Interview with Ryan Sweet, Chief US Economist at Oxford Economics

Prospects for the US Economy, Key to Global Growth in 2023, Look Rather Grim

By *Japan SPOTLIGHT*

The outlook for the US economy in 2023 is a key to the global economic outlook. The continuing tight monetary policy in the US to mitigate inflation could affect the rest of the world economy. More importantly, this inflation could be a drag on economic recovery from the pandemic disaster. High interest rates stemming from tight monetary policy could worsen the situation and also expand the fiscal debt which has already reached a high level due to repeated fiscal stimulus in the wake of the pandemic.

How the US macropolicy mix can avoid inflation and a business recession (so-called stagflation) is a key to today's global economy. On this issue, *Japan SPOTLIGHT* interviewed Ryan Sweet, chief US Economist at Oxford Economics.

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The Direction of US Monetary Policy in the Midst of Inflation

JS: Assuming that geopolitical crises will continue even if the war in Ukraine ends, is it likely that inflationary pressure due to rising oil and food prices could remain? Would the current tight US monetary policy continue?

Ryan Sweet

Sweet: It's hard to say with any certainty when the geopolitical tensions in Eastern Europe between Ukraine and Russia are going to end or be resolved. So that adds a lot of difficulty to forecasting where global oil prices are headed. On top of that, you have the fact that OPEC is pretty much committed to trying to get global oil prices to be right around $90 per barrel: that's where they want them to be. Energy is a key source of inflation in the US, adding a lot to year-over-year growth in the consumer price index.

Our forecast assumes that global oil prices steadily decline over the next couple of years, but I think that risks are weighted to the upside on that – just because of OPEC's commitment to keeping oil prices elevated. We need oil prices to come down to be disinflationary along with an easing in global supply chain stress and that's also going to be disinflationary for goods – i.e., stuff that Americans are buying. Most of our inflation problem, more than half of the inflation problem in the US, is due to supply shocks. By that I mean Russia's invasion of Ukraine, the pandemic and oil supply chains – and monetary policy can't affect these. The Fed cannot influence the supply side of the economy and can only influence the demand side, so the risk is that they're going to have to tighten more than we are anticipating and more than markets are anticipating to really kill the demand side of the economy and bring inflation back down.

US Fiscal Policy

JS: How do you estimate the impact of fiscal spending upon US inflation?

Sweet: Overall there was a lot of fiscal stimulus during the pandemic and that was warranted; we were staring into the abyss. The economy was in a deep recession and unlike in the past, the nature of this recession was different. There was a lot of fiscal stimulus. That added a little bit to inflation but nowhere near the supply shocks – that's energy and supply chains, and also I'd argue that rental inflation in the US today is driven by supply shock. We didn't build enough affordable homes over the last decade or more. Fiscal policy added very little in terms of our inflation problems – our inflation problems are supply side. Particularly when you look at a lot of this fiscal stimulus there is still $1.6 trillion in excess savings that's parked in people's checking accounts or under their mattresses or buried in their backyards. It's not out in the economy and generating economic activity and therefore by definition it can't be generating inflation.

JS: Apart from the impact of fiscal policy on the demand side, the budget deficit must be another key issue for the US economy. In addition to the continuing fiscal expenditure, there would be higher interest rates due to monetary policy, meaning that

debt will increase in the long run. That would be a critical situation for US fiscal policy. Can it be mitigated?

Sweet: First, there's not a strong causal relationship between government debt and inflation. If you go back to the 1960s, there was not a lot of causal relationship between them, meaning that an increase in government debt as a share of GDP doesn't really cause changes in inflation. However, the US has to get its fiscal house in order. It doesn't have to be this year or next year or the year after that, but in the long run this is not sustainable. The last thing you want to do is shift to fiscal austerity where the government is cutting back on government spending, because the economy is vulnerable right now. Even if anything else goes, when the economy is teetering on the edge of a recession, the last thing you need is the government to implement austerity. Government debt matters when the bond market says it matters and I don't think the bond market is overly concerned that rising interest rates are going to put a significant burden on the US ability to pay that debt – because federal interest payments as a share of GDP are still very low. So even if rates are rising, it's going to add an enormous amount of interest cost burden but it's still very manageable.

US Economy Most Likely in Recession in 2023

JS: The US economy is basically in good shape – as you mentioned, the fiscal budget debt is not a problem even in the long run. Next year, the US economy would seem to be recovering with inflationary pressure being mitigated to some extent. So overall, would you say that the US economy is moving in a good direction next year?

Sweet: You are much more optimistic than I am! I think there are some fault lines that are starting to develop in the economy. For example, manufacturing is about to fall into recession in the US and you can't have part of the economy in recession without a broader economic downturn. But I think the Fed is committed to doing anything and everything possible to bring inflation back down to their target and I think they're going to overdo it. I think a recession is more likely than not sometime in 2023. It's possible that I'm wrong and we skirt a recession but looking at some of the leading indicators in the economy we're going to be very vulnerable for the first half of next year, especially if anything else goes wrong. You have high interest rates from the Federal Reserve and the past tightening of financial market conditions; that's all going to hit the economy during the first half of next year.

To be more specific, for the next couple of months we could see continued strength in the labor market; initial claims for unemployment insurance benefits in the US are low, creating a boatload of jobs. The unemployment rate is low but again that's kind of irking the Fed because it needs the economy to grow below its potential to reduce monthly job growth in order to reduce wage growth and by extension hopefully reduce some of the demand inflation down the road. So if the Fed gets frustrated it's going to push harder and harder and that's going to break something – either breaking the economy, inflation, or growth.

Inflation-Wage Spiral

JS: How about the relationship between wages and prices in the US economy?

Sweet: It's a big concern if we develop a wage-price spiral where wages are pulling up inflation. That's sticky inflation. Right now it goes the other way – the causal relationship is that inflation is causing changes in wages. So people are seeing higher prices at the pump, higher prices at the grocery store and demanding higher wages. That's not a wage-price spiral like what we had in the early 1970s and 1980s. Inflation expectations for the most part are anchored, and that's preventing us from going into that wage-price spiral.

Impact of External Demand

JS: How about external demand? Protectionism is rising and we have an uncertain situation because of the war. Many economists see negative prospects for external demand, but would you concur with these?

Sweet: Yes, this is the first time I can remember since being a professional economist that the global economy is likely to go into recession first and pull the US down with it. At least in the last several cycles the US gets a cold and the rest of the world catches it, and we pull them down, but this time around Europe is struggling and is likely to experience a recession. The United Kingdom is most likely to experience a recession next year. China's economy is arguably oriented towards a growth recession, meaning the economy is not growing fast enough to prevent unemployment from rising or inflation from accelerating. So there's a lot of hurdles and I think the global economy is going to struggle next year and that's going to feed back into the US.

Long-Term Factors

JS: The green and digital economy in some countries seem to be tipped as sources of economic growth in the long run. How about the US economy?

Sweet: Yes, the shift towards green technology is going to be a boon for the US economy. Just because climate change is an enormous downside economic risk – not in the next few years but in the longer term for my kids (they're 8, 5 and 2). The biggest economic risk to them is climate change. So I think you'll see a lot of business investment and a lot of government spending on green technology that's going to bode well for manufacturing in the US. But this is a key downside risk that needs to be taken very, very seriously.

JS: How about the digital economy?

Sweet: I often get asked if robots are coming to take our jobs. There will be some automation and some jobs are going to be automated away, but so far the evidence is more like creative destruction. So you're destroying a job in one industry but creating jobs in another industry and so it doesn't mean that we're going to see massive amounts of unemployment.

When I was an undergrad a long time ago, they showed us stories from the *Wall Street Journal* from the 1970s and 1980s saying that "robots are coming to take your jobs" and that hasn't played out. I think that you're seeing labor supply issues in the US particularly in hospitality and restaurants, and there you'll see more automation for labor-saving technology. That takes time but will also open up opportunities for those workers to shift into other industries. So you've got a decline in retail, and the number of mom and pop stores as those workers left into transportation and warehousing; so rather than jobs disappearing, it's that you're automating ones where you're having labor supply issues. US data for employment is positive but it is way too strong. We need job growth south of 100,000 per month if the Fed is going to pull off a soft landing and I think that's increasingly unlikely just given the strength of the labor market.

JS: Does inequality remain a big issue for the US economy?

Sweet: It's definitely a big issue. While I worry about climate change, over the next five or 10 years inequality is even more concerning, and there are a lot of factors behind it: the decline in unionization, and the skew towards people who own stocks in the stock market. Even looking at the recent decline it's up a ton over the last 10, 15, 20 years. House prices are rising so all of that skews towards higher income households, and so this is the hollowing-out of the middle class. You get this barbell effect and that's problematic in the long run.

JS: What do you think about industrial policy? China is strengthening its competitiveness with industrial policy and the US might be concerned about it, so will you strengthen your own industrial policy efforts?

Sweet: This isn't a China-versus-US policy comment but just the idea that the US is going to re-shore a lot of manufacturing is overdone, I think. The capital stock for manufacturing in the US is really old, so manufacturers are going to have to be very convinced that this deglobalization trend is going to accelerate or continue to invest in improving the capital stock in US manufacturing. Some things will be re-shored, maybe biomed/pharmaceuticals/PPE and things like that – but this broad-based bringing back of a lot of US manufacturing is very overdone, not just because the capital stock is old but also because labor unit costs are still very high in the US compared to the rest of the world. JS

Written with the cooperation of Joel Challender who is a translator, interpreter, researcher and writer specializing in Japanese disaster preparedness.