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Remaining Steady as the Economy Reopens

Remarks by

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It is a pleasure to join the Economic Club of New York for this discussion.[1] Consumer demand is strong, vaccine coverage is expanding, and pandemic-affected sectors are reopening in fits and starts. As was the pandemic shutdown with its ebbs and flows, the reopening is without precedent, and it is generating supply–demand mismatches at the sectoral level that are temporary in nature. Separating signal from noise in the high-frequency data may be challenging for a stretch. The supply–demand mismatches at the sectoral level are making it difficult to precisely assess inflationary developments and the amount of resource slack from month to month.

Looking through the noise, I expect we will see further progress in coming months, but the economy is far from our goals, and there are risks on both sides. The best way to achieve our maximum-employment and average-inflation goals is to be steady and transparent in our outcome-based approach to monetary policy while remaining attentive to the evolution of the data and prepared to adjust as needed.

Pent-Up Demand and Supply Constraints

Last week's updated estimate of first-quarter real gross domestic product continued to show strong annualized growth of 6.4 percent. I expect a further acceleration in output growth driven by consumer demand during the current quarter as the reopening of the economy broadens.[2]

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[1] I am grateful to Kurt Lewis of the Federal Reserve Board for his assistance in preparing this text. These views are my own and do not necessarily reflect those of the Federal Reserve Board or the Federal Open Market Committee.

[2] For example, the median forecast for annualized real gross domestic product (GDP) growth in the second quarter is 7.9 percent in the most recent Survey of Professional Forecasters; see Federal Reserve Bank of Philadelphia (2021), *Second Quarter 2021 Survey of Professional Forecasters* (Philadelphia: Federal Reserve Bank of Philadelphia, May), https://www.philadelphiafed.org/surveys-and-data/real-time-data-research/spf-q2-2021. The most recent estimate of annualized second-quarter real GDP growth from the GDPNow model at the Federal Reserve Bank of Atlanta was 9.3 percent; see https://www.atlantafed.org/cqer/research/gdpnow (accessed May 28, 2021). The Blue Chip consensus forecast for the second quarter was 9.2 percent in May.

Looking through the month-to-month variation, the data suggest that very strong underlying spending growth is continuing this quarter, fueled by recent fiscal support and continued reopening. Real personal consumption expenditures (PCE) stepped down slightly in April after surging 4.1 percent month over month in March due to a strong spend-out that month of fiscal support from the American Rescue Plan. A similar pattern of moderation in April following outsized strength in March is also evident at the level of individual goods categories, including clothing and general merchandise, as well as spending at sporting goods, hobby, books, and music stores. Spending growth is strong in the pandemic-affected services sectors that are reopening, with spending at restaurants and bars increasing 3 percent in April after surging 13.5 percent in March.

The shift in the spending data from March to April provides a useful reminder to exercise caution in extrapolating from individual data points in the current environment. Growth this year is expected to be the strongest in decades as the economy bounces back from the depressed level associated with the pandemic. The supplemental savings accumulated over the course of the pandemic from fiscal support and constrained services consumption hold the potential for a substantial amount of additional spending, but there is uncertainty about how much of it is likely to be spent out this year as opposed to being spent out more slowly over time.

While the early spend-out from fiscal support in the first quarter of this year was exceptionally strong, whether that strength will be maintained depends in part on the distribution of the remaining additional savings. Spending could moderate, for instance, if the additional savings is concentrated among higher-income households that may have already completed many of their durable goods purchases and may return to pre-

pandemic consumption of discretionary services rather than making up for the underconsumption during the shutdown.[3] The timing of household consumption out of the accumulated savings will be very important for the strength of demand not just this year, but also next. Today's fiscal tailwinds are projected to shift to headwinds next year. So an important question is how much household spending will continue to support growth into next year as opposed to settling back to pre-pandemic trends, which would be an additional headwind relative to the strong makeup consumption we have seen so far this year.

During the current reopening phase, the surge in demand is hitting some sectors before the supply side has had a chance to catch up. Many businesses shrank in order to survive the pandemic and now may be struggling or moving cautiously to expand capacity. These mismatches are exacerbated in some sectors by idiosyncratic supply disruptions, such as in semiconductors, steel, and lumber. Importantly, the reopening pains associated with mismatches between demand and supply in most sectors are temporary in nature and are likely to be resolved as pent-up demand moderates and businesses hire and expand. These temporary reopening mismatches are evident in recent data on both the employment and inflation sides of our mandate.

Supply–Demand Mismatches in Inflation

The reopening dynamics are evident in the April inflation readings. I had been anticipating a notable move up in inflation beginning in April and lasting several months due to a combination of base effects and temporary reopening supply and demand

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[3] See Wendy Edelberg and Louise Sheiner (2021), "The Macroeconomic Implications of Biden's $1.9 Trillion Fiscal Package," Brookings Institute, *Up Front* (blog), https://www.brookings.edu/blog/up-front/2021/01/28/the-macroeconomic-implications-of-bidens-1-9-trillion-fiscal-package.

mismatches.[4] Core PCE inflation moved up to 3.1 percent on a 12-month basis in April, while 12-month total PCE inflation rose to 3.6 percent amid high energy prices. A significant portion of these 12-month readings reflect contributions from base effects that resulted from the pandemic-related price declines in March 2020 dropping out of the 12-month calculation.

Core PCE inflation is estimated to be 2.4 percent in April after adjusting for base effects. Apart from base effects, the underlying factors driving the increase in inflation are consistent with my expectations that we would see temporary price increases associated with sectoral supply–demand imbalances, and that the timing and sectoral incidence of these increases would be difficult to predict. While the level of inflation in my near-term outlook has moved somewhat higher, my expectation for the contour of inflation moving back towards its underlying trend in the period beyond the reopening remains broadly unchanged.

The increases in a few categories that were prominent contributors to the month-over-month April core PCE reading of 0.66 percent illustrate the role of temporary frictions associated with the economy's unprecedented reopening. Used vehicles, airfares, and accommodations together contributed nearly one-third of month-over-month core PCE inflation in April even though the cumulative weight of all three components in the core PCE basket is only 3 percent. The major contributors to the April core PCE inflation increase are not significant drivers of core inflation historically.

[4] See Lael Brainard (2021), "Patience and Progress as the Economy Reopens and Recovers," speech delivered at "The Road to Recovery and What's Next," a virtual conference sponsored by the Society for Advancing Business Editing and Writing (via webcast), May 11, https://www.federalreserve.gov/newsevents/speech/brainard20210511a.htm.

The used vehicles category contributed just over 0.1 percentage point to the April core PCE reading. On the demand side, stimulus payments and low borrowing rates have given households additional capability to purchase vehicles, and the pandemic appears to have increased the relative value of private transportation. On the supply side, with the limited production of new cars due to the semiconductor shortage, rental car companies have become buyers in the used vehicles market in order to restore the capacity they had shuttered during the pandemic, whereas they would normally be net sellers in this market. As a result, used car prices, which had followed a slight downward trend in the years leading up to the pandemic, jumped a record 10 percent in April. While these pressures may persist over the summer months, I expect them to fade and likely reverse somewhat in subsequent quarters.

Similarly, the travel-related accommodations and airfare sectors also contributed nearly 0.1 percentage point to month-over-month core PCE inflation. Prices in these categories are recovering from depressed values well below their pre-COVID levels. Prices are expected to continue to rise amid renewed summer travel, but the natural limitations to making up spending on foregone travel are likely to result in a normalization of demand growth after a few quarters, and the capacity in these sectors will likewise increase from their depressed pandemic levels as hiring proceeds.

In assessing the risk that such transitory pricing pressures get embedded in persistently high inflation, it is critical to remember that inflation averaged less than 2 percent over the past quarter-century, and that statistical measures of trend inflation ran

consistently below 2 percent for decades before the pandemic.[5] Relative to the entrenched inflation dynamics that existed before the pandemic, the sharp temporary increases in some categories of goods and services seem unlikely to leave an imprint on longer-run inflation behavior.

To be sure, I will keep a close watch on a range of indicators for any signs of an unwelcome change in longer-term inflation expectations. The measure of breakeven inflation compensation based on Treasury Inflation-Protected Securities (TIPS) suggests that the recent inflation data have not disturbed longer-run inflation expectations. Indeed, since the April consumer price index data were released, TIPS-based breakeven inflation compensation for the next five years, as well as those for the five-year, five-year-forward, have moved down, not up. The TIPS measures suggest that market participants are demanding less compensation for expected longer-term inflation than they were before the April inflation data were released, rather than more.

Survey-based measures of inflation expectations are mixed. The most recent Survey of Professional Forecasters showed an increase in median PCE inflation expectations over the next five years from 2 percent to 2.2 percent, and a smaller increase for inflation expectations over the next 10 years, from 2 percent to 2.1 percent.[6] Similar to the market-based measures, this survey measure implies a slight decline in the forward

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[5] Monthly 12-month total PCE inflation averaged 1.8 percent over the 25 years ending in April 2021. Statistical models estimate that underlying core PCE inflation ranged from 0.1 to 0.4 percentage point below the 2 percent longer-run target in the period just before the pandemic. See the point estimates for 2019:Q2 in table 1 in Jeremy B. Rudd (2020), "Underlying Inflation: Its Measurement and Significance," FEDS Notes (Washington: Board of Governors of the Federal Reserve System, September 18), https://doi.org/10.17016/2380-7172.2624.

[6] For more information on the Survey of Professional Forecasters, see Federal Reserve Bank of Philadelphia (2021), *Second Quarter 2021 Survey of Professional Forecasters* (Philadelphia: FRB Philadelphia, May), https://www.philadelphiafed.org/surveys-and-data/real-time-data-research/spf-q2-2021.

inflation measure used to proxy for longer-term inflation expectations relative to medium-term expectations. In contrast, the median response in May to the University of Michigan Survey of Consumers regarding inflation over the next 5 to 10 years moved up to a level last reached in 2013.[7] The Board staff's Index of Common Inflation Expectations, which combines the most recent signals from both market- and survey-based indicators, edged up a few basis points, reaching the bottom end of its range of values before the 2014 decline.[8]

The inflation dynamics seen over the past few decades have led to inflation that is somewhat below target and relatively stable. Inflation dynamics have generally evolved very gradually. Longer-term inflation expectations have been well anchored, so when some developments have pushed inflation above or below target, the rise has not been embedded in the ongoing inflation rate.

Supply–Demand Mismatches in Employment

A temporary mismatch between the surge in demand and a fitful supply response at the sectoral level is also evident in recent employment data. While job openings are at the top of their range, the payroll data in April were surprisingly weak. In part, the weak payrolls reflected some sectors where supply chain disruptions are limiting production despite strong demand. While motor vehicle sales were robust through April, a semiconductor shortage has resulted in production limits and the idling of a number of

[7] For more information on the University of Michigan's Surveys of Consumers, see https://data.sca.isr.umich.edu.

[8] For more information about the Index of Common Inflation Expectations, see Hie Joo Ahn and Chad Fulton (2020), "Index of Common Inflation Expectations," FEDS Notes (Washington: Board of Governors of the Federal Reserve System, September 2), https://doi.org/10.17016/2380-7172.2551.

U.S. auto plants.[9] These plant closings were evident in a decline of 27,000 jobs in the manufacturing of motor vehicles and parts in April, more than accounting for the 18,000 decline in manufacturing employment overall. Similarly, employment in construction was flat in April after increasing notably in March, as single-family housing starts dropped 13 percent over the month amid shortages of lumber that constrained contractors' activity.[10]

The lackluster 218,000 increase in private payrolls in April also reflects post-pandemic sectoral reallocation. Sectors that expanded employment substantially in response to COVID-related demand appear to be shedding jobs in preparation for a post-pandemic world, with delivery services jobs declining by 77,000 and grocery store jobs declining by 50,000.

With the most recent Job Openings and Labor Turnover Survey data showing a record 8.1 million job openings at the end of March, it appears that labor supply is lagging behind labor demand in several sectors, in part reflecting ongoing concerns about the virus and caregiving responsibilities.[11] At the time of the April survey, 2.8 million

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[9] According to media reports, a number of U.S. auto plants have been idled by the shortage of semiconductors. See, for example, Mike Colias (2021), "GM to Halt Production at Several North American Plants Due to Chip Shortage," *Wall Street Journal,* April 8, https://www.wsj.com/articles/gm-to-halt-production-at-several-north-american-plants-due-to-chip-shortage-11617893417; and Nora Naughton (2021), "Ford Prolongs Shutdowns at Several U.S. Plants Due to Chip Shortage," *Wall Street Journal,* April 21, https://www.wsj.com/articles/ford-prolongs-shutdowns-at-several-u-s-plants-due-to-chip-shortage-11619031751.

[10] According to an April survey by the National Association of Home Builders, price spikes in lumber have led 19 percent of respondents to delay building or selling homes and another 15 percent to pour the foundation and then pause building until framing was possible; see Paul Emrath (2021), "How Builders Try to Deal with Rising Lumber Prices," *Eye On Housing* (blog), April 21, https://eyeonhousing.org/2021/04/how-builders-try-to-deal-with-rising-lumber-prices.

[11] The labor force participation rate (LFPR) of women ages 25 to 34 stepped up 0.7 percentage point in March to 76 percent but was unchanged in April at that level. Likewise, the LFPR for women ages 35 to 44 moved up 0.4 percentage point to 74.5 percent in March and was unchanged in April. Research has shown that mothers are bearing the majority of pandemic-related childcare responsibilities. Labor force participation fell much less for fathers compared with other men and all women at the onset of the

people reported being out of the labor force because of the pandemic, and only 23 percent of the 18-to-64-year-old population were fully vaccinated. The vaccinated fraction of the working-age population had increased to 40 percent by mid-May.[12] Constraints related to schooling and childcare are ongoing, and these have disproportionately affected Black and Hispanic mothers and mothers in lower-income households.[13] While it is now rare for a school district to be fully remote, recent estimates indicate that just over one-half of U.S. students are in school districts that continue to operate in a hybrid learning environment rather than fully in person.[14]

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pandemic; the recovery has also been more pronounced for men and women without children. See Olivia Lofton, Nicolas Petrosky-Nadeau, and Lily Seitelman (2021), "Parental Participation in a Pandemic Labor Market," FRBSF Economic Letter 2021-10 (San Francisco: Federal Reserve Bank of San Francisco, April 5), https://www.frbsf.org/economic-research/publications/economic-letter/2021/april/parental-participation-in-pandemic-labor-market.

[12] The share of people ages 18 to 64 years old who are fully vaccinated is calculated using the percentage of people fully vaccinated on April 17 by age group according to the CDC's COVID Data Tracker (available at https://covid.cdc.gov/covid-data-tracker) and then weighting each age group based on the U.S. Census Bureau's 2019 population estimates (available at https://www2.census.gov/programs-surveys/popest/technical-documentation/file-layouts/2010-2019/nc-est2019-agesex-res.csv) for the corresponding age group.

[13] In the most recent Survey of Household Economics and Decisionmaking, 36 percent of Black mothers and 30 percent of Hispanic mothers reported not working or working less at some point in 2020 because of disruptions to childcare or in-person K–12 schooling. Similarly, 33 percent of unmarried mothers and nearly one-third of mothers with family income less than $50,000 reported not working or working less. See Board of Governors of the Federal Reserve System (2021), *Economic Well-Being of U.S. Households in 2020* (Washington: Board of Governors, May), https://www.federalreserve.gov/publications/files/2020-report-economic-well-being-us-households-202105.pdf. Research also indicates that participation for mothers in households with an annual income below $50,000 per year declined nearly 9 percent relative to pre-pandemic levels, while participation for mothers in households with incomes above $100,000 fell a little under 2 percent. For more information, see Olivia Lofton, Nicolas Petrosky-Nadeau, and Lily Seitelman (2021), "Parents in a Pandemic Labor Market," Working Paper Series 2021-04 (San Francisco: Federal Reserve Bank of San Francisco, February), https://doi.org/10.24148/wp2021-04.

[14] Staff calculations using data from the week of May 10, 2021, indicate that the fraction of students in a school district utilizing a hybrid of remote and in-person learning is 56 percent, whereas 42 percent of students have returned to fully in-person education and about 2 percent are in districts that remain in a fully remote-learning posture. These shares of students are calculated using school districts' operating statuses from the AEI's Return to Learn Tracker, where each school district is weighted based on the number of students enrolled in 2019 according to the National Center for Education Statistics. See https://www.returntolearntracker.net.

There is some debate about whether the supplemental funds provided by unemployment insurance (UI) benefits are leading workers to stay on the sidelines.[15] The high level of employment gains in the lowest-wage sector and the reduction in continued claims seem inconsistent with supplemental UI benefits playing a large role in the April employment report. The largest employment gains in the otherwise tepid April employment report were in the low-wage leisure and hospitality sector, where UI replacement rates are among the highest. In addition, between the March and April reference weeks, continued UI claims, inclusive of Pandemic Emergency Unemployment Compensation and Extended Benefits, fell by about 1.3 million—indicating that many workers returned to work despite previously receiving UI benefits.

It is difficult to disentangle the effects of concerns about contracting the virus or caregiving responsibilities brought on by the pandemic from those of UI benefits. All of these factors are likely to diminish by autumn with the return to fully in-person school, continued progress on vaccinations, and the expiration of supplemental UI benefits in early September—or earlier, in many states.

For all these reasons, the supply–demand mismatches in the labor market are likely to be temporary, and I expect to see further progress on employment in coming months. That said, today employment remains far from our goal. Jobs are down by over 8 million relative to their pre-pandemic level, and the shortfall is over 10 million jobs if we take into account the secular job growth that would have occurred over the past year

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[15] Research indicates that the additional income provided to the unemployed through the CARES Act likely had little labor-supply-induced effect on the unemployment rate in early to mid-2020 and likely only a small effect on the job-finding rate in early 2021. For more information, see Nicolas Petrosky-Nadeau and Robert G. Valletta (2021), "UI Generosity and Job Acceptance: Effects of the 2020 CARES Act," Working Paper Series 2021-13 (San Francisco: Federal Reserve Bank of San Francisco, May), https://doi.org/10.24148/wp2021-13, and the citations within.

in normal circumstances. As of April, the overall prime-age employment-to-population (EPOP) ratio is 76.9 percent, more than 3 percentage points below its pre-pandemic level. The shortfall in the prime-age EPOP ratio is around 5 percentage points for Black and Hispanic workers relative to their October 2019 peaks.

Policy

Although continued vigilance is warranted, the inflation and employment data thus far appear to reflect a temporary misalignment of supply and demand that should fade over time as the demand surge normalizes, reopening is completed, and supply adapts to the post-pandemic new normal. Under our guidance, adjustments in the path of monetary policy are transparently tied to realized progress on our maximum-employment and 2 percent average-inflation goals. Jobs are down by between 8 and 10 million compared with the level we would have seen in the absence of the pandemic. And it will be important to see sustained progress on inflation given the preceding multiple year trend of inflation below 2 percent. While we are far from our goals, we are seeing welcome progress, and I expect to see further progress in coming months.

I am attentive to the risks on both sides of this expected path. I will carefully monitor inflation and indicators of inflation expectations for any signs that longer-term inflation expectations are evolving in unwelcome ways. Should inflation move materially and persistently above 2 percent, we have the tools and experience to gently guide inflation back down to target, and no one should doubt our commitment to do so.

Just as it is important to be attentive to upside risks, it is also important to be attentive to the risks of pulling back too soon. In the previous monetary policy framework, the customary preemptive tightening based on the outlook to head off

concerns about future high inflation likely curtailed critical employment opportunities for many Americans and embedded persistently below-target inflation. The entrenched pre-pandemic combination of low equilibrium interest rates, low underlying trend inflation, and a flat Phillips curve is likely to reassert itself after reopening is complete. This type of environment creates asymmetric risks, since the lower bound constraint means that policy can respond more readily when inflation surprises to the upside than to the downside.

Remaining steady in our outcomes-based approach during the transitory reopening surge will help ensure the economic momentum that will be needed as current tailwinds shift to headwinds is not curtailed by a premature tightening of financial conditions. The best way to achieve and sustain our maximum-employment and average-inflation goals is by remaining steady and clear in our approach while also being attentive to changing conditions.