Will spare capacity swamp supply chains?

Chief economist's comment

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- Durable goods demand has been exceptionally high. It is likely to fall. This will slow GDP and lead to lower inflation.
- The biggest error in analyzing the economic impact of the pandemic is to try and treat the past 18 months as a normal cycle.
- There was nothing normal about economic activity in 2020, and there is nothing normal about economic activity in 2021.
- This year has seen an all-time high in the supply of goods. There has been an extraordinary surge in demand for consumer durable goods. The strength of goods demand is not likely to last.
- Historically, a surge in consumer durable goods demand is met with a reaction, often taking demand below trend. The pattern of savings, and the speed with which savings are drawn down will dictate the speed of demand normalisation.There is a possibility of surplus supply in 2022.

Source:Prism

Consumers have been buying huge amounts of durable goods—things like televisions and washing machines. Global manufacturing has had to produce more than ever before to meet this demand, yet even so demand has overwhelmed supply in the short term. But this boom in demand for goods is unlikely to last. Consumers are likely to behave as they do when wars end, or with a tax rebate. The surging demand for consumer durable goods could be replaced by *below* normal demand in late 2022, and potentially spare capacity. Consumers will still spend, but there are only so many washing machines a person realistically wants to own.

What has happened?

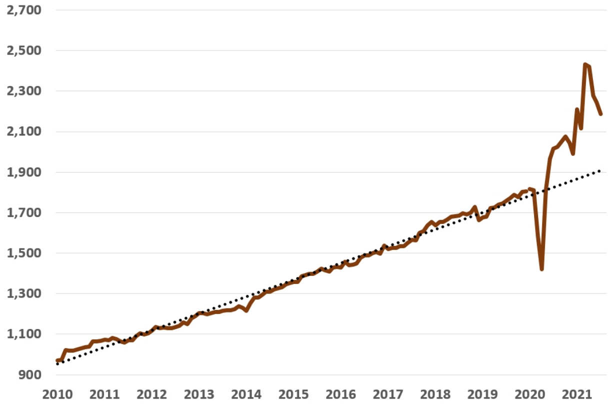
In developed economies, three separate effects have conspired to create a surge in demand for durable consumer goods.

1. During lockdowns, it was more difficult to purchase durable goods, and people delayed their spending (economists call this “pent-up demand”).
2. During 2020 restrictions on spending money on goods and services meant people had more income than they could spend. They were forced to save money, which gave them an unexpected windfall of spending power.
3. As restrictions eased, people found it easier (or were more willing) to spend on goods rather than services, and there was a huge shift in consumption patterns.

These three trends have driven an extraordinary level of demand for consumer durable goods. In the US, real consumer spending on durable goods has been over 25% above trend. Europe has also seen real retail sales of durable goods that far exceed normal levels.

Not normal demand—US

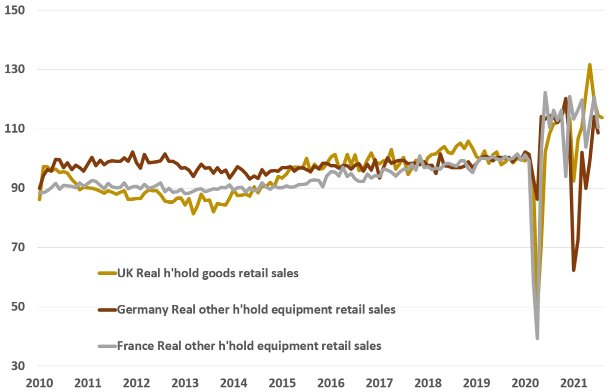
US real durable goods spending, 2012 chained dollars, SAAR



Source: Haver, UBS

Not normal demand—UK and Europe

Real household equipment retail sales, 2019 average = 100

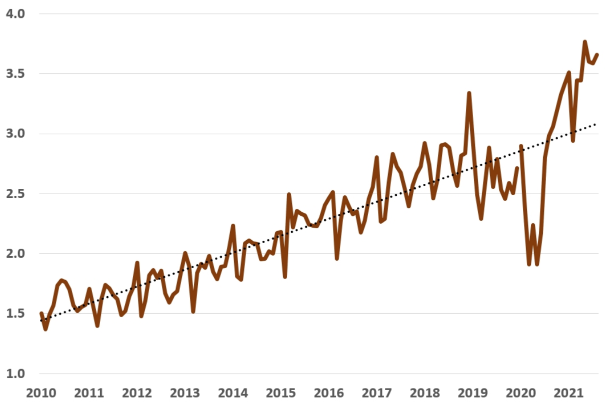


Source: Haver, UBS

Less developed markets have also benefited from the exceptional demand of developed economy consumers. Global supply chains have been supplying goods at an unprecedented pace. Furniture exports to the US, for example, have soared.

Not normal demand—US imports

Value of household furniture imports, USD bn



Source: Haver, UBS

What happens next?

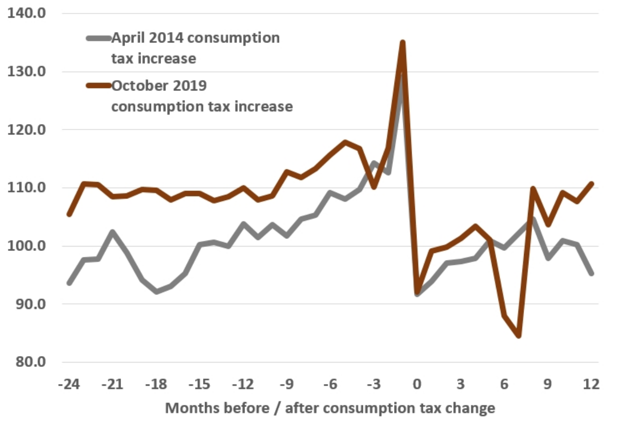
The first two trends of pent-up demand and forced savings are things that we have seen before. The shift from spending on services to spending on goods is a lot more unusual. But overall, consumers are likely to follow the patterns of the past. That would mean the robust demand today will give way to weaker demand tomorrow.

Durable goods consumption will likely slow through all three effects. Once the pent-up demand has been satisfied, there is no further need to spend. The person who has bought a new washing machine this year does not rush to buy another new washing machine next year. Savings can only be spent once. As the savings are used, consumers will have to return to living within their income, or their income plus credit growth. And as restrictions ease there are already signs of a switch back to favor spending on services rather than spending on durable goods. These factors are likely to push consumer durable goods demand below trend at some point in 2022.

This pattern of above trend then below trend demand is quite common. One parallel is around Japan's consumption tax changes. In advance of a tax increase there was a rush to purchase durable goods and demand soared above trend. After the tax change, durable goods demand went below trend.

Durable goods demand reaction

Japanese real durable goods consumption around tax changes (2015=100)

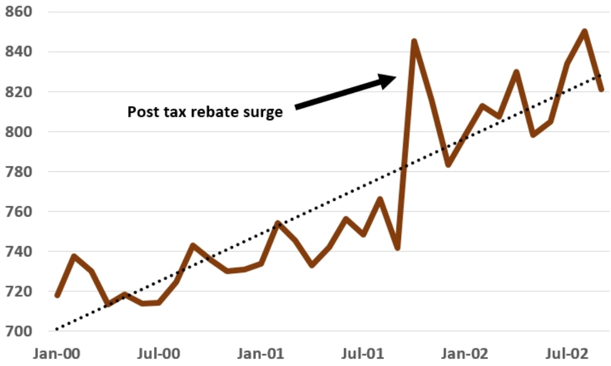


Source: Haver, UBS

The US tax rebate in 2001 also showed this pattern. The rebate was relatively small (at USD600 per person), paid between July and September. Durable goods sales spiked in October 2001, and then just as quickly sank back.

Durable goods demand reaction—US

Real US durable goods spending around USD600 tax rebate, 2012 chained dollars, SAAR



Source: Haver, UBS

Exactly the same pattern was seen after the second world war. US consumers accumulated savings during the war. As rationing lifted, they were able to spend those savings (and with a marriage boom, they chose to spend on household durable goods). Sales of durable goods boomed, and then corrected. In this case the level of demand was still higher than before the war—the trend shifted up, but the level was below the immediate peak. This may be the pattern in the US today, as savings acquired during the pandemic were considerable.

This all suggests that durable goods demand is likely to slow significantly in the coming months, as savings diminish and people spend money on having fun.

What does this mean for growth?

Logically slower consumer demand means lower GDP demand—and this is likely as demand for consumer durable goods normalizes. However, there are two factors to bear in mind. First, manufacturing production is likely to slow later than demand for consumer durable goods. This is because retailers have reduced inventories in an attempt to meet the exceptional demand levels, and those inventories will be rebuilt when consumer demand slows.

Second, overall consumer spending will slow less than the demand for durable goods. This is because some of the slowdown in spending on goods is driven by a shift to spending on services—a trend already emerging in the United States.

It is unlikely that there is an abrupt slowdown in GDP growth as a result of the normalization of demand. However, there is clearly going to be some slowdown. Moreover, manufacturing sentiment-based indicators are very likely to overreact to the normalization of demand, and could present a more sensational picture than the economic reality.

What does this mean for inflation?

A demand surge typically creates one of two reactions from companies. Where a company's brand is important, or where customers are expected to keep coming back, companies tend not to raise prices. A price increase in the face of a demand surge is not viewed as "fair" by customers (however much this may defy the economic laws of supply and demand). Companies that need a good reputation or customer loyalty do not want to be seen as unfair, and so will tend to lengthen the time it takes to deliver goods to customers as an alternative to raising prices. The slowdown of durable goods demand is therefore not likely to impact inflation for these companies, as the surge in consumer demand did not particularly create price increases.

Where a good is commoditized, or where there is no prospect of a repeat purchase, a seller will use a demand surge as an excuse to get as much money as possible out of the buyer. Customer loyalty does not matter, and so it is in the seller's interest to raise prices so that the demand surge is rationed to balance available supply. This is what has driven the temporary spikes in inflation in developed economies. Used car prices in the US are an excellent example of a product that is mainly one-time sales, and which has seen a demand surge.

As demand for durable goods normalizes, sellers of these products will not be able to get as much money from their buyers, as supply and demand will come into balance. Indeed, if demand for these durable goods dips below trend, their prices could fall (deflation).

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Version B/2021. CIO82652744