

## Christopher J Waller: The economic outlook and monetary policy

Remarks (via webcast) by Mr Christopher J Waller, Member of the Board of Governors of the Federal Reserve System, at the Global Interdependence Center's 39th Annual Monetary and Trade Conference, The LeBow College of Business, Drexel University, Philadelphia, Pennsylvania, 13 May 2021.

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Thank you, Kathleen, and thank you, George and the Global Interdependence Center, for the invitation to speak to you this afternoon. I am with you to talk about my outlook for the U.S. economy and the implications for monetary policy.<sup>1</sup> In the last week we have received employment and inflation reports that have garnered a lot of attention. Incorporating this information into my outlook, I have two messages today. The first is that, despite an unexpectedly weak jobs report, the U.S. economy is hitting the gas and continuing to make a very strong recovery from the severe COVID-19 recession. Let's remember, and this applies to latest inflation data too, that a month does not make a trend—the trend for the economy is excellent. My second message is that, despite the unexpectedly high CPI inflation report yesterday, the factors putting upward pressure on inflation are temporary, and an accommodative monetary policy continues to have an important role to play in supporting the recovery.

The pandemic and resulting public health response led to the sharpest drop in employment and output the United States has likely ever experienced—22 million jobs lost in eight weeks and an annualized decline of 30 percent in real gross domestic output for the second quarter of 2020. These numbers are simply staggering, and they left us in a deep, deep hole. Not so long ago, it seemed like the economic damage from COVID-19 might be with us for a long time, and that a full recovery could take many years. But thanks to the rapid development of vaccines and aggressive fiscal and monetary policy, the economy is recovering much faster than anyone expected six months ago.

I said a few weeks ago that the economy was ready to rip, and in many respects, that is exactly what it is doing. The initial estimate of first quarter real gross domestic product (GDP) growth came in at a 6.4 percent annual rate, surpassing the level of output in the first quarter of 2020, before the full force of COVID-19 hit the economy. Second-quarter growth is likely to be as much as 8 percent, and the prospects are good that GDP will be close to trend output by the end of 2021. New home sales continue to be strong. We are seeing robust household spending on durable goods despite supply bottlenecks that I will discuss in a moment. Surveys of purchasing managers point to continued solid growth in both manufacturing and business services.

So, what about that jobs report? That thud you heard last Friday was the jaw of every forecaster hitting the floor. It was a big surprise for me and most people, but it probably should not have been, because it fits with what we have been hearing from businesses about labor supply shortages. GDP is back to its pre-pandemic level, but we have recovered only 14 million of the 22 million jobs lost last spring.

To fully understand how the labor market is performing, I like to refer to the Federal Reserve Bank of Atlanta's labor market distribution spider chart.<sup>2</sup> The chart plots data for 15 different labor market indicators in an easy-to-read manner. Using this chart, you can compare all these indicators for February 2020, April 2020, and March 2021. Looking at these months allows one to compare the very healthy labor market of February 2020 with the depths of the pandemic decline in April 2020 and see both how well we have rebounded since then and how much farther we still have to go.

The takeaway from that chart is that the labor market has recovered on many dimensions, such as hiring plans, job openings, quits rates, and firms unable to fill job openings. But on other

dimensions, the labor market is far from recovering to its pre-pandemic level. Employment, as I said, is still below where it was in February 2020, by 8 million jobs. The unemployment rate is still 2.5 percentage points higher than it was in February 2020, and we know that it is even worse for some groups—nearly 10 percent for Black workers and nearly 8 percent for Hispanics. The employment-to-population ratio continues to be depressed from February 2020. The upshot is that several measures of labor market conditions have fully recovered, but other measures indicate that the overall labor market has a long way to go to get back to full strength. In short, some of the labor market’s cylinders are firing away, and some are still sputtering, so monetary accommodation continues to be warranted.

This chart, like the disappointing jobs report for April, shines a light on a current puzzle characterizing the U.S. labor market—a lot of job openings, but high unemployment rates and a low labor force participation rate. We hear repeatedly from our business contacts about firms boosting wages yet still being unable to attract workers.<sup>3</sup> While clearly this is a real problem for some firms at the moment, I believe this mismatch is temporary.

I think of the current problem as follows. When the pandemic hit, both labor demand and labor supply fell dramatically. The combination of widespread vaccines and fiscal and monetary stimulus caused consumer demand to recover sharply. This situation, in turn, caused labor demand to rebound quickly, particularly in goods-producing industries. However, due to factors like continued fears of the virus, the enhanced unemployment insurance, child-care issues, and early retirements, labor supply has not rebounded in the same fashion, which led to a situation with excess demand for labor and upward pressure on wages.<sup>4</sup> And that is exactly what we saw in the April jobs report. Average hourly earnings rose 20 cents in April for private-sector nonsupervisory workers, to \$25.45.

But it is likely the labor supply shortage will be temporary. As vaccinations continue to climb, fears of reentering the labor force should decline. By September, most schools and daycare facilities are expected to fully reopen, resolving recent child-care issues for many families. Finally, the enhanced unemployment benefits passed in response to the pandemic expire in September, and research has shown repeatedly that the job-finding rate spikes as unemployment benefits run out.<sup>5</sup> Thus, while labor demand is currently outrunning labor supply, supply should catch up soon.

Now let me turn to the other leg of the Fed’s dual mandate, price stability. That second thud you heard yesterday was forecasters’ bodies following their jaws to the floor after the CPI report was released. It was a surprise, but a look at its causes doesn’t alter my fundamental outlook, which is that the main pressures on inflation are temporary.

First, let me address concerns that strong growth threatens to unleash an undesired escalation in inflation. In August 2020, the Federal Open Market Committee (FOMC) adopted a new policy framework that includes flexible average inflation targeting and a policy stance based on economic *outcomes* as opposed to economic *forecasts*.

Flexible average inflation targeting means we aim to have inflation overshoot our 2 percent longer-run goal if inflation had been running persistently below target. Given that we missed our inflation target on the low side consistently for the past eight years or so, the FOMC has said that it will aim to moderately overshoot its inflation target for some period but then have it return to target. Our willingness to aim for above-target inflation also means we will not overreact to temporary overshoots of inflation—we need to see inflation overshoot our target for some time before we will react.

An outcomes-based policy stance means that we must see inflation before we adjust policy—we will not adjust based on forecasts of unacceptably high inflation as we did in the past. Call this the “Doubting Thomas” approach to monetary policy—we will believe it when we see it.

We asked to see it, and lo and behold, we are now starting to see inflation exceeding our inflation target. But the critical question is: for how long? Although inflation is starting to exceed our 2 percent target, in my view, this development is largely due to a set of transitory factors that are occurring all at once. I can think of at least six.

First, there is what we economists call “base effects,” which is the simple arithmetic of what happens when the very low inflation readings of the first half of 2020 fall out of our 12-month measure of inflation. That adjustment will be over in a few months. A second temporary factor is higher energy prices, which have rebounded this year as the economy strengthens but are expected to level off later this year. Retail gasoline prices have jumped in some areas due to the disruption of the Colonial Pipeline, but the effect on inflation should be temporary also.

A third factor is the significant fiscal stimulus to date. Stimulus checks put money in people’s pockets, and when they spend it, there will be upward pressure on prices. But when the checks are gone, the upward pressure on prices will ease.

A fourth factor is a reversal of the very high savings that households have built up over the past year. As households draw down these savings, demand for goods and services will increase, which again will put upward pressure on prices. But, just like stimulus checks, once the excess savings is gone, it is gone, and any price pressures from this factor will ease.

A fifth factor is supply bottlenecks that manufacturers and importers are currently experiencing; supply chain constraints are boosting prices, particularly for goods—less so for services. One strength of a capitalist system is that markets adjust. If demand and prices rise for a product, supply will follow, and bottlenecks will dissipate. So once again, price pressures induced by bottlenecks should reverse as supply chains catch up and orders get filled.

Finally, the excess demand for labor I described earlier is likely to continue to push wages up in the next couple of months. How much of this increase gets passed through to prices is unknown, but some of it will. However, as I argued earlier, once labor supply catches up, this wage pressure should ease.

I expect that all of these factors will cause inflation to overshoot our 2 percent longer-run goal in 2021. But they will not lead to sustained, high rates of inflation. Financial markets seem to think the same—5-year breakeven inflation expectations are around 2.5 percent, and 5-year, 5-year-forward measures are around 2 percent, when adjusted for the difference between CPI (consumer price index) and PCE (personal consumption expenditures) inflation rates.<sup>6</sup> Hence, markets do not believe the current factors pushing up inflation will last for long.

While I fully expect the price pressure associated with these factors to ease and for some of the large increases in prices to reverse, it may take a while to do so. Shortages give producers pricing power that they will be reluctant to let go of right away. Wage increases for new workers may cause firms to raise wages for existing workers in order to keep them. Consequently, there may be knock-on effects from the current wage increases. The pandemic has also caused firms to restructure their supply chains, and, as a result, bottlenecks may last longer than currently anticipated as these supply chains are rebuilt. There are also asymmetric price effects from cost shocks—prices go up very quickly but often tend to come down more slowly, as consumers slowly learn that the bottlenecks have gone away.

For these reasons, I expect that inflation will exceed 2 percent this year and next year. After that, it should return to target. And in my view, this fluctuation is okay—our new framework is designed to tolerate a moderate overshoot of inflation for some time as long as longer-term inflation expectations remain well-anchored at 2 percent.

Before I turn to the implications of all this for monetary policy, a word about the housing market. As I said earlier, housing is a bright spot in the economy that is encouraging investment and

lifting household wealth, which is all good, but with memories of recent history in mind, the fast growth in housing prices in most areas of the United States does bear close watching. Housing is becoming less affordable, and that price increase has the biggest effect on low-income individuals and families who have struggled the most since last spring and who are always the most vulnerable to rising rents and home prices. Prices for lumber and other inputs for housing are skyrocketing, and while that occurrence is not having a significant effect on inflation, it is limiting the supply of new homes and helping feed the house price boom. Fortunately, the banking system is strong and resilient—going through multiple Fed stress tests and a tough, real-life stress test this past year. Nevertheless, I am watching this sector closely for signs of stress and will continue to do so.

So, in summary, the economy is ripping, it is going gangbusters—pick your favorite metaphor. But we need to remember that it is coming out of a deep hole, and we are just getting back to where we were pre-pandemic. Labor market indicators are more mixed with 8 million workers still without jobs. But many of the problems holding back labor supply will dissipate over time, and we should return to the robust labor market we had in February 2020. Inflation is currently being driven above our 2 percent inflation target but is expected to return to target in subsequent years as transitory inflation shocks fade.

Highly accommodative monetary policy, in conjunction with unprecedented fiscal support, has supported a rapid recovery from a uniquely sharp, pandemic-caused recession. The improving economy is helping repair the significant economic damage suffered by individuals, families, and businesses, but there is still a way to go before we fully recover.

In light of that fact, I expect the FOMC to maintain an accommodative policy for some time. We have said our policy actions are outcome based, which means we need to see more data confirming the economy has made substantial further progress before we adjust our policy stance, because sometimes the data does not conform to expectations, as we saw last Friday. The May and June jobs report may reveal that April was an outlier, but we need to see that first before we start thinking about adjusting our policy stance. We also need to see if the unusually high price pressures we saw in the April CPI report will persist in the months ahead. The takeaway is that we need to see several more months of data before we get a clear picture of whether we have made substantial progress towards our dual mandate goals. Now is the time we need to be patient, steely-eyed central bankers, and not be head-faked by temporary data surprises.

Thank you for the opportunity to speak to you, and I would be happy to respond to your questions.

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<sup>1</sup> I am grateful to John Maggs and Jane Ihrig for assistance in preparing these remarks. These remarks represent my own views, which do not necessarily represent those of the Federal Reserve Board or the Federal Open Market Committee.

<sup>2</sup> See Federal Reserve Bank of Atlanta (2021), “Labor Market Distributions Spider Chart,” updated May 7, available at [www.atlantafed.org/chcs/labor-market-distributions](http://www.atlantafed.org/chcs/labor-market-distributions).

<sup>3</sup> See Board of Governors of the Federal Reserve System (2021), Beige Book, [National Summary](#) (Washington: Board of Governors, March 3). As indicated in paragraph 2 of that document, “labor supply shortages were noted by contacts as most acute among low-skill occupations and skilled trade positions. Constraints on labor supply included those related to COVID-19, childcare, and unemployment benefits.”

<sup>4</sup> According to the Federal Reserve’s upcoming Survey of Household Economics and Decisionmaking, in July 2020, 22 percent of parents reported they were not working or working less because of childcare or schooling disruptions. Those numbers were 36 percent for Black mothers and 30 percent for Hispanic mothers. See Jerome H. Powell (2021), “[Community Development](#),” speech delivered at the “2021 Just Economy Conference,” sponsored by the National Community Reinvestment Coalition, Washington (via webcast), May 3.

<sup>5</sup> For example see Ioana Marinescu and Daphné Skandalis “Unemployment Insurance and Job Search

Behavior", *The Quarterly Journal of Economics*, Volume 136, Issue 2, May 2021, Pages 887–931.

- 6 Breakeven inflation expectations are derived from Treasury constant-maturity securities and comparable Treasury inflation-indexed constant-maturity securities, otherwise known as TIPS (Treasury Inflation-Protected Securities). The latest values imply what market participants expect inflation to be over the stated period on average. They are based on CPI inflation, whereas the preferred inflation measure for the FOMC is PCE inflation, which tends to run 0.3 percentage point below CPI on average.