Current Economic Conditions

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THE CUPBOARD IS BARE

Real Gross Domestic Product in the United States grew at a 6.5% seasonally adjusted annual rate in the second quarter. This was considerably less than the consensus forecast of 8.5% growth and my forecast of 8.0% growth. The shortfall relative to forecast was due entirely to a drawdown in inventories. The average forecast from the Consensus Economics panel, of which I'm a member, was for private business inventories to decline at a $36.7 billion annual rate. They actually fell at a $165.9 billion annual rate. The $129.2 billion shortfall subtracted 2.9 percentage points from GDP growth. (The change in private inventories is included as part of investment in the calculation of GDP.) Inventories have declined in four of the last six quarters, leaving them significantly lower than they were at the end of 2019.

Other data also suggest that inventories are unusually lean. Business inventories, which peaked in August 2019, fell sharply in the first half of 2020. Manufacturers' inventories have rebounded to new highs, due in part to otherwise completed vehicles awaiting semiconductors. Wholesale inventories have also rebounded to new highs but remain below their long-term trend. (These data are not adjusted for inflation; the rebounds reflect large price increases as well as physical restocking.) Retail inventories have rebounded little. Inventory/sales ratios remain depressed at both wholesalers and retailers. While a high inventory/sales ratio often tells you more about (weak) sales than it tells you about inventories, a low I/S ratio usually means that inventories are too (and unsustainably) lean.

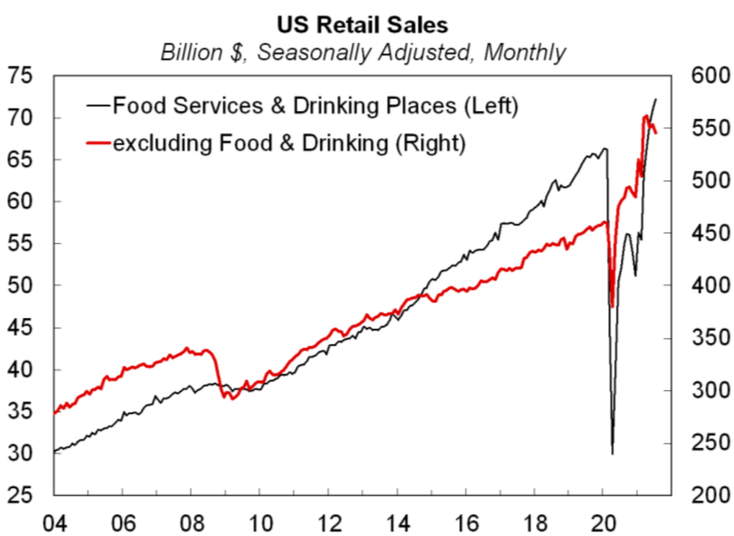
A drawdown in inventories is confirmation that supply is not keeping up with demand, something I've written about repeatedly in recent months. While demand remains strong, supported by massive fiscal and monetary stimulus, an incomplete but still substantial rebound in employment, and rising wages and salaries, supply remains constrained. Domestic production has been constrained by the inability of businesses to hire enough workers, the result of overly generous unemployment insurance benefits, closed schools, and fears of COVID-19. The federal enhancement to unemployment insurance expires next month. If schools reopen as expected, labor shortages could ease significantly, but the resurgence in COVID cases could keep workers on the sidelines, especially if it causes schools to close again. The 943,000 increase in payroll employment in July suggests that the decision of 26 states to end the federal enhancement to UI benefits early is already increasing employment, but those data don't reflect the recent upturn in COVID cases. Production has also been constrained by the global shortage of semiconductors.

Normally, when domestic production of goods is constrained and can't keep up with demand, imports rise to fill the gap. While imports have rebounded to new highs since the recession, they are also being constrained. This reflects COVID-related disruptions to production around the world, the shortage of semiconductors, and shipping constraints that are preventing foreign goods from getting to U.S.

businesses and consumers. These constraints reflect a lack of ships, backups at U.S. ports caused by labor shortages, and (most of all) a shortage of shipping containers. The result has been a quintupling over the last year in the cost of shipping a 40-foot container from East Asia to the United States.

Eventually, supply constraints will ease, and manufacturers, wholesalers, and retailers will rebuild inventories. This will temporarily boost GDP and industrial production. The key uncertainties regarding the rebuilding of inventories are when that rebuilding will occur and to what extent the shelves will be restocked with domestically produced goods vis-à-vis imports. I have recently lowered my forecast for GDP growth in the second half of 2021 and raised it in the first half of 2022. Given the current extent of supply constraints – foreign, domestic, and in-between – it is unreasonable to expect a rapid near-term restocking of inventories. That will have to wait until next year when supply constraints are likely to ease.

The second uncertainty – whether shelves will be restocked with domestic goods or imports – is harder to address at a macroeconomic level; the resolution depends on conditions in individual industries and decisions made by individual businesses. It's also very important; if shelves are restocked with imports, the increase in inventories, which adds to GDP, is exactly offset by an increase in imports, which reduces GDP. Restocking with imports helps the global economy, but it does little for U.S. GDP, industrial production, or employment. Fortunately, U.S. producers who have enough workers and who are not dependent on imported materials have a great opportunity to gain market share at the expense of imports. High shipping costs are effectively a protective tariff, albeit a temporary one. But boosting production to take market share might require investments that make scarce workers more productive. Businesses won't make investments unless they think they can sustain market-share gains in the long run.



Retail sales (excluding food services and drinking places) declined 1.5% in July, despite strong growth in employment and the rollout of child tax credits. This might signal a reversal of last year's shift in consumer spending from services to goods, but it's also clear that lean inventories are costing retailers sales. Because dealers have very few vehicles to sell, light vehicle sales have fallen from an 18.3 million seasonally adjusted rate in April to a 14.8 million rate in July. Home Depot's earnings announcement noted that sales were held down by a lack of appliances to sell. The fact that sales at food services and drinking places were up in July suggests that rising COVID cases don't account for the decline in retail sales; that's probably an August story, not a July story. (Retail sales data are nominal; they are not adjusted for inflation. With prices rising rapidly, real retail sales have fallen more than nominal sales over the last three months.)

In contrast to retail sales, industrial production in U.S. manufacturing rose 1.4% in July, suggesting for the first time that supply is starting to catch up with demand. An 11.2% increase in production of motor vehicles and parts led the July advance, but most industries posted strong gains. Building permits for single-family homes fell in July to their lowest level in a year; supply is not catching up with demand there.

If supply is indeed starting to catch up with demand, manufacturers, wholesalers, and retailers might be able to start rebuilding their inventories. Unless this is done solely by boosting imports, it will boost growth in U.S. GDP and industrial production. Increased supply could also take some pressure off inflation, but this might not happen until inventories have returned to normal. In the meantime, inflation is likely to remain well above the Federal Reserve's 2% target. So far, the Fed isn't hitting the monetary brakes. They aren't even taking their foot off the gas. They're just thinking about gradually easing up on the gas.