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Financial FQs

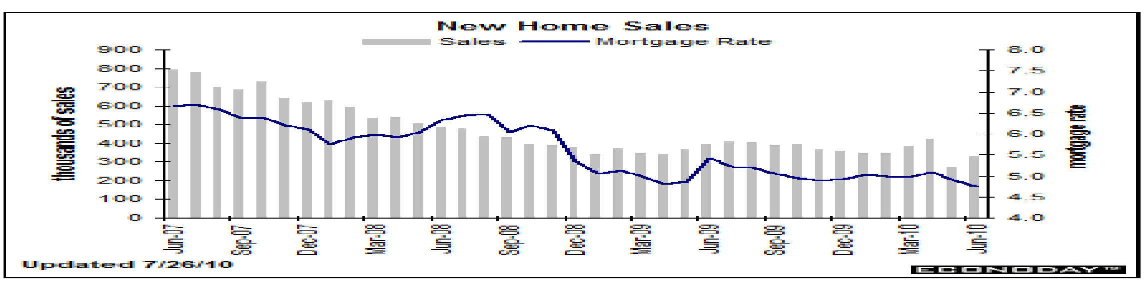
What is Pentup Demand?

We are now hearing that pent up demand is growing as the economic recovery takes its time. What is it, and what would it mean for an earlier recovery? Fed Chairman Bernanke mentioned that 'demand' could grow in a recent speech to South Carolina's legislators.

> "While the support to economic activity from stimulative fiscal policies and firms' restocking of their inventories will diminish over time, rising demand from households and businesses should help sustain growth…In particular, in the household sector, growth in real consumer spending seems likely to pick up in coming quarters from its recent modest pace, supported by gains in income and improving credit conditions. In the business sector, investment in equipment and software has been increasing rapidly, in part as a result of the deferral of capital outlays during the downturn and the need of many businesses to replace aging equipment."

Demand usually refers to aggregate demand, a key concept of Keynesian economic theory. The theory being that if consumers, businesses and governments have growing incomes/revenues, then their 'demand' for more goods and services will increase. This might seem obvious to anyone who has taken Economics 101, but it is not so obvious how to calculate aggregate demand.

We know several factors that affect pent up demand. For instance, the 2010 Harvard Joint Housing Taskforce Housing Study estimates that 15 million new households will be formed over the next decade, including immigrants. Yet new home growth has slowed drastically. And there are maybe 1 million surplus existing homes, due to the housing collapse. Yet even with the overhang, the demand for housing is bound to grow exponentially over the next decade.



New home sales in June actually rebounded 23.6 percent after plunging a revised 36.7 percent in May. The June pace recovered to an annualized 330,000 from a revised 267,000 for May and revised 422,000 for April. While the comeback is welcome, the bad news is that May's record drop was revised down notably from the initial estimate of a 33.0 percent decline. The latest figure is down 16.7 percent on a year-ago basis.

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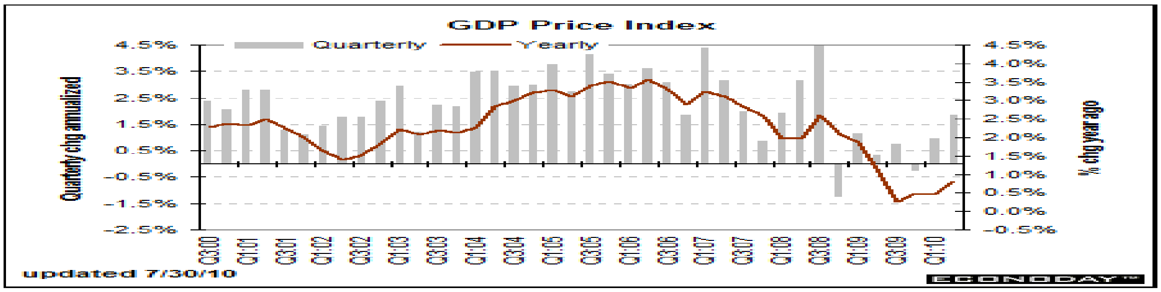
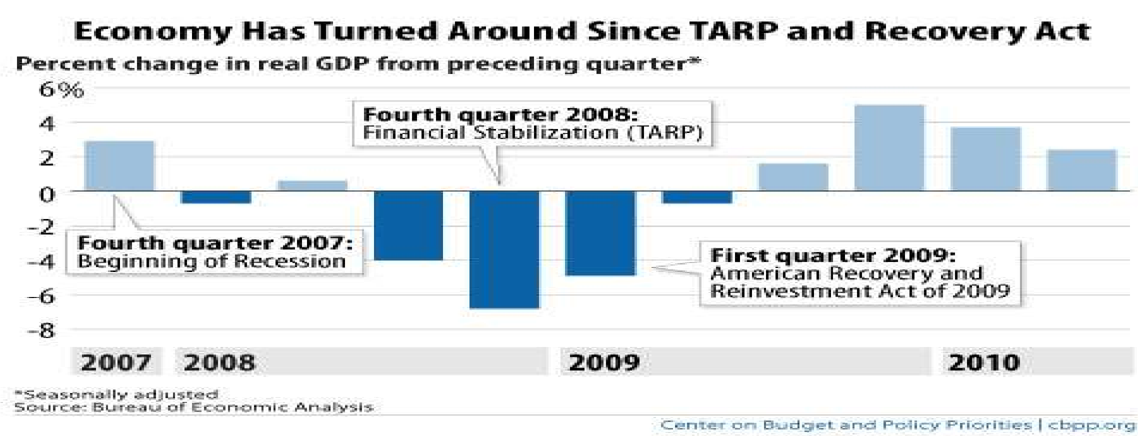
Another factor that suppresses demand is surprise, deflation. We are now in a deflationary environment, and studies show that consumers hold back from purchases if they believe prices can fall further—which creates a self-fulfilling prophecy. So rising prices also will signal increasing demand.



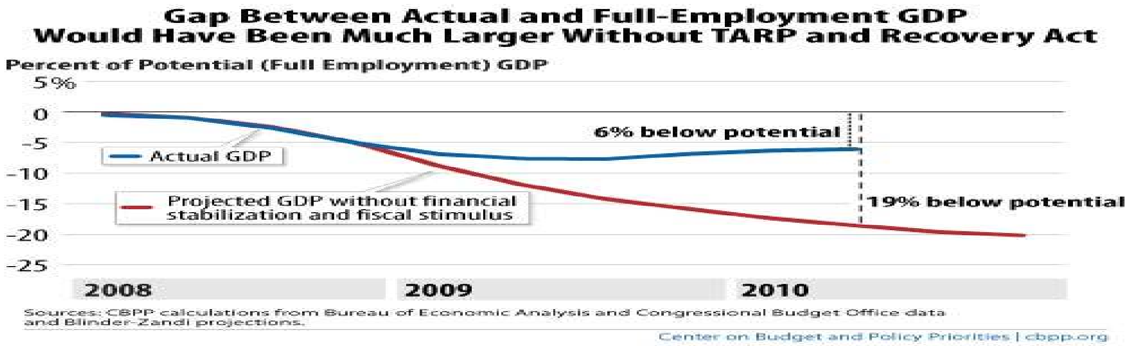
For instance, the just released second quarter Gross Domestic Product report showed falling prices. Though economy-wide inflation accelerated in the second quarter as the GDP price index rose an annualized 1.8 percent, following a 1.0 percent in the first quarter.

The acceleration in prices was due to the impact from higher imports—which signals greater demand. But the price index for gross domestic purchases, which measures prices paid by U.S. residents, increased a bare 0.1 percent annualized in the second quarter, following a 2.1 percent boost in the first quarter. The core rate excluding food and energy prices increased just 0.9 percent in the second quarter, compared with a rise of 1.6 percent in the previous quarter.

So despite all of the doomsayers, the recovery continued in the second quarter but at a moderate pace. Yes, growth is still below par but not into a double dip, thanks mainly to the TARP and ARRA programs' stimulus spending. Second quarter GDP came in at an annualized 2.4 percent growth, following a revised first quarter gain of 3.7 percent.



The latest quarter was led by a rebound in residential investment, a jump in investment in equipment & software, and by inventories. Personal Consumption Expenditures also posted a moderate gain along with government purchases.



In fact, the best measure of pent-up demand, is what is called the "output gap". The San Francisco Federal Reserve puts out that calculation. It was minus 6.1 percent in Q1 2009, but would have been as high as 19 percent without the TARP and ARRA stimulus spending, says the Center for Budget and Policy Priorities (CBPP), a non-partisan think tank.

The output gap measures how far the economy is from its full employment or "potential" level that depends on supply-side factors of the economy: the supply of workers and their productivity. During a boom, economic activity may for a time rise above this potential level and the output gap is positive. During a recession, the economy drops below its potential level and the output gap is negative. In theory, the output gap can play a central role in monetary policy deliberations and strategy.

In fact, one of the goals of the Federal Reserve is to maintain full employment, which corresponds to an output gap of zero. And it is the employment rate that best determines output, so we know that the Fed isn't going to begin to raise interest rates, until the unemployment rate declines substantially, which means that pent-up demand will begin to kick in.

Was Bernanke being too optimistic? We don't think so, nor does the stock market, which continues to rally.

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