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Commentary

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The two-track recovery: Some sectors boom while others flounder and prices accelerate

Philip Cross

Overview

The economy continued to recover in the first quarter, although at an uneven pace because of government mandated openings and closings of various sectors to control the virus, while the roll-out of vaccines lagged in Canada. Growth was led by housing and natural resources, while some personal and business services industries struggled to recover at all despite record fiscal and monetary stimulus to the overall economy. This has resulted in a two-track recovery.

Meanwhile, inflation surpassed expectations as surging commodity prices fuelled by the widespread reopening of the US economy were compounded by shortages of key inputs ranging from semiconductor chips to labour. Indeed, given these supply shortages, official statistics probably understate inflation, which will continue to rise this year because of the soaring cost of commodities and housing.

Policy-makers also appear to be drawing lessons from the financial crisis for managing the aftermath of the pandemic. After all, financial crises have a

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depressing effect on growth years into the future. In contrast, the pandemic seems to have a much less lingering impact on the macroeconomy. As a result, maintaining a high level of stimulus risks raising demand above what the economy can supply without fuelling higher prices.

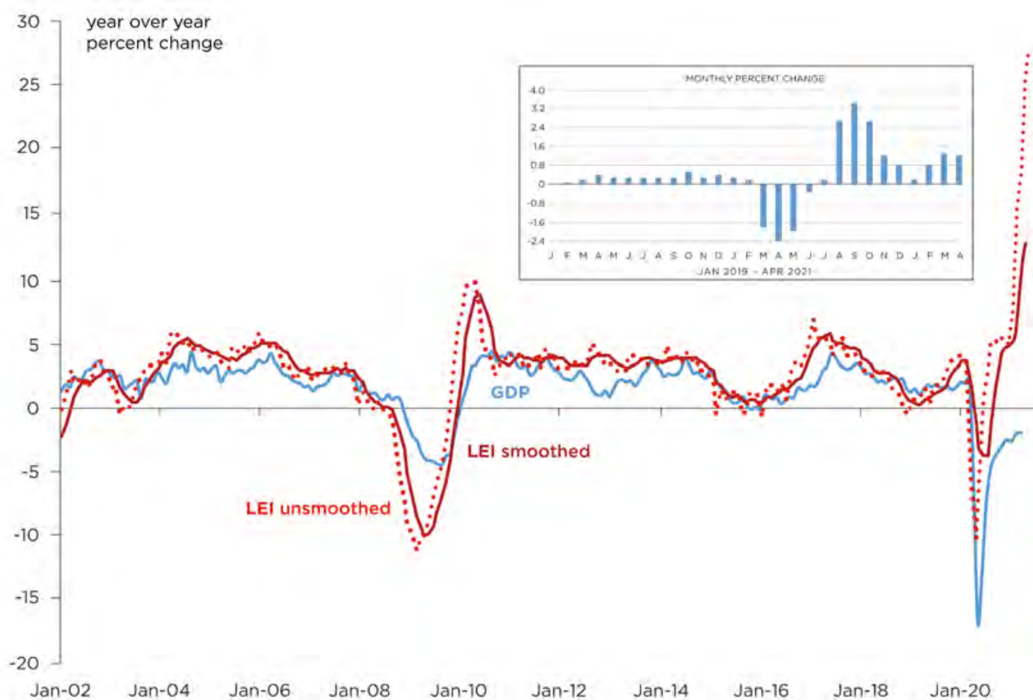
Introduction

Real GDP increased 1.4 percent in the first quarter, its third consecutive gain that has recouped almost 90 percent of its record 13.1 percent drop in the first half of 2020. However, growth was largely confined to housing, which contributed almost two-thirds of growth. Exports picked up in response to soaring commodity prices, but consumer spending and business investment languished despite strong income growth for both households and firms.

Statistics Canada's preliminary GDP estimates for April point to a setback when several provinces took stringent measures to slow a resurgence of the virus, while employment fell in both April and May for the same reason. However, this reversal will likely be temporary and growth should resume over the summer.

The Macdonald-Laurier Institute's leading economic indicator (LEI) pointed to a resumption of growth into the second half of the year (Figure 1). The LEI rose 1.2 percent in April, its 10th consecutive increase. Growth was broadly-based, with eight of the 10 components advancing and two unchanged.

Figure 1: MLI'S Leading Economic Indicator (LEI) and GDP



Growth was led by the housing and stock markets, which also buoyed consumer confidence. Surging global growth also sent commodity prices higher, with metals and lumber hitting records and oil recovering all of its losses in 2020.

Recover continues to be uneven

The recovery from the pandemic has proceeded at two different speeds. Most sectors are growing rapidly, with many prospering as never before. However, about one-tenth of the economy has seen little growth since last spring and remains well below pre-pandemic levels. The strongest performing industries were related to housing (including residential construction, real estate brokers, and legal services related to real estate transactions), agriculture, retailing, professional services, and the public sector.

However, a few industries have seen little or no recovery and their output remains far below their level before the pandemic began. These include personal services (notable arts, recreation and entertainment, and accommodation and food), business services (such as janitorial and security services for office buildings that remain mostly empty), and transportation (notably airlines and mass transit), which altogether account for about 10 percent of total GDP. Output in these industries is between 20 percent and 50 percent below their pre-pandemic highs, reflecting both larger than average declines during last spring's lockdown and little or no recovery of demand over the last three quarters.

The inability of some industries to adapt to the pandemic is reflected in the continuing high level of long-term unemployment (defined as out of work for over half a year), which shot up from 179,000 before the pandemic to 478,000 in May. While overall unemployment has come down slowly over the past year, nearly one-third of the unemployed have been out of work for half a year or more. These unemployed workers presumably are receiving government support as they await the reopening of their workplaces and are not transitioning to work in other industries.

It is readily apparent that broad monetary and fiscal stimulus is of limited use in an economy where most industries are prospering but a select few continue to lag. On the one hand, the unprecedented surge of house sales and prices across the country on top of years of rapid growth in some cities (notably Toronto and Vancouver) has distorted Canada's capital stock. According to Statistics Canada, the stock of capital in residential structures has surpassed non-residential structures for the first time ever (Canada's stock of non-residential capital itself is large because of our investment in natural resources and manufacturing).

Meanwhile, lagging industries are having difficulty adjusting to social distancing, whether in hotels, restaurants, office building, mass transit, airlines, or spectator events. This problem cannot be addressed by low interest rates or deficit spending; no amount of stimulus will allow or entice customers to return until the virus is controlled or eradicated. Instead, the unprecedented stimulus is boosting sectors of the economy, notably housing, where supply is struggling to keep up with demand.

A more sensible approach would be to scale back economy-wide stimulus, reducing the upward pressure on prices in many sectors, and provide direct aid to the easily-identifiable sectors of the economy where demand is structurally impaired.

Inflation exceeds forecasts

Consumer price inflation in April exceeded the consensus forecast of economists. In the US, prices rose by 4.2 percent – the most since September 2008 – while in Canada the consumer price index (CPI) rose by 3.4 percent, its highest year-over-year reading since September 2011. The surprising results reflect both the chronic difficulty economists have forecasting and the impact recovering from the pandemic has on boosting demand while supply remains disrupted by shortages of material and workers.

While overall demand has returned to near its early 2020 level, its sectoral distribution shows a marked shift from personal and business services to housing, natural resources, and retail goods. However, supply has not shifted between these two broad sectors, simultaneously creating shortages and under-employment. The rapid recovery of demand in 2021 is being fuelled by an international economy driven by growth in the US and China, a huge reservoir of pent-up demand and savings carried over from the lockdowns in 2020 and early 2021, and unrelenting monetary and fiscal stimulus. The housing market is Exhibit A for monetary stimulus, with even the Governor of the Bank of Canada admitting soaring house prices are "not normal," hardly surprising since there is nothing normal about record low interest rates.

Meanwhile, it is becoming increasingly clear that the pandemic has disrupted the supply of products people want to buy. Surging global demand caught many commodity markets off guard, sending metals and lumber prices to record highs. Equally problematic is a global shortage of semiconductor chips after the industry (mostly based in Asia) scaled back production early in the pandemic just as demand for its product exploded as the world went online. Chip shortages have crimped the production of everything from automobiles to TVs. Shortages were clearly a factor in the US auto market, where buyers unable to order a new vehicle instead turned to the used vehicle market and bid up prices by 22 percent (the split between new and used vehicles is not available in Canada, but the same process is very likely happening here).

Shortages are also appearing in the labour market. While the recovery of employment to pre-pandemic levels is far from complete, employers everywhere bemoan a lack of people available to work. US Federal Reserve officials say they are lowering job forecasts as business hiring plans continue to outstrip the supply of people willing or able to work (starting in June, 24 states in the US are reducing unemployment benefits to encourage a return to work). Evidently many older workers who left the labour force last year have either retired permanently or are afraid to return until the virus is eradicated. Meanwhile, at least some younger workers are happy to live on generous government subsidies as long as possible.

Another consideration in analyzing the April inflation rate is that supply shortages mean the official statistics probably understate inflation. The CPI does an excellent job of measuring prices in normal times, with the consensus of experts that the CPI usually slightly overstates inflation.[1] However, the CPI is not designed to capture the impact of supply shortages, partly because shortages are rarely a problem outside of centrally planned economies. Since waiting is a cost for consumers and therefore represents a price increase, both choices are equivalent to higher prices. However, this does not show up in the CPI which only compares prices of the same products over time.

Given the difficulty of forecasting in the current environment, any assurances the spike in inflation is temporary can be questioned. Inflation, as measured by the CPI, is going to continue to rise this year because of the soaring cost of commodities and housing. Whether higher inflation continues into next year depends on whether higher prices become embedded in expectations and wages and when and how fast stimulus is withdrawn. One implication of the inability of supply to keep up with demand is that some of the artificial stimulus could be withdrawn without slowing the recovery, while beginning the process of normalizing monetary policy and financial markets.

The trouble with economic forecasts

Economist's forecasts are missing the mark more than usual in the current environment. The miss on inflation follows an even larger error in forecasting the US jobs report for April, when the consensus forecast of an employment gain of one million far exceeded the actual increase of 266,000. Economists simply have little understanding of how an economy performs in a pandemic when government edicts can change the fortunes of an industry overnight and household behaviour has shifted in ways that no one predicted.

Not that economics ever had a good track record at forecasting. As the historian Niall Ferguson (2021, 76) observed recently, "economic forecasters are in reality far worse at their jobs than weather forecasters." Economists routinely miss major events such as an economy's run into recession. For example, the IMF predicted only 17 of the 469 downturns in national economies between

1988 and 2019, while wrongly predicting recessions that did not occur 47 times (Shiller 2019, xiv). A Philadelphia Federal Reserve Bank review of professional forecasts of a decline in GDP one year in the future found them to be "worthless" (Shiller 2019, 301). Economists have trouble forecasting growth outside of turning points: a study of IMF growth rate forecasts two years in advance found the average forecast error was 2.8 percentage points between 2000 and 2014 (Banerjee and Duflo 2019, 6).

Despite their poor track record, the demand for economic forecasts remains strong. As the economist John Kenneth Galbraith once quipped, "Pundits forecast not because they know, but because they are asked."[2] Mervyn King, the former Governor of the Bank of England, observed: "There is a seemingly insatiable demand for economic forecasts" (King 2016, 122). As an example, he recounted the outraged reaction of many Members of Parliament when he truthfully told the Treasury Select Committee "I don't know. I don't have a crystal ball…They thought it was my job to have an official crystal ball in order to tell them what the future held" (King 2016, 122-123). Paul Volcker, another legendary central banker from his days as Chair of the Federal Reserve Board, reminds us about the "failure of economists to make reliable forecasts, the essence of a 'real' science'" (Volcker 2018, 162).

Economists simply have little understanding of how an economy performs in a pandemic.

The reason economists have such a poor track record of forecasting was aptly summarized by Denis Healey, the UK Chancellor of the Exchequer. In his November 1974 economic statement, Healey observed that the origin of economic forecasts "lies in the extrapolation from a partially known past, through an unknown present, to an unknowable future according to theories about the causal relationships between certain economic variables which are hotly disputed by academic economists, and may in fact change from country to country or from decade to decade" (quoted in Jones 2012, 246). There are many things unknowable about the future that affect the economy, including the course of innovation and knowledge "and future knowledge cannot be gained before its time" (Hutchison 1977, 10).

Hutchison also notes that even if the tools available to forecasters have improved with advances in computing power, what economists are trying to forecast is becoming "more imprecise, speculative and uncertain" (Hutchison 1977, 29). This is because technological change is accelerating, production relationships are more complex due to globalization, higher incomes make both consumption and the supply of work of households more difficult to predict, and growing government interventions in the economy and society result in more unintended and unpredicted consequences. His conclusion is that economics suffers from the most dangerous form of ignorance, which is

“ignorance regarding the limits and limitations of one’s knowledge” (Hutchison 1977, 5).

One of the problems with the Keynesian prescription of fiscal stimulus is that it presumes an ability to forecast accurately and then for policy to be nimble enough to react quickly. Finance Minister Freeland quotes Treasury Secretary Janice Yellen that the lesson of the slow recovery after the 2008-2009 financial crisis was that fiscal stimulus was withdrawn too soon. This is debatable; countries that withdrew stimulus quickly such as Germany and Canada had above-average rates of recovery.

More importantly, policy-makers appear to be drawing lessons from managing the aftermath of a financial crisis for managing the aftermath of a pandemic. There is a rich literature that shows how financial crises have a depressing effect on growth for up to a decade, as past excesses in debt are worked down and resources are reallocated after years of over-investment. Conversely, the pandemic appears to have few lingering effects on the macroeconomy; growth is rebounding quickly in most sectors, and therefore maintaining a high level of stimulus risks raising demand above what the economy can supply without fuelling higher prices.

About the author

Philip Cross is a Munk Senior Fellow at the Macdonald-Laurier Institute. Prior to joining MLI, Mr. Cross spent 36 years at Statistics Canada specializing in macroeconomics. He was appointed Chief Economic Analyst in 2008 and was responsible for ensuring quality and coherency of all major economic statistics. During his career, he also wrote the "Current Economic Conditions" section of the Canadian Economic Observer, which provides Statistics Canada's view of the economy. He is a frequent commentator on the economy and interpreter of Statistics Canada reports for the media and general public. He is also a member of the CD Howe Business Cycle Dating Committee.

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Endnotes

1 For example, according to Heravi and Silver's summary, three major investigations of measurement bias in the US CPI all found that adjusting for quality changes was the largest challenge (Heravi and Silver 2017, 235). Reinsdorf and Moulton (1997, 431) estimate the upward bias of the US CPI was about 0.8 percent a year; the Bank of Canada estimates the bias here is about 0.5 percent (Sabourin 2012, 1).

2 Less charitably, Galbraith also said "The only function of economic forecasting is to make astrology look respectable."

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