI for finished goods up 1.2%. That was the seventh time in 10 months this year that the PPI has risen by at least 1%, leaving it up 12.5% year-over-year. After the PPI report, I tweeted that my 4.5% forecast for 2022 CPI inflation was the highest in the September Consensus Economics survey . . . and that it was too low. My forecast is now 5%.

Inflation has remained higher for longer than the Federal Reserve expected. The Fed still expects inflation to decline next year, but it won't recede as much as the Fed expects. Inflation this year has been led by prices of motor vehicles and by prices of energy and other commodities. The Fed thinks these prices will come down next year, bringing the inflation rate down with it. There are two problems with this argument. First, prices of vehicles and energy are unlikely to fall as much as the Fed expects, if at all. Vehicle demand will be supported by the rebuilding of rental fleets, which were sold off when travel demand was low and used vehicle prices were high, and by the delayed replacement of old vehicles that weren't replaced this year because manufacturers couldn't produce enough new vehicles to replace them. U.S. oil and gas production has stalled after a partial recovery from its early-pandemic decline. Drilling activity has not recovered enough to get production back to its pre-pandemic peak and bring prices down.

Second, while the rate of increase in vehicle and energy prices is likely to decline in 2022, the main drivers of inflation will shift from cars and commodities to labor and rent. The two measures of shelter costs in the CPI – rents and owners' equivalent rent – reflect what is happening in the real world with a considerable lag. More timely measures of house prices and rents, such as the CoreLogic® single-family rent index, which was up 10.2% year-over-year in September, suggest that the shelter component of the CPI, which accounts for 32.6% of the total, is likely to accelerate next year.



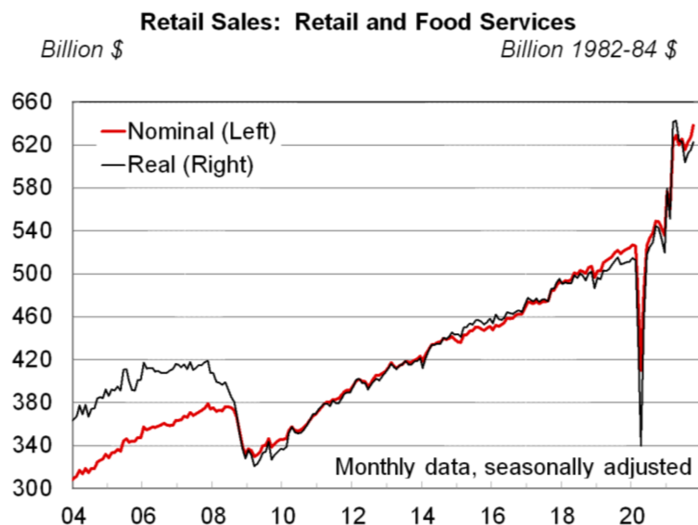
The Employment Cost Index, the best measure of labor costs, rose at a 5.4% annual rate in the third quarter, the biggest increase since the series began in 2001. Despite this big increase, wages and salaries have not been keeping up with inflation; real wages have been falling. That isn't likely to persist in an economy with more than 10 million job openings. Labor costs are likely to rise rapidly next year, and businesses will pass some (but not all) of the higher labor costs through to their customers.

With rents and labor costs accelerating and vehicle and energy prices not coming down as much as expected, inflation will remain higher than

the Fed expects. However, I don't expect inflation to spiral out of control like it did in the 1970s, for two reasons. First, far fewer workers (and pensioners) receive cost-of-living adjustments (COLAs) than was the case in the 1970s. Unless unions negotiate new contracts that include COLAs, it will be hard to sustain a wage-price spiral. Second, demographics don't support inflation the way they did in the 1970s, when baby boomers were entering the labor force in large numbers. Those boomers needed cars to get to work and houses or apartments to live in; they could not defer those purchases even if they thought prices were too high. Today, the population is much older, and older consumers are more willing **and** more able to defer purchases when prices are high. The improved durability and longevity of motor vehicles facilitates this deferral in a very important sector of the economy.

Persistent higher-than-expected inflation creates winners and losers. Inflation lifts (nominal) corporate earnings, which in turn lifts stock prices. Contrary to what analysts expect, earnings rise despite rising costs, because some companies pass through more than 100% of their cost increases. This behavior is only consistent with profit-maximization if the price increases are driven by stronger demand rather than by higher costs. Absent stronger demand, passing through more than 100% of a cost increase is never optimal, but some companies do it anyway. The biggest losers are those who put their savings in bank accounts and (non-indexed) bonds rather than in stocks and those with pensions that are not indexed for inflation. Their reaction to inflation could force the Fed to tighten sooner and more than they had planned. It could also play a big role in determining the outcome of the 2022 and 2024 elections.

I don't think increased **supply**, by itself, can bring inflation back down to the Fed's 2% target in the next year or two. Reduced **demand** for goods would also be needed, and that would require either a shift in consumer spending from goods to services, reversing the shift during the 2020 recession, or a reduction in total consumer demand driven by tighter fiscal and monetary policy. The Fed has announced a gradual (eight-month) phase-out of its bond purchases, but has indicated that it won't begin to raise short-term interest rates until that "taper" is complete. Because monetary policy affects economic growth with long and variable lags, growth is likely to remain strong through 2022. Monetary policy affects inflation with an even longer lag, so it will take much longer to bring inflation back down to 2%.



For now, demand remains strong, and growth accelerated in October. Headline retail sales, which are not adjusted for inflation, rose 1.7% in October, leaving them up 16.3% year-over-year. Real (inflation-adjusted) retail sales declined from April to July and remain below their April peak, but they rose 0.7% in October and were up 9.5% year-over-year. Industrial production in U.S. manufacturing rose 1.2% in October, more than reversing the declines in August and September. This suggests supply is recovering. Motor vehicle production led the rebound. Manufacturing indexes from the Federal Reserve Banks of New York and Philadelphia suggest another big increase in November.

Fiscal and monetary policy in early 2020 were very effective in easing the pain of recession and triggering a strong recovery, but the December 2020 relief bill was too large, and the March 2021 bill was total overkill. Making matters worse, the Fed should have reacted to the excessive fiscal stimulus by ending its bond purchases and raising interest rates. It did not. Consequently, demand has grown much faster than supply, and inflation has risen to 31-year highs. Bringing inflation back down to the Fed's 2% target will require much tighter monetary policy, which will eventually slow economic growth and probably cause a recession. But I don't expect either a recession or a return to 2% inflation in the next two years.

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