Current Economic Conditions

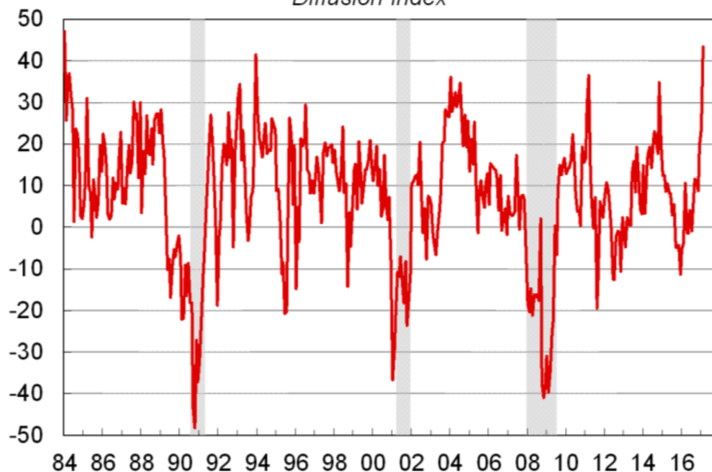
Robert C. Fry, Jr., Ph.D. February 17, 2017

TIME TO RAISE INTEREST RATES AGAIN (AND BY MORE THAN A QUARTER POINT)

Until this week, I expected the Federal Reserve's Federal Open Market Committee to raise its target federal funds rate three times this year, by a quarter of a percentage point each time, with the first hike coming in June. After statements from Federal Reserve Bank of Richmond President Jeffrey Lacker and Fed Chair Janet Yellen and a flood of higher-than-expected inflation and growth data, I now expect the FOMC to raise rates four times, with the first hike coming in March. Unfortunately, I still expect the FOMC to stick to quarter-point hikes, a gradualist approach that contributed to the housing crisis in the last decade and that increases the risk of inflation and asset bubbles in this decade.

On February 14, President Lacker told an audience at the University of Delaware that "rates need to rise more briskly than markets now seem to expect" and that the next hike should come "sooner rather than later." He specifically cited the "disastrous" 15-year inflation that resulted when the Fed delayed raising rates in 1966. His remarks were released to the press at the same moment that the Bureau of Labor Statistics reported that the Producer Price Index for final demand rose a much-larger-than-expected 0.6% in January. A jump in gasoline prices accounted for much of the January increase, but the PPI for final demand goods less food and energy accelerated for a third straight month.

Later in the day, Fed Chair Yellen told a Senate committee that "all meetings are live," implying that a rate hike was possible at the FOMC's March meeting. She also admitted that waiting too long to raise rates could be "unwise." The following day, the BLS reported that the Consumer Price Index rose 0.6% in January, taking the year-over-year percent change to 2.5%. Retail sales ex autos and gasoline rose 0.7%, and December sales were revised up. The headline industrial production index showed a 0.2% decline in January, but this was due to a big decline in utility output caused by mild weather. The industrial production index for U.S. manufacturing was up 0.2%, and this was held down by a big (and likely temporary) cut in motor vehicle production. Ex autos, industrial production in U.S. manufacturing was up 0.5%, with widespread strength across most industries. This confirmed the strong Institute of Supply Management purchasing managers' report from February 1. An early peek at economic conditions in February shows further strength. New claims for unemployment insurance are at historic lows. The Federal Reserve Bank of New York's Empire State Manufacturing index and the Federal Reserve Bank of Philadelphia's Current Activity index for manufacturing both surged in February, the Philly Fed index by a record amount to its highest level since 1984! Growth in early 2017 has obviously been stronger than the Fed expected, with inflation higher.

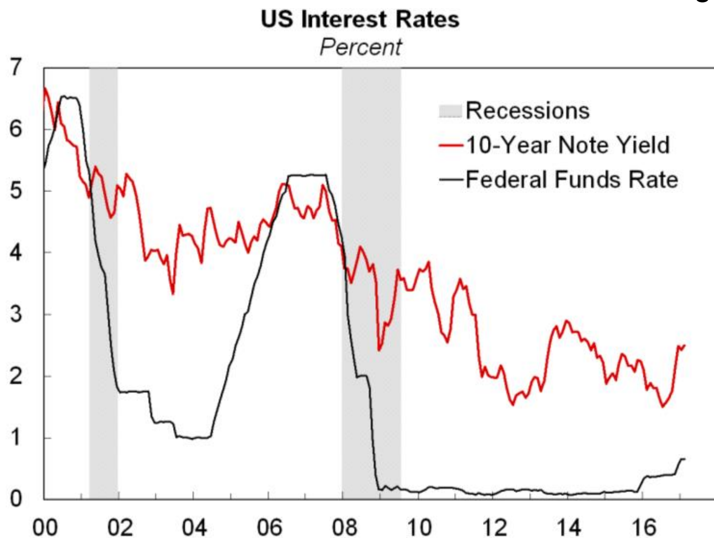


Commodity prices also suggest that growth has accelerated, that inflation is picking up, and that monetary policy is too stimulative and needs to be tightened. The price of copper, called "Dr. Copper"

because it quickly and accurately detects accelerations and decelerations in economic growth, rose to $6110/tonne on February 13 from a low of $4310 in January 2016 and $4636 as recently as last October. This reflects the acceleration in growth in China since early 2016, a resumption in growth in residential construction in the United States, and a resumption in growth in manufacturing globally. The price of iron ore has also increased sharply. The price of gold has risen since late December, suggesting higher inflation. I am not going to start offering investment advice, and I don't have a reliable bubble detector, but some analysts think the stock market is getting a little frothy.

Even though Milton Friedman and Edmund Phelps debunked the notion of a long-term "Phillips Curve" tradeoff between inflation and unemployment 50 years ago, some economists would like to see inflation rise above the Fed's 2% target to force unemployment down. I'm sympathetic to the argument that labor markets should be allowed to tighten further to boost real wages and salaries, but not to the argument that inflation should be allowed to rise above 2%. Some business leaders suffer from "money illusion" – the failure to distinguish between real (inflation-adjusted) and nominal (unadjusted) magnitudes – and would also like to see higher inflation. They would prefer 8% earnings growth with 3% inflation to 5% growth with no inflation, even though on an after-tax basis the former is definitely inferior to the latter. I don't expect the Fed to lower its inflation target to zero, which I'd prefer, but I hope they will react quickly if necessary to prevent inflation from staying persistently above 2%.

Those who've read my newsletters and my articles on Forbes.com know I believe that excessively low interest rates have **hurt** economic growth. I also believe that a handful of quarter-point rate hikes will initially **boost** economic growth, by getting potential homebuyers off the fence and by boosting the interest income of (mostly older) savers. The December rate hike has not reduced demand for houses; home sales are being held back by a lack of supply, not by mortgage rates. Stronger growth is definitely a good thing if the recent pickup in inflation proves temporary or if an expansion in productive capacity in response to tax reform and deregulation keeps inflation from rising. But if inflation continues to rise and bubbles develop, a series of quarter-point interest rate hikes will leave the Fed behind the curve. From 2004 to 2006, the FOMC raised its federal funds rate target by a quarter point at **every** meeting, and that wasn't fast enough to choke off the housing bubble that led to the worst financial crisis and recession in 75 years. Currently, few economists expect the FOMC to raise rates faster than a quarter point every **other** meeting. That won't keep inflation from rising undesirably, and it won't stop asset bubbles from inflating. Given the current level of long-term interest rates, the FOMC should raise the federal funds rate to 1.5% as soon as possible, then base its next move on the response of commodity prices and long-term interest rates. Given the size of the federal debt, it would be far better to get the funds rate to 3% relatively quickly and stop there than to have to raise it to 5% or more to put the inflation genie back in the bottle because they didn't raise it quickly enough.



There is a risk that the pickup in actual and expected growth could be short-lived. If Congress fails to pass a corporate tax reform bill this year, the expected surge in business investment won't happen. Growth in China has accelerated since early 2016, but debt, demographics, and pressures for and against devaluation of the Yuan mean that growth is likely to slow sharply and permanently, probably by the end of 2018 but possibly much sooner. That could slow growth globally. There are also risks that measured inflation could be pushed higher by President Trump's trade and immigration policies and by the Border Adjustment Tax in the House Republican tax reform plan. Barring a failure to pass tax reform, the risks tilt toward higher inflation and argue that the Fed should raise rates more quickly than markets expect.

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