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Economic Outlook

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Soft Landing or Stagflation?

By John H. Makin

The nominally quiet summer months of July and August witnessed three important events that may well sharply alter the U.S. and global economic landscape during the balance of 2006 and into 2007. On July 19, as Federal Reserve chairman Ben Bernanke signaled the Fed's belief that slowing growth would bring inflation under control, the Fed published its forecast of U.S. growth and inflation for the remainder of 2006 and for 2007. Then, on July 28 and August 1, revisions of U.S. GDP and wage data were published that showed lower growth over the past several years accompanied by modestly higher inflation and higher wage growth. Finally, on August 8, the Fed's Open Market Committee (FOMC) decided not to raise the federal funds rate by 25 basis points for the first time in twenty-six months. The total increase of 425 basis points from 1 percent in June 2004 to 5.25 percent in June 2006 was allowed to stand—at least for the time being.

In the statement accompanying the August 8 decision to pause in the sequence of rate hikes, the Fed was careful to clearly signal its discomfort with rising inflation and to acknowledge that additional tightening may be needed. Its core outlook that slowing growth would reduce inflation—producing a "soft landing"—was underscored by the decision to pause and was reflected in the accompanying FOMC statement. After acknowledging that core inflation has been rising, the Fed's statement remained sanguine: "[I]nflation pressures seem likely to moderate over time, reflecting contained inflation expectations and the cumulative effects of monetary policy actions and other factors restraining aggregate demand."

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Among the "other factors restraining aggregate demand," the Fed pointed to a cooling housing market and to (higher) energy prices.

Fed May Be Too Sanguine

There are three problems with the Bernanke Fed's scenario of lower growth and lower inflation. The lower growth needed to retard inflation—growth below the economy's sustainable trend rate—is still not a sure bet. Second, the relationship between lower growth and lower inflation is a tenuous one at best; inflation is only likely to come down gradually and with a considerable lag after growth slows. The growth slowdown could include a period of stagflation.

Finally, the substantial revisions to GDP data over the past several years released with the second quarter GDP report suggest that the economy's sustainable, noninflationary growth rate may not be 3.25 percent to 3.5 percent, as many have assumed, but rather 3 percent or lower. That consideration is of singular importance. If growth has to go below trend to bring down inflation, then a forecast of 3 to 3.25 percent growth (the Fed's "central tendency forecast" for 2006 and 2007) may actually be inflationary.

The report released on July 28 of 2.5 percent U.S. economic growth in the second quarter was taken by markets as a sign that the economy was slowing in a manner consistent with the Fed's forecast and consistent with the notion that lower inflation will follow later this year or early next year. However, the second quarter figure has already been revised up to about 3 percent, and the composition of second quarter U.S. GDP

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growth raises questions about how much of a slowdown may be in prospect. The main reason for the lower-than-expected second quarter growth rate was an unexpected drop in equipment and software spending largely due to weaker outlays on transportation equipment. Government spending was also unexpectedly weak.

The transportation category of capital spending is notoriously volatile and reductions are usually followed by sharp rebounds, as probably will be the case in the third quarter. Government spending was weak at only a 0.6 percent annual rate because of a reported weakness in defense outlays. The third quarter is the end of the current 2006 fiscal year and probably will see a rebound in defense spending and in other categories of government outlays.

The Fed's outlook for slower growth was not supported by the July retail sales report released on August 11. We know that consumer spending has slowed to some extent, partly because of a slowdown in motor vehicle purchases. However, excluding automobiles, the annualized growth rate of retail sales over the past three months was 7.9 percent, equal to the brisk pace during all of 2005. While consumer spending may yet slow, the notion that housing weakness and the lagged effect of past Fed rate increases will slow demand growth remains in question. Higher energy prices may restrain spending on other categories, but they also contribute to pipeline inflation.

Even given a slowdown in U.S. growth to a level around 3 percent (as assumed by the Fed), there is no guarantee that inflation will start to fall promptly. In fact, inflation may continue to accelerate steadily. It appears likely that the core inflation rate as measured by the Consumer Price Index (CPI) will reach 3 percent by autumn, while the core inflation indicated in the Personal Consumption Expenditures (PCE) survey appears to be on track for a 2.5 percent rate of growth. In fact, the core CPI inflation rate is already running at a 3.2 percent annual rate over the past three months, reinforcing the notion that a sustained move above 3 percent is probable.

If core inflation measures, which the Fed prefers to see at 2 percent or lower, are continuing to rise steadily above 3 percent, any sign that the economy is growing at the Fed's forecasted 3 percent rate, or accelerating above that, undercuts its strategic overview that slowing growth means slower inflation in the future.

The final concern about the Fed's lower growth/lower inflation call concerns the impact of the revisions to GDP data over the past several years. Broadly speaking, average growth was revised from a 3.5 percent rate to a 3.25 percent rate, largely to reflect lower capital spending. Meanwhile, inflation was revised modestly higher, so that by the second quarter of this year the core PCE year-over-year inflation rate stood at 2.4 percent instead of the previously reported 2.2 percent.

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The revisions to the GDP and inflation numbers over the past several years raised serious questions about the level of sustainable, noninflationary U.S. growth. During 2004 and 2005, when U.S. growth was averaging just 3.25 percent instead of the previously believed 3.5 percent, the unemployment rate was falling at about five-tenths of one percent per year. Simultaneously, inflation has risen with a lag over the past year. During 2004 and 2005, core CPI inflation held steady at 2.2 percent. Over the six months ending in June, it has accelerated to a 3.2 percent annual rate.

If the unemployment rate falls and inflation rises with the economy averaging 3.25 percent growth, then we know that the sustainable trend growth rate for the U.S. economy has to be below that level. We know that because sustained growth at 3.25 percent is increasing pressure on labor markets, as measured by the lower unemployment rate, and increasing pressure on prices, as measured by the rising core CPI (which omits the initial impact of higher oil prices). This conclusion means that the Fed's own forecast of 3 percent growth may not be consistent with falling inflation, even if it comes to pass. It may be that growth has to be held at a level below the trend growth rate in order to bring inflation down. That could imply a growth rate between 2 percent and 2.5 percent for a year as a necessary condition for the lower inflation that the Fed expects alongside its 3 percent growth forecast for the coming year.

Expect More Fed Tightening

Given the likelihood that sustainable trend growth for the United States lies at or below 3 percent, a substantial

body of macroeconomic research conducted over the past two decades suggests that the Fed will have to continue boosting the fed funds rate at least to 6 percent. The August 8 pause may mean that a subsequent 50 basis point rate increase is required or that a longer string of 25 basis point increases will be needed to contain rising inflation pressure. Beyond that, there is no guarantee that a 6 percent federal funds rate would cap inflation. After all, year-over-year nominal GDP growth, a good guide for estimating an equilibrium fed funds rate, was 6.9 percent during both the first and second quarters of this year.

Currently, markets remain unconcerned about the possibility that the Fed may need to tighten more in order to contain inflation and/or to bring growth down to a level that implies lower inflation. Fed funds forward markets imply only about a 20 percent chance of another 25 basis point increase in the fed funds rate perhaps later this year or early next year. Meanwhile, the yield on two-year notes is about 35 basis points below the current fed funds rate of 5.25 percent, indicating that markets expect the fed funds rate to start coming down in 2007.

U.S. interest rates have been held down by a number of exogenous factors. The uncertainty surrounding the Middle East conflict between Israel and Hezbollah along with the new elevated level of terrorist threats on airlines have created a widespread move into safe assets like U.S. government securities. That has helped to hold down U.S. interest rates. Beyond that, the U.S. federal budget deficit for the current fiscal year, a measure of the increase in the supply of U.S. government securities, has again been reduced to about $260 billion or 2 percent of GDP, the lowest level within the G7.

If by the end of October, U.S. third-quarter growth is reported at or above 3.5 percent, while year-over-year core inflation approaches 3 percent, the need for further increases in the fed funds rate, perhaps at a more rapid pace, will be obvious.

A Lively Autumn

While investors are optimistic about the Fed's ability to achieve a soft landing, the data appearing over the next several months are more likely to raise serious questions about the outlook for lower inflation. If by the end of October U.S. third-quarter growth is reported at or above 3.5 percent while year-over-year core inflation approaches 3 percent, the need for further increases in the fed funds rate, perhaps at a more rapid pace, will be obvious. Since the path for inflation for the next six months is largely predetermined, markets may be left hoping for a growth slowdown as a way to hold out the promise of lower inflation in the future. The Fed's decision to pause in August may turn out to be less of a cause for celebration than investors generally have supposed.