SUMMER 2022

SYKES
COLLEGE OF BUSINESS

THE TAMPA BAY ECONOMY
A UNIVERSITY OF TAMPA SEMI-ANNUAL REVIEW

Will Aggressive Monetary Tightening Push the U.S. Economy into a Recession?

By Vivekanand Jayakumar, Ph.D.

Vivekanand Jayakumar, Ph.D.

Trying to forecast an economic recession well in advance is an endeavor that is fraught with pitfalls. The economist Ezra Solomon once observed that the "only function of economic forecasting is to make astrology look respectable." Economists have had a less-than-stellar track record when it comes to growth forecasts. In fact, the old adage, "It is difficult to make predictions, especially about the future", is especially apt when it comes to forecasting business cycle turning points.

A 2018 study[1] looked at 153 recessions in 63 countries between 1992 and 2014 and found the vast majority were missed by economists. In fact, the study found that forecasters predicted only 5 out of 153 recessions in the year prior to the actual downturn.

It is not just recessions that forecasters have had trouble predicting. The Federal Reserve (Fed) persistently overestimated U.S. GDP growth between 2007 and 2016[2]. After correcting for this tendency in the recent past, Fed officials found themselves making a new set of costly forecasting errors during the past year—they persistently underestimated inflation in 2021.

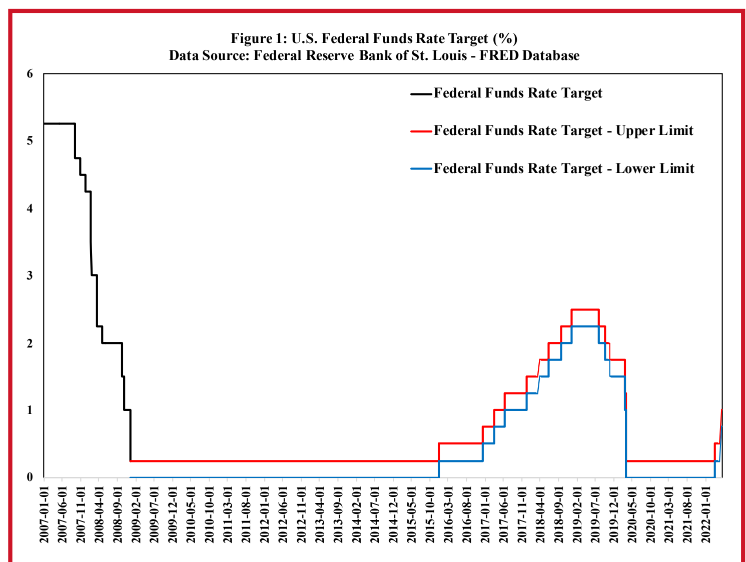
Generating accurate and timely economic forecasts is no easy task. The real world is a complex and messy place in which frequent swings in the beliefs and sentiments of various economic agents both influence and determine actual economic outcomes. Furthermore, economists face the added challenge of having to deal with a feedback loop—a forecast that is widely accepted may itself affect the reality that it was originally aiming to predict.

Does this mean that economic forecasting is a largely futile exercise? Not necessarily. Though economic forecasts are inherently imprecise and lack the certitude of scientific prediction, there is still considerable value to be attained if early detection of underlying economic trends generates useful and actionable insights.

In evaluating the prospects for a U.S. recession, one can detect several harbingers that suggest a high likelihood of an economic downturn sometime next year. Most significantly, the extent of monetary contraction required to bring inflation under control suggests financial conditions will tighten substantially over the next 12 months. As discussed below, given the starting point of this particular Fed tightening cycle, the odds of a hard landing for the U.S. economy are rather high.

The policymaking arm of the U.S. central bank, the Federal Open Market Committee (FOMC), belatedly decided to initiate monetary tightening with the announcement of a 25-basis point increase in the target range for the federal funds rate on March 16. Prior to that hike, the target range had been kept at 0-0.25% since the middle of March 2020 **(Figure 1)**. Surging inflation and a robust labor market also forced the FOMC to put an end to its net purchases of U.S. treasuries and mortgage-backed securities (MBS) in early March. The pandemic round of net asset purchases (simply referred to as quantitative easing or QE) resulted in about a $4.6 trillion expansion of the Fed's balance sheet in just two short years **(Figure 2)**.

It has become increasingly apparent that ultra-accommodative monetary policies deployed during the past two years, in conjunction with unprecedented levels of fiscal stimulus, has caused the U.S. economy to overheat and generate demand-pull inflation. In hindsight, the $1.9 trillion fiscal stimulus package pushed through in the early



Continued on page 2

Continued from page 1

Will Aggressive Monetary Tightening Push the U.S. Economy into a Recession?

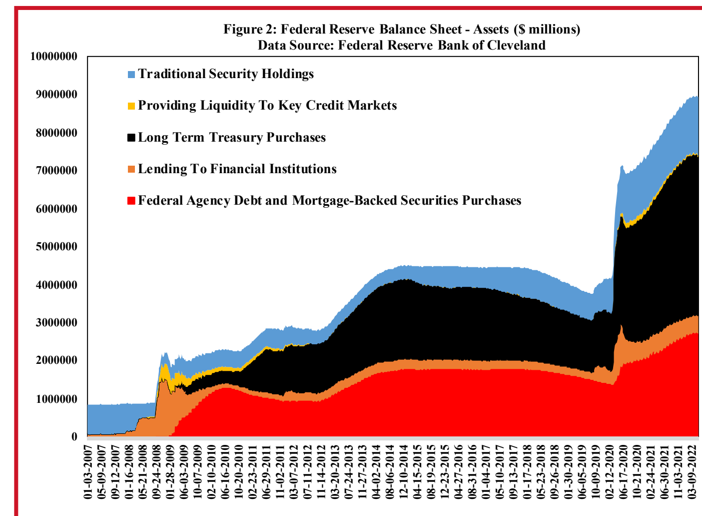
days of the Biden administration appears to have been excessive as it overstimulated spending on durables like autos, electronics and building materials. Furthermore, the Fed not only kept policy rates at near-zero levels for far too long but also continued adding substantial levels of liquidity even after it became abundantly clear that the economy was overheating. This caused many asset prices to soar and added further fuel to two interest rate-sensitive sectors—real estate and durable goods—that were already encountering supply-demand imbalances.

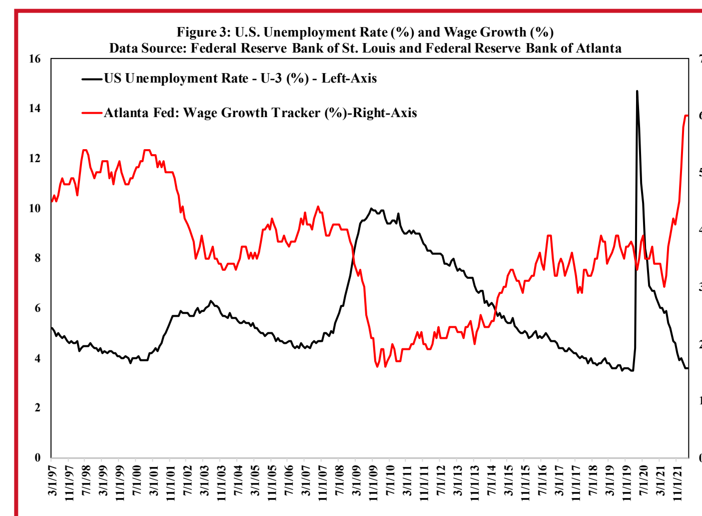
In recent months, clear signs of economic overheating have emerged – inflation rate has soared to 40-year highs (headline CPI inflation reached 8.6% in May 2022) while the unemployment rate has fallen to historically low levels (3.6% in May 2022). A 50-basis point rate hike in May, a 75-basis point rate hike in June, and a clear indication of more rate hikes to follow in the second half of 2022 suggest a shift towards a more aggressive monetary policy stance. Even some formerly dovish Fed officials are now calling for “an expeditious march to neutral by the end of the year as a prudent path”[3].

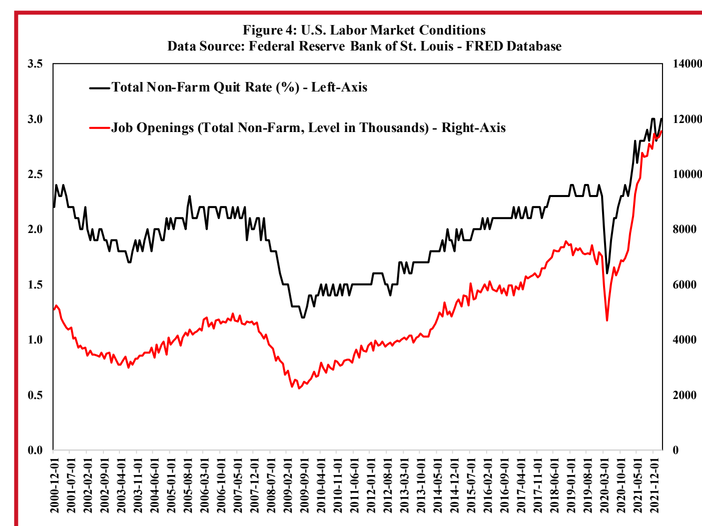
Extremely tight labor market conditions—characterized by a very low unemployment rate (**Figure 3**), record levels of job openings and historically high quit rates (**Figure 4**)—are fueling rapid nominal wage growth and raising concerns of a potential wage-price spiral. The fact that the U.S. labor force participation rate has not returned to its pre-pandemic level is constraining the economy’s production capacity and contributing to labor market tightness. The U.S. central bank is starting its monetary tightening from an unusual position with the unemployment rate already near historic lows while the core PCE inflation rate is at a 40-year high.

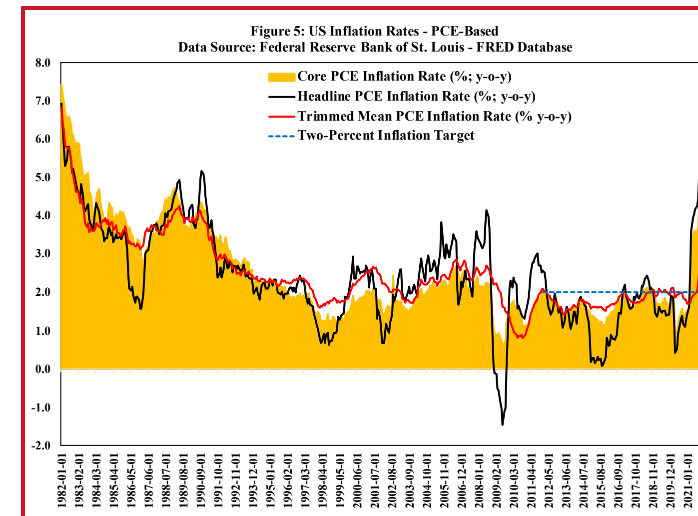
Fed Chair Jerome Powell recently offered up a somewhat lukewarm argument for a soft landing by observing that in “three episodes—in 1965, 1984, and 1994—the Fed raised the federal funds rate significantly in response to perceived overheating without precipitating a recession”[4]. However, in none of those circumstances did the Federal Reserve tighten enough to cause a deterioration in the labor market. Specifically, in all three circumstances, the unemployment rate actually fell from relatively high levels even as the Federal Reserve raised rates. This time around, the central bank is tightening policy with unemployment at 3.6% while the core PCE inflation rate is above 5.0%. Essentially, in order to sufficiently cool the economy, the Fed needs to push rates high enough (well above the neutral rate) to cause unemployment rate to rise and generate disinflationary forces.

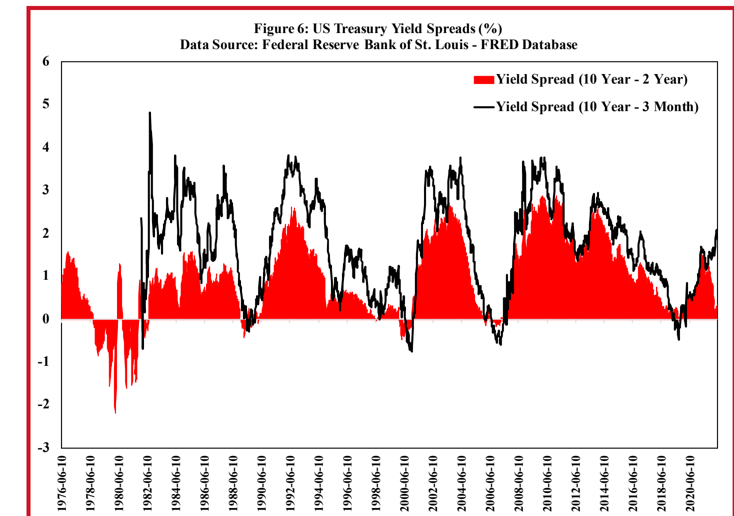
The U.S. economy has also been buffeted by a series of supply shocks that have generated cost-push inflation. Rolling shortages of critical inputs (such as computer chips) have imperiled global supply chains and affected production of automobiles and various other products. Intermittent lockdowns and disruptions associated with multiple COVID-19 infection waves created











additional challenges for producers worldwide. More recently, Russia’s ill-advised invasion of Ukraine has created a tragic humanitarian crisis in Europe and generated geopolitical shockwaves whose full effects are likely to be felt for years to come. Economic sanctions imposed on Russia (and its collaborator, Belarus) and the collapse of the Ukrainian economy have created supply disruptions that have led to a worldwide surge in food, energy and metal prices.

Even prior to the latest commodity price shock, PCE-based inflation rates in the U.S. had surged to levels not seen since the early 1980s (**Figure 5**). If Europe actually goes through with a ban on oil and/or natural gas imports from Russia, then global energy prices are likely to remain elevated for an extended period. Extreme weather and geopolitical shocks have also raised concerns of a global food crisis in 2022. Persistently high food and energy prices will sooner or later generate demand destruction as consumers cut back on purchases of other goods and services.

It is worth noting that oil price surges have foreshadowed majority of the U.S. recessions that have occurred since 1970. “Oil shocks were associated with the 1973-74 OPEC embargo, the 1978-79 Iranian Revolution, the 1980 Iran-Iraq war and Saddam Hussein’s invasion of Kuwait in 1990. Economist James Hamilton has argued that a spike in oil prices from 2007 to 2008 even contributed to the Great Recession. Past studies have shown that the U.S. economy reacts asymmetrically to oil price fluctuations. Specifically, the adverse or negative economic impact arising from rising oil prices often exceeded the stimulative effect resulting from falling oil prices. Economists have identified both direct and indirect economic effects associated with a sudden (and unexpected) spike in oil prices”[5].

Having clung to an ultra-accommodative monetary policy stance for far too long, it is now widely acknowledged that the Fed has fallen behind the curve. The central bank currently faces the unenviable task of having to tighten interest rates in the face of commodity price shocks, severe geopolitical uncertainties, and domestic and global growth deceleration. Having frittered away the opportunity to end monetary accommodation and initiate monetary tightening under relatively favorable circumstances (that were prevalent through much of last year), the Fed is now faced with the delicate situation of trying to engineer a soft landing for the U.S. economy even as the metaphorical runway keeps getting shorter and shorter.

With the expected ratcheting up of the pace of monetary tightening in the coming months as the Fed tries to get rates back to neutral and beyond, inversion of yield curves is quite likely. At present, the spread between the 10-year and 2-year yield has narrowed even as the gap between the 10-year and 3-month yield has widened (**Figure 6**). In the past, inverted yield curves have been accurate predictors of economic downturns.

Another challenge facing the central bank is associated with the significant financial distortions and speculative excesses that have resulted from ultra-loose monetary policies. The extraordinary amount of liquidity that was pumped into the financial system between March 15, 2020 and March 15, 2022, along with the Fed’s adherence to a near-zero policy rate regime during that period, contributed to a speculative fervor in numerous asset classes (including meme stocks, SPACs, cryptos and NFTs). There was also a substantial increase in non-financial corporate borrowing as yields were kept artificially low. Now that the end of the easy-money era is upon us, it is not surprising that sharp and disruptive swings in asset values have arisen. As the Fed unwinds its nearly $9 trillion balance sheet, the risk of a severe financial dislocation cannot be ruled out.

The Fed has indicated its desire to pursue a relatively aggressive quantitative tightening (QT) timeline. QT refers to downsizing of the central bank’s balance sheet and it involves either a sale of assets that were acquired during multiple rounds of QE and/or a balance sheet runoff (not reinvesting the proceeds from maturing securities). With financial markets throwing a tantrum in

Continued on page 4

Continued from page 3

Will Aggressive Monetary Tightening Push the U.S. Economy into a Recession?

anticipation of aggressive monetary tightening, the central bank needs to clarify to market participants that the so-called "Fed Put" is no longer in play and that its primary goal this year is to restore price stability. As noted elsewhere, the "central bank's penchant for turning a blind eye to surging asset prices and financial distortions while staying ever ready to step in and clean up the damages caused by the collapse of asset bubbles has led many market participants to believe in the existence of a "Fed Put"[6].

Consumer confidence and sentiments have started to fray as U.S. households encounter heightened asset market volatility, increased geopolitical uncertainty, and surging inflation. Rapid rise in rent, along with food and gasoline price spikes, have created a cost-of-living crisis for many as nominal wage growth fails to match the spike in headline inflation. Although retail sales and overall consumer spending have held up so far, recent sharp declines in both the University of Michigan's consumer sentiment survey and the OECD's consumer confidence indicator (**Figure 7**) portend serious economic headwinds for the US economy.

Rising pessimism among US households can impact future economic performance. Specifically, the "ability of changes in confidence to directly influence the economy seems intuitive. Consumers who are nervous about their future employment or worried that an imminent stock market correction would wipe out a substantial chunk of their savings might be reluctant to make big purchases and take on new debt. The resulting fall in consumption would then lead to an economic contraction that validates consumers' worst fears."[7].

The Fed's fight to reestablish its credibility and restore price stability is a central factor that is likely to play a decisive role in determining whether the U.S. achieves a soft or a hard landing. However, external events have added an additional layer of complexity. Ongoing geopolitical turmoil has increased the chance of a European recession. The stalling of the Chinese economy along with the rising threat of a currency and debt crisis in several emerging markets poses additional risks to an already vulnerable global economy. A sharp slowdown abroad may have a blowback effect on a U.S. economy that is already facing record-high trade deficits.

The above discussion clearly suggests that the odds of a recession over the next 12-18 months are quite elevated. Any economic downturn may, however, turn out to be relatively mild if geopolitical uncertainty eases and supply shocks dissipate in the coming months. The likelihood of a mild rather than a deep recession is also reliant on asset market corrections occurring in a relatively orderly manner.

Write to Prof. Jayakumar at
vjayakumar@ut.edu

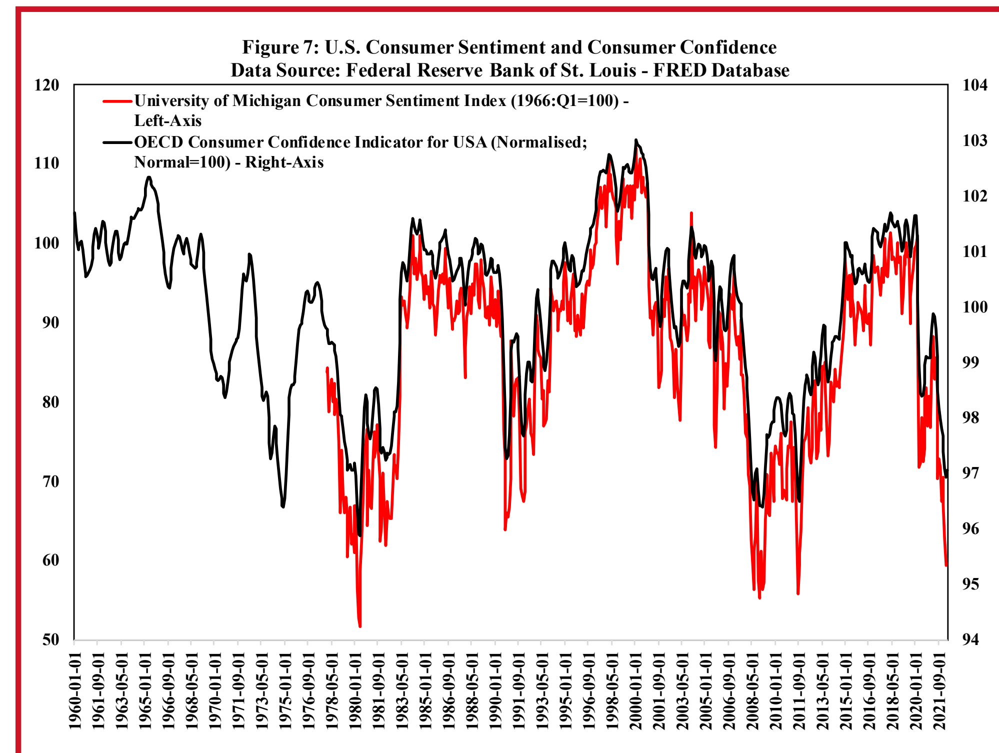


Figure 7: U.S. Consumer Sentiment and Consumer Confidence
Data Source: Federal Reserve Bank of St. Louis - FRED Database

[1] An, Zidong and Jalles, João Tovar and Loungani, Prakash, "How Well Do Economists Forecast Recessions?" (March 2018). IMF Working Paper No. 18/39

[2] Kevin J. Lansing & Winnie Yee, 2020. "Wringing the Overoptimism from FOMC Growth Forecasts," FRBSF Economic Letter 2020-03, Federal Reserve Bank of San Francisco

[3] Mary C. Daly, 2022. "Steering Toward Sustainable Growth," FRBSF Economic Letter 2022-10, Federal Reserve Bank of San Francisco

[4] Jerome H. Powell, "Policy Options for Sustainable and Inclusive Growth", Remarks at the 38th Annual Economic Policy Conference National Association for Business Economics, Washington DC, 21 March 2022

[5] Jayakumar, Vivekanand, "Does the Spike in Oil Prices Presage an Economic Downturn? The Hill, published online on March 8, 2022

[6] Jayakumar, Vivekanand. "Have Misguided Policies Led to Recent Asset Bubbles and Boom-Bust Cycles?", The Hill, Published online on Feb. 16, 2021

[7] Timothy Sablik, 2019. "Talking Ourselves into a Recession: Could Our Expectations About the Economy be Self-Fulfilling?" Econ Focus, Federal Reserve Bank of Richmond, issue 4Q

Tampa Bay Forecast: Two Years of Economic Expansion

By John R. Stinespring, Ph.D.

John R. Stinespring, Ph.D.

This spring marks the second year of economic expansion in the U.S. since the severe, though historically short, economic recession of the COVID-19 pandemic. The official business cycle dating body, the NBER (National Bureau of Economic Research) dated the recession as lasting two months from March through April 2020. From that point on, a robust economic expansion developed. But is it robust enough to withstand the current economic headwinds of inflation, interest rate hikes and geopolitical turmoil? In this update, I will examine the main features of the current expansion in the Tampa Bay economy (TBE), to get insight into its potential resilience. We will see that local employment, housing, and aggregate spending expanded rapidly in the Tampa Bay metropolitan area (consisting of Hernando, Hillsborough, Pasco, and Pinellas counties combined) through the first part of 2022.

Let us first consider the labor market. **Figure 2.1** shows the unemployment rate for the U.S., Florida, and the TBE. In the March-April 2020 recession, the unemployment rate spiked in the U.S. at 14.7, Florida at 13.9, and the TBE at 14.2. The data show that this sharp spike was followed by a nearly equally-sharp decline in unemployment in the months that followed. As of April 2022, the unemployment rate had dropped to 3.6, 3.0, and 2.9 respectively. The graph shows that these rates are close to their pre-pandemic lows.

Of course, it is possible the lower unemployment rate may be a result of lower labor force participation, such as one might expect if the TBE were experiencing a great resignation. **Figure 2.2**, however, indicates that our overall labor force quickly rose back to its trend growth rate. In fact, all major industries have recovered most of their pandemic recession job losses by February 2022 with the clear exception of leisure and hospitality as seen in **Figure 2.3**. That sector saw a labor force cut of more than 50% (165,000 down to 81,000). Yet, even there, it remains only 3.6% below its pre-pandemic high. This rapid catch-up is attributable, in part, to a 24% increase in weekly wages in the six months following the recession.

The severe contraction then rapid expansion in the labor market is reflected in the movements in TBE gross sales. Gross sales serve as a proxy for our local economy's aggregate demand. **Figure 2.4** shows the

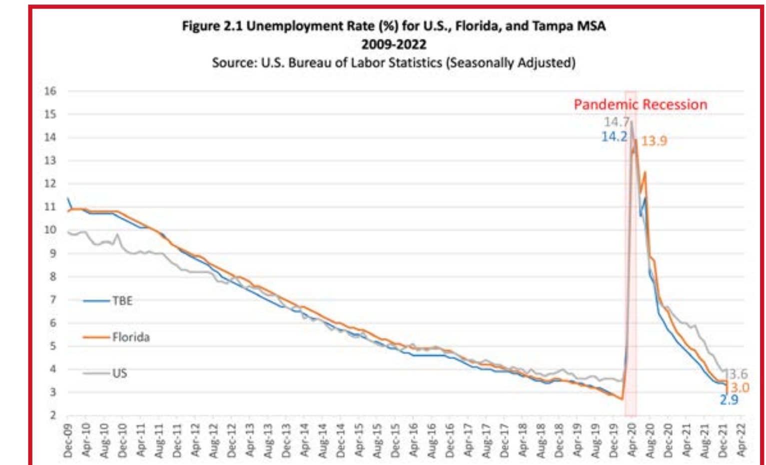


Figure 2.1 Unemployment Rate (%) for U.S., Florida, and Tampa MSA 2009-2022
Source: U.S. Bureau of Labor Statistics (Seasonally Adjusted)

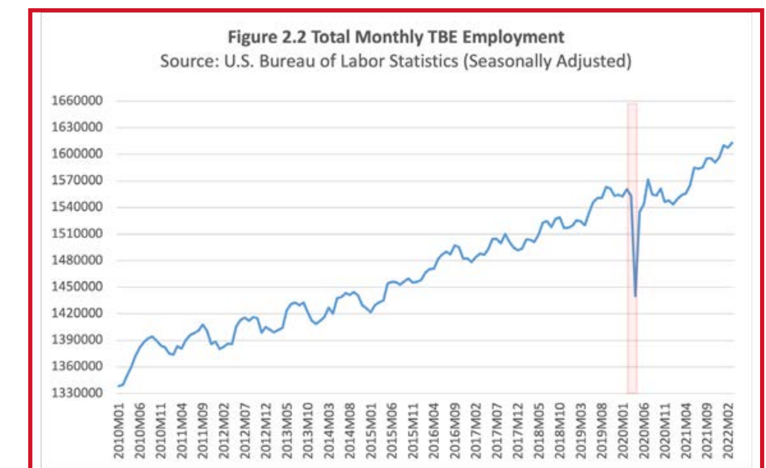


Figure 2.2 Total Monthly TBE Employment
Source: U.S. Bureau of Labor Statistics (Seasonally Adjusted)

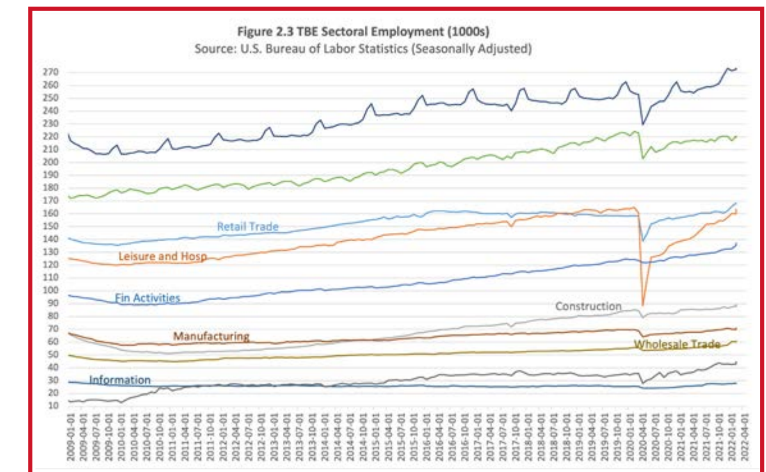


Figure 2.3 TBE Sectoral Employment (1000s)
Source: U.S. Bureau of Labor Statistics (Seasonally Adjusted)

Continued from page 5

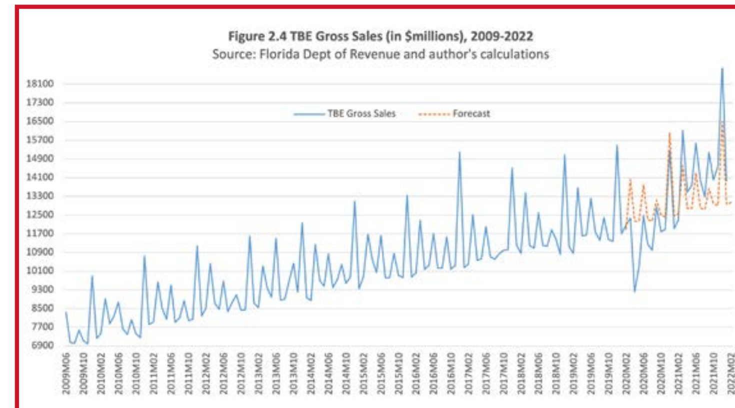
Tampa Bay Forecast: Two Years of Economic Expansion

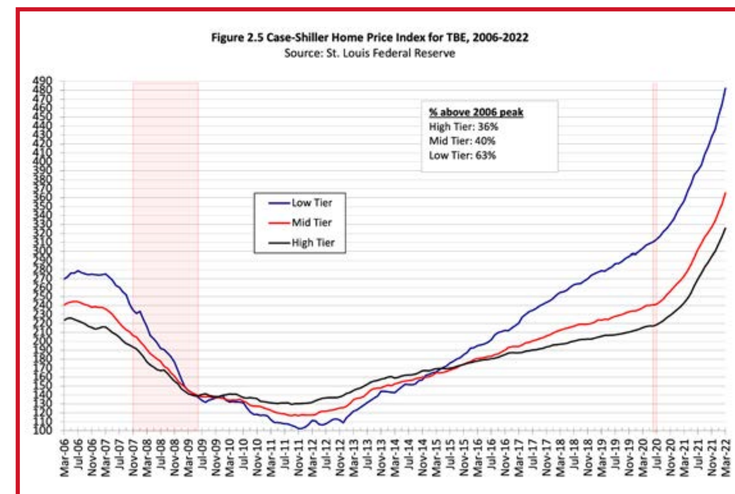
TBE's actual monthly gross sales (solid line) along with a pre-pandemic forecast of sales (dotted line) extrapolated through February 2022. The figure shows demand fell well below the pre-pandemic forecast during the recession and then exceeded it starting in December 2020. Perhaps these high sales numbers are attributable to inflation? After all, the Tampa Bay metropolitan area experienced 9.6% inflation over the January 2021 to 2022 period, the highest rate of all large U.S. metropolitan areas. The inflation-adjusted data, however, show the same relatively high sales growth above trend since the expansion began. More likely explanations for the above-trend demand include the large stimulus payments provided by the federal government and the extremely low interest rates maintained by the Federal Reserve. Combining this fiscal and monetary stimulus with consumers' accumulated savings from the pandemic shutdown led to unusually-high spending.

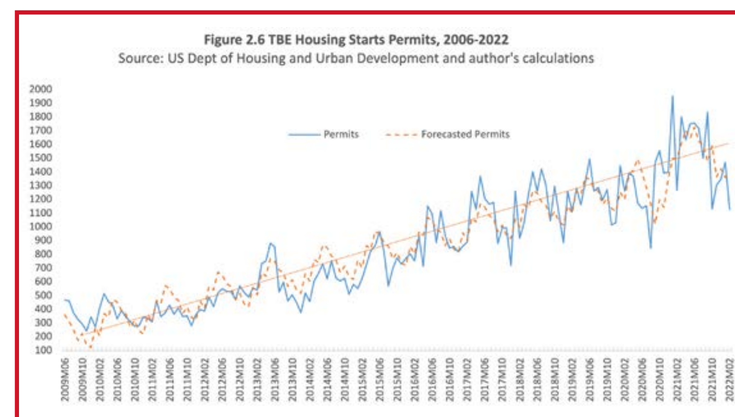
Housing is one market in Tampa Bay that revealed little to no negative signs of slowdown during and after the pandemic. In fact, housing price growth has accelerated. The market is particularly important as housing construction serves as a leading indicator to predict the future direction of the economy. All recorded recessions for the TBE have been preceded by significant decreases in housing. **Figure 2.5** shows the Case-Shiller Home Price Index (indexed to 100 in the year 2000) for low-tier, mid-tier and high-tier homes from March 2006 to March 2022. Like unemployment, the recessionary impact on housing lasted well beyond June 2009, persisting all through 2011. Yet around the pandemic period, only a short-lived price plateau is visible, and only for mid-tier and high-tier homes. After that, price growth accelerated again so that by March 2022, high-, mid-, and low-tier home prices were 36%, 40%, and 63%, respectively, above their 2006 peaks.

Monthly housing starts are more volatile than home prices. **Figure 2.6** shows TBE housing permits since the end of the Great Recession in June 2009 through February 2022. Starting in early 2011, housing construction (here proxied by monthly permits, seasonally adjusted for new single-family residences) has been trending upward. Data analysis of the period leading up to the pandemic recession shows a significant upward trend of 8.3 additional permits monthly. Though significant dips below the forecast occurred after the recession, the data analysis shows a strong reversion to trend. This implies that little should be inferred from such deviations.

This update has shown the Tampa Bay economy has experienced a robust expansion since the severe two-month contraction caused by the COVID-19 pandemic. Is the expansion too robust? Is the economy overheating? Like the U.S. economy, high inflation is signaling that demand conditions are outstripping supply. In particular, TBE home prices and retail sales have been accelerating rapidly. Concerns of overheating have (finally) motivated the Federal Reserve Bank to pursue interest rate hikes to dampen it. Such hikes are designed to curb aggregate demand just enough to create a "soft landing" for the U.S. economy that controls inflation while avoiding recession. Given the challenge of achieving this, forecasts for a U.S. recession in 2023 have risen over recent months indicating that the "soft landing" is becoming less likely as events develop. Geopolitical shocks to the world economy only add to the challenge. As of now, however, the expansion continues apace in the TBE, and recessionary signs have yet to appear in our local data.







Write to Prof. Stinespring at
jstinespring@ut.edu

THE TAMPA BAY ECONOMY

F. Frank Ghannadian, Ph.D.
Dean, Sykes College of Business

The *Tampa Bay Economy* newsletter is free for individual and organizational subscribers.
To subscribe, visit **ut.edu/business/tampabayeconomy/subscription/**

Working with a dedicated team driven by a shared vision can make all the difference. Regions Commercial Relationship Managers know that developing a strong understanding of your business and its unique operations helps us provide highly responsive, personalized solutions. Let us leverage our capabilities and create a comprehensive financial strategy to help guide and strengthen your business.

Commercial Banking | Treasury Management
Capital Markets | Specialized Industries

Michael G. Jones
Commercial Banking
813.226.1280 | michaelg.jones@regions.com

regions.com/commercial-banking

THE UNIVERSITY OF TAMPA
SYKES COLLEGE OF BUSINESS

AACSB ACCREDITED

The University of Tampa | John H. Sykes College of Business
401 W. Kennedy Blvd. | Box O | Tampa, FL 33606-1490 | **ut.edu**