Current Economic Conditions

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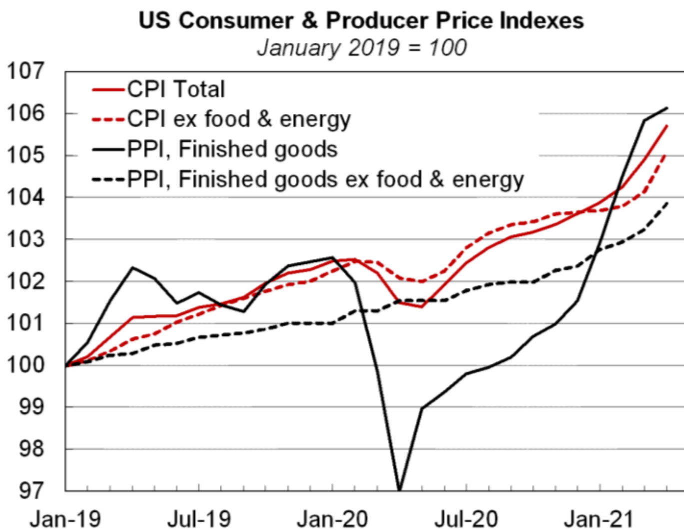
PRICES ARE RISING. IS INFLATION RISING TOO?

The U.S. Consumer Price Index rose 0.8% in April. It was the biggest increase since June 2008 and was four times the consensus forecast. The "core" CPI, which excludes volatile food and energy prices, was up 0.9%, 4.5 times expectations. That was the biggest increase since 1981! Price increases were especially large for car and truck rentals (16.2%), airline fares (10.2%), used cars and trucks (10%), and lodging away from home (7.6%), reflecting the expectation and reality of increased travel as COVID-19 risks diminish. The Producer Price Index also rose more than expected in April. The headline index was up 0.6%, as was the PPI for finished goods, which I prefer. The increase in finished goods prices came on top of a 1.7% increase in March.



Because of the way we usually measure inflation, i.e., by the 12-month (year-over-year) percent change in a price index, the April jump in prices raised measured inflation and will continue to do so for a full year. The total CPI was up 4.2% year-over-year in April. The core CPI was up 3.0% year-over-year. That was the biggest increase since 1996. But economists distinguish between a one-off increase in prices and an ongoing persistent increase in prices. The latter is inflation; the former is not, even if it looks like it in the data.

There are four possible interpretations of the big jump in prices in April. First, it could be a temporary increase in prices that will be reversed when the bottlenecks caused by the COVID-19 pandemic ease. This is nothing to worry about. In fact, if price increases are the signal that elicits more supply, it's a good thing. Some prices, particularly commodity prices that are determined in auction markets, probably will come back down. However, prices (and wages) that are set by human decisions tend to be sticky downward; businesses are more reluctant to cut them than to raise them. If that's the case, the big jump in prices in April could be a one-off increase that **won't** be reversed. It's not really inflation, but it does permanently reduce purchasing power. The third possibility is that this is part of a temporary or "transitory" increase in the rate of inflation. Prices will continue to rise, but the rate of increase will soon subside. This is what the Federal Reserve is hoping for and betting on (with our money). The Fed wants inflation, as measured by the rate of increase in the Personal Consumption Expenditures price index, to average 2% "over time." Since inflation has been below 2% since the Fed announced that target, that will require inflation to slightly exceed 2% "for some time" before falling back to 2%. The fourth possibility, the worst-case scenario, is that the current rise in prices proves to be the beginning of an increase in inflation that is bigger and far more persistent than the Fed hopes and that ultimately requires a recession to undo.

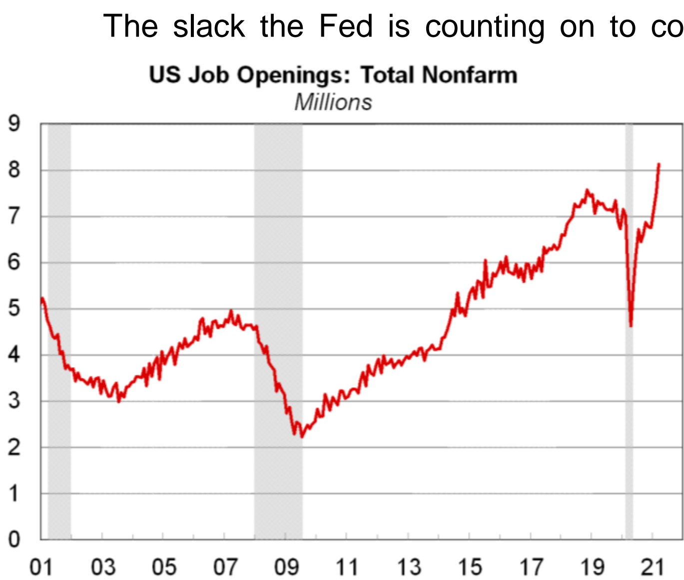
The Fed is betting that inflation won't rise too far and stay elevated too long when there is still significant slack in the global economy, regardless of how low interest rates are or how fast the money supply grows. They don't plan to raise short-term interest rates until the U.S. unemployment rate – one

very narrow measure of slack – gets to a level consistent with "full employment," presumably around 3.5%, where it was before the pandemic. They know that businesses don't raise prices because interest rates are low or because the money supply is growing too fast; they raise them because quantity demanded exceeds quantity supplied at the current price. That occurs when there is little slack in a market, i.e., when capacity utilization is high, inventories are depleted, and products are sold out and "on allocation."

Data on unemployment and capacity utilization suggest there is plenty of slack in the global economy, but we can't take advantage of it right now because port backups and shortages of shipping containers prevent imports from playing their usual role as an inflation relief valve, as do tariffs on Canadian lumber. Domestically, U.S. labor markets are much tighter than unemployment rate indicates, but that could change when enhanced unemployment insurance benefits, which are discouraging many people from accepting jobs, expire this fall. The Fed apparently believes that when current bottlenecks ease, we will revert to a world where globalization, demographics, and technology keep inflation low.

While I acknowledge the arguments for a transitory increase in inflation, I think the Fed is taking a big risk by not reducing its purchases of Treasury bonds and mortgage-back securities and by "not thinking about thinking about raising interest rates." The correlation between money supply growth and inflation is obviously much weaker than in the past, but unless it has totally vanished, it seems rational to believe that the fastest money supply growth on record just might translate into higher inflation. The Fed doesn't seem to be worried about inflation; I believe that worrying about inflation is a central banker's most important job.

The slack the Fed is counting on to control inflation could disappear quickly. Remember, the unemployment rate was 3.5% just 15 months ago. Even if everyone goes back to work as COVID risks diminish, schools reopen, and enhanced UI benefits expire, there won't be enough people to fill all job openings, which stood at a record 8.1 million at the end of March. If my forecast is correct, real Gross Domestic Product will exceed potential GDP, the highest level that can be sustained without an acceleration in inflation, in the third quarter of 2021. Unless the Congressional Budget Office's estimate of potential GDP is much too low, which is certainly possible, the underlying rate of inflation is likely to rise until a slowdown in growth brings GDP back down to potential. That probably won't happen without a tightening in fiscal and monetary policy.



My forecast is that measured (year-over-year) inflation will peak this month and will decline over the next year, but I don't think it will decline as much as the Fed expects and I think it will head back up as soon as current elevated price levels fall out of the calculation. If inflation does fall back to 2%, it will only be for a month or two. Inflation will then rise until the Fed tightens policy enough to get inflation back down. (If it comes down to 2% next year and stays there, I'll congratulate the Fed and admit they were right.) I'm assuming the Fed starts raising interest rates in the third quarter of 2022. If that's the case, they might get inflation back down to 2% without a recession. If they stick to their current plan and wait until 2024 to raise rates, inflation will be much harder to get under control without a recession. A little insurance against inflation would be prudent; a quick hit to stock prices now is preferable to a bad recession in a few years.

I'll close with a quick review of real economic activity. Payroll employment rose by just 266,000 in April, the biggest disappointment relative to expectations in decades. Industrial production in U.S. manufacturing rose 0.4% but was still below January's level; the semiconductor shortage continues to restrain vehicle production. Housing starts and building permits fell on a seasonally adjusted basis.

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