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Inflation: Where Are We Now?

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With the data we have seen from the last few months, it's fair to say that no one has a very good idea of where the economy is. At the most basic level, we have seen seven months of incredibly rapid job creation this year; the economy added 3.3 million jobs through July, along with two consecutive quarters of negative growth. We don't have to join the Trumpers in calling this a recession, to be bothered by seeing two main economic indicators going in opposite directions.

I suspect most economists (I haven't done a poll) would agree that the negative growth reported for the first two quarters was a statistical fluke. The GDP data are often revised

by large amounts, so it would not be surprising if we see a very different picture after comprehensive revisions next year.

In this respect, it is worth noting Gross Domestic Income (GDI) grew at a 1.8 percent annual rate in the first quarter. In principle, GDI should be the same as GDP, since it is just measuring the income side of the GDP equation. While the two measures never measure up exactly, the size of the divergence in the first quarter was extraordinary. This is consistent with the view that GDP for the quarter may be revised upward. (We don't have GDI data for the second quarter yet.)

Is Inflation Slowing?

But the different story being told by the jobs and the GDP data is only one of the confusing aspects of the current economic situation. Many of us, who thought the uptick in inflation in 2021 was likely to be transitory, were encouraged by evidence that wage growth seemed to be slowing in the spring. While I am typically happy to see workers getting higher pay, the hourly rate of wage growth at the end of 2021 exceeded 6.0 percent. There is no way that we can sustain a pace of 6.0 percent wage growth without inflation in the neighborhood of 4.0 percent higher.

For this reason, I was happy to see that the rate of hourly wage growth seemed to have slowed to close to 4.0 percent by June. This may still be somewhat higher than a pace that is consistent with the Fed's 2.0 percent inflation target, but the difference hardly seems like much to worry over. (Wage growth averaged 3.4 percent in 2019, when inflation was still comfortably under the Fed's 2.0 percent target.)

Then we got the Employment Cost Index (ECI) data for the second quarter. This showed wages rising at a 5.6 percent annual rate in the second quarter. While there are methodological differences that could explain some of the gap between the ECI wage data and the much lower number reported for the average hourly wage in the monthly payroll data, none could plausibly explain away a difference of this magnitude.

It turned out that we really didn't have to explain much when the July employment data came out. The June wage data was revised up, and, with strong wage growth reported for July, we were looking at a rate of growth in the average hourly wage of more than 5.0 percent, not very different from the growth rate reported in the ECI.

In short, wage growth clearly had not slowed as much as many of us thought. Wages were still growing at a pace much faster than would be consistent with the Fed's 2.0 percent target.

This is the bad news part of the story, then we got some good news last week. The July Consumer Price Index showed that inflation was zero in July, as a sharp fall in gas prices offset price increases in other areas.

The Producer Price Index (PPI), which measures the prices of goods at earlier stages of production, provided even better news the next day. The overall finished goods index fell 0.5 percent. While this was also driven largely by a sharp fall in gas prices, inflation in the broader index also showed signs of moderating. The core PPI, which excludes food, energy, and trade, rose just 0.2 percent in July. This followed an increase of 0.3 percent in June. This provides some evidence that inflationary pressures at earlier stages of production seem to be lessening.

We got more evidence along these lines the next day when the Labor Department released data on Import and Export prices. The overall index for import prices fell by 1.4 percent in July, again driven by a sharp decline in oil prices. However, even the non-fuel index fell by 0.5 percent, its third consecutive monthly decline. This also supports the view that price pressures are easing in substantial segments of the economy.

In this respect, it is worth noting that import prices do not include shipping costs. These also have been falling sharply in recent months, although they are still substantially above their pre-pandemic level.

There is other evidence we are getting through the supply chain problems from the pandemic. The July data for motor vehicle production showed a sharp jump, putting us above our pre-pandemic levels. The jump in new and used car prices, due to reduced production resulting from a semi-conductor shortage, had been a major factor in inflation over the last year. As cars become more widely available, we can expect the recent rise to be at least partly reversed.

In other areas, stores have mostly managed to restock their inventories. The non-auto inventory-to-sales ratio is back to pre-pandemic levels.

In the same vein, the Baltic Dry Goods Index, an index that measure the prices of a number of widely traded commodities, has fallen by more than 50 percent from peaks hit last October. It is now at roughly the same level it was at before the pandemic.

Even the price of chicken seems to be tumbling. Chicken and egg prices had soared due to an outbreak of Avian flu, that devasted the country's chicken stock. It seems farmers have largely rebuilt their flocks and now have plenty of chicken to sell.

Perhaps most importantly, the price of gas is continuing to fall. Unless there is a sudden surge in gas prices in the last third of August, the CPI is likely to show a drop in gas prices

for the month of close to 10 percent. This should mean another month where the increase in the CPI is near zero. If we get some good news on car prices, and some of the other items that saw supply chain related run-ups earlier this year, we may see a small price decline in the August CPI.

Is the Fed Done Hiking Rates?

It would be crazy to take two months of data and say this means that we are out of the woods on inflation. The monthly data are erratic, and in any case, no one believes that gas prices will keep falling 10 percent a month. If we don't see substantial reductions in core inflation, then we will again see big monthly jumps in inflation once the decline in gas prices slows or moderates.

However, a couple of months of slower inflation can buy us some time. The main concern raised by the inflation hawks is that expectations of higher inflation will become embedded in the economy, leading to the sort of wage-price spiral we saw in the 1970s. That does not seem to be happening.

Our main measures of consumer expectations, the Michigan Consumer Sentiment Index and the New York Fed's Survey of Consumer Expectations, actually show inflation expectations have edged downward. It seems that, whether rightly or wrongly, consumers are basing expectations of inflation in part on short-term movements in gas prices.

There is a similar story with investors. The break-even inflation rates for both five-year and ten-year Treasury bonds has been trending downward. It does not seem that we are in any imminent danger of expectations of high inflation getting embedded in the economy.

The fact that inflation expectations seem to be moderating, coupled with evidence that inflation is slowing in major areas, means that the Fed should be able to take some time to get a clearer assessment of where the economy is and the impact of its rate hikes to date.

What the Rate Hikes Have Done

There is little doubt that the Fed's rate hikes have achieved their goal of slowing the economy and weakening the labor market, the big question is by how much. Most immediately, the rate hikes sent mortgage rates soaring, with the 30-year mortgage rate went from lows of under 3.0 percent in late 2021 to peaks of almost 6.0 percent in June.

The rise in mortgage rates had the predictable effect on the housing market. Existing home sales are now down more than 20 percent from year ago levels. After soaring by more than 30 percent over the last two years, prices also seem to be headed downward. This is great news for those concerned about another housing bubble and out-of-control rents.

Of course, the relationship between the house sales market and rent, which is what appears in the CPI and other measures of inflation, is indirect. In general, the two move in the same direction, but not in tandem. (The housing bubble years were a major exception, with house sale prices soaring, while rents moved roughly in step with the overall inflation rate.)

The logic where fewer people buying homes might lead to lower rental inflation is that people who might have moved into larger units, or bought a second home, are discouraged by higher mortgage rates. This leaves more units on the market, which can then be available as either lower-priced ownership housing or as rentals. (Housing often flips between being ownership units and rentals. Roughly 30 percent of all rentals are single-family homes.) Anyhow, there is some evidence that rental inflation is slowing, both in private indexes of market rents and in the July CPI, although rental inflation remained very high for the month.

Higher rates have also led to a sharp falloff in housing starts, which are now down more than 8.0 percent from year ago levels. While the falloff in starts is bad news from the standpoint of housing supply, it is worth noting that completions have actually been rising. This is another area where supply chain issues have created serious problems.

While the annual rate of starts rose from around 1.3 million before the pandemic to peaks of more than 1.8 million, completions remained near 1.3 million. Builders were apparently unable to get the materials or parts needed to finish the houses they started. Completions were at 1.42 million in July, 3.5 percent above the year ago level.

It is also worth noting that construction employment has continued to rise, even as starts fell. Presumably builders are still looking for more workers to complete homes that they had previously started.

The biggest impact of the rate hikes has probably been on mortgage refinancing, which is down more than 80 percent from year ago levels. This hits the economy in two ways. Hundreds of thousands of workers are directly employed in the refinancing process. For example, the number of people employed in the category of real estate credit is down by 20,000 from its year ago level (a bit less than 7.0 percent). The job loss due to the plunge in refinancing is likely to increase in the months ahead.

The other way that the falloff in refinancing slows the economy is by reducing access to credit. People often refinance for more money than their existing mortgage in order to get money for remodeling, vacations, or other uses. With this source of credit largely cut off, people will have less money to spend on these other items. (Many news articles have

noted a recent increase in credit card debt and attributed it to economic hardships due to inflation. In fact, the main cause has probably been the lack of access to credit through refinancing.)

Is the Labor Market Normalizing?

From the standpoint of longer-term inflation prospects, the key issue is whether the labor market is returning to a more normal state. Ideally, we would like to see a strong labor market, where workers feel comfortable quitting jobs they don't like and have enough bargaining power to secure real wage gains, but not one that is so strong that wage growth continues at an unsustainable pace. We clearly have moved in this direction as a result of the Fed rate hikes, the question is whether we are there yet.

One often cited measure arguing that the labor market is overheated is the rate of job openings. This stood at 6.6 percent in June. This is considerably higher than its pre-pandemic peak of 4.8 percent, but down sharply from the 7.3 percent rate reported for March.

In some sectors it has already fallen back to pre-pandemic levels. For example, in construction the job opening rate was 4.2 percent in June, down from a 5.5 percent peak in March, and well below the 5.3 level hit in April of 2019. The 5.1 percent rate in retail is down from a 7.4 percent rate in March and below the pre-pandemic peak of 6.3 percent. The 8.9 percent job opening rate for hotels and restaurants is more than two full percentage points above its pre-pandemic peak, but still down sharply from the 12.2 percent rate reported in December of 2021.

There is a similar story with quits rates, which are still above pre-pandemic levels, but have fallen from recent peaks. The overall quit rate stood at 2.8 percent in June, compared to a pre-pandemic peak of 2.4 percent. This is down from a 3.0 percent rate in November and December of last year. The 4.0 percent quit rate in retail is only slight above the 3.8 percent pre-pandemic peak and down from a 5.0 percent rate last December. The 5.7 percent quit rate in hotels and restaurants compares to a 5.2 percent pre-pandemic peak, but is down from the 6.4 percent rate reached in July and November of last year.

In short, these data show that the labor market is still very strong, but moving quickly back towards rates of openings and quits that are comparable to what we saw before the pandemic. In a similar vein, the share of unemployment that is due to people who have voluntarily quit their jobs stood at 14.7 percent in July. This is high, but below a 15.1 percent peak in February, and also below a 15.1 peak hit in June of 2019. In other words, it is not higher than the share we would expect to see in a strong but stable labor market.

Another key measure of the state of the labor market is unemployment insurance claims. The 4-week moving average has risen to nearly 250,000 from just over 170,000 in April. While 250,000 weekly claims is still low, the rise since earlier in the year indicates that employers feel comfortable laying off workers when they don't think they need them. This would not be the case if they didn't think they could hire new workers in response to an upturn in business.

These labor market data all point in the same direction. The labor market continues to be strong, but it is somewhat weaker than it had been at the end of 2021 and earlier in 2022. This weakening would be a reason to expect a slower pace of wage growth going forward.

Of course, it is possible that wage growth will not weaken. The standard Phillips Curve analysis relates changes in the pace of wage growth to the unemployment rate. With the unemployment rate sitting at 50-year low of 3.5 percent, the Phillips Curve would not be predicting a slower wage growth at this point. But not much about the economy has followed a Phillips Curve path since the pandemic (it didn't fit very well before the pandemic either), so we probably should not put too much confidence in Phillips Curve predictions at this point.

While many economists are anxious to have the Fed push forward with an aggressive path of rate hikes, there is good reason to be cautious. If we deliberately raise the unemployment rate, and throw millions of people out of work, it will be the most disadvantaged in the economy and society who will be hardest hit.

And, the impact is not just on the people who actually lose their jobs, but on millions more who will be fearful of losing their jobs. In addition, tens of millions may feel stuck at dead end jobs with poor working conditions and abusive bosses. We should always be cautious about a policy that deliberately throws people out of work and try to avoid going this route unless it is absolutely necessary. (We should also come up with better routes for dealing with inflation, but I'll skip that one for now.)

The recent government data on inflation, along with a wide variety of private measures, give us good reason to believe that we are seeing at least a temporary pause where the monthly inflation data will be moderate. As noted, there is clear evidence of substantial labor market weakening, which could slow the pace of wage growth to a rate consistent with moderate inflation. The Fed should take advantage of this pause to slow its path of rate hikes and get a better sense of where the labor market now stands.

This first appeared on Dean Baker's Beat the Press blog.

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