

Searching

by John Tuccillo, PhD
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Sometimes you have to wonder where all this recovery is. The administration tells us often how much better off we are. So maybe it's in Washington. The Beige Book, the compendium of reports to the Federal Reserve Board from the twelve regional Federal Reserve Banks, continues to be a happy document. It tells of sales growth, employment stability and manufacturing expansion. So, maybe the recovery is to be found in these. But then again, there are other numbers, ones which speak of a different economy. These leave you scratching your head about where and when this economy will reach its full potential.

The first number is the rate of inflation. For 2005, it reached 3.4 percent, the highest in five years. To be sure, that rate was led by energy prices (the rate without energy and food—the so-called “core” rate was 2.2 percent for the year, and even that was up), but nonetheless, we need to consume energy, so inflation in terms of how it affects ordinary consumers was up. Inflation at this rate is not necessarily bad, nor is it historically very high. But the trend is bad and most analysts suggest that 2006 will be no better and probably worse.

We should not like inflation. It distorts the choices that people make in the market place, raises interest rates, and often invokes bad public policy that only makes the economy worse off. There was no sadder period for the American economy in recent years than 1971-1982, when public policy efforts to fight inflation nearly ruined us.

Sometimes inflation works for us. After all, most of us now live in more expensive houses—and we haven't even moved! In fact, if your income has increased by more than the rate of inflation, you are better off. But if you are, then you are abnormal. Real hourly earnings, that is, the average change in wages after inflation, fell 0.5 percent in 2005. Because people worked a bit longer, real weekly earnings fell only by 0.4 percent. In other words, most Americans were worse off in terms of purchasing power in 2005 than they were in 2004. But the statistics tell us they were worse off in 2004 than they were in 2003 and worse off in 2003 than they were in 2002. In other words, real income has fallen for three straight years. If the rate of inflation increases, this will only worsen. At this rate, the average American can't take much more recovery.

What happens next? There is little expectation that inflation will diminish in 2006. The course of oil prices early in the year—their stubborn rise through the mid-\$60s a barrel—indicates that Americans will be paying more to move around. Eventually, some of the increase in energy prices will be translated into the prices of other goods, and that will add to inflation. A rate of 4 percent or more would not be out of the question.

This means, in turn, interest rates will also rise. The Fed has produced (as of this writing) 14 increases of 0.25 percent in short term rates in a kind of “death by a thousand cuts” approach to slowing inflation. Long term rates have not risen by as much, but they too are moving up at a glacial pace. That pace will probably quicken in 2006.

When interest rates rise, interest sensitive sectors slow down. The housing sector will stall a bit in 2006 and price appreciation will slow. Part of this will be caused by no-down-payment and interest-only financing will bite many homeowners, and part will be caused by homeowners feeling less wealthy because appreciation has slowed or stopped. This is important because the build up in household wealth generated by the robust housing market has been largely responsible for sustaining consumption even as real income has fallen. If households perceive that the homes they own are worth less, they will reduce spending and the economy will suffer.

The mainstream forecast for this year calls for a slowing of most good numbers and an acceleration of most bad numbers. The net will be a growing economy that looks a little off from 2005. The interesting thing about the mainstream forecast is that it's hard to find any upside potential. In other words, if there are shocks to this economy in 2006—and there most certainly will be—they will produce a much worse economy than forecast. The thing about the rate of inflation is that it creates more openings for these negative shocks the higher it is. This is the time to be a bit more conservative in your economic and business planning. It will pay off.