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Normalization Means Higher Inflation

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The U.S. economy, for most of the last fifty years, has grown at a rate of about 3 percent, while everyone wished for 4 percent. Inflation averaged about 3 percent, while everyone wished for 2 percent. Since the revival of 3 percent productivity growth after 1995, growth has averaged about 4 percent except during the brief 2001 recession. Last year, inflation dropped to about 1 percent and fear of deflation had more than a few policymakers actually wishing for 2 percent.

Now we are heading back toward a more normal state of affairs with 3 percent growth and 3 percent inflation. Against the backdrop of the higher-growth, lower-inflation era just ending, the transition to such normalcy will be an uncomfortable one, carrying with it some problems for the Federal Reserve. How the transition is managed will determine whether or not inflation gets out of hand during the late post-bubble period. The risk of higher inflation is presently tied largely to the Fed's confidence in sustained high productivity growth and to its tendency to target financial markets for fear of systemic risk, as demonstrated by its aggressive accommodation (50 basis points of rate cuts) after the 1998 *Long Term Capital Management* collapse and its current near obsession with preparing markets for every twenty-five basis point rise in the fed funds rate.

Slowing Growth

At midyear 2004, the U.S. economy is slowing against the wishes of its managers, while the Chinese economy is also slowing but in accordance with the wishes of its managers. This combination has lowered second-quarter global growth to about 3 percent (down from above 4 percent the previous year) and has provoked some market changes. Most commodities and oil are well below their second-quarter price highs. Major global equity markets are flat or down for the year to date, with Japan the only exception, up a moderate 8 percent at midyear. Currencies are broadly trendless, reflecting uncertainty about the relative impact of slower growth upon Asia, Europe, and the United States.

Interest rates were broadly lower in the first quarter and higher in the second, as employment growth rose in the United States along with inflation. The June growth slowdown has taken U.S. interest rates off their highs just as the Fed has started to raise its policy interest rate. That move came in response to higher inflation and an employment growth surge that seemed to be gathering momentum but then quickly lost steam.

"Messy" comes readily to mind as a characterization of both the global economy and markets. Why is the Fed tightening as global growth slows? The answer lies with a reversal of last year's disinflation trend whereby the Fed's favored inflation index, the Core PCE Deflator, has accelerated from a low year-on-year rate of about 1 percent last December to 1.6 percent as of May. Inflation expectations over the next year, as measured by the University of Michigan Survey of Consumers, have jumped to 3.4 percent, up sharply from a low 1.6 percent a year ago. That is far above the newly increased 1.25 percent level of the federal funds rate—not to mention the "fourth of July special" on the two-year note yield at 2.5 percent. That puts the expected real yield on the two-year note at minus 90 basis

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points, far below the average level of plus 340 basis points (adjusted by six-month annualized core CPI inflation) since that note's 1976 inception.

Painful Post-Bubble Adjustments

Markets face some painful choices regarding the outlook for the real economy that can be subsumed under the heading of "post-bubble adjustments." The U.S. and global economies, not to mention corporate earnings growth, may continue to slow, thereby encouraging hope that inflation will stop rising. Steady inflation could stabilize long-term interest rates, with the Fed normalizing short-term rates at around 3 percent. Alternatively, growth may resume, with inflation continuing to rise, forcing more Fed tightening than is currently expected. No one wants to contemplate the third possibility, stagflation, where growth slows and inflation rises, but it is probably the most likely outcome as the economy normalizes to 3 percent growth and inflation. The negative impact on corporate earnings and stock prices from stagflation could be ugly. A weaker dollar, necessary to help cushion the pain, would transmit the pain of U.S. stagflation abroad.

The second half of 2004 will be the mirror image of higher growth and lower inflation as seen in the second half of 2003. In short, a whiff of stagflation is in the air.

Last year's U.S. investment bounce and this year's U.S. employment bounce are both testimony to the power of highly stimulative monetary and fiscal policy measures put in place since the bubble burst in March 2000. They are also testimony to the limitations of stimulative policy. The effects are temporary unless they ignite sustained spending growth in the private sector and that, in turn, requires sustained employment growth. Waning demand growth, falling productivity growth, and China's great reservoir of raw labor make sustained U.S. employment growth unlikely as we move into the second half of 2004.

Hindering a return to 4 percent growth is the fact that the need for still more expansion of capacity in the U.S. economy—or in the global economy, for that matter—remains in question, especially without the powerful policy boost to U.S. spending. Capital spending is running at a level roughly consistent with maintenance of capacity—just offsetting depreciation. Employment is growing at a year-over-year rate of 1 percent, as the long-run average has accelerated from a 0.5 percent growth rate in March. The U.S. policy framework for the second-half includes some fiscal drag, with tax cuts for households ending, and some monetary drag, as the Fed raises interest rates from emergency low levels, thereby ending the refinancing boom and the extra stimulus for the borrowing that drives home buying and auto buying.

Unless employment growth resumes accelerating, we shall be lucky to achieve a growth rate much above 3 percent in the second half. Meanwhile, inflation, having turned up, will probably creep higher. It will be boosted by rising unit-labor costs as productivity growth slows and labor presses for higher wages in the face of rising inflation expectations. The second half of 2004 will be the mirror image of higher growth and lower inflation as seen in the second half of 2003. In short, a whiff of stagflation is in the air. The dollar and U.S. stocks will struggle and then fall. Interest rates will wander as currencies have done in the first half of 2004, but probably will drift higher as modestly positive real yields are restored.

A move toward 3 percent growth and 3 percent inflation would constitute nothing more than a return to long-term trends for the U.S. economy. Growth has averaged 3.3 percent over the last decade, while inflation, as measured by the PCE Core Deflator, has averaged 1.7 percent. After twenty-two years of disinflation, most pronounced over the last decade, higher inflation is probably to be expected. In that environment, interest rates on ten-year notes have averaged about 6 percent while the federal funds rate has averaged 4 to 5 percent.

The drift toward higher inflation will be tolerated by a Fed concerned about the health of financial markets during a period of lowered growth expectations. At some point, the Fed will have to stop slipping its inflation target higher and risk disappointing, or even surprising, markets—something Chairman Greenspan has been loathe to do. Perhaps the painful choices will be left to his successor. Meanwhile, anyone who doubts that post-bubble periods are hard to manage need only look to Japan which, only now, may be emerging from a post-bubble slump that started over a decade ago.

Normalization Risks

The process of a U.S. post-bubble normalization to growth lower than 4 percent and inflation higher than 1 or 2 percent will seem like stagflation. Whether that uncomfortable situation turns into more inflation or just

moderate 3 percent growth with 3 percent inflation depends very much on the Fed and its perception of U.S. growth potential. That, in turn, depends on the Fed's estimate of productivity growth.

If trend productivity growth is 2 percent, then adding a percentage point for the long-run growth of the labor force would put growth potential at 3 percent. Alternatively, 3 percent trend productivity growth boosts growth potential to 4 percent. The problem lies with the sad fact that economists do not know much about the determinants of productivity growth and its changes. Tying monetary policy to productivity growth, as Chairman Greenspan has hinted at doing, is dangerous. If the Fed thinks productivity growth is around 3 percent and aims for 4 percent growth, an actual productivity growth rate of 2 percent (3 percent noninflationary growth potential) will result in inflation. Inflation could easily reach 3 percent before the mistake on sustainable productivity growth is discovered. We cannot even explain changes in productivity growth, much less predict them.

The coming year will see the Fed decide whether to target price stability or try to sustain growth and financial markets. The only way the latter course can work without higher inflation is for productivity growth to hold up at around 3 percent. Otherwise, inflation will continue to creep up.

The problem of a possible Fed inflation error becomes greater if the central bank is closely attuned to the condition of financial markets—especially equity markets—as it adjusts policy. Suppose that underlying productivity growth is falling from 3 down to 2 percent. Rising unit-labor costs will depress expected profits and stock prices. If the Fed keeps interest rates low to support equity markets as lower productivity growth depresses expected earnings and sustainable trend growth, demand growth will exceed output growth. Higher inflation will be the result.

The drift to lower productivity growth, if it occurs, eventually leaves the Fed with a very painful choice. Just as equity markets and the dollar are falling because of stagflation, the Fed must choose whether to target stable inflation and a stable dollar or respond to falling equity markets by holding down the fed funds rate in order to target higher growth. After more than twenty years of disinflation and a fear of "systemic risk" in global financial markets, it is very easy to opt for the hope that the trend growth rate is 4 percent and to keep boosting demand. That is how, if trend growth is below 4 percent, sustained inflation begins.

Where Should Inflation Go?

But the story does not end here with the return to inflation. Japanese policymakers at the Bank of Japan opted for the no-inflation route when Japan's lower trend growth rate emerged after the late 1980s equity and property bubbles. Even with massive—if wasteful—government spending, the economy remained unable to escape a deflationary slump. European policymakers also have chosen to target low inflation while assuming a low trend growth rate for the European economies. In short, the major central banks outside of the United States have for the past decade chosen to target low inflation, while tolerating slow growth and high or rising unemployment.

Perhaps, given this background, the Fed should tolerate a rise of inflation to 3 percent. In fact, as already noted, inflation expectations for the next year as measured by the Michigan Consumer Survey have already risen to 3.4 percent. Ten-year inflation expectations derived from a comparison of regular and inflation-indexed Treasury notes stand at 2.5 percent. Reigning in those rising inflation expectations would take a more rapid increase in the federal funds rate than the 2 percentage points expected by the end of 2005.

The "what's wrong with a little inflation?" query is always met with the counter that "a little (inflation) becomes a lot" because it is too tempting for the central bank to validate higher spending growth in the hope that output growth will rise. But if productivity growth slips to 2 percent, the higher spending growth aimed at 4 percent sustainable growth and 3 percent productivity growth will result in higher inflation.

The coming year will see the Fed decide whether to target price stability or try to sustain growth and financial markets. The only way the latter course can work without higher inflation is for productivity growth to hold up at around 3 percent. Otherwise, inflation will continue to creep up as the Fed agonizes over how to explain it away while staying closely attuned to the needs of financial markets for less upward pressure on interest rates. Indeed, we may already have reached this point during the run-up to the Fed's much-discussed June 29–30 statement,

which saw a 25-basis point boost of the fed funds rate to 1.25 percent. We should note the Fed's unprecedented efforts to "prepare" financial markets for the tiny rise in the fed funds rate that fell far short of the recent rise in actual and expected inflation.

The choice of whether to target low inflation or to tolerate higher inflation is not an easy one. The experiences of post-bubble Japan and the European Central Bank are not strong testimonies to the economic benefits of targeting low inflation. A modest inflation overshoot may cushion growth and equity markets for a brief period and at the same time reduce burdens built up during the post-bubble period, especially by U.S. households. Moreover, the costs, per se, of a stable 3 percent inflation rate compared to a stable 2 percent inflation rate are not well documented.

If U.S. inflation rises over the next year, it will be because productivity growth drops more than the Fed thinks it will.

Rather, the often-valid criticism of moving to a higher inflation rate is that it will not be stable since the same painful choices are required when ending a move to higher inflation at 3 percent versus at 2 percent. In fact, the costs may be higher at 3 percent because inflation expectations will be higher and more firmly entrenched. Halting the rise of inflation expectations only gets more painful as the inflation rate rises. Beyond that, substantially higher inflation—6, 7, or 10 percent—tends to be more volatile. Empirical evidence supports the notion that more volatile inflation coincides with more volatility of relative prices, lower productivity growth, and overall lower growth.

The fact that lower productivity growth is a bad thing is inescapable. The fact that it is almost impossible to predict the path of productivity growth means that monetary policy mistakes occur as it rises or falls. A rise in productivity growth can be deflationary until the central bank detects it and sets policy to boost demand growth and inflation stabilizes. A drop can be inflationary until demand growth is curbed and inflation stabilizes.

If U.S. inflation rises over the next year, it will be because productivity growth drops more than the Fed thinks it will. In fairness to the Fed, its board members may be wise to hope for the best—at least for a while—on productivity growth. If they are too cautious and set policy too tightly while productivity growth holds up, disinflation could reemerge. More likely they will be a little too accommodative. In that case, inflation will creep up and we will see sharper Fed rate increases by year-end and a recession by next summer.

Three percent growth and 3 percent inflation is not an unusual combination for the postwar U.S. economy. In fact, it would be a relatively favorable post-bubble outcome judged, say, against Japan's experience. But it would be a shock in view of most current expectations, especially at the Fed.

Inflation tends to rise and fall in long cycles of about twenty-five years. Maybe what we are seeing in nervous, directionless markets this summer is a gradually emerging sense that something familiar—falling inflation—is being replaced by rising inflation.