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Rising Prices Do Not Necessarily Mean Inflation

Instructors in economics principles courses delight in providing examples where the demand for apples rises relative to oranges, hence increasing the price of apples. The rising apple prices eventually elicit more production of apples, putting downward pressure on apple prices. Similar responses occur in the orange market. This is "price theory in action" with prices and production adjusting according to market signals. How quickly prices and production change, depends on the ease of bringing new resources into the market (often from other uses). Economists term this responsiveness as "elasticity", and this peculiar terminology may be one of the major reasons why non-majors hate economics courses.

Since March 2020, the COVID-19 pandemic put unusual pressure on the normal market mechanisms. New car sales plummeted which led to a dearth of used car trade-ins, so used car prices soared. Stuck in their own homes, but (in many cases) with money to spend, large numbers of consumers planned home improvement so lumber prices soared. Fueled by continuing low interest rates, many put bids in on new homes. In many cases (again) prices soared. All of these have largely been "goods events," and as supplies adjust, they can be expected either to level or fall.

In contrast, services took a big hit. People stopped getting haircuts (leading to lots of long hair and dark roots), going to restaurants (take-out yet still), and to dentists, and doctors. Dry cleaners, theaters, cinemas, and concerts (all services) saw their markets dry up. Even into Fall 2021, there has not been upward pressure on service prices. The prices of goods have risen relative to those of services. Relative prices change. This is not necessarily inflation.

Because Americans buy so much from abroad, the waterborne port services have been hard put to keep up with all of the imports. Loading and unloading containers from cargo ships is a labor-intensive endeavor. More ships, more labor, and observers are seeing more ships waiting to use ports since the second oil price crisis of the late 1970s, when coal carrying ships (or "colliers") were sitting outside the ports of Baltimore and Norfolk, waiting to be loaded. Again, the responsiveness has been slow (small elasticity), and delivery has been slow as well.

Where does COVID-19 come in? These bottlenecks and price run-ups were <u>not occurring</u> during an economy with less than 4 percent unemployment in early 2020. Fewer people are working and consumers in the United States have seen resulting supply chain issues including limited variety and slow delivery. One might expect these issues to decrease if and when COVID-19 has been brought down to low levels.

Inflation is measured with a "market basket" of thousands of goods. Updated monthly, if a market basket cost $1,000 (denominator) on November 1, 2020 and $1,040 (numerator) on November 1, 2021, this would indicate an inflation rate of 4 percent. Because our 2020 price level was depressed due to the pandemic, "last year's denominator" (from 2020) was depressed, leading to recent "year over year" inflation rates over 5 percent. An inflation rate of 5 percent implies that all goods went up by 5 percent. The discussion above suggests that such was not the case.

Other aggregate measures yet (still) do not reflect large amounts of expected inflation. Ten-year interest rates (as of October 27) are at 1.52 percent, and housing market participants can borrow money for 30-year fixed rate mortgages at a rate of about 3 percent. These interest rates do not reflect heavy inflation expectations. Your blogger's first 30-year mortgage in 1978 was 10 percent. His last one (paid off in 2013) was over 6 percent. Rates of 3 percent do not reflect high inflationary expectations.

We have seen major economic shocks since March 2020 that rivaled if not exceeded those of the Great Recession (2007 – 2009). They have led to over 750,000 deaths in the United States, an uprooting of the education system, and a serious public health dilemma in terms of providing the necessary curative and palliative goods, and convincing the population to use them. Inflation is a potential issue but at least at this time, not as important as the others.

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