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Assessing Progress as the Economy Moves from Reopening to Recovery

Remarks by

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The economy is reopening, consumer spending is strong, and hundreds of thousands of workers are finding jobs in the hard-hit leisure and hospitality sector each month. Pent-up demand has outstripped capacity in some sectors, as businesses that had pared back to survive the pandemic are encountering bottlenecks as they rehire and restock.[1] These mismatches have made it more difficult to interpret the first few months of reopening data.

The second quarter of 2021 saw a large wave of demand buoyed by fiscal transfers, resulting in annualized real personal consumption expenditures (PCE) growth of 11.8 percent. Real gross domestic product grew at an annual rate of 6.5 percent in the second quarter of 2021, slightly less than many forecasters had projected, as that strong consumer demand outstripped production, resulting in a significant decline in inventories.

The tailwinds to growth from the fiscal stimulus during the first half are shifting to headwinds that will continue through the remainder of 2021 and 2022. Even so, pent-up consumption and full reopening are expected to more than offset fiscal headwinds in the second half such that PCE is expected to grow at a robust rate, and growth is expected to remain strong through the remainder of the year. By the end of the year, the U.S. economy is expected to achieve average annualized growth of 2.2 percent since the onset of COVID-19—slightly above most estimates of longer-term potential output growth. In short, growth this year is expected to compensate fully for last year's sharp contraction—as a result of the strong policy response, effective vaccines, and the resilience and adaptability of American households, workers, and businesses.

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

While we are seeing progress on employment, joblessness remains high and continues to fall disproportionately on African Americans and Hispanics and lower-wage workers in the services sector.

Last December, the Committee indicated that asset purchases would continue until substantial further progress toward our employment and inflation goals had been achieved. The June data showed that there is a shortfall of 6.8 million jobs relative to the pre-pandemic level and 9.1 million jobs relative to the pre-pandemic trend, respectively. The employment-to-population (EPOP) ratio is 3.2 percentage points short of its pre-pandemic level for prime-age workers, a group that is not affected by the elevated level of early retirements during the pandemic. Thus, as of June, we had closed between one-fourth and one-third of the employment shortfall relative to last December according to a variety of measures.

Although the EPOP ratio for Black individuals has improved more strongly than the overall ratio over the course of 2021, closing about 40 percent of the December gap, it remains more than 3 percentage points below its pre-pandemic level and more than 2 percentage points below the current level of the EPOP ratio for white individuals.

Currently, it is difficult to disentangle the effects on labor supply of caregiving responsibilities brought on by the pandemic, fears of contracting the virus, and the enhanced unemployment insurance that was designed in part to address such constraints. Importantly, I expect to be more confident in assessing the rate of progress once we have data in hand for September, when consumption, school, and work patterns should be settling into a post pandemic normal.

I fully expect progress to continue, ultimately leading to a labor market as strong or stronger than we saw before the pandemic. Looking ahead, if jobs were to continue to increase at the second-quarter average monthly pace, about two-thirds of the outstanding job losses as of December 2020 and nearly half of the gap relative to the pre-pandemic trend would be made up by the end of 2021. If, instead, the rate of job growth were to accelerate notably, those levels could be reached somewhat sooner.

Today's data showed that core PCE inflation rose 0.45 percent in June, once again driven by outsized contributions from a handful of categories. New and used vehicles contributed just under 40 percent of the June increase in core PCE, while price increases for travel-related items like hotels, airfares and rental cars contributed another 25 percent.[2] All told, price increases associated with vehicles and vacations, categories that comprise about 8 percent of the core PCE basket, were responsible for over 60 percent of the June core PCE price increase.

Recent high inflation readings reflect supply–demand mismatches in a handful of sectors that are likely to prove transitory. In assessing inflation, an annualized 24-month measure that looks through the steep declines and subsequent rebound in prices in categories affected by the pandemic currently has core PCE inflation running at 2.3 percent and headline PCE inflation running at 2.4 percent. It is reasonable to expect these measures to remain near those levels for much of the rest of the year. By comparison, this 24-month measure was running at 1.6 percent in December 2020.

[2] The notable gap between the June PCE reading and the CPI reading is due, in part, to the lower weighting of vehicles in the PCE measure.

I am attentive to the risk that inflation pressures could broaden or prove persistent, perhaps as a result of wage pressures, persistent increases in rent, or businesses passing on a larger fraction of cost increases rather than reducing markups, as in recent recoveries. I am particularly attentive to any signs that currently high inflation readings are pushing longer-term inflation expectations above our 2 percent objective.

Currently, I do not see such signs. Most measures of survey- and market-based expectations suggest that the current high inflation pressures are transitory, and underlying trend inflation remains near its pre-COVID trend. Since the June FOMC meeting, five-year, five-year-forward inflation compensation based on Treasury Inflation-Protected Securities has declined a little less than 20 basis points, on net, and it currently stands at 2.2 percent, at the low end of its range of values prior to the 2014 decline. The second-quarter reading from the Federal Reserve Board's index of common inflation expectations stands at 2.05 percent, which is at the bottom of the range that prevailed from 2008 to 2014, when 12-month total PCE inflation averaged 1.7 percent.[3]

Many of the forces currently leading to outsized gains in prices are likely to dissipate by this time next year. Current tailwinds from fiscal support and pent-up consumption are likely to shift to headwinds, and some of the outsized price increases associated with acute supply bottlenecks may ease or partially reverse as those bottlenecks are resolved. Lumber prices have fallen, wholesale used car prices appear to have peaked, and auto semiconductor production is projected to expand.

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[3] For more information about the index of common inflation expectations (CIE), 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. The CIE data are available through the second quarter on the Board's website at https://www.federalreserve.gov/econres/notes/feds-notes/research-data-series-index-of-common-inflation-expectations-20210305.htm.

While there is good reason to expect that the inflation dynamics that prevailed for a quarter-century will reassert themselves on the other side of reopening, I will remain vigilant to any signs that inflationary pressures are likely to prove more persistent or that expectations are moving above target. If inflation moves persistently and materially above our target, we would adjust policy to guide inflation gently back to target.

There are risks on both sides of the outlook. There are upside risks to consumption spending associated with the high level of households' savings. There are downside risks associated with the Delta variant. While the economy's momentum is strong, vaccination rates remain low in some areas, and fears related to the Delta variant may damp the rebound in services and complicate the return to in-person school and work in some areas and slow the rotation from goods to services that account for three-fourths of the shortfall in jobs

In coming meetings, we will continue to assess progress and the conditions under which it will be appropriate to start paring back the pace of our asset purchases. Twenty-four-month core PCE inflation is now running at a 2.3 percent average annualized rate. In contrast, employment is still down by 6.8 million to 9.1 million relative to its pre-COVID level and trend, respectively, and it has closed about one-fourth to one-third of its December gap. The determination of when to begin to slow asset purchases will depend importantly on the accumulation of evidence that substantial further progress on employment has been achieved. As of today, employment has some distance to go.

It is important to emphasize that the achievement of substantial progress that will determine when the Committee starts reducing the pace of asset purchases is distinct from the maximum employment and inflation outcomes that are in the forward guidance

for the policy rate. Remaining attentive to changing conditions and steady in our step-by-step approach to implementing policy under our new framework should ensure that the economy's momentum is sufficient when tailwinds shift to headwinds to achieve and sustain maximum employment and inflation robustly anchored at 2 percent.