Current Economic Conditions

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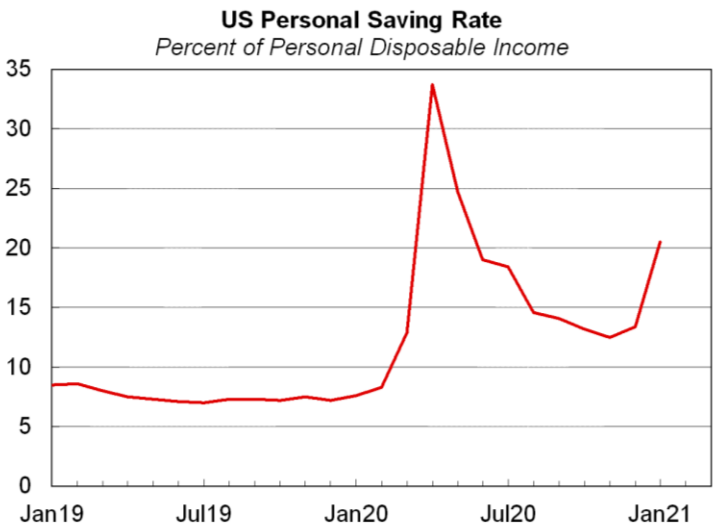
CAN SUPPLY MEET THE DEMAND?

The number of new COVID-19 cases in the United States peaked the week ending January 12. (It has since declined by nearly 80%.) The U.S. economy accelerated immediately thereafter. This month, Congress passed, and President Biden signed, the American Relief Plan Act, which will inject $1.9 trillion into the U.S. economy. About 85% of U.S. households will receive "recovery rebate" checks of $1400 per person. There are unemployed individuals who need the aid included in the ARPA, but the broad economy does not need that much stimulus. In fact, it's not clear that the economy can handle that much stimulus.

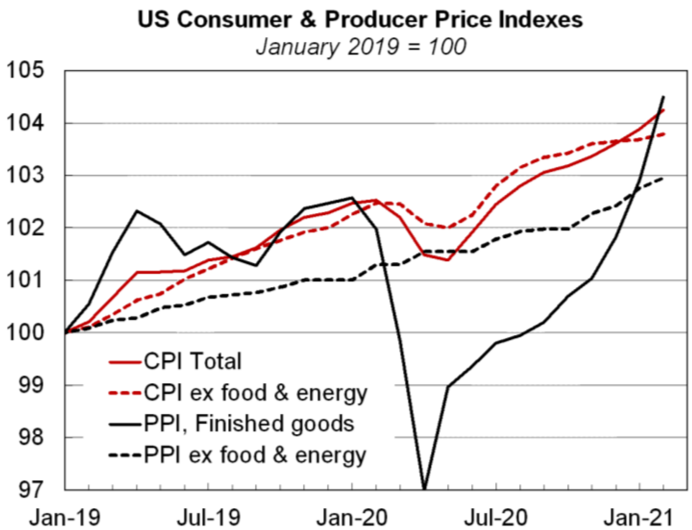
The macroeconomic impact of the relief plan will depend on whether households **try to** spend their relief checks or choose to save them. If they save them, the short-term stimulus to the economy will be smaller, but to an economist who was taught that Americans don't save enough, a higher saving rate seems like a good thing. Last spring, following the first round of relief packages, the personal saving rate rose from its normal range of 5-8% to a record high of 33.7% in April. It declined to a still-elevated 12.5% in November but rose to 20.5% in January after December's $900 billion relief package. It will surge again, approaching its record high, in March. If households put their relief checks in the bank or into Treasury bonds, that will dampen the upward pressure that the swollen federal budget deficit puts on interest rates. If they put them in the stock market, that will put upward pressure on stock prices. That makes people wealthier in the short-term, but unless it translates into more business investment, it will mean smaller returns on stocks in the future. It could also worsen the distribution of income and wealth and increase political pressure for anti-investment tax policies. However, to the extent 20-somethings use their checks to buy stocks and become junior members of the investor class, pressure for such policies could diminish.



If households try to spend their relief checks, will supply be able to meet the increased demand? Will consumers be able to buy the goods and services they want to buy? A shortage of semiconductors is already constraining motor vehicle production globally; computers could be in short supply as well. Construction and home improvements have been constrained by shortages of labor and materials since early in the recovery. Builders and manufacturers are having trouble hiring workers, due at least in part to Unemployment Insurance benefits that exceed pre-layoff wages in some states. Normally, when domestic production can't meet demand for goods, we import the difference. That's not possible now because of a shortage of shipping containers and because labor shortages have ships lined up, waiting to be unloaded.

Even restaurants might have problems meeting demand. Working parents, especially working mothers, might need to stay home with children until the schools open. Some unemployed waiters and waitresses might find they can make more money in construction and manufacturing and won't go back to restaurant work unless wages are higher. (Enhanced unemployment insurance benefits might keep some unemployed waitstaff from taking **new** jobs but not from returning to their old jobs.) Some restaurants might not be able to hire enough workers to reopen; and some that excelled at take-out and delivery and had their best year ever in 2020 might choose to operate with a smaller waitstaff than they had in the past. In contrast, I don't think airlines and theme parks will have problems meeting demand for quite a while.

When supply can't meet demand at current prices, prices rise. Whether this means a persistent and problematic increase in inflation or just a one-off increase in prices depends on several factors. Demographics, technological change, competition, and slack abroad will continue to restrain inflation, but fiscal and monetary policies are pushing in the opposite direction. The Federal Reserve intends to let inflation run above their 2% target "for some time" and, for better or worse, they'll probably get their wish. My view, or at least my hope, is that if the Fed starts raising interest rates (and stops buying long-term securities) in 2022, it can engineer a soft landing, and inflation will fall back to 2% without a period of sub-trend growth and rising unemployment. If they start raising rates in 2023, which is my current forecast, it will take a period of sub-trend growth and rising unemployment, i.e., a "growth recession," to get inflation back down to the 2% target. If they wait until 2024 to start raising rates, which is what the Fed has signaled, it will probably take a full-blown recession to get the inflation genie back in the bottle.



U.S. Consumer and Producer Price Indexes rose sharply in February, but this largely reflected rising energy prices. Inflation, as measured by year-over-year increases in price indexes, will rise sharply through May, as prior-year comparisons fall. Inflation will then decline for a few months, but I expect it to turn up later this year and rise through 2022. What happens after 2022 depends largely on the Fed.

Payroll employment rose a better-than-expected 379,000 in February, but retail sales fell 3.0% after January's (upwardly revised) 7.6% surge, and industrial production in manufacturing fell 3.1%. Production of motor vehicles and parts, down 8.3%, was held back by the semiconductor shortage. Production of chemicals (excluding pharmaceuticals), down 12.1%, was held back by bad weather in Texas. These problems are temporary; I expect industrial production to rise strongly over the remainder of the year.

Unlike supply-siders who cite "Say's Law," I don't believe that supply creates its own demand. Neither do I believe that demand creates its own supply, which is what is implied by the simplistic Keynesian model in my freshman economics textbook. (Keynesian economists don't believe that, but politicians who never got past Econ101 seem to.) I believe the goal of macroeconomic policy should be to keep supply and demand in balance and growing in lockstep at the maximum sustainable rate. Too much demand relative to supply, and you get inflation. Too little, and you get unemployment. I also believe that you should listen to markets. Last year's relief packages ($2.2 trillion in April and $900 billion in December) did not put significant upward pressure on bond yields. That probably means those packages did more good than harm. But when Democrats won control of the Senate, making a $1.9 billion package likely, yields on 10-year Treasuries surged, rising from 0.93% on January 4 to 1.67% this morning. That might be a warning that a package of that size could do more harm than good. Ultimately, though, inflation and growth will have the last word on big fiscal packages and expansionary monetary policies. If these polices don't result in higher inflation that requires a recession to wring it out of the economy or an asset bubble that ends badly, I'll have to admit that they were probably a net positive. If they push up inflation too far, either by boosting demand or by restraining supply, and thereby make a recession necessary, we might wish that we had opted for fiscal and monetary policies that the economy could digest more easily.