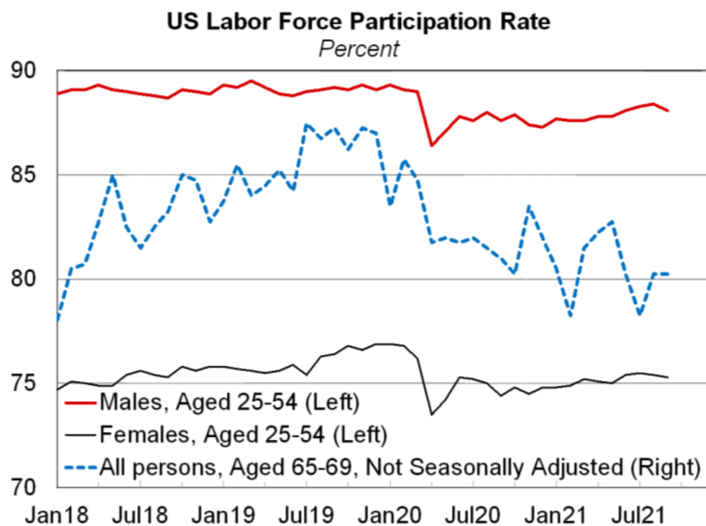
Current Economic Conditions

Robert C. Fry, Jr., Ph.D. October 20, 2021

A LITTLE LESS GROWTH, A LOT MORE INFLATION

In the last month, I've resumed giving live speeches on the economic outlook. One of the big advantages of speaking live, versus virtually, is that I learn more during the question & answer period after the speech (and the cocktail reception the night before the speech). What I've learned in the last month is that supply constraints are even worse than I realized and that prices have risen more than government price indexes suggest. I've realized that the U.S. economy doesn't have enough labor or capital to achieve my old forecast. Consequently, I've lowered my growth forecast for the next three quarters. And because demand remains strong while supply is constrained, I've raised my inflation forecast.

Payroll employment rose just 194,000 in September and remains nearly five million below its pre-pandemic peak. Employment hasn't recovered because the labor force participation rate, the percentage of the adult population that is either working or looking for a job, remains well below pre-pandemic levels. The decline in the participation rate has been especially large for older baby boomers. Baby boomers who had continued to work into their late sixties, after balancing the boost to their net worth from government stimulus checks and a booming stock market against the risks of getting COVID-19, have retired in large numbers. The labor force participation rate for those aged 65-69 has fallen 2.8 percentage points since September 2019. (I use September data for both years because some data aren't seasonally adjusted.) Participation for those aged 25-54 has fallen by 1.1 percentage points. Contrary to reports that attribute the shrunken labor force to mothers' staying home to take care of children while schools and daycare centers are closed, the "prime-age" participation rate has fallen by about the same amount for both men and women. Labor force growth has also been limited by a decline in immigration due to Trump Administration policies and to travel restrictions imposed in response to the COVID-19 pandemic.

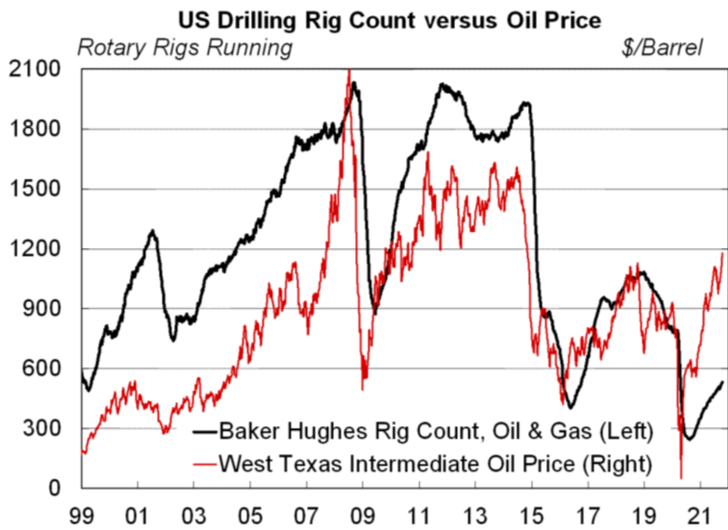


I don't discount that labor force participation was held down by enhanced unemployment insurance benefits that paid many people more to stay home than to work, by school and daycare closures, and (especially) by fear of the virus that causes COVID-19, but there's more to it than that. People are taking advantage of a tight labor market to leave unsatisfying jobs; the quit rate is at record highs in what is being called "The Great Resignation." If the quitters take higher-paid, higher-productivity jobs, that will boost economic growth, but if they opt for more satisfying but lower-productivity jobs, it will hurt growth, even if it improves happiness. Ultimately, money talks, and a big further increase in wages and salaries – more than businesses can pass through in higher prices – will be needed to alleviate labor shortages and attract workers to higher-productivity jobs.

Production is also being limited by capacity constraints. Except in the energy complex, where supply **has** been reduced, this generally reflects excess demand, not reduced supply. The increase in

demand for goods, the result of government stimulus checks **and** a shift in consumer spending from services to goods in response to COVID-19 risks and lockdowns, has overwhelmed the ability of the global economy to meet that demand. Investment in equipment and intellectual property products, e.g., software, has rebounded from the recession but is not booming. Productivity-enhancing investments in equipment have been slowed by the global semiconductor shortage and by shipping constraints that have slowed imports. Also, rising prices for capital goods mean that the dollars budgeted for capital expenditures don't buy as much equipment as they would have when budgets were prepared last fall.

Unlike investment in equipment and software, investment in nonresidential structures remains near its recession low. There isn't much demand for retail space and office buildings now, but nonresidential structures also include a category called "Mining Exploration, Shafts and Wells," which is dominated by oil and gas drilling. The number of drilling rigs in operation has been rising in response to high oil prices but is well below historical levels. Drilling is being constrained by government policies that discourage future fossil-fuel development, by ESG investing, and most importantly, by what equity analysts call "capital discipline," a desire to avoid over-investment that lowers prices and returns. This issue goes beyond oil and gas drilling and explains why businesses haven't increased capital expenditures more despite record corporate profits, instead choosing to return more capital to shareholders through dividends and stock buybacks.



Strong global demand combined with reduced drilling, OPEC+ production cuts, calm winds that cut European wind-power production, and China's efforts to shift away from coal have put upward pressure on oil and natural gas prices. The price of Brent Blend crude oil, the international benchmark, has risen above $85/barrel in recent days. Until last year, every recession in the last 50 years had been preceded by – "caused by" might not be an overstatement – a large increase in oil prices. The growth in U.S. oil and gas production caused by hydraulic fracturing and horizontal drilling drastically reduced the vulnerability of the U.S. economy to higher oil prices, to the point that some analysts think that rising oil prices are no longer bad for U.S. economic growth. But if rising oil prices no longer elicit as large a drilling and production response as before the pandemic, higher oil prices will again be unambiguously bad for the U.S. economy.

With demand still strong, supply unable to keep up with demand because of limited supplies of labor and capital, and oil prices rising, inflation remains well above most forecasts, particularly those of the Federal Reserve. While there has been a slight deceleration in the Consumer Price Index in recent months, there has been no deceleration in the Producer Price Index for Finished Goods, which rose 1.5% in September, leaving it up 11.7% year-over-year. (My audiences are tilted heavily towards business-to-business sales, which are reflected in the PPI, not the CPI.) The upward revision to my inflation forecast largely reflects the fact that even if inflation declines going forward, it will be declining from a high level.

Similarly, the downward revision to my growth forecast reflects a slowdown that has already occurred because of supply constraints involving labor, energy, semiconductors, and shipping capacity. Industrial production in U.S. manufacturing fell 0.7% in September, and August's 0.2% increase was revised to a 0.4% decline. "The production of motor vehicles and parts fell 7.2 percent, as shortages of semiconductors continued to hobble operations, while factory output elsewhere declined 0.3 percent." I expect growth in industrial production and Gross Domestic Product to accelerate in the fourth quarter, due mostly to the decline in COVID-19 cases, but barring increased labor force participation, increased business investment, and more drilling activity, growth will be slower than I expected a few months ago.

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