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A Brief Monetary Policy Update

The Fed has finally lifted inflation expectations, and is clearly over-shooting its inflation target. They have finally signaled a bit of interest in normalizing monetary policy. So, all is good now, right?

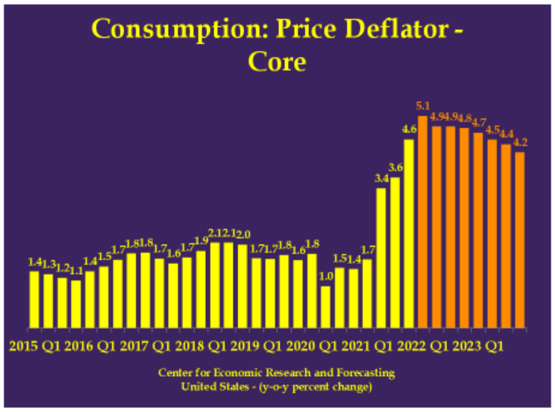
What the Fed has actually done is to back itself into a very tight and uncomfortable corner. To explain, I point out that their plan for this year is not one they are likely to carry out. Financial markets expect at least four interest rate hikes in 2022. If we presumed that each hike would be 25 basis points, then that would lead to a rate a full percentage point higher than now. I predict that by the time rates are 50 basis points higher than now US stock markets will correct in a noticeable way. The Fed is a central bank that is beholden to equity markets. Such a correction will undoubtedly scare the Fed, and they will cease raising rates. They might even bring them back down again, straining their already weakened credibility. This will represent the ceiling falling down on the Chair and the Board, but this is not the end of the story.

After denying the obvious for many months, the Fed now admits that inflation is not transitory. The latest CPI release measured greater than seven percent inflation. This continues a pace of price increases not seen since the early 1980s. With the Fed's mandate of fighting inflation, they would face pressure to raise rates to stem rapid inflation. However, the Fed will be worried about a financial markets' reaction to further rate hikes. This will represent the floor rising up under the Chair and the Board.

The American people should understand that the Fed has backed itself into a difficult corner. Since 2008, they embarked on a sequence of new policy interventions that are not recommended or well understood. They appear to be unclear about what their mandate is, despite commentary to the contrary. While the large balance sheet they carry is stimulative and inflation-contributing, they are reluctant to reduce that balance. The Fed does not know how to unwind the extraordinary and untested policy interventions they have enacted without causing significant displacement in markets and the broader economy. This will be true even if *they decide they* are ready to unwind them.

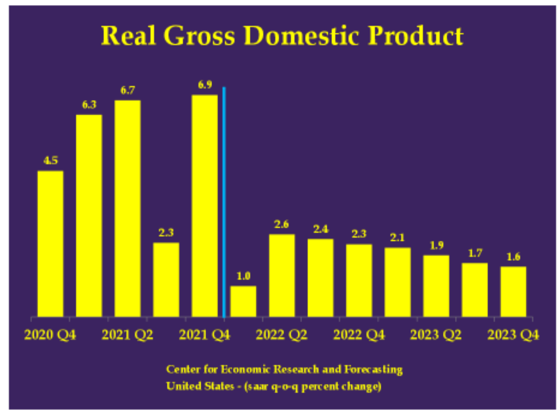
The U.S. Economic Forecast

Inflation is here. The combination of fiscal and monetary policies, flooding the economy with trillions of dollars, has created a spending bubble. The prospect for reasonable fiscal and monetary policy restraint in the next two years is very low. Thus, our forecast for the next eight quarters is for inflation to remain higher than at any time since the early 1990s.



Overall 2022 Q1 GDP growth is likely to drop to a rate under the trend rate of 2.4 percent due to the evolution of inventory investment. Inventory investment contributed a whopping 4.9 percentage points to 2021 Q4 growth, a contribution unlikely to occur again in the quarter ending March 2022. Our baseline 2022 Q1 forecast is for GDP growth of one percent. This forecast is driven by positive contributions from consumption and government expenditure. We anticipate that investment (driven by inventories) and trade will subtract from growth.

The GDP bounce-back of above-trend growth from the depths of the Pand-cession are probably over. In our baseline scenario, we forecast consumption expenditure growth of four percent in Q1 of 2022, and then a steady decline in consumption growth thereafter. This scenario implies GDP growth of 2.6 percent in 2022 Q2 gradually declining to 1.6 percent at the end of 2024. Investment growth is uninspiring, especially in the outer quarters of the next two years.



Our inflation and growth forecasts are reminiscent of the 1970s Stagflation era. The 1980-82 era experienced 7.9 percent inflation and 0.05 percent economic growth. These numbers for the next eight quarter baseline forecast are 4.5 percent and 1.9 percent, respectively, where all figures here are annualized quarter on quarter growth.

The forecasted economic growth is substantially better than what occurred in the early 1980s, despite being significantly under the long-run U.S. historical experience. The inflation rate is about 3.4 percent lower but this is misleading. The neutral rate of interest is

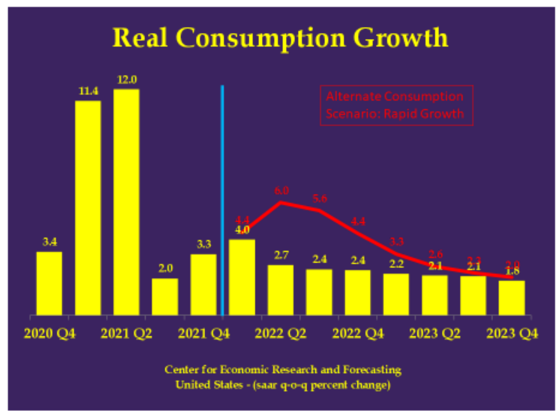
3 percentage points lower now than it was in the early 1980s. Inflation perniciously impacts both households and firms. The firm impact is through the real rate of interest, which is computed by subtracting inflation from the market rate. Abnormally low real interest rates distort firms' investment decisions. With the lower current neutral interest rate, the distortions will be similar to the early 80s despite inflation that is about 3 percent lower.

The story of above-trend inflation and below-trend growth is driven by policy and demographics. Policies are fueling inflation through excessive spending and monetary stimulus, and they are slowing growth through disincentives to investment and work effort.

Demographics, especially a long-term aging trend, are driving the labor force participation rate lower. Also, at this time there is an intensification of low labor force participation, the so-called Great Resignation, that is hopefully short term.

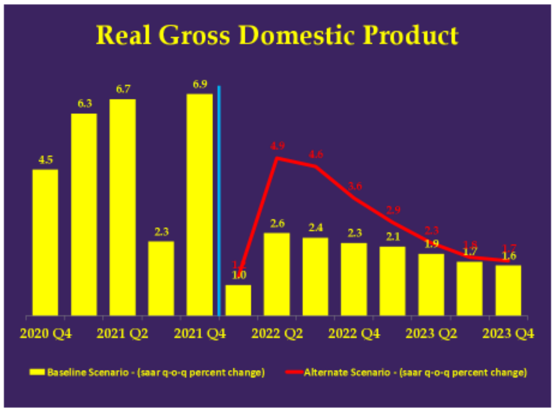
A Spending Driven Alternate Forecast Scenario

When there is a reasonably high probability that the economy will evolve in a different manner going forward forecasters will provide an alternate scenario to their baseline forecast. This time, CERF recognizes the very real possibility that household expenditure growth will substantially exceed that of our baseline forecast. This possibility would be driven by the ongoing policy stimulus, the resulting $2.6 trillion of excess savings, and the pandemic-driven desire for goods consumption expenditures.



In our alternate scenario, consumption growth would strengthen to six percent growth by the second quarter of 2022, and then subside to rates fairly close to our baseline by mid-2023.

In the stronger consumption growth scenario, GDP growth rises to 4.9 percent in 2022 Q2, remains substantially faster until mid-2023, whereupon it settles down to growth similar to the baseline forecast.



Other Risk Factors to This Forecast

While there are a variety of risk factors to this forecast, the largest one is Russia's invasion of the Ukraine, which occurred just under 24 hours ago as of this writing. This will augment already high energy commodity prices and boost broad inflation measures in many countries, including the United States. Equity markets around the world will be volatile.

It might end up providing the Fed with a reason to not normalize their policies. I suspect the Fed does not truly want to normalize monetary policy, thus they will happily accept any opportunity, or excuse, to maintain a massive balance sheet.

Russia's invasion of the Ukraine is a serious concern for the United States despite being somewhat protected from a strong negative impact to our overall economy.