Current Economic Conditions

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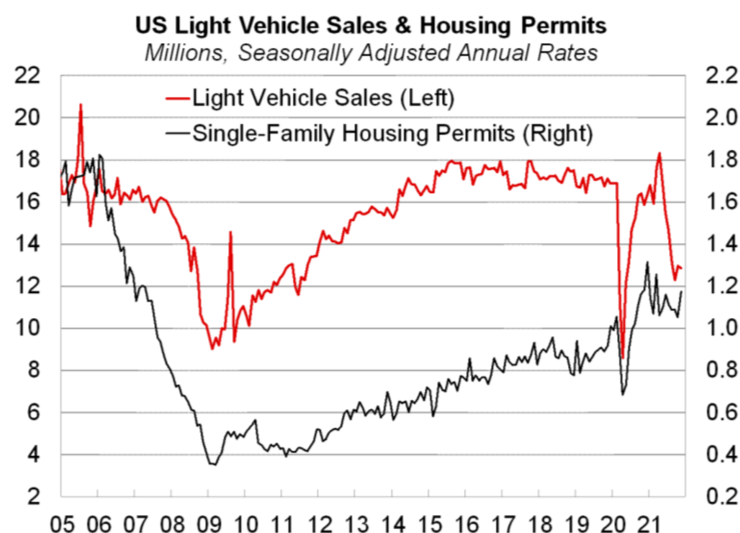
THE (ALMOST) MYTH OF STAGFLATION

If asked to describe the U.S. economy of the 1970s and early 1980s with one word, many might choose the word "stagflation," a portmanteau of stagnation and inflation. People seem to remember that period as one of slow growth and high inflation. But if you look at the data, you'll realize that stagflation is an accurate characterization of exactly one year, 1979. During the rest of the 1973-1982 period, when inflation (gauged by the Consumer Price Index) never fell below 5%, U.S. real gross domestic product was either growing strongly or declining. Stagflation only existed **after** a period of strong growth had exhausted the spare capacity in the economy and **before** interest rates had risen enough to cause a recession. When you hear forecasts of stagflation in 2022, you should keep in mind just how rare the phenomenon is. It is much more likely that the U.S. economy will experience both strong growth and high inflation in 2022.

The main reason to expect continued strong growth in 2022 is that monetary policy works with what Milton Friedman called "**long** and variable lags." [Emphasis mine.] In the late 1970s, the Federal Reserve began raising short-term interest rates in August 1977. The federal funds rate rose from 5.4% in July 1977 to 10.0% in January 1979, when growth slowed sharply. A recession didn't begin until January 1980, after the federal funds rate had risen to 13.8% under Fed Chair Paul Volcker and after President Carter had imposed credit controls. This year, inflation has risen to its highest level since 1982, but the Fed still has not begun to tighten monetary policy. In fact, it is still easing. It is phasing out (at an accelerated rate) its purchases of government securities, but this "tapering" is not tightening; it is easing at a declining rate. The Fed is unlikely to tighten monetary policy, by raising its target federal funds rate, before March 2022. The **long** lag until monetary policy starts to slow the economy doesn't start until then.

Fiscal policy usually works with a much shorter lag, but I don't expect fiscal policy to slow economic growth next year, even if Democrats fail to pass President Biden's Build Back Better bill and federal government spending declines from the inflated levels of 2020 and 2021. Between funds allocated by previous stimulus bills but not spent yet, federal funds allocated to the states but not spent yet, and funds given directly to households and not spent yet, we're more likely to get a fiscal ramp than a fiscal cliff.

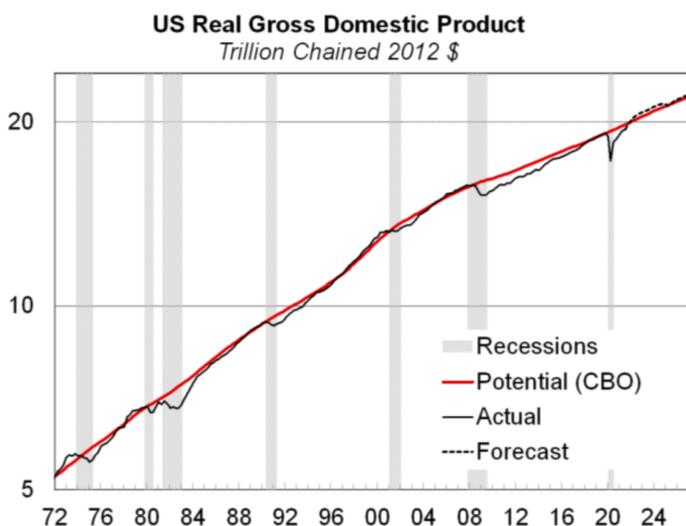


With monetary and fiscal policies unlikely to have a contractionary impact on the economy in 2022, growth is likely to be dominated by regular business-cycle dynamics, not by policy, and those dynamics argue for continued strong growth. Even though growth this year will be the strongest since 1984, it would have been much stronger if not for supply constraints that have held down two of the most important sectors of the economy: motor vehicles and housing. Motor vehicle sales fell from an 18.3 million seasonally adjusted annual rate in April to a 12.3 million rate in September. As the global semiconductor shortage eases and vehicle production recovers, sales are likely to rise above

a 16 million rate in the second half of 2022. Home building has been constrained by shortages of labor, lumber, and lots. Single-family housing permits, the most important number in the monthly housing report, fell from a 1.315 million seasonally adjusted annual rate in December 2020 to a 1.054 million rate in October 2021. Permits rose in November and are likely to rise in 2022 as supply constraints ease. Housing starts, investment in residential construction (in GDP), and spending on floor coverings, furniture & fixtures, and appliances will follow in quick succession. With two of the most important sectors of the economy growing rapidly in 2022, GDP growth is likely to remain well above trend. More broadly, inventories are still very lean in most of the economy. Inventory restocking is likely to boost manufacturing in 2022.

Growth has accelerated in recent months. The Federal Reserve Bank of Atlanta's GDPNow, an estimate of current-quarter GDP growth based on available monthly and weekly data, stands at 7.2%. Industrial production in U.S. manufacturing rose 0.7% in November. Payroll employment rose by a disappointing 210,000, but the rest of the employment report showed significant strength. In particular, the household survey used to calculate the unemployment rate showed a 1.136 million surge in civilian employment. (The payroll survey counts jobs; the household survey counts employed persons. People shifting from two part-time jobs to one full-time job could help explain the disparity.)

Strong growth in the fourth quarter of 2021 and first quarter of 2022 will leave GDP above the Congressional Budget Office's estimate of potential GDP, the highest level of GDP that can be sustained without an acceleration in inflation. Measured inflation might come down next year as the transitory components of inflation ease (even if prices don't come down), but the stickier underlying components of inflation (e.g., rent and labor costs) are likely to accelerate, keeping inflation well above the Fed's 2% target. The transitory part of inflation, driven by temporary supply/demand imbalances, will fade, but the stickier underlying part, driven by the lift to aggregate demand provided by loose monetary and fiscal policies, won't fade until policy is tightened. Recent inflation readings have caused me to raise my forecast of annual CPI inflation in 2022 to 6%. I expect CPI inflation to remain above 3% until the next recession.



Eventually, growth will slow as tighter monetary policy starts to bite and the economy simply runs out of spare capacity and unemployed workers that can be put back to work. But with GDP above potential, inflation is likely to remain high. That's when stagflation becomes a real risk. But that's a 2023 or 2024 story, not a 2022 story. In theory, a prolonged period of stagnation or below-trend growth could bring GDP down to below potential and allow inflation to decline, but it's more likely that a shock or a Fed trying to get inflation down to 2% will push the economy into recession. That's probably a 2024 or 2025 story.

I began by referring to the 1970s, but some things that affect inflation have changed since then. The surge in inflation from the mid-60s to the early 80s coincided with the coming of age of the Baby Boomers. They added much more to demand (e.g., for cars and housing) than they did to supply, putting upward pressure on prices. Today, those Baby Boomers **and** the U.S. population are much older, and older people are more resistant to price increases than the young. Also, despite some backtracking under Presidents Trump and Biden, globalization puts downward pressure on inflation relative to the 1970s. But one thing has not changed since the 1970s: the tendency of policy-makers to blame inflation on a series of one-off events (e.g., higher oil prices, COVID-19) rather than on their own actions. In a May 1980 speech at Harvard University, Barry Bosworth, former Director of the Council on Wage and Price Stability, did exactly that. Harvard Economics Professor Hendrik Houthakker responded, "That's the one-damned-thing-after-another theory of inflation." The more things change, the more they stay the same.

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