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Macroeconomics - News Analysis, Spring 2021

Financial Times (May 12, 2021): US consumer prices rise at fastest pace since 2008

Article summary

In April, consumer prices rose 4.2 y/y%, a large spike from the 2.6 y/y% change in March. Core CPI was up 3% in April compared with last year. This surge worries some who think that strong fiscal and monetary support along with supply chain disruption and high demand as a result of rapid COVID-19 vaccinations will trigger a short-term rise in prices. US equities fell after publication of the most recent CPI figures.

Policy makers are still working under the assumption that any inflationary spikes caused by the current fiscal and monetary stimulus will be temporary. Both President Biden and Secretary Yellin have made statements that they believe the current surge to be fleeting. One justification for the assumption that the current rise in prices will be temporary is that the current year's rise in prices is compared against last year's price dip. There are still disinflationary pressures present in the global economy that policy makers believe will persist.

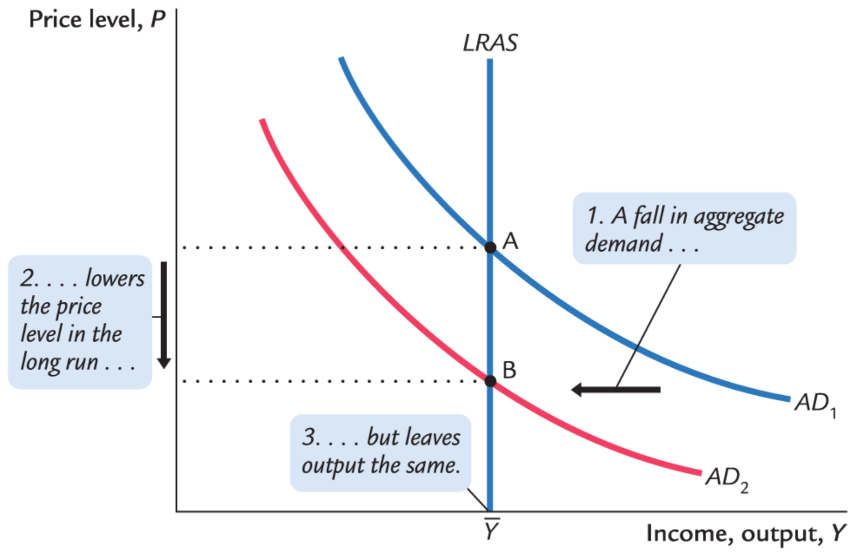
This current spike in prices does not mean that an inflationary period is coming, however the first part of the story of inflation is no longer speculation. The Fed is not expected to adjust policy as a result, as consumer prices have recently been below the Fed's 2% target.

Despite reassurances and a calm stance from policy makers, the markets fell upon publication of the CPI increase. There is other evidence that the business sector is responding to concerns over inflation by raising prices. Berkshire Hathaway report seeing higher prices charged to them. Tyson Foods has raised prices substantially and is preparing for continued prices increases throughout the second half of the year. Raw materials, logistics, packaging, and labor are all contributing to price increases.

Analysis

The extended period of monetary expansion by the Fed, along with the fiscal expansions of the past year have made inflation in the short-term a concern for many. Last spring, the economic slump resulting from the pandemic depressed GDP growth. The fiscal and monetary support was necessary to keep businesses afloat and provide incentives for individuals to stay home and reduce the severity of the harm caused by COVID-19.

In terms of aggregate supply and demand, the effect of the monetary expansion can be seen in the chart to the right. Long run aggregate supply (LRAS) is determined by the amount of capital, labor, and the available level of technology. These things have remained stagnant throughout the pandemic, with the labor force possibly contracting due to more people choosing not to work unless compelled by circumstance. An increase in the money supply causes the aggregate demand (AD) curve to shift to the right. This results in a rise in price levels.

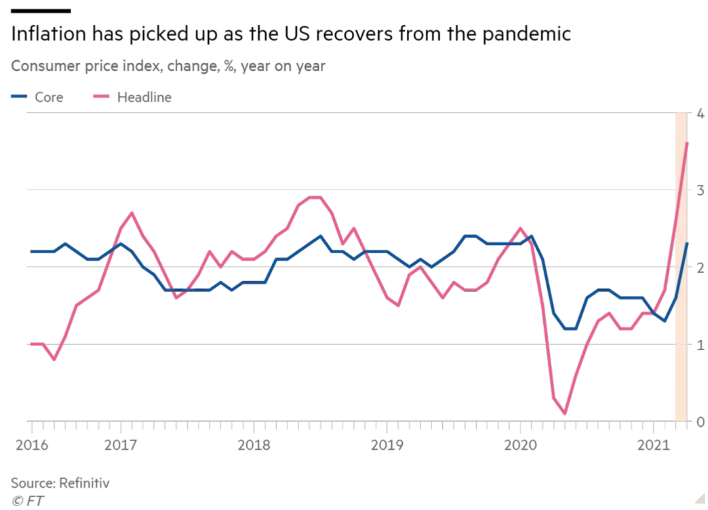


Mankiw, *Macroeconomics*, 10e, © 2019 Worth Publishers

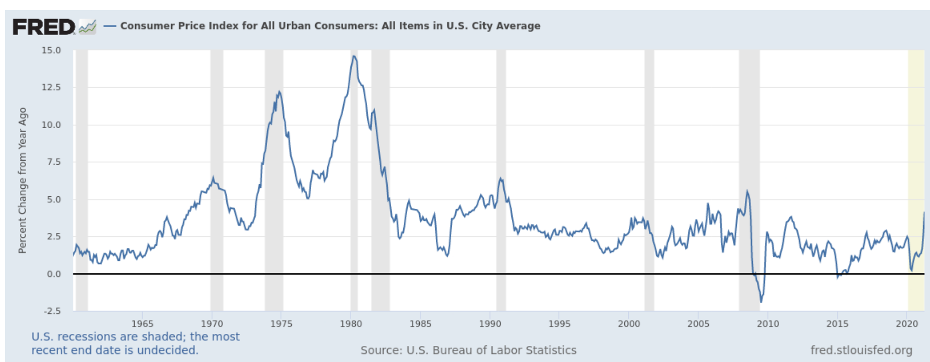
In addition to a rise in the CPI, the *FT* article also mentions some concrete examples of Tyson Foods and Berkshire Hathaway planning for, and experiencing, price increases. Consumer and business expectations with regard to inflation are an important driver of future inflation as well. Tyson Foods is planning for increased inflation throughout the year. No doubt this will influence smaller producers as well. If producers price for expected inflation, this can result in a self-fulfilling situation.

The Federal Reserve is maintaining that this spike in prices will be temporary. They don't have plans to raise the federal funds rate or revise the monetary expansion. This reserved stance is, at least in part, a way to reassure markets that the situation is under control. If people trust the Fed, this can quell nervousness about inflation. Conversely, if the Fed were to raise the federal funds rate and halt the monetary expansion upon receiving the latest CPI figures, this could ignite a period of inflation due to the response of businesses and consumers.

FT includes the following chart to show the increase in inflation. Although the y/y% spike in CPI for April was large, viewed in a larger historical context, this recent jump appears somewhat less severe. In the second chart below, it can be seen that inflation is still low by historical standards, and it will take more than a month, or maybe 6, for the Fed to change course. An article by James Mackintosh at the *WSJ* makes the case that the Fed is ready to endure more inflation than consumers would like. Of course everyone wants to prevent an inflationary period like the US experienced throughout the 1970s, but the correct course of action to restore the economy after the events of the last year while also preventing a significant inflationary period is unclear.



The labor market is still recovering from last year, but not at the expected pace. Using the Philips curve as a guide, in order to reduce unemployment to the natural level, it may be necessary to suffer a rise in inflation. This is perhaps a signal that the current rise in CPI is just a sign that the economy is in the process of recovery. The concern is that due to the expansionary fiscal and monetary policies over the last year, this has primed the economy for a not-yet-realized inflation. With the federal funds rate hovering near 0% and expansionary policies already in place, if there is not an increase in the labor markets there are fewer options left to spur growth.



Risk Assessment

With a potential significant inflationary period on the horizon, firms no doubt would like to prepare for any reasonable future scenario. The approaches that firms take to managing risk are varied, both in scope and complexity. 'Risk' can be understood as anything that endangers the overall health of the company. Some of these will be industry or location specific, others will be the result of larger trends. Some analysis of risk is conducted primarily through discourse, while other methods are highly technical and rely on econometric analysis. Any of these methods can be valid approaches to managing risk so long as they actually help prepare a company for a risk before it happens. The best methods will be those that prompt a company to prepare for a possible risk that wasn't previously considered before and actual occurrence of that event.

In support of a generalized approach to macro risk management, I propose a framework for categorizing and understanding the origin of different risks. This is an overview of an approach to integrating an analysis of macro events into an actionable plan for a firm. Rather than being a detailed method, which is best developed according to the resources of each business, the following can be read as a heuristic device to aid in creating and informing suitable risk management plans.

All firms watch and use similar macro data, periodically released by government agencies for free. The way that this data relates to any business or industry requires domain specific knowledge. A report from *The Risk Management Society* details a simple method for a company to begin understanding macro risk. This method involves searching for strong correlations between macro data and internal company data. Once significant correlations are found, this knowledge can then be used in conjunction with the most recent macro figures to inform future plans. While this method is useful, it is important to keep in mind that macro trends affect all industries and businesses, and even if a macro trend does not directly influence your business, it could influence a tangentially related business or industry.

It could be a useful approach to organize macro risk analysis at the firm level according to two different orders. A first-order risk is the kind described above; a direct relationship between a macro variable and an internal variable. A second-order risk is a connection between macro indicators and associated firms or industries. Identifying second-order risk no doubt a much larger and more difficult task. Larger amounts of data are involved, and the domain knowledge required is likely beyond what might typically be available in house.

Separating risk in this way has the possibility of providing clarity as to what kind of risk a firm is facing. First-order risks should, in a mature company, be well understood and not result in many unexpected events. Second-order risks will be less well understood. Over time, a business-specific portrait of second-order risks, developed as the firm weathers various economic turns, could prove to be a useful tool for managing a wider range of risks than would otherwise be possible.

Sources

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