Current Economic Conditions

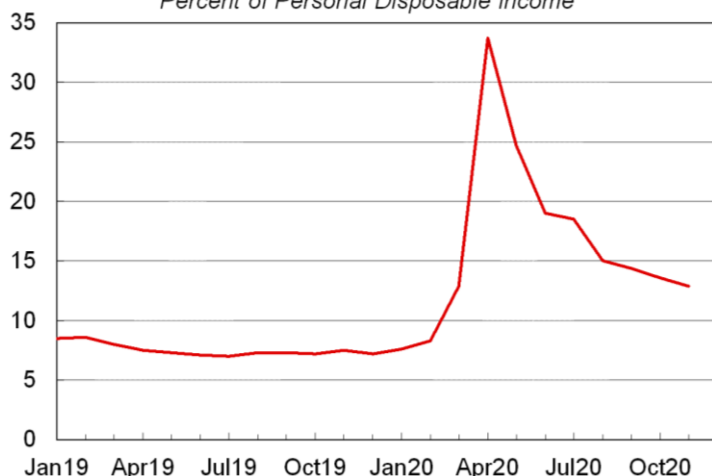
Robert C. Fry, Jr., Ph.D. January 19, 2021

US ECONOMY OFF TO WEAK START IN 2021, BUT INFLATION RISK RISING

The U.S. economy weakened at the end of 2020 and has stumbled out of the gate in 2021. Nonfarm payroll employment fell 140,000 in December. Retail sales fell a much-worse-than-expected 0.7%, and the so-called "control group" used to calculate Gross Domestic Product fell 1.9%, the biggest decline since April's record decline. Most of the decline was at food services and drinking places. While the decline in retail sales is partly attributable to the failure of Congress to pass a relief bill until December 21 and failure of the President to sign the bill until after Christmas, most of the weakening in the economy is simply the result of the surge in COVID-19 cases. So far, January looks even worse. Initial claims for unemployment insurance rose to 965,000 – the highest since August – in the week ending January 9. Manufacturing bucked the weakening trend in December; industrial production in U.S. manufacturing rose 0.9%.

Despite the weakening of the economy, which I expected, I've raised my forecast for growth in 2021. Passage of the $900 billion relief package in late December accounts for some of the upward revision, but most of it simply reflects recognition of the fact that the economy has outperformed my expectations since it hit bottom last April. That's because consumers and businesses have adjusted to the pandemic and have reallocated spending and resources from activities that can't be done safely to those that can.

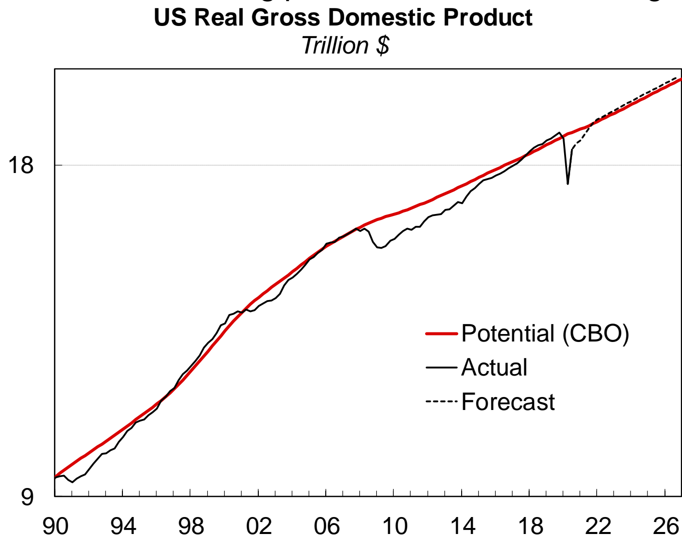
I currently estimate that real Gross Domestic Product grew at a 5% annual rate in the fourth quarter of 2020, down from a 33.4% rate in the third quarter. I think growth will slow further in the first quarter of 2021, due to the post-holiday surge in COVID-19 cases, but passage of the relief package and the continued strength in manufacturing and housing introduce significant upside potential. Roughly $500 billion of the $900 billion relief package will go to households. If they were to spend all of that in the first quarter, it would boost **annualized** consumer spending by $2 trillion. If prices and the other components of GDP were unaffected, this would raise real GDP by 9.3%. But when you annualize this increase – GDP data are reported as annualized quarterly growth rates – it boosts GDP growth by 42.7 percentage points!



In the real world, the impact would be much less and will be spread out over a longer period of time. The relief package will help those who are unemployed and living on the edge, but many who get the $600 relief checks don't need the money and will save it, at least until vaccinations make them willing to patronize a restaurant or board a plane. The savings rate rose substantially after last year's stimulus packages. It fell through the year but remains well above pre-recession levels. It will rise again this month and yet again if President-elect Biden's rescue package is passed. If you assume that consumers spend 80% of the $500 billion received by households, spread evenly over the four quarters of 2021, and that 20% of that spending is satisfied by imports, GDP growth will be raised by 1.7% percentage points over the course of 2021. That's not 42.7%, but it's still a substantial boost. Those who

want to add another $1400 to the $600 relief checks ignore what has happened to the saving rate and have lost sight of just how much $900 billion is. Most Americans still have incomes; what they need is the opportunity to spend their income safely. Perhaps 10% of people need help getting through the pandemic, closer to 90% will get checks. A more-targeted stimulus would do as much good at a much lower cost.

If GDP grows as fast as I expect, it will surpass the Congressional Budget Office's estimate of "potential GDP" in the fourth quarter. Potential GDP is the highest level of GDP an economy can maintain without an acceleration in inflation. If my forecast is correct, there are three possibilities. First, CBO could be underestimating potential GDP. Even though low oil prices hurt the economy in the short run by causing declines in drilling activity and oil and gas production, I still believe that, in the long run, low oil prices are good for productivity growth and economic growth more broadly. There's also reason to believe that working from home, for many the silver lining of the pandemic, will boost productivity. Creative destruction could also boost potential GDP. If workers shift from low-productivity jobs in food services to higher-productivity jobs in manufacturing and construction, potential GDP will rise. (If this happens, bars and restaurants will have a hard time reopening and operating profitably even after the pandemic.) Shifting workers from brick and mortar retail stores to Amazon fulfillment centers and their competitors could also boost productivity.



The second possibility is that economic growth, propelled this year by an unsustainable expansion in aggregate demand, will slow quickly when actual GDP catches up with potential GDP. This will probably require a more-rapid tightening in fiscal and monetary policy than most forecasters and policymakers expect. The third possibility, of course, is that inflation accelerates, and I've recently raised my inflation forecast for the 2022-2025 period. There are already some signs of rising inflation. The year-over-year increase in the Consumer Price Index, which rose from 0.2% last May to 1.3% in December, could reach 3% in May, but this will be due to transitory "base" effects, i.e., very weak prior-year comparisons; inflation will decline after May. But after that brief decline, the underlying rate of inflation is likely to increase over the next few years. Statistically, there is tremendous inertia in broad measures of inflation, especially when volatile food and energy prices are excluded. On the positive side, this means that inflation won't rise very quickly. On the negative side, it means that once the inflation rate rises above the Federal Reserve's 2% target, it will take a while (and maybe a recession) to get it back down to 2%. The Fed has signaled a desire to let inflation run above 2% "for some time." They should be careful what they wish for.

If I'm wrong and we don't get higher inflation, it will be because most of the money injected into the economy chases financial assets rather than goods and services. That will push up stock prices. That needn't imply a bubble that will burst, but it does imply that future returns will be lower than what we're used to. Old people with big stock portfolios gain in the short term at the long-term expense of young people who are just starting to accumulate stocks.

The problem with fiscal and monetary stimulus is not that it doesn't work or that it imposes costs on the economy in the long run. It's that stimulus doesn't go away when it's no longer needed. Spending programs and tax cuts become permanent, and the Fed raises interest rates much too gradually because it's afraid to shock financial markets. While many criticize the stimulus already enacted (and President-elect Biden's proposal for another $1.9 trillion), that is **not** what will get us in trouble. It's failure to withdraw stimulus quickly enough **when markets tighten** that will cause problems. The Fed will likely wait too long to raise rates and will raise them too slowly. This will necessitate raising them further than they intend.

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.