What Happens Next – Sunday May 23, 2021
COVID, Stimulus, Fake News, Future of Retail
Desmond Lachman

Larry Bernstein:

We're going to go onto our second speaker, Desmond Lachman. Desmond is a very good friend of mine. We worked together at Salomon Brothers, where he was chief emerging market economist and former deputy director of the IMF. He is currently at AEI. Desmond:

Desmond Lachman:

What I want to talk about was inflation and whether we're going to be getting inflation in the U.S. economy. A good way to think about it is to think about two parts of inflation. One is asset price inflation, and the other is actual price inflation like consumer prices, et cetera. If we start with asset price inflation, there's no doubt that we've got asset price inflation in spades. We're just seeing very elevated equity valuations. We're seeing bubbles in housing markets, emerging markets, credit markets, what people are calling the "everything bubble", and that owes a lot to what the Fed did last year in response to the COVID pandemic. What they did is they increased the size of their balance sheet by something like four trillion dollars. It took Powell's Fed to do that in something like six months to nine months, whereas Bernanke in 2008, it took him something like six years. So, we've had mass printing of money that really got asset price inflation going.

The issue with price inflation, the argument that we haven't had it so far is that the recession was deep. You've got a lot of unemployed workers. You've still got something like eight to ten million fewer people working now than before. So, you think that there's downward pressure, but the issue is that we've got huge amount of stimulus in the economy. So, there was an initial stimulus package, two billion plus. In December, we had $900 billion. Now with Biden, just the first part of his three proposals that he's rushed through Congress, he's got $1.9 trillion through Congress. So if you take the $1.9 trillion and add it to the $900 billion that gives you something like $2.8 trillion, which is 13% of GDP. That is massive stimulus by any standard.

What makes one think that that has to be inflationary is that the gap, in other words, the difference, between the level at which the economy is operating and the level at which it could operate at full employment, the congressional budget office estimates that's only 3%. So, to throw 13% of that at a 3% problem, that has to raise red flags about inflation later on this year. You're going to close those gaps. The economy is going to overheat. You're going to get the inflationary pressure. What strengthens the argument that you're going to get inflationary pressure is, there's a huge amount of pent-up demand in the economy. One way we know that there's got to be a lot of pent-up demand is savings rates during the lockdown were particularly high. As we go to normalization, opening up the economy, everybody's vaccinated, we would expect that pent up demand to be spent. So, that comes on top of the 13% stimulus that they're getting. That is another source of major inflationary pressure.

Another way of looking at the pent-up demand is if you look at the money supply, broad money supply now is growing at something like 25%. That is by far the fastest rate of money supply we've seen in the past 60 years. You know, previous peaks were something like 12 to 13%. Here, we're talking about 25%. On the demand side, you've got huge amount of demand. And then you run into issues on the supply side, that because you've got unemployment insurance will last until September, what you're seeing now are labor market shortages, job openings are so much higher than the number of people who come forward to work. And then you've got problems on the supply chains that have got interrupted like computer chips. Automobile companies can't produce as many cars.

When you put the whole picture together, it's difficult for me to see how you're not going to get an overheating of the economy towards the end of the year, and that is going to give rise to inflationary pressure. We've of course seen inflationary pressure in a number of ways. The latest CPI print was much above what was expected, something like 4.2%. And if you look at inflationary expectations, that is worrying too, that you look at the bond market, the 10-year breakeven inflation rates when you subtract nominal yields from inflation-indexed yields, they imply a market forecast of inflation of something like 2.5%, which is above the 2% Fed's inflation target. And you've also got consumer expectations of inflation. You look at the Michigan survey, they're at over 4% inflation. So, you're seeing inflationary pressures building up all over the place.

Now, another reason why you think you're going to get inflation going forward is the Fed is indicating that they're going to tolerate higher inflation. So, they're happy with inflation running above 2% for a while. What that means is it's unlikely that the Fed is going to step on the brakes any time soon that heightens the chances that you're going to overshoot on the inflation side. The Fed is going to be late to the party. They should be anticipating that the economy will overheat. They should already be moving towards a tightening stance. That is not occurring. Now, the reason that I'm not sure that we get inflation really taking hold in next year, in 2022, is because once the Fed slams on the brakes, then you've got the problem with all of these asset price bubbles that I started talking about, and those asset price bubbles all premised on the notion that interest rates are going to stay close to zero forever.

When the interest rates start going up, that's the time that you expect the bubbles to burst. If the bubble does burst, then you're going to have problems. The Fed came out with a financial stability report. They pointed out that there's too much leverage in the hedge funds, et cetera. If you've got an everything bubble, you've got emerging markets tanking, this isn't going to look pretty next year. So the short answer is I think I see inflationary pressure building through the remainder of this year, the Fed slams on brakes, we're in a different ball game. Then we'll be back to talking about deflation and needing to pump the economy up again.