

Economic Review

with Nicholas S. Perna, Ph.D., Webster Bank Economic Advisor



Musings & Amusings: from "Car Talk"

An elderly man gets pulled over by a cop. "Do you realize your wife fell out of the car a mile back?" The driver replied: "Thank goodness... I thought I'd gone deaf!"

The human cannonball told the circus owner he was going to retire. "But you can't!" protested the boss. "Where am I going to find another man of your caliber?"

The Bi-Polar Express. Economic events were unfolding very rapidly in the final months of last year. Currency exchange rates of a number of nations have plummeted. Crude oil prices have plunged almost 50 percent. Although there are many pluses from cheaper oil, one casualty is the joke I was planning to use:

When I got home late last night, my wife demanded that I take her some place expensive... so, I took her to a gas station... and then the fight started...

This came from *Car Talk*, my favorite radio show, hosted by the Magliozzi brothers. Tommy passed away a few months ago and I'll include a few of their corniest sayings in his memory.

Some key economic indicators have been extremely volatile. Quarterly Gross Domestic Product (GDP) growth jumped all over the place, all but obscuring the underlying trend of about 2.5 percent. Stock prices bounced around as well but were on track to end 2014 more than 10 percent above the rather rich levels of the year before, and 25 percent ahead, of the pre-recession peaks reached nine years ago.

At the same time, the U.S. economy was looking better and the Federal Reserve seemed to be in no big hurry to "normalize" interest rates. In her final briefing of 2014, Fed Chairwoman Janet Yellen gave a rather upbeat forecast for the next year or two.

The Talmudic Fed. In mid December, financial markets braced for some bad news about interest rates, as they waited for the results of the December 16-17 Federal Open Market Committee (FOMC) meeting. The FOMC had been winding down purchases of securities under the Quantitative Easing (QE) program all year and bought the last bonds in October. The Fed had been saying that it would wait a "considerable time" after ending the purchases before raising short-term interest rates.

Markets were relieved when the Fed stated it will "be patient" in hiking rates. Yellen later elaborated that there was essentially no difference between waiting a "considerable time" and being "patient." No rate hike was likely until at least next April and the exact timing would be "data determined." She was reiterating that the timing of the tightening is contingent on the improvement of the economy and the pace of inflation.

Yellen also pointed out that job formation was rather decent but there was still room for recovery. Actual and expected inflation are well-behaved. And in a practice begun under her predecessor, Ben Bernanke, she gave fairly detailed projections of the economy. The Fed anticipates a little less than 3 percent GDP growth in each of the next two years with unemployment falling to 5.3 percent next December and 5.1 percent at the end of 2016. Two years from now, consumer inflation would be in the vicinity of 2 percent. Thus, by 2016, both unemployment and inflation should be in line with the Fed's stated goals.

And now for the best part. While Yellen wouldn't pinpoint the exact start of the federal funds "lift off," she indicated that the forecasts made by individual FOMC members showed the key rate at 1¼ percent next December and 2½ percent a year later. By 2017, the fed funds rate will reach its "longer run" value of 3¾ percent.

Because the Fed does not control them directly (unlike fed funds), there was no mention of the outlook for long term bond yields. The Fed's forecasts of the economy and short-term rates are close to those of the *Wall Street Journal* survey of economists. These prognosticators see the 10-year Treasury note, which is currently around 2.25 percent, slightly above 3 percent at the end of 2015 and close to 4 percent at the end of 2016. What about after that? My guess is that the Fed's 3.75 percent short-term rate means that the Treasury note yield will be in the vicinity of 5 percent.

As for risks, Yellen said that the impact of the turmoil in Russia on the United States would be on the small side. We'll see.

Oil Slips. One of the last year's biggest surprises was the rapid collapse of oil prices from \$107/bbl in June to \$55 by December. Since each barrel contains 42 gallons, gasoline prices have fallen more than a dollar a gallon. Now, I'm no oil expert. In fact, I locked in my home heating for the winter when prices had fallen to \$80/bbl! Anyway, here's my take on what's happening.

Petroleum demand and supply have both been shifting. Demand is off with Europe close to recession along with parts of South America and Asia. China, which is a big fossil fuel consumer, has slowed. The government has been trying to deflate a real estate bubble and move the economy away from exports toward consumer goods in an attempt to lift living standards. Oil supplies are plentiful. Production is rising from shale in North America and increased extraction elsewhere.

Remember your Econ 101 professor droning on about price elasticity, substitutes, complementary goods, etc.? Well, the demand for oil is quite inelastic: you don't use a lot less when prices rise and don't buy a lot more when prices fall – at least in the short run. The demand curve is almost vertical. Contrast this with hamburger. If prices go up a lot, you'll switch to chicken, hot dogs, or whatever. There are ample substitutes. And when ground meat prices fall, you'll serve more and bigger burgers, fewer hot dogs, and fewer chicken nuggets.

Oil's inelasticity means that even small shifts in supply and/or demand mean large changes in price. A recession moves the demand curve to the left and prices fall a lot. New extraction technologies move the supply curve to the right and prices fall.

It is way too early to conclude that we're in some new era of permanently low oil prices. In fact, I think that oil prices will start rising again during 2015 and maybe even validate my prediction of \$80/bbl. The rise will primarily reflect the pickup in demand as the world economy gains some momentum.

Speaking of paradigm shifts, one of my favorite pieces of Tommy & Ray humor goes something like this:

The decline of western civilization began with the introduction of the automatic transmission. That's when we all became shiftless.

A major benefit from lower oil prices is increased confidence and consumer spending. One negative is lower investment in oil exploration. According to a reputable economic research firm, the net impact is to

boost real GDP by 0.2 percent for each \$10/bbl oil price drop – provided prices stay down for a year. So if prices bottom out around \$50/bbl and rise to \$80 a year from now, this should add about half a percentage point to 2015 real GDP growth – helping to put it close to 3 percent for the year. This is a decent improvement from 2014's 2.5 percent rise.

Oil exporting nations have been hit hard by all this. Russia was already in tough shape before the oil price plunge thanks to sanctions imposed by the Western powers to punish Putin for his reckless invasion of Ukraine. What's now at risk is Russia's ability to repay its foreign lenders as oil revenues plummet and the ruble collapses. A weaker ruble increases the burden of paying back those loans which are stated in dollars and euros. In order to put a floor under the currency, Russian monetary authorities have raised interest rates to 17 percent – a desperate action that will further weaken the economy.

While the direct effects of all this on the U.S. might be small, the impact on global financial markets could be large if Russia defaults on its borrowings. This is exactly what happened in 1998 when Russia's default led to the near-collapse of the big Long Term Capital hedge fund and brought us to the brink of a worldwide financial crisis.

Regional Convergence. Surprisingly, variability in the region has been falling along one important dimension: the growth rates of jobs have been converging. Connecticut, Massachusetts, Rhode Island and metro New York – all areas are gaining jobs at similar rates that are just a tad slower than the nation.

Connecticut stands out with a large acceleration of the rate of job formation during 2014. Connecticut is definitely improving. However, it is hard to say to what degree because the monthly jobs numbers have been so erratic – much more so than the neighboring states.

There's some good news. Given the 2014 momentum, forecasters are saying that the entire region is very likely to have rather decent job gains in the coming year. Of course, this is contingent on a continuation of national economic growth.

One last "lame joke" from *Car Talk*:

Doctor: "I have good news and bad news. Which do you want first."

Patient: "The good news"

Doctor: "You have 3 days to live."

Patient: "Then what's the bad news?"

Doctor: "I got the tests results 2 days ago"

Happy New Year!