The stock market is worried about inflation. Should it be?

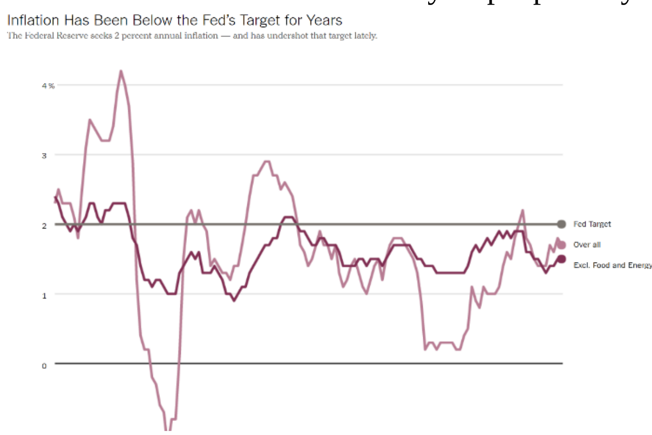
Is the economy at risk of overheating? The answer will depend on what really drives price increases, and what the Fed does.

By Neil Irwin

February 7, 2018 – *The New York Times*

To the degree the recent wild swings in the stock market are rooted in economic fundamentals, these are the fundamentals to fear: that the already strong economy may overheat, inflation may spike, and the Federal Reserve may then raise interest rates more aggressively to try to combat that higher inflation.

The kernel of evidence that supported those fears was a report Friday that average hourly earnings for American workers rose 2.9 percent over the 12 months ended in January, the highest since the economic expansion began nine years ago.



It's only a single data point, and an erratic one at that. But when paired with a rock-bottom unemployment rate and some signs of acceleration in economic growth, it suggests that overheating/inflation is a meaningful risk for the United States economy in 2018 in a way it hasn't been for a decade.

What does it all mean and how real is the risk? To answer the question, it helps to start with some basics.

What is inflation?

Inflation is when the buying power of a currency falls over time. When inflation is 2 percent, a basket of products that cost $100 today would cost $102 a year from now.

But people buy lots of different things, some prices are always rising and others falling, and the exact mix of items I buy is different from the mix of items you buy.

That's why government statisticians and mainstream economists focus on indexes created to try to capture the full range of goods and services people consume, weighted by how much an average household spends on each.

Plenty of people may have their own preferred way of measuring inflation; in recent years a profusion of commentators has emphasized declines of the dollar relative to other world currencies, or to gold, as definitive evidence. But the advantage of broad indexes is they approximate, if imperfectly, how much prices are changing for the range of things ordinary people buy.

Is inflation good or bad?

It's both.

High inflation can be disastrous. In Venezuela right now, in Zimbabwe a few years ago, in Weimar Germany in the early 1920s, inflation was so extraordinarily high that the currency essentially ceased to be a useful medium of exchange, leading to a barter economy and breakdown of the country's financial system.

Even miler versions of high inflation, such as the inflation that topped out at more than 14 percent in the United States in 1980, is damaging. At that level, those who have accumulated savings or fixed pensions see their purchasing power vanish over time, and borrowing costs skyrocket (ask anyone who took out a home loan in the early 1980s what their mortgage rate was). That dynamic can impede growth and create broad unhappiness. The economist Arthur Okun even invented the "misery index" in the 1960s, calculated by adding up the unemployment rate and inflation rate.

But when inflation turns negative — that would be deflation, meaning the purchasing power of a currency rises over time — it can also be disastrous. Debts become more onerous over time, and consumers and businesses have incentive to hoard cash rather than spend or invest it.

That's what the United States and other countries experienced during the Great Depression, and it has been experienced in milder forms by Japan over much of the last 20 years and Europe since 2010.

So how much inflation do we want?

It might seem inherently bad to have the purchasing power of a falling dollar. But having a bit of inflation seems to grease the wheels of the economy while not distorting economic decisions too much. It helps cushion against deflation, and gives the Fed room to cut interest rates and stimulate the economy during a downturn, helping keep the economy on an even footing.

Over the last couple of decades, central bankers around the world have mostly settled on 2 percent per year as the optimal level of inflation that they aim for. It's a level low enough that the purchasing power of their currencies is fairly stable and people don't have to worry about inflation all that much in doing business with one another, while also keeping a buffer to prevent deflationary effects from taking hold.

That said, 2 percent is a fairly arbitrary number, and some economists argue that steady inflation at a somewhat higher level would help prevent recessions.

The important thing is arguably less the exact level of inflation and more that it is fairly stable over time. It is big swings that tend to be most disruptive, favoring either debtors (inflation) or creditors (deflation), and generally contributing to lack of faith in a country's financial system.

For now, though, 2 percent is the goal.

How much inflation are we getting?

Under the inflation measure that the Federal Reserve most focuses on, prices rose only 1.5 percent in 2017, below the target. That's based on the personal consumption expenditures price index, excluding food and energy (the logic being that commodity prices can swing wildly for reasons unrelated to underlying inflation trends).

That's not far from the 2 percent target. But the numbers have been undershooting that target continuously since 2012. That undershooting has been a key rationale for the Fed's keeping interest rates low — its aim is to boost economic growth and thus help get inflation up to the 2 percent target.

Wait, what does inflation have to do with economic growth?

The answer is more uncertain than you might think. A central component of the models that mainstream economists have used for decades is that the inflation rate is shaped by the amount of "slack" or unused capacity in the economy, especially unemployment.

The intuition goes like this: When the unemployment rate is high, there are lots of workers available for any employer that wants to hire them. So employers don't need to compete for workers by paying higher wages. But if the unemployment rate is low, companies have to pay more to get employees, driving up wages. Higher wages in turn mean more money coursing through the economy chasing finite goods and services, creating inflation.

That basic relationship between unemployment and inflation is known as the Phillips Curve. It did a pretty good job explaining inflation trends from the 1950s to the 1980s, and still forms the underpinnings of how many policymakers think about where inflation comes from: that inflation is essentially evidence that the economy is running too hot, producing goods or services at a level that is not sustainable.

It is a little like revving a car. Once a car is already at top speed, if you push the accelerator harder, you won't go any faster, but you may overheat the engine. Inflation, in this model of how the world works, is the evidence of overheating.

Is that really how the world works?

That's not at all clear.

For one thing, the Phillips Curve relationship hasn't been working quite right in the last decade. The unemployment rate has fallen from 10 percent in late 2009 to 4.1 percent today, and yet wages have been rising at a modest rate, between about 2 and 2.5 percent, throughout that time (at least until the January 2.9 percent gain).

Even as wage gains start to emerge, the relationship between higher wages and overall inflation isn't ironclad, either. For example, the Fed's preferred inflation measure dipped through the first eight months of 2017 despite a low unemployment rate and steady wage gains.

You can imagine a lot of factors that affect inflation that are unrelated to the domestic labor market. Perhaps in a modern, globalized world, when there is a shortage of American workers, companies are better able to outsource service work and import manufactured goods, rather than bid up wages.

If low unemployment spurs new investment in productivity-enhancing machinery, wages could rise without broader inflation breaking out, because higher worker pay would result in higher output, not just more money chasing the same goods.

Or maybe employers have so much power in the labor market now that they can keep wages depressed despite low unemployment, rather than get in bidding wars with one another.

The traditional overheating story might be right. But the recent evidence is hardly definitive.

What does this all have to do with the stock market?

The unemployment rate is already low, and the new tax cut may push economic growth even higher. Wall Street knows that if Fed officials think inflation is poised to exceed its 2 percent target, they will raise interest rates to try to stop that from happening.

If the Fed — under new leadership, as Jerome Powell became chairman this week — believes it can let the economy roar ahead without inflationary pressure, it will probably continue its recent practice of low interest rates and gradual rate increases, which in turn is good news for stocks.

But if the overheating/Phillips Curve narrative is coming true, the Fed will have to raise interest rates to try to cool the economy, which would make capital more costly for businesses and dampen consumer spending. That's all bad news for stocks.

What happened Friday was that a wage number was published that was consistent with the overheating/Phillips Curve story of how the economy works, which is a big reason markets sold off.

So is high inflation really a risk right now?

For the last decade, the Fed has been more focused on trying to get inflation higher rather than lower, so in some sense the possibility of finally breaking out of that low-inflation, low-growth, low-interest-rate pattern would be welcome.

Right now, prices in the bond market suggest that the Fed is in a sweet spot — that inflation will indeed hover around 2 percent in the years to come. As recently as August, inflation-protected bond prices implied that prices would rise only 1.6 percent a year over the next five years; that is up to 2 percent now.

But there are risks on both sides of that forecast.

One month's wage number doesn't definitively mean that the first step of the overheating story is happening — low unemployment translating into higher pay for workers. And it definitely doesn't mean that the second step is happening — higher wages translating into higher overall price inflation.

Seeing how things evolve in 2018 and beyond will be fascinating not just for watchers of the stock market and the Federal Reserve, but also for all those who would like to see a bigger paycheck, or who dread what higher inflation might do to their savings.