Current Economic Conditions

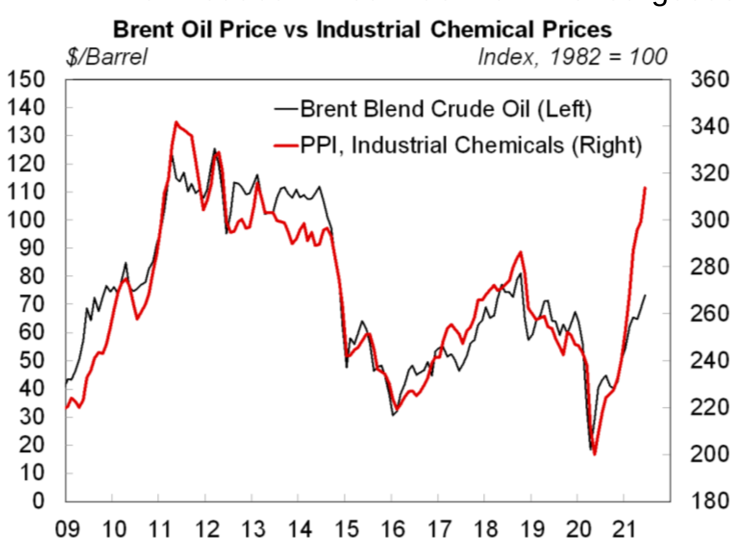
Robert C. Fry, Jr., Ph.D. July 20, 2021

SUPPLY NOT CATCHING UP WITH DEMAND

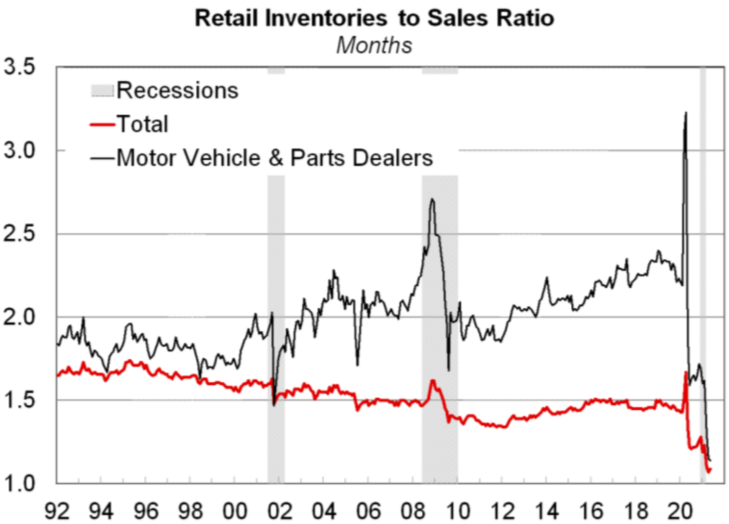
The monthly increase in the Consumer Price Index exceeded expectations for a third straight month in June, rising 0.9% and leaving the CPI up 5.4% from prior-year levels. The "core" CPI, which excludes food and energy prices, also rose 0.9% and was up 4.5% year-over-year. The year-over-year inflation rates partly reflect weak prior-year comparisons, but inflation is running hot even without these base effects. Over the last four months, the core CPI has risen at a 9.0% annual rate, the highest for any four-month period since 1981. (The total CPI has risen at a 9.2% rate, also the highest since 1981.) New and (especially) used vehicles accounted for about 45% of June's increase in the CPI, continuing the pattern of recent months, but prices of food, energy, shelter, and transportation services also rose strongly.

While some prices could come back down when supply constraints ease and others could rise at slower rates, there seems to be plenty of inflation in the pipeline. Rents are rising as people return to cities. House prices have surged to record highs, the result of record-low mortgage rates and supply constraints. The two main measures of shelter costs in the CPI, rent (for rental properties) and "owner's equivalent rent" (for owner-occupied housing) reflect increases in rents and house prices with a lag of a year or more. The increases in rents and house prices that we've seen this year will show up in measured inflation next year. Shelter accounts for about 40% of the core CPI and about 20% of the core Personal Consumption Expenditures price index, the Federal Reserve's preferred measure of inflation.

The Producer Price Index for finished goods, which measures prices at the wholesale level, rose 1.2% in June, leaving it up 9.2% year-over-year. Over the last six months, it has risen at a 14.2% annual rate. The PPI isn't always a leading indicator for consumer prices – market conditions don't always allow businesses to pass cost increases on to their customers – but the PPI does sometimes indicate that there is (more) inflation in the pipeline. The June increase in the PPI for finished goods was led by big increases in prices of iron and steel scrap (+9.9%) and industrial chemicals (+4.5%). Increases in industrial chemical prices reflect the quadrupling in crude oil prices since April 2020 and the lingering inability of chemical supply to catch up with chemical demand following the plant shutdowns caused by the Texas cold snap in February.



The inability of supply to catch up with demand shows up in other data as well. While retail sales rose a surprisingly strong 0.6% in June, supported by aggressive fiscal and monetary stimulus, rising incomes, and abundant savings, industrial production in U.S. manufacturing fell 0.1%. (Total industrial production rose because of big increases in mining and utilities.) Much of the weakness was in industries affected by the global semiconductor shortage, i.e, motor vehicles and parts (-6.6%), electrical equipment, appliances, and components (-2.2%), and machinery (-0.5%). Production of computer and electronic components, up a below-trend 0.4%, is also being constrained by the semiconductor shortage. Building permits for single-family homes fell in June to their lowest level since August 2020, reflecting the interaction of supply constraints and seasonal adjustment. Unadjusted permits remained close to their March peak.



With supply unable to keep up with demand, inventories have been drawn down. The ratio of retail inventories to retail sales fell to an all-time low in April before edging up slightly in May. Inventories at motor vehicle dealers are especially lean. Retail sales excluding autos were up 1.4% in June; total retail sales would have risen more than 0.6% if dealers had had more vehicles to sell. Inventory drawdowns reduce Gross Domestic Product in the short run, but they set the stage for stronger growth in the future as inventories are replenished. Manufacturing has been weaker than expected in recent months, reflecting supply constraints that have been slow to dissipate. The silver lining is that industrial production will remain strong next year even after demand starts to slow. Announced expansions in the semiconductor industry will ease supply constraints caused by semiconductor shortages. The end of enhanced unemployment insurance benefits and the reopening of schools will ease supply constraints caused by labor shortages.

The Federal Reserve announced last August that it would target 2% inflation “over time.” Since inflation was running below 2% until recently, this implies that inflation will be allowed to run above 2% “for some time.” But average inflation targeting is meaningless unless you specify a starting point for calculating the average. The Fed could justify practically any monetary policy, from the most dovish to the most hawkish, by cherry-picking the starting point. My hawkish friends would like to start the calculation in December 1965, when President Johnson unleashed 17 years of high inflation by physically assaulting and intimidating Fed Chair William McChesney Martin. That would require 37 years of zero inflation to get average inflation back down to 2%. Extreme doves would like to start the calculation in 1996, when the Fed unofficially established a 2% inflation target. That would allow inflation to exceed 2% until everyone currently at the Fed has retired. But there are two more logical starting dates: January 2012, when the Fed made its 2% inflation target official, and August 2020, when the Fed announced its switch to average inflation targeting. If the Fed were using August 2020 as the starting point, they would be tightening policy already, as the recent surge in inflation has lifted cumulative (annualized) inflation since August 2020 above 2%. That leaves January 2012 as the logical starting point. That choice would require 2.5% inflation until 2026 or 3.0% inflation until late 2023 to get to the average inflation target. That isn’t what those of us who hate inflation want to hear, but it explains why the Fed has shown no sense of urgency when it comes to raising interest rates. But if inflation fails to fall back below 3% in the next few months, the Fed won’t be able to justify their inaction much longer.

During my corporate career, I often supplied data that were used to justify price increases. This made me uncomfortable for two reasons. First, I share the view of Matt Ridley, who wrote a column in the *Wall Street Journal* in 2011 called “Three Cheers for the Cheapeners and Cost Cutters.” It is the cheapeners (e.g., Rockefeller, Carnegie, Walton, Bezos) who raise living standards, including their own. Second, price increases, when done en masse, are like sending an engraved invitation to the Fed, asking them to raise interest rates. Usually, that’s not good for the economy. This year, however, is not the right time to warn businesses about the downside of price increases. With labor and materials costs rising so rapidly and demand so strong, profit-maximizing prices are rising almost everywhere. Less technically, when you’re sold out and your competitors are sold out, you should raise prices. Period. As for inviting the Fed to raise interest rates: in the current environment, that’s entirely appropriate.

Copyright © 2021 Robert Fry Economics LLC. All rights reserved.
Distribution, reproduction or copying of this copyrighted work without express written permission of Robert Fry Economics LLC is prohibited.