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Systemic Risk, Inflation and Growth: What has the pandemic taught us?

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Overview

U.S. Treasury Secretary and former Chair of the Federal Reserve Board Janet Yellin recently admitted that she did not understand the causes of the exceedingly high inflation currently plaguing the U.S. economy. This shouldn't come as that big of a surprise given the fact that the economy is demonstrating signals that simply don't match up with mainline economists' understanding of how it works. As the stock market continues to decline and inflation fails to abate, the Federal Reserve is signaling additional interest rate increases. The Fed seems to be following an old rule: "if inflation, then increase interest rates." Just today (15 June) the Fed has announced an increase of 75 basis points, the largest single increase in rates since 1994.

The major flaw in that response lies in that very misunderstanding of the nature and causes of the current inflation. The traditional policy of raising interest rates in response to inflation assumes that the latter is present due to the "overheating" of an economy producing at or near full capacity, and hence, driven by excess demand. If we look, even from a distance, however, we find that this doesn't fit with the current situation, in which we see the following:

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January Dates To Remember:

1st: HAPPY NEW YEAR

16th: Martin Luther King Day

- Over 11.4 million unfilled job vacancies, 4.5 million of which have developed since the beginning of the COVID pandemic.[1]
- Virtually stagnant ***real*** employee earnings growth since the beginning of the pandemic shutdown, despite the increase in job vacancies.[2]
- Just under 4.0 million people who have left the labor force since the beginning of the pandemic.[3]
- A return to the pre-COVID trend of slow growth in the real U.S. GDP of about 1.5 to 2.0 percent.[4]
- Supply chain-driven production shortfalls in many key manufacturing industries, including food and automobiles.

The bottom line: the U.S. economy is anything BUT overheating, and additional interest rate increases may have an impact akin to that of giving an already sedated medical patient additional doses of morphine.

While the COVID pandemic is blamed by many as the root of this problem, that event has merely served as an accelerant in hastening the coming of the future in which we currently exist. It began over 50 years ago. The fact that these changes have been 50 years in the making means that a solution to our current economic dilemma will not come quickly.

The Problem

The explanation for what we are experiencing in the current economy comes down to two main points: 1) the immediate cause of our current inflation is that over $6 trillion in money supply (M2) has been created since the beginning of the pandemic, while at the same time the supply of consumer goods and services has decreased as a result of the impacts of the pandemic shutdowns and discontinuities; 2) problems with the supply chain lie in the fact that both the U.S. and the global economies are no longer adequately diversified, and hence, are subject to much greater forces of systemic risk. The pandemic both accelerated and magnified the impact of that systemic risk.

Coming into the 1970s, the U.S. economy needed to be rebuilt. The global (offshore) economy was already being rebuilt after the destruction of the second world war. The oil embargo of 1973 ended up serving as the catalyst for the changes in the U.S. that began in that decade. The rebuild has taken place both steadily and in spurts over the past four decades. The four main stages correspond to: 1) the corporate restructuring of the

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[1]Organization for Economic Cooperation and Development; accessed on Federal Reserve Bank of St. Louis Economic Data.
[2]U.S. Department of Labor, Bureau of Labor Statistics.
[3]Ibid
[4]Federal Reserve Bank of St. Louis, Economic Data
[5]Federal Reserve Bank of St. Louis, Economic Data

manufacturing base in the 1980s; 2) the business process reengineering and introduction of internet commerce in the 1990s; 3) the implementation of additional information technology and automation in the 2000s; and the monetization of the economy and growth of e-commerce following the credit market meltdown of 2008. The consequences of the rebuild include but have not been limited to the following:

- Global sourcing under just-in-time inventory and production management strategies.
- Increased employment of information technology and automation replacing human capital resources (i.e., fewer jobs in many industries).
- Leverage-driven consolidation across most industries.
- Declining long-term growth in real private investment spending.
- High rates of cash payouts to investors by way of either dividends and/or share repurchases.
- Widening disparities in the distribution of income between the upper 5% and the rest of the household base.

One of the major consequences of this U.S. ***and*** global economic rebuild is that we lack adequate diversification and are now exposed to greater concentrations of risk. One of the best examples of this is what has happened because of the breakdown in the supply chain of silicone chips.

Chips have become basic elements of virtually any durable good. The typical automobile, for example, contains up to 400 of these individual components. As the global economy engaged in its 50-year rebuild process, chipmaking consolidated into a very small number of large operations. The combination of the pandemic and a single building fire has disrupted the supply chain so badly that U.S. automobile production is down by almost 3 million units per year. Each of the major U.S. automakers currently has open lots full of product that would be finished and out for sale but for the availability of the chips.

The impact of this shortage has been massive inflation in both new and used vehicle prices. This can be clearly seen in Exhibit 1, which shows the Consumer Price Index (CPI) for New and Used Vehicles and the monthly moving average of new vehicle assemblies. As shown in the exhibit, production plummeted at the beginning of the pandemic, started to come back, and plummeted again when the industry ran short of the chips necessary to complete production. The consequence has been a 30% increase in average new and used car prices.[6]

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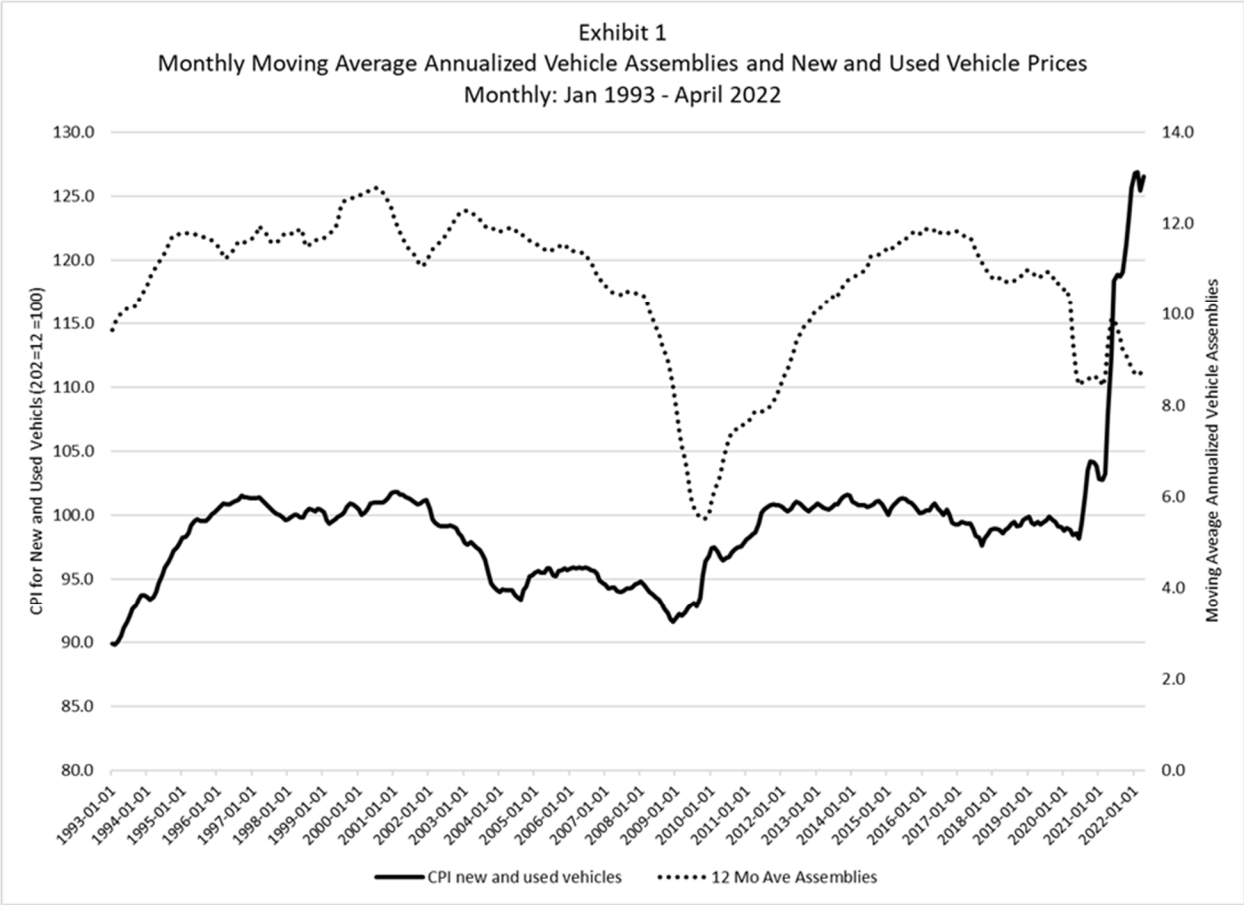
[6]Motor vehicle assemblies: Federal Reserve Bank of St. Louis, Economic Data; CPI: U.S. Department of Labor, Bureau of Labor Statistics



Money and Inflation

The Federal Reserve responded to the pandemic by dramatically expanding monetary reserves. These reserves turned into federal government borrowing and spending that has led to the creation of over $6.6 trillion in money supply (M2) between March 2020 and April 2022. There is no chance that the introduction of that level of new money would not lead to price inflation at a time when production of goods and services has been reduced because of a global pandemic. To believe that our current inflation is not due to excess money creation combined with reductions in supply is foolish. The effects are plain to see in Exhibit 2.[7]

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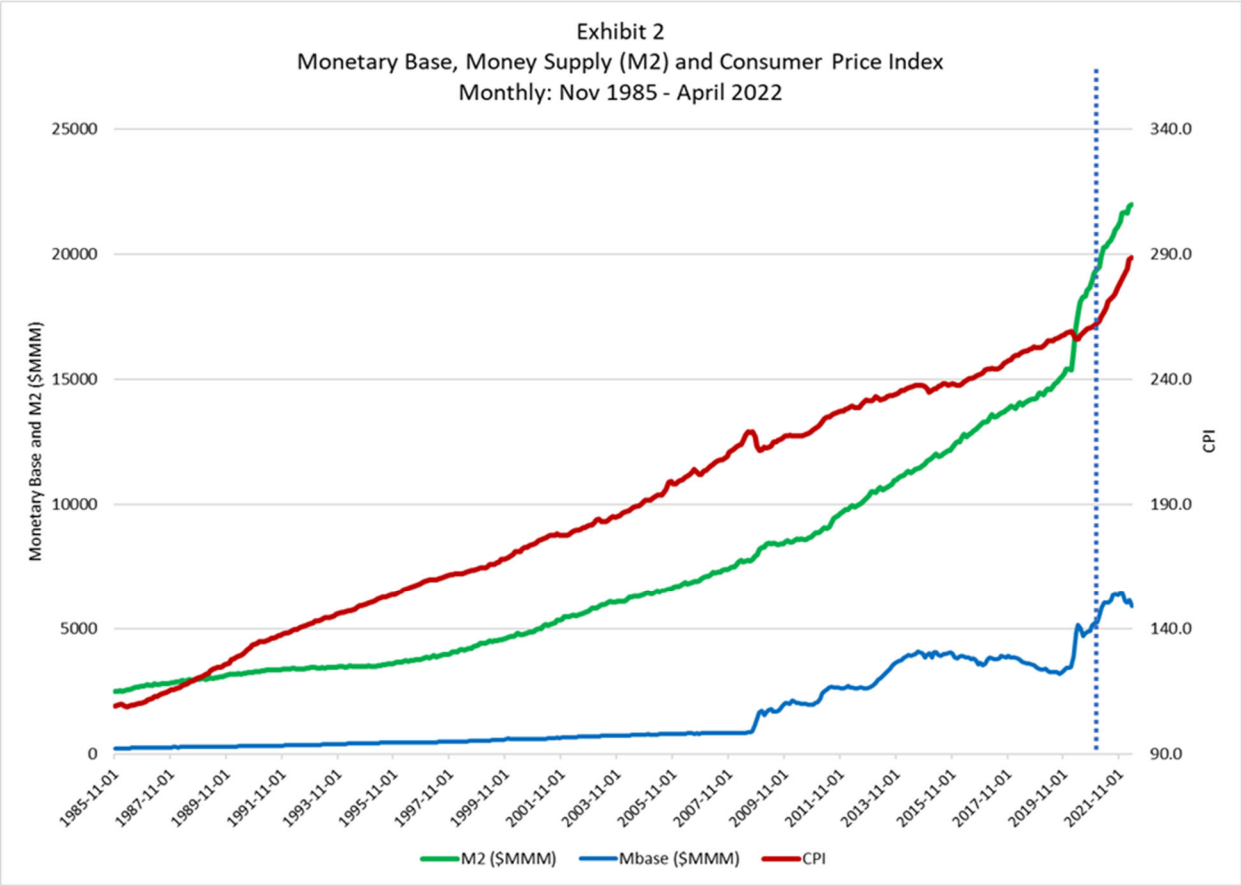
[7] Federal Reserve Bank of St. Louis, Economic Data; CPI: U.S. Department of Labor, Bureau of Labor Statistics

The Federal Reserve had engaged in a series of quantitative easing policies between 2009 and 2015 as the economy recovered from the market meltdown of 2008. As can be seen in Exhibit 2, the Fed was in the process of tapering down the reserves in the monetary system (i.e., the monetary base) up to the beginning of the pandemic. Despite this tapering, the money supply (M2) continued to grow at a fairly steady rate.

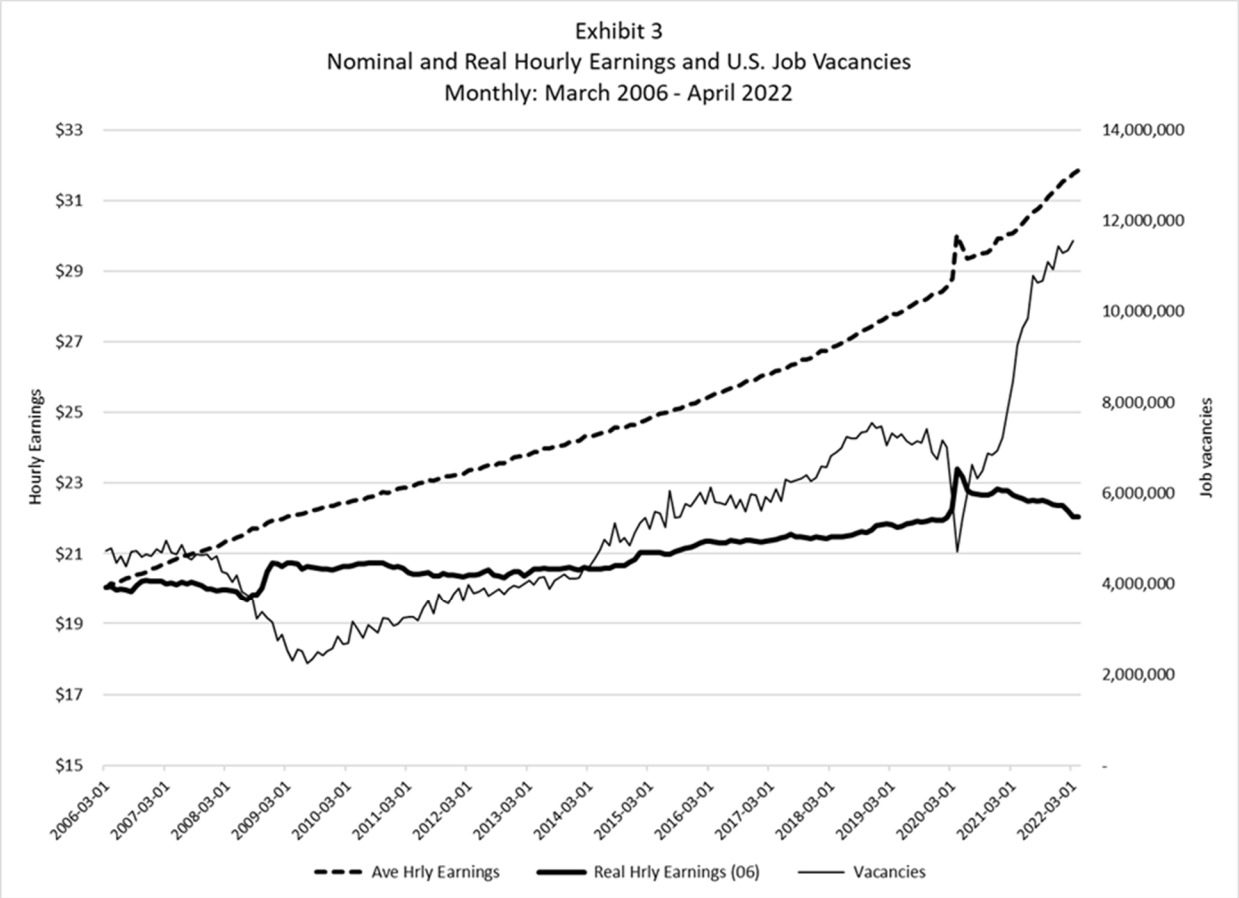
The Fed began increasing reserves almost immediately upon the shutdown of the economy in March 2020. As can also be seen in Exhibit 2, this led to dramatic growth in the money supply. The increase in the money supply was matched almost dollar-for-dollar by federal government borrowing and spending over the same time. This kept the economy from collapsing because of the pandemic shutdown. It also, however, provided consumers, businesses and investors with income and cash flow at a time where fewer goods were being produced and fewer services offered.

This is, in and of itself, inflationary. As is clear in the CPI trend during the pandemic, an initial period of deflation upon commencement of the economic shutdown has been followed by prices that have risen at an average annual rate of 5.1% since February 2020, and 8.2% in the year ending April 2022.



False Signals

Both economists and political leaders have pointed to several factors in support of statements regarding the current strength and recovery of the U.S. economy. These include claims that the unemployment rate is low, wages and employee compensation are increasing, consumer savings are high, and output is once again growing. In fact, while the unemployment rate is low, almost 4.0 million people have left the labor force. There are over 11.4 million unfilled job vacancies in the United States, over 4.5 million of which have developed since the beginning of the pandemic. While nominal hourly earnings may be rising, real hourly earnings are exactly the same as they were when we entered the pandemic shutdown.[8]



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[8] OECD

As the economy recovered from the financial market meltdown of 2009, nominal increases in hourly earnings were mostly negated by what little inflation existed over that period. As can be seen in Exhibit 3, real hourly earnings went from $20.70 in late 2009 up to $22.02 immediately prior to the pandemic shutdown. While rising during the pandemic, real hourly earnings have since returned to that same level ($22.03), even as unfilled job vacancies have been soaring. While the volume of output has fallen, corporate profit rates have often risen, in part due to lower growth in wages. Even though wages might be growing, they are not growing fast enough to keep up with inflation and they are not serving to draw additional labor resources to fill those existing job vacancies.[9]

The industries that have been hardest hit by job vacancies are retail and wholesale trade, leisure and hospitality, health care services and professional business services. There are over 1,000,000 unfilled government jobs. The south is by far the hardest hit of the four regions for which measurements are provided, with the northeast being least impacted. Details can be seen in Table 1 below.[10]

Table 1: Unfilled Job Vacancies by Industry and Region (Thousands)

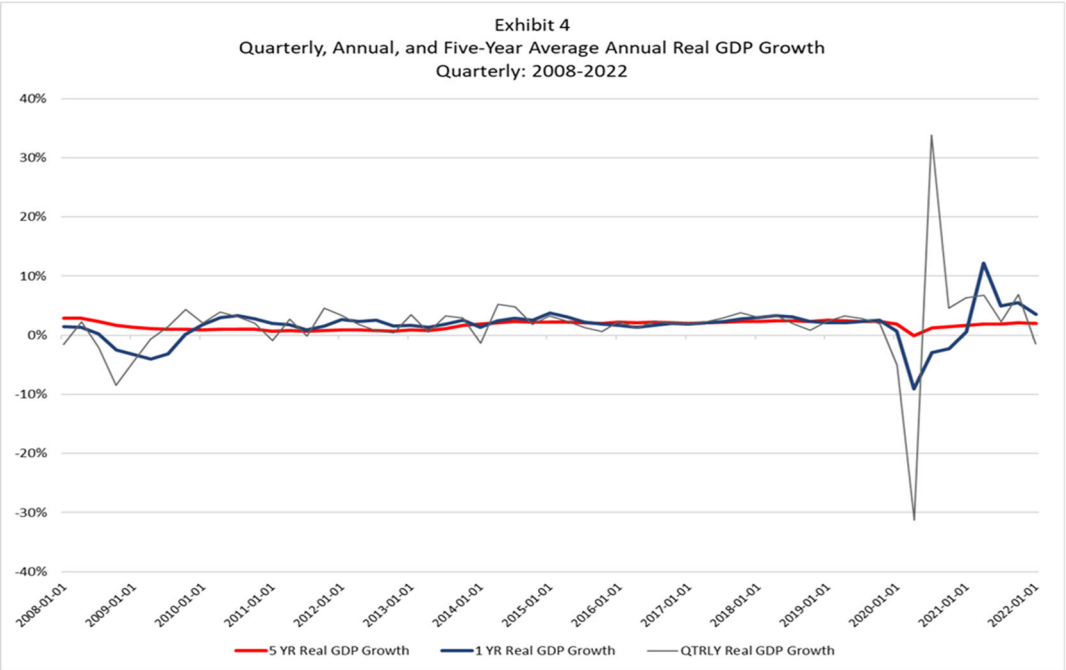
Categories	Apr. 2021	Dec. 2021	Jan. 2022	Feb. 2022	Mar. 2022	Apr. 2022P
Total (000)	9,265	11,448	11,283	11,344	11,855	11,400
INDUSTRY						
Total private	8,309	10,343	10,235	10,256	10,812	10,392
Mining and logging	22	34	37	36	45	44
Construction	329	359	383	383	426	449
Manufacturing	865	746	859	785	877	996
Trade, transportation, and utilities	1,773	1,942	1,832	1,993	2,036	1,958
Professional and business services	1,660	2,021	2,078	2,038	2,330	2,181
Education and health services	1,543	2,187	2,146	2,256	2,278	2,004
Leisure and hospitality	1,201	1,990	1,698	1,720	1,660	1,513
Other services	362	362	483	412	426	470
Government	956	1,105	1,048	1,088	1,044	1,008
Northeast	1,649	1,923	1,952	1,911	1,980	1,822
South	3,588	4,330	4,237	4,262	4,650	4,411
Midwest	2,022	2,530	2,587	2,487	2,533	2,648
West	2,007	2,664	2,507	2,684	2,693	2,519

[9] U.S. Department of Labor, Bureau of Labor Statistics
[10] U.S. Department of Labor, Bureau of Labor Statistics

These are not signs of a healthy and/or overheating economy. Rather, they are signs of a weakening economy in which the events of the past two years have both accelerated and masked the impacts of the underlying weaknesses that existed prior to the pandemic. These weaknesses, which can be characterized by low rates of investment spending and real growth, and increased levels of systemic risk, are now showing up in a big way.

The Weakness in Underlying Long-Term Growth

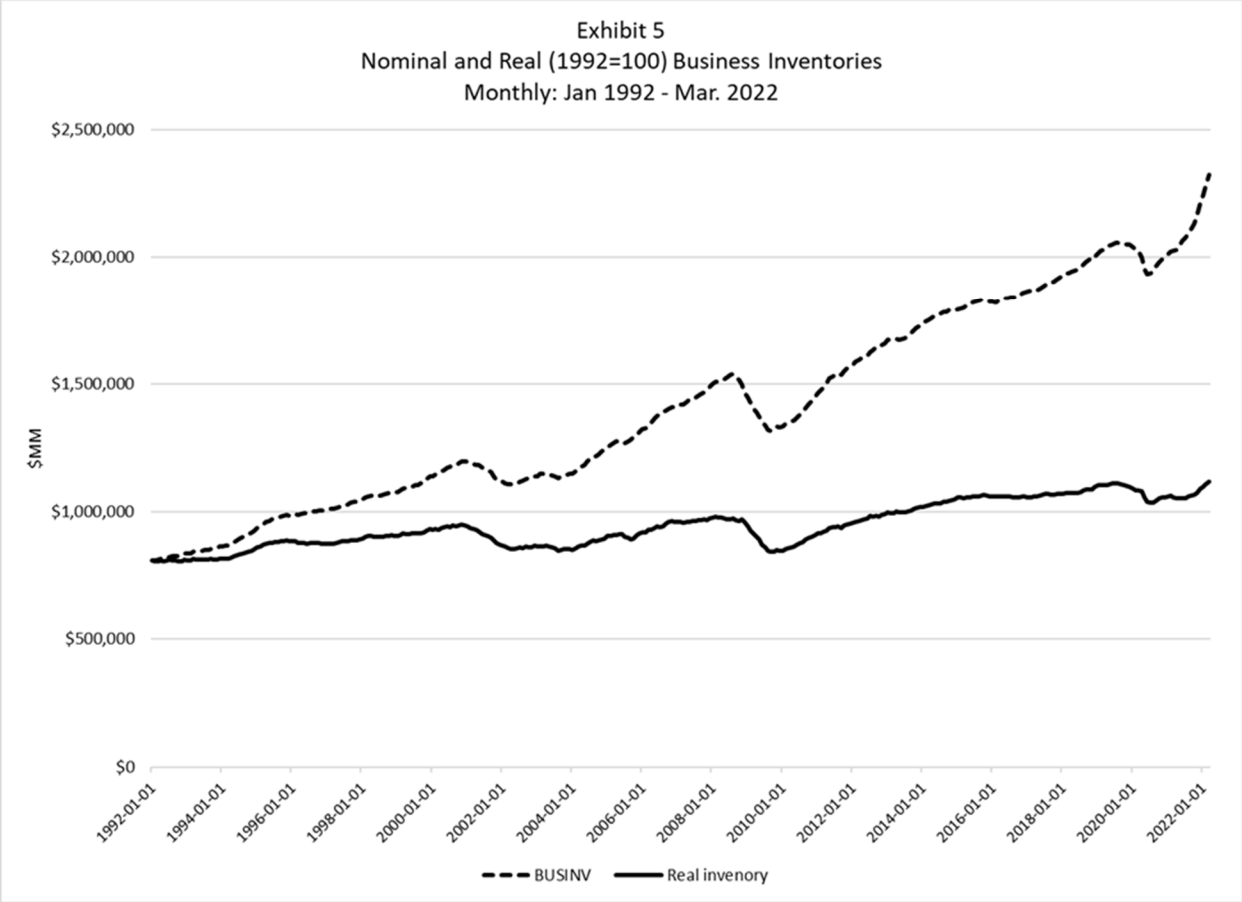
Examining different rates of real GDP growth demonstrates that the effects of the pandemic were extreme and that we are returning to a longer-term trend of slow growth. As can be seen in the real GDP growth rate measured on a quarterly basis, the economy shrunk by over 30% at the outset of the pandemic shutdown, only to recover at just over the same rate by the fifth quarter following. The annual average growth rates show a similar but more muted pattern of decline and recovery. As can be seen in the five-year average annual real GDP growth rate, however, it seems that the pandemic has had little impact on the long-term trend. We are currently returning to a trend which has ranged between 1.5% and 2.0% since the market meltdown of 2008. There is current cause for concern, however, in the fact that both the quarterly and annual growth rates continue to decline. This is a clear sign of the weakness remaining in the U.S. economy and is cause for concern as the Fed considers additional interest rate increases. Such rate increases will not serve to stimulate real growth. Rather, they are more likely to stifle growth opportunities that may currently exist. [11]



[11] Federal Reserve Bank of St. Louis, Economic Data

Another point made by economists in reference to there being a strong economy is that inventories appear to be increasing. While this may be true if we measure inventory in nominal terms, inventory measured in real terms has only recovered to its pre-pandemic level.

Inventories are measured based on a purchase price and quantity of units. As inflation has increased, so have inventory valuations. As can be seen in Exhibit 5, nominal inventories have grown by $390 MMM since they bottomed out in June 2021. In real terms, however, this increase is only $77 MMM, and only $32 MMM above its pre-pandemic level.[12]



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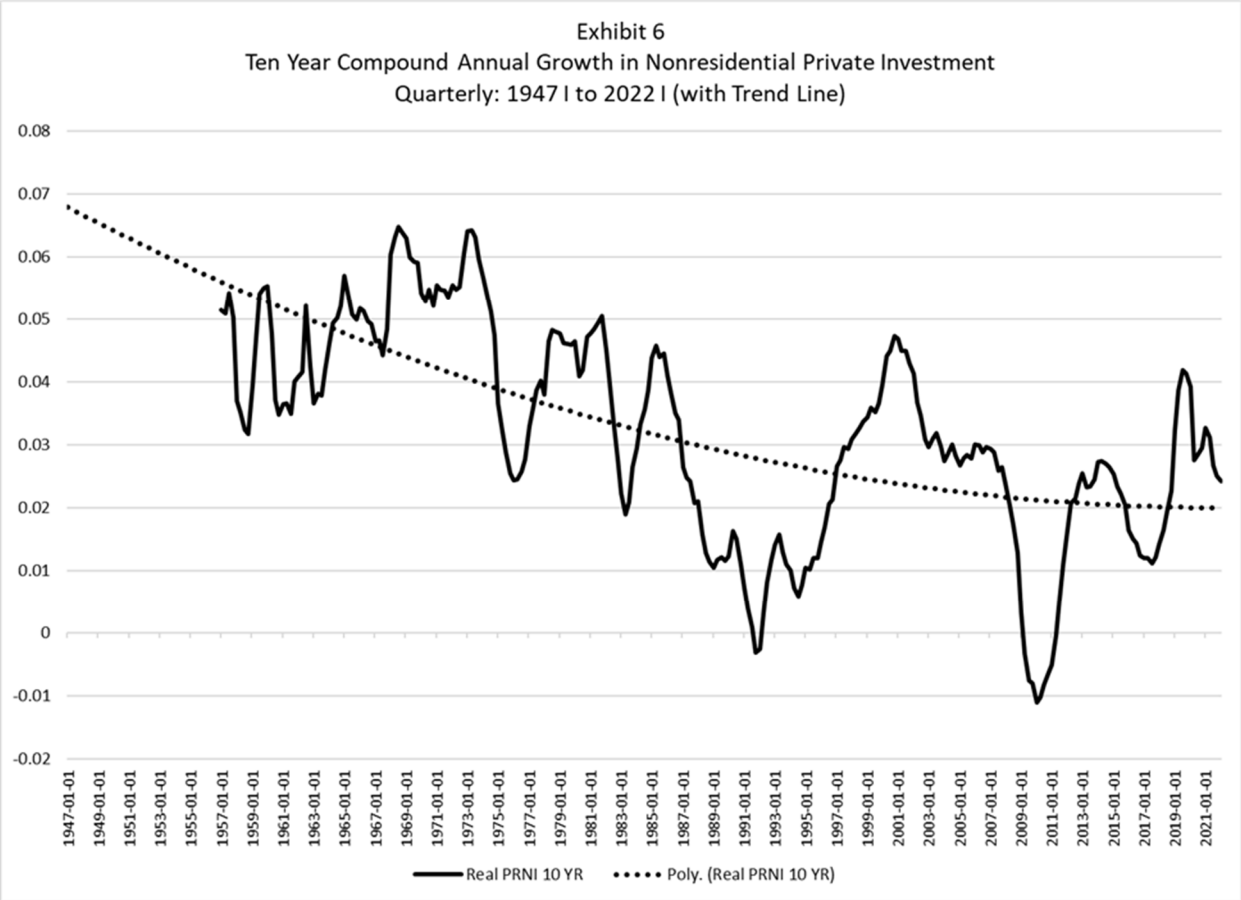
[12] Ibid.

Most economists will agree that high growth economies are typically characterized by high rates of growth in capital investment spending. Evidence of a declining rate of capital investment spending in the U.S. explains the declining overall trend in real economic growth. As can be seen in Exhibit 6, which displays the ten-year average annual growth rate in real private non-residential investment spending, this rate has tended to fall over the past 50 years. As this has fallen, the rate at which corporate cash flows are distributed back to investors by way of dividends and share repurchases has increased, as market transactions have converted many U.S. companies into giant ATM machines for investors. This lack of broad reinvestment will continue to plague the economy as we seek to recover from the effects of the pandemic, as these trends were already in place before the pandemic began.[13]



[13]Ibid.

Is there a solution?
As mentioned at the top of this article, both the U.S. and global economies have been substantially rebuilt and continuously restructured over the past 50 years. This, I would argue, has led to extreme consolidation of both the ownership and control of assets, and has limited the diversification of assets across the global economy. Limiting diversification in this case has opened the global economy to the effects of much more concentrated systemic risks, which have been exacerbated by the pandemic. As ownership, control and the location of assets continue to be organized in such a concentrated and consolidated manner, the global economy and, to a greater degree, certain national economies will continue to be subject to greater degrees of systemic risk and the impact of disruptive factors such as the pandemic and the war in Ukraine have shown.

The problems with which we are currently plagued will persist until this structure is unwound. How this can happen without significant policy intervention is problematic. Fifty years of relatively unmitigated financial market activity, fueled by liberal money creation by the major financial powers has led to concentration and consolidation of the global ownership and control of assets, and the market cannot be trusted to unwind it. The question we must address as a global society is: how much time do we have before it will collapse under its own weight? Levels of government, corporate, and individual indebtedness have never been greater, and real economic growth is slowing. How will those debts be paid?

What is interesting to note is that both the progressive and populist elements within the U.S. political environment seem to, at least intuitively, sense the presence of this same problem. The difficulty is that we can't seem to get together on a solution. The problem has become clear; we are now more vulnerable to the impacts of systemic risk both due to the lack of global diversification of assets and the heavy indebtedness of most economies. While there is not a quick fix to this problem, we continue to be vulnerable to a spontaneous collapse. This is the danger that needs to be avoided.

What does this mean for Credit Managers?
Creditors' customers have, for the past two years, enjoyed the benefits of having access to significant low-cost cash. The $6 trillion in federal spending, much of which went into supplemental unemployment compensation, interest free and forgivable payroll loans and stimulus checks, has enabled consumption and kept the corporate coffers relatively full. That has now come to an end, and the reality is that inflation is going to eat away at consumer savings and growth will continue to be slow. It is increasingly likely that we will begin to see increasing degrees of credit stretching (higher DSO and ADD) and financial distress, especially as we get into the third and fourth quarters, when the full impact of this year's interest rate increases will begin to be felt. It would now be a good time to reexamine the risk in your credit portfolios and tighten your standards for the rest of the year.

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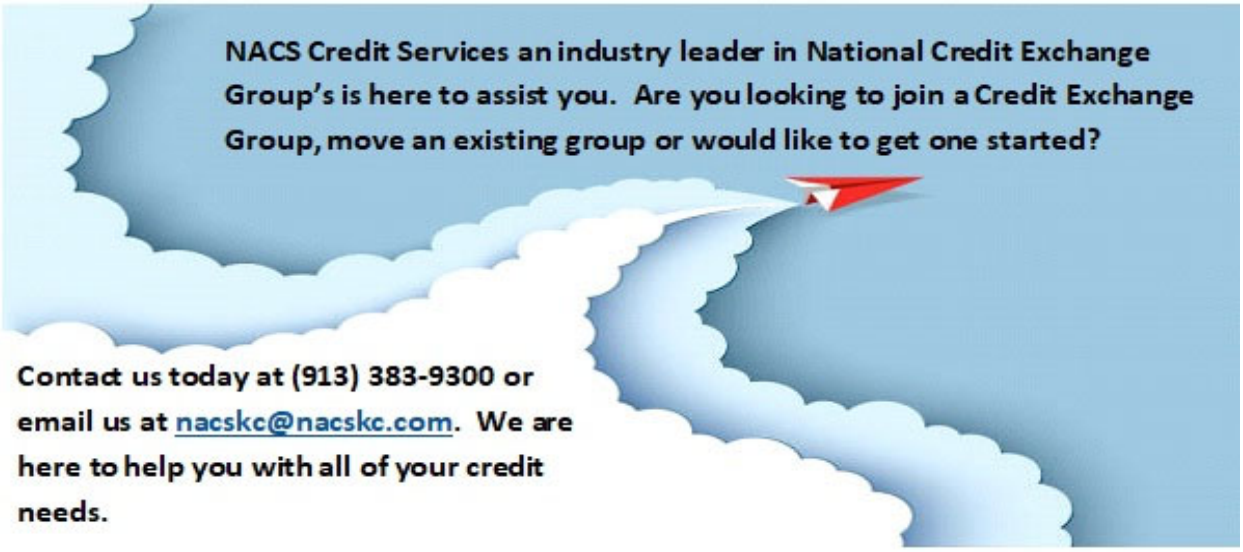
JANUARY WEBINARS

Credit Professionals Alliance has been working hard to provide our clients with the most up-to-date webinars concerning today's challenges in the credit field. Watch your email for upcoming registration information on all of the following webinars.

January 11th:	**Credit & Sales Partnership**
January 12th:	**Philadelphia Federal Reserve Economic Outlook 2023**
January 25th:	**Bad Debt Reserve - CECL is here again!**

Be sure to check out our website www.nacskc.com/education.html for additional educational opportunities as these are constantly being updated.

Are you looking for Certification and Certificate opportunities? Credit Professionals Alliance can lead you in the right direction, contact Rhonda Ross for additional information at



Educational Update:
Credit Research Foundation Webinars

January 2023

CRF offers a variety of educational programs: Proctored Courses, On-Demand Courses as well as webinars.

March 13-15, 2023	March Forum—New Orleans, LA
August 7-9, 2023	August Forum & Expo—Kansas City, MO
November 6-8, 2023	November Forum—Mission Hills, CA

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The following webinars are being offered by NCS Credit
to register for these go to: www.ncscredit.com/education-center/webinars

January 10, 2023
Webinar: The Basics of the UCC Process

January 19, 2023
Webinar: Subchapter V Bankruptcies and Impacts on Trade Creditors

January 31, 2023
Webinar: The Basics of the Lien and Bond Claim Process

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