Current Economic Conditions

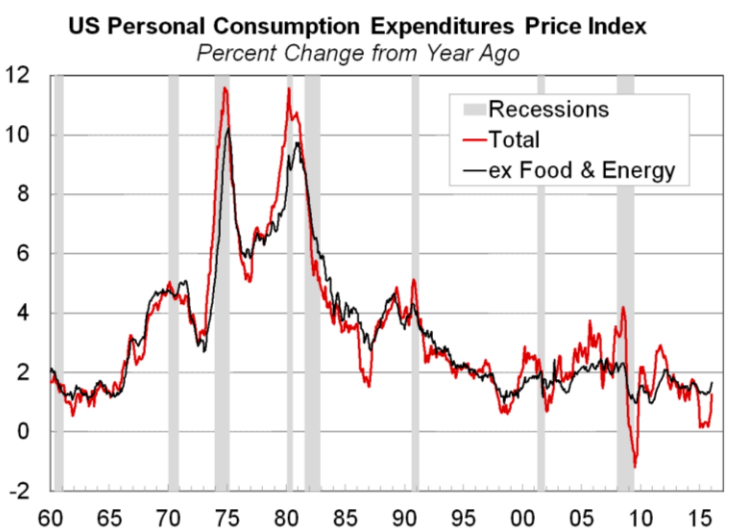
Robert C. Fry, Jr., Ph.D. March 25, 2016

GENERATING EXCITEMENT IN A BORING ECONOMY

I have been writing a monthly newsletter on the economy for more than 21 years. For most of those years, I had no problem coming up with a topic each month. That has changed in the last few years. There are only so many ways to say "disappointingly slow," which is how I would characterize the U.S. economy since mid-2010. I've tried to spice things up by writing about more "exciting" topics, like the decline in oil prices or the slowdown in China. Other times, I've put on my political economy hat and written about economic policy and why growth was disappointingly slow. But for an economist who considers himself a business-cycle analyst, persistently slow growth, without booms and busts, is boring.

For several years, I have ended my presentations on the economic outlook with a PowerPoint slide that says "The real issue is slow long-term growth, not recession," and I've urged my audiences and my profession to focus on long-term growth in their businesses and the overall economy rather than on quarterly earnings reports and cyclical fluctuations in the economy. Given the power of compound growth, taking actions to boost a long-term growth rate from, say, 2.0% to 2.5% will accomplish much more than hitting a quarterly earnings target or forecasting/avoiding the next recession or bear market. Companies should be focused on consistent research and investment programs that produce long-term growth, not on panic-driven actions to hit quarterly earnings targets. My fellow economists and the policy-makers they advise should be focused on structural reforms (tax reform, regulatory simplification, investment in infrastructure), not on countercyclical fiscal and monetary policies.

Some economic analysts have not been content to describe the economy in all its boring reality and don't appreciate the cumulative impact of boosting growth from 2% to 2.5%. Instead, they've stoked fears that economic conditions are much worse than they really are. For years, inflation hawks have claimed that the monetary policies pursued by the Federal Reserve and other central banks would cause inflation to spiral out of control. Meanwhile, central bankers and inflation doves have lived in constant fear of deflation. The reality? Inflation, as measured by the 12-month percent change in the Personal Consumption Expenditures Price Index, excluding food and energy, has been in the 1.3-1.7% range for 38 straight months. That isn't "price stability" – price stability means **zero** inflation – but it certainly isn't hyperinflation or deflation either, and it should cause up to question the credibility of both inflation-phobes and deflation-phobes.



Many analysts have also been talking about a "manufacturing recession" or "industrial recession" lately, and some even think the overall economy is falling into a recession. Total industrial production was indeed down 1.0% year-over-year in February, but this decline was due entirely to a 9.9% decline in mining production caused by the decline in oil and gas prices and a 9.3% decline in utility production caused by mild weather. Industrial production in U.S. manufacturing fell all of 0.4% from July 2015 to December 2015, but was up 1.8% year-over-year in February after two monthly increases pushed it to a new post-recession high. Year-over-year growth hasn't been in negative territory since 2009 and hasn't been above 4.3% since early 2011. Year-over-year growth in real Gross Domestic Product has remained in an even narrower range; it has been between 0.9% and 2.9% since 2010. Pessimists handpick their starting and ending points to show that the housing recovery has stalled, but a longer-term view that looks past monthly fluctuations caused by weather or regulatory changes shows that the slow recovery in housing starts and home sales remains intact. Single-family housing starts rose in February to their highest seasonally adjusted annual rate since 2007.

There are several reasons why people think the economy is worse than it is **and** why they want to convince others that it is worse than it is. Business leaders think the economy is worse than it is because they focus on nominal (dollar) magnitudes that depend on volumes **and** prices rather than on real (inflation-adjusted, constant-dollar) magnitudes that depend only on volumes. Real growth is disappointingly slow, but only slightly below historical norms. Because of low inflation, especially for goods, nominal growth is at rates that before 2007 were only associated with recessions. Businesses would be happier with stronger nominal growth even if that growth were solely the result of faster price increases. Economists, on the other hand, know that revenue growth due to price increases is zero-sum growth; it makes sellers better off, but makes buyers worse off. Real growth, due to volume increases, is positive-sum growth.

There are at least four groups of people who want to convince others that the economy is worse than it really is. Republicans want people to think the economy is bad because the incumbent President is a Democrat, and Republicans believe a weak economy will help the Republican Presidential candidate in November. Most Democrats want people to believe the economy is weak because they want to boost government spending, and they think a weak economy bolsters the case for more spending. (Among the major Presidential candidates, only Hillary Clinton has any incentive at all to say anything good about the economy, and that incentive is apparently very weak.) Many investors, plus businesses that benefit from low interest rates, want to convince the Federal Reserve that the economy is weak so they'll keep interest rates lower for longer. Finally, the news media know that bad news is always better for television ratings and newspaper circulation than is good news. The public accepts all of this negativity because, as Austrian-American economist Joseph Schumpeter said, "Pessimistic visions about almost anything always strike the public as more erudite than optimistic ones." It's pretty sad that I get called an optimist for not forecasting a recession even though I don't have U.S. GDP growth rising above 3%, despite low oil prices.

The U.S. economy isn't the only major economy that is being mischaracterized as much weaker than it really is. The problem is even bigger in Europe. Because of unrealistic expectations for potential growth and an excessive concern about deflation, the European Central Bank has panicked and driven interest rates into negative territory. (The ECB probably assumed that negative rates would weaken the Euro and make European manufacturers more competitive. Counterintuitively, the Euro has strengthened.)

I do not claim that U.S. and European economies are doing well. Growth remains disappointingly slow and will without tax and regulatory reform. But exaggerated fears of deflation and irresponsible references to an "industrial recession" are not only unjustified; they're harmful. By discouraging investment and (to a lesser extent) consumer spending and home sales, they cause growth to be slower than it otherwise would be. Better to accept boring than to hurt the economy by generating unjustified excitement.