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Asking the Hard Questions: An Update from Stonebridge's Chief Economist

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Inflation is considered bad for the economy. Why? Is a higher price ever a good thing?

The U.S. is a market economy, which means that price changes provide important information to market participants, as well as to policy makers. Interpreting this information is not always as easy as it may seem. After all, in our economy, prices determine how the goods and services that we produce are allocated. You buy what you can afford, and the price determines whether it is affordable. Importantly, prices also determine what is produced.

When prices go up, there is generally too much money chasing too few goods, resulting in inflation. The implication is that demand is excessive or that supply is being constrained by something other than price. When prices go down, there isn't enough money to chase with. The result is deflation. The implication is that there is insufficient demand or too much supply.

Most everyone agrees that too much inflation is bad for the economy because it saps the purchasing power of consumers. Essentially it takes more dollars for consumers to maintain their living standard. Unless consumers experience a comparable increase in wages and salaries, they suffer. This explains why individuals living on fixed incomes are the ones that are hit the hardest by inflation.

Inflation is not simply high prices. Rather, it is the process of getting to those high prices. Moreover, price increases need to be widespread across goods and services to be considered inflation. Unfortunately, a sharp increase in the price of one category of goods or services could raise the overall price index used to measure inflation, even though it may be a temporary relative price hike. For example, if the price of apples goes up, then consumers might prefer to buy fewer apples and more of another fruit to preserve their living standard. The response by consumers may depend on why apple prices rose in the first place. If it was due to stronger demand, then the higher price most likely will be paid. If the higher price was due to a shortage of apples, purchasing other fruit may be the only option, which will likely raise the prices of other fruit as well. Of course, it is not always this simple.

The higher price of petroleum products due to a supply shortage is a good example of the dilemma that central banks face in their fight against inflation. The economic sanctions on Russia for its invasion of Ukraine have essentially restricted the supply of petroleum products available globally. Russia can still produce these petroleum products, it just doesn't have a market for them because of the sanctions. Under such circumstances, what incentive do oil companies have to invest in drilling for new oil and gas or to invest in increasing capacity if Russian output would suddenly become available, flooding the market and undercutting any investment oil companies made?

In addition, the ongoing push to be less dependent on fossil fuels in the future provides even less incentive for oil companies to invest in new capacity. The only thing that might provide an incentive is if oil prices skyrocket and are expected to stay there. The problem is that this spike in the relative price of oil would have spillover effects on other consumer items, such as airfares, delivery costs, electric bills and the obvious gasoline prices. The implication of a higher price of a particular good or service is that supply needs to increase to match increased demand, or demand needs to decline to match decreased supply. The former would always be preferred over the latter but unfortunately, increasing supply is not always an option.

The bottom line is that the inflation experienced over the last couple of years was more complicated than excess demand alone. It may be that a large share of the inflation in 2021 was demand related, but it was supply constraints that may have been the overwhelming factor in 2022, particularly crude oil and natural gas supply.

Why has inflation been so stubbornly high? What is the outlook for inflation over the next year?

For the U.S., several factors have contributed to the inflation upturn during the last two years, including economic shutdowns here and abroad. Such shutdowns prevented people from going to work, making it impossible to find many of the goods and services they wanted to buy at any price. Additionally, the federal government provided pandemic relief to businesses and households finances with federal debt that was monetized by the Fed. Supply was being constrained and demand was being encouraged. Under such circumstances, it should be no surprise that inflation climbed higher. In the second half of 2021, it looked as if inflation was starting to subside a bit before taking off again in early 2022, due to Russia's invasion in Ukraine and increased tensions between the U.S. and China.

Many, including the monetary authorities, thought that the supply gap in the economy in 2021 would close quickly, with supply returning to match demand at more stable prices. Remember when the Fed thought inflation was transitory? Unfortunately, supply did not recover or it was too slow to recover to calm prices hikes. The zero-COVID policy still followed by China provides a great example. This policy continues to put strains on supply channels, forcing global businesses to find alternative vendors. Unfortunately, they are often not available as quickly as needed, if ever. It takes time and money for businesses to ramp up their production capacity to displace China, whether here or abroad. In addition, as mentioned earlier, the economic sanctions against Russia for invading Ukraine have created an energy supply problem that has put upward pressure on the price of crude oil, as well as natural gas. The conclusion is that inflation most likely will slow over the next year.

Indeed, a slowdown may already be underway. According to the latest report from the Bureau of Labor Statistics, the consumer price index (CPI) rose at a slower pace in October than the consensus expected. The monthly increase of 0.4%, if repeated in each of the final two months of the quarter, will result in the CPI rising at a 4.6% annualized rate for the fourth quarter; this is identical to the pace for the fourth quarter shown in our October 6th Economic Outlook. Although one data point does not make a trend, the October CPI report may reflect a continuation of a trend initiated in the third quarter. Apparently, consumer price inflation peaked in the second quarter of this year at a whopping 10.5 percent annual rate, before slowing to 5.6% in the third quarter. The fourth quarter is expected to register another slowdown, projected at 4.6%. Over the four quarters of 2023, inflation is expected to slow further because of both softer demand and some further easing of supply disruptions. The most recent forecast shows the CPI up 2.7% over the four quarters of next year, dramatically lower than the 7.5% over the four quarters of this year.

Previously you have worked with the Fed, I'd love to hear your insight as to how they may work to get inflation in check?

I worked as a research economist at the Board of Governors of the Federal Reserve System in Washington, DC for 14 years. I arrived at the Fed in August 1973, just in time for a substantial inflation episode that lasted for nearly a decade. During the first oil embargo in October 1973, there were several legislative and regulatory proposals being floated to help cap energy prices. Unfortunately, the few that were actually implemented by Congress, as well as the Fed, in hindsight most likely exacerbated the inflation problem.

The concern was that the shortage of oil due to the embargo would depress economic activity, which would have a more devastating impact than elevated crude oil prices. At the time, the widely held view was that there was a very limited supply of crude oil reserves in the world and that OPEC controlled the spigot. In that regard, the initial Fed policy response in October 1973 was to cut the federal funds rate 50 basis points to 10% from 10.5%. I wish I knew the rationale behind this move. The Fed was far from transparent about its policy moves, both past and future. The only reason that I can think of for this rate cut was to treat the oil price hike in 1973 as a relative price shock imposed on us by OPEC. One way to return the relative price of oil back to its previous level was to allow the prices of everything else to increase. Hum!! As farfetched as this sounds today, there were some very prominent economists recommending such a move. Obviously, it didn't work as planned. It wasn't until the Fed raised interest rates dramatically in the early 1980s that inflation was back in check.

This time around, I believe that raising short-term interest rates was the correct response, but I expected rate hikes to start sooner than they did. In addition, I question whether the Fed needs to remain as aggressive as it has been over the last four policy meetings. Indeed, I can make a case for the Fed pausing for a bit to see what the effect of the rate hikes already implemented might mean for the economy and for inflation. That said, it does not sound like the Fed has any interest in pausing, although they appear to be making a case to slow the pace of rate hikes.

I disagree that the Fed needs to implement a policy to destroy aggregate demand. Instead, they should set policy to slow demand growth to give supply a chance to improve. Indeed, higher prices provide businesses the incentive to produce more, assuming that other policies do not dilute that price incentive. The challenge will be to produce more with less, resulting in increased productivity and a relatively stable unemployment rate, leading to lower inflation with little pain. However, the likelihood of the Fed achieving such a perfect landing is very low.

Can the U.S. economy avoid a recession or are we already in one?

I doubt we are in a recession, largely because employment, income, and consumer spending data do not favor such a conclusion. Recessions are timed by a committee of economists at the National Bureau of Economic Research (NBER). This committee relies on a relatively short list of variables to make its determination of the business cycle. Although real GDP is considered in the NBER's calculations, it is used more for timing the recession than it is to determine whether we are in one.

Will we avoid a recession? There is a surprisingly good chance that the recession can be delayed. The good news, however, may not be so good. Even if there is no recession next year, economic growth is still very likely to be anemic. In particular, many of the headwinds plaguing the U.S. economy this year will continue next year. It will be difficult for the U.S. economy to perform above its potential, which I estimate to be about 1.25%.

Although recession could be delayed, it cannot be avoided. Assuming the Fed follows through on its advertised rate hikes, the next recession could occur as early as next year. This seems to be the consensus at the moment. If the U.S. slips into recession next year, I expect it to be relatively shallow but not necessarily quick. The implication is that the unemployment rate will rise but top out at a level well below the peaks of the last two recessions.

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