For release on delivery
12:00 noon EDT
May 11, 2021

Patience and Progress as the Economy Reopens and Recovers

Remarks by

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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, 2021

I want to thank Heather Long and the Society for Advancing Business Editing and Writing for inviting me to join you today.[1]

Strong fiscal support and increasing vaccination rates drove a strong rebound in activity in the first quarter, and the second quarter looks to be even stronger. The outlook is bright, but uncertainty remains, and employment and inflation are far from our goals. While more balanced than earlier this year, risks remain from vaccine hesitancy, deadlier variants, and a resurgence of cases in some foreign countries. The latest jobs report is a reminder that the path of reopening and recovery—like the shutdown—is likely to be uneven and difficult to predict, so basing monetary policy on outcomes rather than the outlook will serve us well.

With the renewal of fiscal support, real disposable personal income surged 61 percent on an annualized basis in the first quarter after a decline of 10 percent in the fourth quarter. Real personal consumption expenditures (PCE) jumped 10.7 percent, supporting a robust 6.4 percent growth rate in real gross domestic product (GDP) in the first quarter, despite a large runoff of inventories amid supply chain bottlenecks.

The second quarter appears primed to exceed the strong first quarter as progress on vaccinations continues, and more consumers return to the sectors adversely affected by COVID-19.[2] The combination of fiscal support and depressed discretionary services spending during the shutdown have enabled households to accumulate considerable

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[1] I am grateful to Kurt Lewis of the Federal Reserve 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] While the seven-day moving average of daily vaccine doses administered has declined from its mid-April peak, over half of the adult population has now been given at least one dose of the vaccine, and around 2 million doses were administered each day of the week ending May 5, the most recent available data. For more information, see the Centers for Disease Control and Prevention (CDC) COVID Data Tracker, which is available at https://covid.cdc.gov/covid-data-tracker.

savings that could continue to fuel spending. Personal savings rose to 21 percent in the first quarter, according to Bureau of Economic Analysis data, on top of the $2.1 trillion increase in household liquid assets reflected at the end of last year.[3]

While the incoming spending data, elevated household savings, and progress on vaccinations point to a very strong modal outlook, there is greater than usual uncertainty about the economy's path. For instance, the strength of domestic demand this year relative to next will depend on how quickly or slowly a large share of accumulated household savings is spent out. This, in turn, hinges in part on the distribution of household savings and how much is concentrated among households who are less likely to spend, perhaps because their services consumption returns only to pre-COVID levels or their near-term demand for durable goods has largely been satiated.[4]

There is also uncertainty about how much of the strong domestic aggregate demand will leak abroad rather than translating into domestic output. As supply chain and shipping bottlenecks ease, international spillovers could lead to some slippage between the increase in domestic demand and domestic resource utilization.

In addition, some of this year's tailwinds are likely to become next year's headwinds. While the fiscal support provided to households is raising consumer

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[3] According to the Financial Accounts of the United States, liquid assets—defined as the sum of currency; checkable, time, and saving deposits; and money market funds—increased about $2.1 trillion from 2020:Q1 to 2020:Q4. The 2020:Q4 release of the Financial Accounts of the United States is available on the Board's website at https://www.federalreserve.gov/releases/z1.

[4] See, for example, the difference in high-frequency indicators of consumer spending between measures of total spending and spending in low-income Zip codes in the weeks following the payment of stimulus under the Consolidated Appropriations Act, 2021. Data are available from Opportunity Insights at https://www.tracktherecovery.org. For further discussion of differing spend-out of COVID stimulus payments for different levels of household wealth, see, for example, Ezra Karger and Aastha Rajan (2020), "Heterogeneity in the Marginal Propensity to Consume: Evidence from COVID-19 Stimulus Payments," Working Paper Series 2020-15 (Chicago: Federal Reserve Bank of Chicago, May; revised February 2021), https://www.chicagofed.org/publications/working-papers/2020/2020-15.

spending and GDP this year, the absence of similar transfers will lower the growth rate of spending next year relative to this year. The boost to spending from pent up demand this year as the economy reopens is also unlikely to be repeated next year.

The latest jobs report reminds us that while there are good reasons to expect the number of jobs and the number of people wanting to work will make a full recovery, it is unlikely they will recover at the same pace. Over the past few months, the demand for workers has strengthened as COVID-affected sectors have reopened. Labor supply has also improved, with many people coming back into the labor force and others extending their hours of work, but there are indications that many other workers still face virus-related impediments. Although the fraction of the population ages 25 to 54 that is employed has improved in each month of this year, the current prime-age employment-to-population (EPOP) ratio of 76.9 percent is still far from the 80 percent level reached during both of the past two expansions.[5]

On the demand side, we saw a welcome increase of 331,000 jobs in the hard-hit leisure and hospitality sector in April following a 206,000 increase in March. But bottlenecks on inputs such as semiconductors appear to be limiting production and hiring in industries such as motor vehicles, contributing to a decline of 18,000 jobs in the manufacturing sector. The increase in average hours worked and the reduction in people who are working part time but would prefer full-time work suggest some employers are responding to the increase in demand by lengthening workweeks.

[5] For additional discussion, see Lael Brainard (2021), "How Should We Think about Full Employment in the Federal Reserve's Dual Mandate?" speech delivered at the Ec10, Principles of Economics, Lecture, Faculty of Arts and Sciences, Harvard University, Cambridge, Mass. (via webcast), February 24, https://www.federalreserve.gov/newsevents/speech/brainard20210224a.htm.

On the supply side, the number of people entering the labor force strengthened for the second month in a row in a welcome sign that more people are actively seeking work as job opportunities and vaccinations increase. But we are also hearing anecdotal accounts that many people face virus-related impediments in returning to full-time work, and many businesses face hiring challenges. With less than one-in-four individuals ages 18 to 64 fully vaccinated at the end of the survey period for the April jobs report, health and safety concerns remain important for in-person work and for people relying on public transport, and childcare remains a challenge for many parents.[6]

Childcare remains an impediment for many parents because the return to fully in-person school is still incomplete and childcare options are still limited in many areas.[7] At the time of the April jobs report, nearly two-thirds of students had yet to return to fully in-person schooling, and this share had only increased by 8 percentage points since March.[8] Consistent with this, the labor force participation rate of women ages 25 to 45 was unchanged in April, after an increase in March that coincided with a surge in education hiring and school reopening. Similarly, April saw a small increase in the number of women who reported that they wanted a job but were out of the labor force for

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[6] The share of people ages 18 to 64 years old who are fully vaccinated is calculated using the percent 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.

[7] See the Return to Learn Tracker, a collaboration of the American Enterprise Institute and the College Crisis Initiative of Davidson College: https://www.returntolearntracker.net. See also Lauren Bauer (2021), "Mothers Are Being Left behind in the Economic Recovery from COVID-19," Brookings Institution, *Up Front* (blog), May 6, https://www.brookings.edu/blog/up-front/2021/05/06/mothers-are-being-left-behind-in-the-economic-recovery-from-covid-19.

[8] The share of students who have yet to return to fully in-person learning is calculated using school districts' operating statuses from the AEI's Return to Learn Tracker (as of the weeks starting March 8, 2021, and April 12, 2021), 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.

family responsibilities, following a large decline in March.[9] Recent research shows that the pandemic has taken a particularly significant toll on the labor market status of many Black and Hispanic mothers and mothers with lower incomes.[10]

Aggregate average hourly earnings increased by 0.7 percent in April in a positive development for workers. Wage increases were broadly distributed across sectors, including an increase of more than 1-1/2 percent, month over month, in hourly earnings in the leisure and hospitality sector.

While labor market conditions have improved in aggregate, significant disparities persist. Although the prime-age EPOP ratio has increased for all racial groups over the past four months, the ratio for Black prime-age workers, at 72.1 percent, is still over 6 percentage points lower than the white prime-age EPOP ratio, while the gap for Hispanic prime-age workers relative to white workers is almost 5 percentage points.

Job losses are disproportionately concentrated in low-wage, high-contact sectors, suggesting that the workers least able to shoulder the economic effect of job loss have faced the greatest challenges. Despite the more than 900,000 jobs gained in the leisure and hospitality sector in the first four months of 2021, jobs in this sector remain nearly 3 million below their pre-COVID level. The leisure and hospitality sector alone accounts for 41 percent of the net loss in private payrolls since the onset of the pandemic.

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[9] The BLS reported that the number of women who wanted a job, searched for work in the previous year (but not in the past four weeks), were available for work, and cited family responsibilities as the primary reason they were out of the labor force fell from 115,000 in February to 69,000 in March and then edged higher to 71,000 in April.

[10] Research 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.

There is good reason to expect a strong rebound in employment over coming quarters, although the different forces affecting demand and supply may lead to uneven rates of progress. But today, by any measure, employment remains far from our goals. The unemployment rate remains elevated at 8.9 percent when we adjust the narrow 6.1 percent U-3 measure of unemployment to also reflect workers who have left the labor force since the pandemic started and those who are misclassified. As of the latest reading, there is an employment shortfall of 8.2 million relative to the pre-pandemic level, and the employment shortfall is over 10 million if we take into account the secular job growth that would have occurred over the period since February 2020 in normal circumstances.[11]

The path of inflation is also difficult to predict, although there are a variety of reasons to expect an increase in inflation associated with reopening that is largely transitory. Most immediately, base effects are likely to contribute substantially to the 12-month readings of headline and core PCE inflation in April and May as the price declines of March and April 2020 roll out of the 12-month calculation. I also anticipate that the recent surge in energy prices, which contributed about 1/2 percentage point to the March 12-month headline PCE reading, will fade over time, although recent pipeline disruptions add some uncertainty.

It is much more difficult to predict the size and duration of supply-side bottlenecks and how these will interact with the pattern of demand to feed through into inflation. The production of certain semiconductors may take some time to ramp up, and

[11] For example, during 2019, after the recovery had matured and the unemployment rate had reached 4 percent, total nonfarm payrolls increased by an average of 168,000 workers per month, or roughly 2 million workers per year.

the feedback effects between shipping delays and container shortages appear to be only slowly working themselves out. In contrast, the manufacturing capacity taken offline by the harsh weather in Texas in February is coming back online rapidly. If past experience is any guide, production will rise to meet the level of goods demand before too long. The supply–demand imbalances in the in-person services sector are expected to be resolved within a few quarters with progress on virus control and the return of in-person schooling. And demand growth itself is expected to moderate after a reopening surge, broadly coinciding with the time when some of the current tailwinds from fiscal support and makeup consumption turn to headwinds. Of course, there may be additional demand and supply surprises that could further complicate the inflation picture.

To the extent that supply chain congestion and other reopening frictions are transitory, they are unlikely to generate persistently higher inflation on their own. A persistent material increase in inflation would require not just that wages or prices increase for a period after reopening, but also a broad expectation that they will continue to increase at a persistently higher pace. A limited period of pandemic-related price increases is unlikely to durably change inflation dynamics. Past experience suggests many businesses are likely to compress margins and to rely on automation to reduce costs rather than fully passing on price increases.[12] In the December Duke CFO Survey, roughly one-half of chief financial officers from large firms and about one-third of those from small firms reported "using, or planning to use, automation or technology to reduce

[12] Regarding compression of margins and pass-through of wage increases to prices, see Ekaterina V. Peneva and Jeremy B. Rudd (2017), "The Passthrough of Labor Costs to Price Inflation," *Journal of Money, Credit and Banking,* vol. 49 (December), pp. 1777–802; and the subsequent analysis in Ekaterina Peneva (2019), "It's All about the Labor Market," presentation delivered at the Brookings Institution, Washington, October 3, https://www.brookings.edu/wp-content/uploads/2019/09/Ekaterina-Peneva.pdf.

reliance on labor."[13] The pandemic-induced shift to virtual, or contactless, versions of many previously in-person interactions is likely to lead to some durable shifts in the use of technology.

Thus, there are compelling reasons to expect the well-entrenched inflation dynamics that prevailed for a quarter-century to reassert themselves next year as imbalances associated with reopening are resolved, work and consumption patterns settle into a post-pandemic "new normal," and some of the current tailwinds shift to headwinds.[14]

I will be carefully monitoring measures of longer-term inflation expectations to ensure they are well anchored at 2 percent. To date, various measures suggest inflation expectations remain well anchored and broadly consistent with our new framework. The Index of Common Inflation Expectations moved back to 2 percent in the first quarter, returning to its level in 2018, which is lower than its level prior to 2014.[15] In addition, the term structure of market-based measures of inflation compensation is consistent with market participants expecting a limited period of inflation above 2 percent. A straight read of the difference between the forward nominal Treasury curve and the forward Treasury Inflation-Protected Securities curve implies inflation compensation is expected

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[13] Details on the CFO Survey, which is a partnership of Duke University, the Federal Reserve Bank of Richmond, and the Federal Reserve Bank of Atlanta, can be found on the Richmond Fed's website at https://www.richmondfed.org/research/national_economy/cfo_survey.

[14] Statistical models estimate that underlying core PCE inflation ranges from 0.1 to 0.4 percentage point below the 2 percent longer-run target. 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://www.federalreserve.gov/econres/notes/feds-notes/underlying-inflation-its-measurement-and-significance-20200918.htm.

[15] 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.

to be higher for the next two years and to decline subsequently and remain stable 5 and 10 years into the future.

I will remain attentive to the risk that what seem like transitory inflationary pressures could prove persistent as I closely monitor the incoming data. Should this risk manifest, we have the tools and the experience to gently guide inflation back to our target. No one should doubt our commitment to do so.

But recent experience suggests we should not lightly dismiss the risk on the other side. Achieving our inflation goal requires firmly anchoring inflation expectations at 2 percent. Following the reopening, there will need to be strong underlying momentum to reach the outcomes in our forward guidance. Remaining patient through the transitory surge associated with reopening will help ensure that the underlying economic momentum that will be needed to reach our goals as some current tailwinds shift to headwinds is not curtailed by a premature tightening of financial conditions.

The outlook is bright, but risks remain, and we are far from our goals. The latest employment report reminds us that realized outcomes can diverge from forward projections and underscores the value of patience. As the economy reopens fully and the recovery gathers momentum, it will be important to remain patiently focused on achieving the maximum-employment and inflation outcomes in our guidance.