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DYNAMIC ECONOMIC STRATEGY©

VOL 6 | ISSUE 15 | April 12, 2023

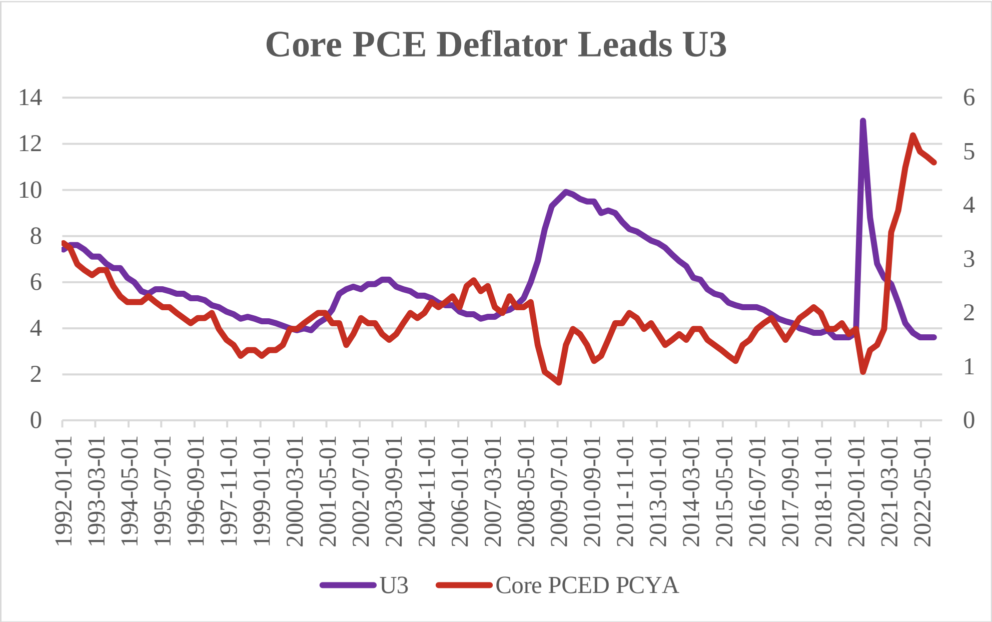
Three Principles That Help Your Thinking on Economics and Finance

Last week I had the opportunity to speak at the Philadelphia Council for Business Economics at the Philadelphia Fed. The Fed has a very nice, serve-youself-site cafeteria with a wide selection of food. I digress. Anyway, during the presentation, I utilized three principles to illustrate a few of the current debates in economics.

"If a man begins with certainties, he shall end in doubts;
but if he will be content to begin with doubts, he shall end in certainties."
Francis Bacon

This is certainly true about the current focus on the unemployment rate as an indicator of inflation. Instead, causality runs from inflation to the unemployment rate as illustrated below in the graph. In a regression with detrended data, the coefficient of inflation is statistically significant and with the correct sign.

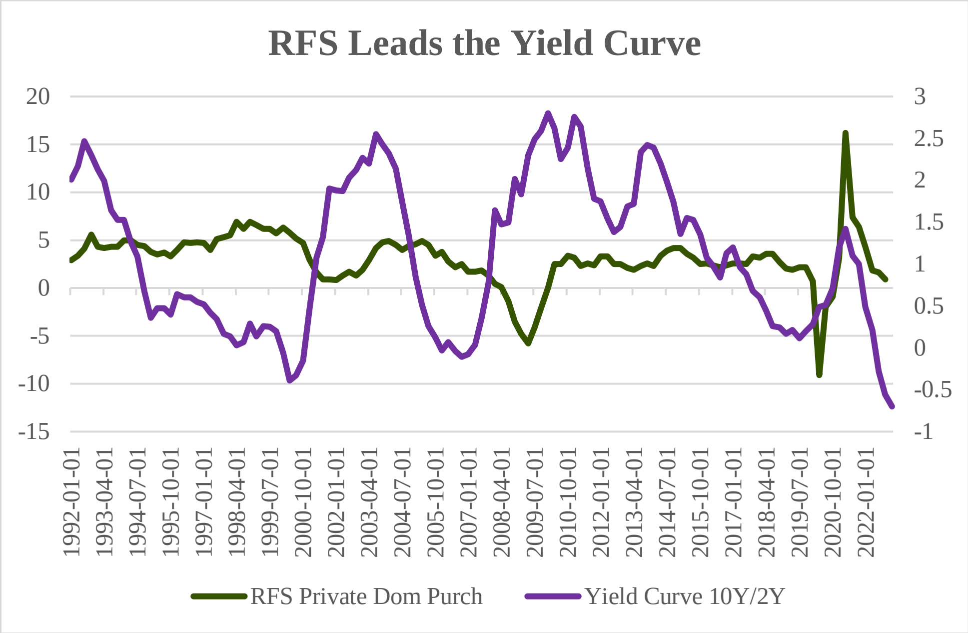
The current focus on inflation and unemployment and their interaction reflects the observations of Milton Friedman in his 1968 presidential address to the AEA and the extensive review of the workings of the labor market in Phelps' *Microeconomic Foundations*. For us, the unemployment rate is a weak reed upon which to hang your inflation forecast and certainly has performed poorly as a guidepost over the last year.



Yield Curve and Real Final Sales

"Money and Income: Post Hoc Ergo Propter Hoc?" *The Quarterly Journal of Economics*, Volume 84, Issue 2 , May 1970 James Tobin

Tobin's point was that simply because event B follows Event A, does not mean that Event A causes Event B. This is particularly true for the yield curve and the economy. The assertion is that an inverted yield curve precedes every recession. Since 1980, that has been true, but it does not mean that the yield curve causes the recession. In fact, the truth is the opposite. Real final sales drives the yield curve, inverted, flat or whatever—not the other way around.



The importance of Dynamic Analysis in Economics and Finance

"One change leaves the way open for the introduction of others" Machiavelli.

One of the fun things in economics and finance is that change in one sector leads to subsequent changes in other sectors. For investors, changes in the pace of economic growth relative to potential, graph below, lead to changes in profit growth and thereby investor expectations for future earnings and thereby equity valuations. Linkages between economics and finance operate as a great wheel with changes in any one place leading to subsequent changes all along the wheel.