RAMBLER INVESTMENT FUND

Inflation Pressures Should Pressure the Fed and Congress to Act

By Katherine Konczak

In response to the economic downturn caused by the COVID-19 pandemic, U.S. officials were quick to react: in March 2020 the Fed cut short-term interest rates to near-zero with no plans to raise them until 2023 and has been implementing quantitative easing (QE) by purchasing $120 billion a month in Treasuries and mortgage-backed securities (MBS) since July 2020. Congress passed three stimulus packages to provide relief to millions of Americans. As a result of the Fed and Congress's swift action, the COVID-19 recession, lasting from February 2020 to April 2020, was the shortest on record at just two months; additionally, economists such as head U.S. economist for Oxford Economics Lydia Boussour forecast 2021 U.S. GDP growth to be 7.5%. With faster than expected economic growth – despite over 7 million fewer Americans working compared to before the COVID-19 pandemic – and the estimated 2021 inflation rate of 3.4% above the Fed's target of moderately exceeding 2%, I believe that continued QE at the current rate and Biden's social spending plans will have little effect on further economic growth and employment. As a result, the Fed should begin tapering its QE in a gradual and well-communicated manner before the end of the year. Furthermore, Congress needs to agree on a smaller spending plan or else risk that the excess liquidity will cause soaring inflation rates to climb even higher, resulting in a further reduction in consumers' purchasing power, sudden interest rate hikes, and market volatility that will threaten economic recovery.

The U.S. economy is already showing signs of overheating, especially when it comes to the housing market. Though lumber prices have fallen from their record high on May 7, they are still nearly double from last spring. Homebuilders are still being quoted at record highs for lumber packages, which in turn makes it more expensive for homebuyers to build their new home. Inflated lumber costs due to its shortage, along with increasing regulatory costs and labor shortages in the homebuilding industry has decreased construction of new homes, contributing to a housing supply shortage. At the same time, the Fed's sustained commitment to purchasing $40 billion in MBS each month has kept current mortgage rates near their historic lows. These conditions caused U.S. house price gains to rise at the fastest pace in more than 30 years and sent the housing market into a frenzy. As a result, families – particularly those who are first-time homebuyers – have been priced out of the housing market due to bidding wars despite the low rates. There is no reason why the Fed still needs to buy $40 million in MBS per month. Given the current state of the housing market, the Fed should begin to taper its purchases of MBS as soon as possible to prevent additional increases in U.S. house prices, bleeding into the rental market with higher rents, or a housing market crash.

Although many economic indicators have returned to their pre-pandemic levels, the Fed projects that the unemployment rate will not drop to its pre-pandemic level until 2023. In spite of unemployment rates hovering around 6% between January 2021 and June 2021, Q1 U.S. GDP grew by 6.4%, and GDP growth for April-June is expected to be 12%. However, even with the significant economic growth the U.S. is experiencing, Federal Reserve Chair Jerome Powell and some Fed officials are still hesitant to begin tapering its QE purchases until the U.S. job market demonstrates more progress towards its pre-covid level. Though the unemployment rate is still far from 3.5% exhibited in February 2020, many businesses, especially in the leisure/hospitality, retail, construction, and restaurant sectors of the economy are struggling to hire workers, even when offering hiring bonuses and increased wages. This, in addition to the relatively same unemployment rate January 2021-June 2021, suggests that the Fed's QE is no longer effective towards increasing employment. It seems that ending the additional $300 a week federal unemployment benefit from the American Rescue Plan would have more of an impact on getting Americans to return to work. The extended unemployment benefits are encouraging Americans to stay at home; according to a study conducted by the University of Chicago, 42% of individuals collecting unemployment receive more than they did working at their previous jobs. Many states that have terminated the federal unemployment benefit, however, have seen an improvement in their unemployment rate: 20 out of the 26 states that have ended the additional benefits pose an unemployment rate below the national average.

In addition to surging housing costs and employers offering wage increases and sign-on bonuses to incentivize Americans to return to work, President Biden's $3.5 trillion social spending plan threatens to increase inflation even more. Though Biden claims that his multi-trillion dollar plan will reduce inflation, I doubt that trillions of dollars in government spending in an economic expansion would drive down inflation. Additionally, Biden and the Fed's reassurance to Americans that inflation is still transitory failed to ease their worries about rising inflation as the Consumer Sentiment Index dropped from 85.5 in June to 80.8 in early July. According to a report from the Bureau of Labor Statistics, the inflation surge resulted in real average hourly earnings to decline by 0.5% in June. Inflation is already showing signs of persisting; there are still unresolved supply chain disruptions, a global shipping crunch, and the housing market has not cooled down. The White House and the Fed need to be more concerned about rapidly accelerating inflation instead of downplaying its effects as transitory. Now is not the time for Senate Democrats to pass a $3.5 trillion reconciliation bill.

With inflation currently at a 13-year high, continued QE at the current pace of $120 billion a month and Biden's massive spending plans will exacerbate inflationary pressures and economic overheating. The Fed and Congress are one policy misjudgment away from harming economic recovery. As the Fed's balance sheet surpassed $8 trillion in June, the need to begin weaning QE purchases is becoming more urgent. The Fed must finalize and announce tapering and inflation control policies at the Jackson Hole Symposium in August or risk becoming entrapped by its liquidity infusions and contributing to elevated unemployment when businesses can no longer afford the increase in wages to attract employees. Should Senate Democrats successfully pass the $3.5 trillion reconciliation bill, the Fed may have to respond even sooner than they intend to. The Fed can taper without a tantrum, but only if it does not wait to do so.