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Some Like it Hot: Risks of a Sustained Rise in Inflation

Diane C. Swonk, Chief Economist

Inflation has begun to move up after being chilled to its core by the pandemic. Everything from the price of bigticket items such as vehicles, appliances and furniture to the price of services is heating up. Airfares, hotel rooms, vacation rentals and rental cars are soaring.

Some of the surge we are seeing is attributable to what are termed "base effects," or a major shift a year ago. Oil prices dropped into negative territory in April of 2020. Yes, negative. The glut triggered by global lockdowns was so acute that producers had to pay buyers to store the oil that, suddenly, no one wanted. That will mean big increases in year-on-year comparisons that exaggerate the annual measures of inflation.

Another portion is due to bottlenecks. It is easier to turn out the lights in a factory than to ramp it back up. The Ever Given, the ship that got stuck in the Suez Canal, compounded delays in the supply chain.

Bubbles have begun to emerge, notably in the prices of homes. Existing home prices surged a record-breaking 17% from a year ago in March after accelerating in 2020. Those increases have not shown up in shelter costs, but will.

Reports of labor shortages are surfacing, despite millions still unemployed. Similar complaints were heard in the aftermath of the 2008-09 recession but it took a decade for wages to pick up.

Vaccinations and Stimulus Fuel Growth

Real GDP rose at a 6.4% rate in the first quarter, driven by the vaccinations, the pent-up demand for travel and two more rounds of emergency aid. Consumers were the largest beneficiaries. Business investment picked up, while inventories plummeted. A jump in federal spending offset weakness at the state and local levels. The trade deficit widened in response to lockdowns abroad. The situation in India is devastating.

The second and third quarters are poised to be the strongest. Consumers are expected to continue to spend with abandon. Business investment is expected to remain strong and add to capacity. Inventories will be slowly replenished, while the drag from trade dissipates. Government spending at all levels will remain strong. Real GDP is expected to average 8.5% over the two quarters.

Growth in the fourth quarter is forecast to moderate to a 5.6% pace. Much depends on vaccine uptake, which has slowed. That ups the ante on more vaccine-resistant variants. Some 70 universities are already requiring students to be vaccinated, while clinical trials for younger children have begun. That will hopefully aid in the push toward some kind of herd immunity. The course of the virus still dominates the outlook for the U.S. and global economy.

This time is different. We have the one-two punch of government spending and easy monetary policy to form a tailwind. Our forecast shows the economy growing 6.7% in 2021, the fastest since 1984. Former Treasury Secretary Larry Summers has become a surprise critic of the administration and the Federal Reserve. He recently warned that the Fed will not "do anything until we see a bunch of drunk people staggering around."

This edition of *Economic Currents* focuses on inflation and how much we should worry. The answer depends on three key factors:

- 1 How rapidly wages accelerate;
- 2 The extent to which productivity growth can curb the need to pass wage gains on to consumers in prices; and
- 3 The speed at which the Fed is willing to counter inflation with rate hikes.

My own take on the Fed is that officials are more focused on getting workers off the sidelines and onto the dance floor than throwing a frat party. This will result in a few people feeling tipsy but not the hangover in inflation triggered by the policy mistakes of the 1970s.

The Fed's end game is to level the playing field and allow workers some of the buzz financial markets have enjoyed. Their goal is to eventually get to a higher plateau on wage growth and rates that is justified by hitting instead of undershooting its 2% target on inflation. The boom triggered by reopening and stimulus has given them a shot at achieving that, but it is a gamble.

Subdued Wage Gains

Base Effects

A sharp drop in low-wage employment a year ago skewed the composition of employment gains toward high-wage workers. Those shifts temporarily boosted the average hourly earnings, and set the stage for what will appear to be a sharp slowdown - a contraction - in average hourly earnings in the months to come. (See Chart 1.)

The wage component of the employment cost index, which more accurately adjusts for the composition of job gains, picked up slightly in the first quarter. All of that gain can be attributed to a surge in bonuses, almost all of which were in finance. (See Chart 2.) Equity markets rose significantly over the year.

We are not expecting to get back to the kind of labor market conditions that push up wages more aggressively until 2023. That is much more rapid than we saw during the last recovery but still some distance away.

Bottlenecks

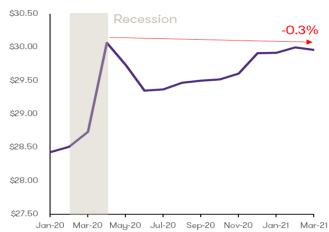
Small and large businesses alike say they are having a tough time getting low-wage workers to return to jobs lost during the pandemic. There are several reasons for the reluctance. Fear is the largest hurdle. Jobs in indoor venues, such as restaurants and bars, remain among the riskiest for workers to contract more contagious variants of the virus. They are wary of returning until they can be assured that they and their families will be safe.

That can't happen until they get widespread access to vaccines, which only just occurred. Then, they will have to wait for the two to six weeks it takes for the vaccinations to hit their full efficacy. That means that many workers may not safely return until June.

Next up is childcare. Too many parents, mostly mothers, still have kids learning online instead of in school. They can't leave those kids home alone to return to work. Summer programs could allow them more options to work, but we may not see a real return of some parents until schools can fully reopen in the fall.

Chart 1

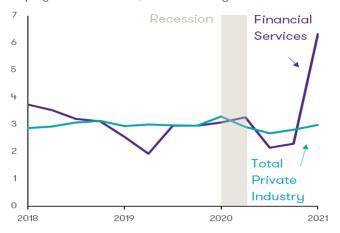
Hourly Wages Stall Average Hourly Earnings (SA, \$/Hour)



Source: Bureau of Labor Statistics/Haver Analytics

Chart 2

Finance Bonuses Drive Gains Employment Cost Index, Yr/Yr % Change



Source: Bureau of Labor Statistics/Haver Analytics

Other workers are suffering the long-haul effects from COVID, which is limiting their ability to work. Sadly, COVID cases were highest in the same communities hit hardest by COVID layoffs.

Some people have developed **agoraphobia** - a fear of going out - which further limits the labor pool. It will take years to understand the full physical and mental health effects of the pandemic.

Supplements to unemployment insurance (UI) and stimulus checks are also being blamed. Research done at the height of the crisis, when supplements to weekly pay were twice what they are today, or \$600 instead of \$300 per week, proved that theory wrong. The lowest paid workers, who benefited the most from the supplements, valued the work more than temporary payouts.

That said, the supplements last longer this time around and could interact with the other hurdles workers face to deter their return. Supplements will lapse in early September, the same time most kids should be back in school.

Retail behemoths - Amazon, Walmart and Target - have announced wage increases. This is increasing the competition for workers. Many would rather accept work in stores or warehouses, where masks are mandatory, rather than at restaurants or bars.

Those companies have the added benefit of leveraging existing technologies, which have boosted the productivity of their workers. That stems the need to pass those wages on in the form of higher prices. It also makes it much harder for smaller competitors and the family-owned restaurants hit harder by the crisis to emerge from a pandemic-induced coma.

The administration has reopened the door to foreign workers who play a critical role in filling seasonal jobs. This will alleviate worker shortages in resort areas. Many workers will be eager to come to the U.S., given better job prospects and the opportunity to get fully vaccinated.

Still, there are actual pockets of labor market tightness, notably in information technology, construction and long-haul trucking. A lack of immigration has exacerbated labor shortages in tech and construction. I honestly can't remember a time when truck drivers were easy to find; it is a hard job with high retirement and burnout rates.

Job hopping among young professionals has accelerated. Some of that represents a catch-up in churn; quit rates plummeted at the onset of the crisis when fears of job loss escalated. High-wage jobs came back faster than low-wage jobs, which made it easier for some workers to change jobs.

Work from home also has a price. The networking, mentoring and team-building that bind young professionals to their employers all but disappeared. Burnout has prompted some to quit and hit the reset button. Applications for graduate school surged for the fall semester, after falling when schools moved online last year.

Retirements by older baby boomers have accelerated. It is unclear how or if those workers will return. We need immigration reform if we hope to fill the holes in the labor market created by aging.

Bubbles

Personal income growth surged 21.1% in March, the fastest pace on record. A third round of stimulus checks accounted for a good portion of those gains. Those payments are not likely to trigger a vicious cycle of inflation because they are temporary. They will, however, likely exacerbate any flare in prices triggered by reopening.

Implications for Inflation

Base Effects

One of the largest boosts to inflation in the near term is a downdraft in prices a year ago. The consumer price index (CPI) will exceed 4% in May. That more than doubles the 1.4% pace in January. The rebound we have seen in energy prices is the primary reason for those increases.

The good news is that much of the downdraft in prices we saw last year was concentrated at the onset of the crisis. That boost to inflation should begin to play out over the summer and into the fall. Any surge in prices lasting much longer would be more troubling.

Bottlenecks

The pandemic exacerbated supply chain problems that were emerging ahead of the crisis for producers. Safety protocols required workers to be staggered across shifts, constraining capacity. A surge in demand for goods caught producers off guard, which caused a shortage of shipping containers, backlogs at ports and further stressed the transportation networks as we all shifted to buying online instead of in stores.

Related pressures wreaked havoc on commodities. The surge in the cost of lumber has been among the most dramatic. Demand jumped, while capacity was severely constrained. Widespread industry consolidation in the wake of the housing bust left fewer producers. Fires in the Northwest last year leveled entire forests.

Most commodity and goods bottlenecks are expected to be cleared by late 2021 or early 2022. The pivot consumers make, away from buying goods back toward services, will help that process along.

Then, we will have backlogs in the service sector to work through. Euphoria over the freedom vaccines provide has spurred demand for vacation travel. Resorts are quickly being booked to capacity for the summer months. Room rates and the cost of vacation rentals are soaring. (I checked; many places are already booked.)

However, the pent-up demand for services is not the same as that for goods. Haircuts lost to lockdowns will not be replaced; there are only so many vacations everyone can take all at once.

Bubbles

The surge in home values is worrisome. Those increases, a rebound in apartment rents and rising hotel room rates will all show up in shelter costs, which alone account for more than a third of the CPI. The worst of the increases is expected to hit in 2022 and 2023.

A Transitory Flare

Chart 3 compares the forecast for the personal consumer expenditures (PCE) index. We chose that over the more familiar CPI because it is a better measure of inflation; it captures the trade-offs that people make when prices flare. Think of the decision to drive to a destination instead of flying when airfares jump; that holds down the actual cost that a family faces when deciding to take a vacation.

The PCE is expected to move significantly higher over the next several months before cooling in fall and winter. We don't expect to see the kind of persistent inflation that would warrant rate hikes by the Fed until well into 2023. An infrastructure package could move up that timeline a bit, but actual spending is spaced out over a decade and accompanied by higher taxes.

Separately, the outbreak in India is a sad reminder of the ongoing risks that a slow rollout of vaccines and variants pose to the global economy. A pandemic anywhere is a pandemic everywhere. Losses tied to regional outbreaks will act as a check on global pricing pressures.

Policy Mistakes

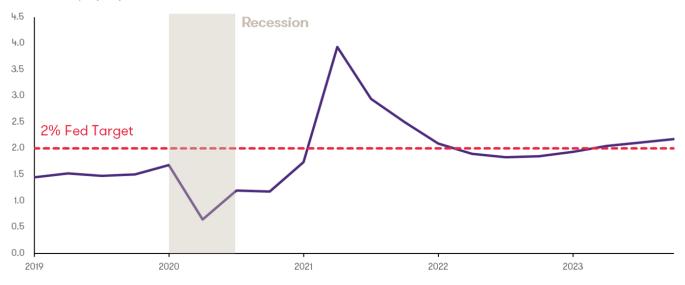
None of those arguments have stopped pundits from worrying about inflation. Some have even resurrected the term "stagflation," which was coined to describe a jump in both inflation and unemployment during the 1973-75 recession. A repeat is unlikely.

"Our forecast shows the economy growing at a 6.7% pace in 2021, the strongest since 1984."

Chart 3

Temporary Inflation Spike

PCE Index %, 40/40



Source: Bureau of Economic Analysis, Grant Thornton LLP

It is hard to comprehend the breadth of policy mistakes that precipitated the inflation of the 1970s. Growing public debt, increased spending associated with the Vietnam War and easy money triggered a pickup in inflation and unemployment in the 1960s. Between 1960 and 1969, inflation more than tripled.

Policy mistakes by President Nixon compounded the rise in inflation. In 1971, the administration:

- Abandoned the gold standard, which caused the dollar to depreciate;
- Levied a 10% tariff on imports; and
- Imposed wage and price controls, which accomplished neither.

Nixon then pressured his Fed Chairman, Arthur Burns, to ease monetary policy to ensure his reelection. (There are tapes from Nixon's term in the White House.) The cut in oil production by the OPEC cartel in 1973 was the straw that broke the camel's back.

Unions pressured firms to compensate for runaway inflation. Annual cost-of-living-adjustments (COLAs), which were indexed to the CPI, were added to contracts. In those days, whatever union workers received, white-collar workers did too. Work my previous mentor did while he was at the Federal Reserve in the 1970s suggested that 80% of wage and salary increases were determined by changes in the CPI. That baked the surge in oil prices directly into wages, which fueled the vicious cycle in inflation.

A repeat of that kind of wage-push inflation is unlikely. Workers don't have anywhere near the bargaining power they had back then.

A "Show Me" Fed

Finally, the Fed has pledged to:

- Look through any near-term flare in inflation, as it is likely to be transitory;
- Wait for significant improvement in employment before it tapers the pace of asset purchases; and
- Hold off on rate hikes until we see a full and more inclusive recovery in employment, wage gains and a sustained increase in inflation.

"Most commodity and goods bottlenecks are expected to be cleared by late 2021 or early 2022."

That last condition is what has raised red flags for the likes of Summers. He sees the Fed's decision to wait out inflation, combined with the surge in fiscal stimulus, as a formula for disaster.

The Fed would prefer to risk overheating than to preemptively derail a recovery in employment before those hardest hit by the crisis have a chance. "...if we get things right, we can really help people. And that's what we're trying to do...if the people who are at the margins of the economy are doing well, then the rest of it will take care of itself," Powell said in a recent interview.

The Fed is applying what it learned from past mistakes. It consistently raised rates before inflation actually materialized. The result cost the most vulnerable of workers opportunities and dampened overall economic growth.

We expect to see economic conditions improve enough for the FOMC to announce a tapering of its \$120 billion per month asset purchases by year-end. Federal Open Market Committee (FOMC) members are expected to hold off on voting for rate hikes until late 2023. Our forecast on rate hikes is sooner than most on the Fed currently expect.

Paradigm Shift

The Fed hopes that the move off of ultra-low rates will eliminate froth without derailing financial markets. The Fed hasn't had to hit the brakes hard to contain inflation for decades. Officials are betting that is still the case today, given how rapidly the economy responds to even small interest rate movements.

Bottom Line

Inflation is going to pick up. Some of the increases will be illusory, conjured by comparison to a downdraft in prices a year ago. Another portion will be due to bottlenecks in both the goods and the services sectors. Asset bubbles are forming. These are more worrisome but, as we noted last month, the surge in home prices is underwritten with a lot more equity in homes than existed during the subprime crisis. We are much better positioned to weather a storm, should we see a broader-based rise in inflation or correction on the other side of the boom we are entering.

The Fed understands that and is willing to let the economy rip, even if that ignites a little heat. We need that warmth for those who are still stranded in the cold by the pandemic. What we don't know is how aggressively the Fed will have to turn down the heat, once we reach that goal.

Economic forecast — May 2021

	2020	2021	2022	2020:4 (A)	2021:1 (A)	2021:2	2021:3	2021:4	2022:1	2022:2	2022:3	2022:4
National Outlook		'										
Chain-Weight GDP ¹	-3.5	6.7	4.1	4.3	6.4	9.5	7.5	5.6	3.7	1.6	1.8	1.4
Personal Consumption	-3.9	7.7	4.3	2.3	10.7	8.9	7.4	4.0	4.5	2.7	2.5	1.9
Business Fixed Investment	-4.0	7.8	5.3	13.1	9.9	5.6	7.0	6.5	5.5	3.8	4.0	4.3
Residential Investment	6.1	12.7	-3.1	36.6	10.7	0.8	2.2	-0.4	-6.0	-5.8	-4.6	-2.2
Inventory Investment	-77	60	180	62	-86	21	104	202	213	188	175	145
Net Exports (bil \$ '12)	-926	-1240	-1265	-1122	-1175	-1251	-1268	-1266	-1269	-1274	-1264	-1254
Exports	-12.9	6.0	7.6	22.3	-1.1	10.5	7.6	8.7	7.5	6.5	7.0	6.4
Imports	-9.3	14.2	5.6	29.9	5.7	16.4	6.9	5.3	5.2	4.8	3.5	3.1
Government Expenditures	1.1	2.7	0.4	-0.8	6.3	9.7	0.0	0.4	0.0	0.0	-1.2	-0.6
Federal	4.3	2.5	-1.5	-0.9	13.9	-1.2	-3.4	-1.6	-1.5	-1.1	-0.4	-1.7
State and Local	-0.8	2.8	1.7	-0.8	1.7	17.2	2.2	1.6	0.9	0.7	-1.7	0.0
Final Sales	-2.9	6.0	3.5	2.9	9.2	7.3	5.9	3.8	3.5	2.1	2.0	1.9
Inflation												
GDP Deflator	1.1	3.2	2.2	2.0	4.0	8.5	-0.3	0.0	1.9	6.9	-0.6	0.3
CPI	1.3	3.0	1.9	2.5	3.7	7.0	-0.1	-0.3	1.8	6.2	-0.4	-0.1
Core CPI	1.7	2.4	2.3	1.8	1.2	7.1	-0.1	0.1	2.3	6.8	-0.1	0.3
Special Indicators												
Corporate Profits ²	-0.7	14.0	0.7	-0.7	17.1	55.0	9.3	14.0	12.1	-3.1	5.5	0.7
Disposable Personal Income	5.8	3.4	-1.9	-10.1	61.3	-26.9	-4.5	-4.6	3.8	0.4	3.4	1.7
Housing Starts (mil.)	1.39	1.60	1.49	1.58	1.61	1.63	1.58	1.58	1.56	1.50	1.48	1.45
Civilian Unemployment Rate	8.1	5.1	3.7	6.7	6.2	5.5	4.7	4.1	3.8	3.7	3.7	3.5
Total Nonfarm Payrolls (thous.) ³	-7293	6846	383	1897	891	2368	2582	1005	607	304	270	350
Vehicle Sales												
Automobile Sales (mil.)	3.5	3.9	3.8	3.9	3.9	4.1	3.9	3.8	3.8	3.8	3.8	3.8
Domestic	2.5	2.6	2.5	2.8	2.6	2.7	2.5	2.5	2.5	2.5	2.5	2.5
Imports	1.0	1.3	1.3	1.1	1.3	1.4	1.4	1.3	1.3	1.3	1.3	1.3
Lt. Trucks (mil.)	10.5	13.4	13.0	12.3	13.1	13.9	13.4	13.1	13.0	13.1	13.0	12.9
Domestic	8.6	10.4	10.1	9.6	10.3	10.7	10.5	10.3	10.2	10.2	10.1	10.0
Imports	2.4	2.9	2.9	2.7	2.8	3.2	2.9	2.8	2.8	2.9	2.9	2.9
Combined Auto/Lt.Truck	14.0	17.3	16.8	16.2	17.0	18.0	17.3	16.9	16.8	16.9	16.8	16.7
Heavy Truck Sales	0.4	0.5	0.4	0.5	0.5	0.5	0.5	0.5	0.4	0.4	0.4	0.5
Total Vehicles (mil.)	14.4	17.8	17.2	16.7	17.5	18.5	17.8	17.4	17.2	17.3	17.2	17.2
Interest Rate/Yields												
Federal Funds	0.4	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
10-Year Treasury Note	0.9	1.7	2.0	0.9	1.3	1.7	1.7	2.0	1.9	1.9	2.0	2.2
Corporate Bond BAA	3.7	3.8	4.2	3.4	3.5	3.7	3.7	4.1	4.0	4.2	4.2	4.4
Exchange Rates												
Dollar/Euro	1.13	1.18	1.19	1.19	1.21	1.20	1.21	1.22	1.22	1.23	1.23	1.24
Yen/Dollar	106.8	111.5	112.5	104.5	106.2	111.0	114.0	115.0	114.0	113.0	112.0	111.0
1 in 2020 GDP was \$18 k trillion in chain-		1 11										

in 2020, GDP was \$18.4 trillion in chain-weighted 2012 dollars.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, \$ figures reflect adjustment for inflation. Total may not add up due to rounding.

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² Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.

^{3.} Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.