Is the Economy Tight or Slack?

Remarks by
Esther L. George
President and Chief Executive Officer
Federal Reserve Bank of Kansas City

August 11, 2021
18th Annual Economic Measurement Seminar
National Association for Business Economics
Remarks delivered virtually

Thank you for inviting me to participate in this year's Economic Measurement Seminar. As you well know, measurement and data are central to monetary policy making. Data are the vocabulary that policymakers use to build the narratives that are essential for making sense of the economy and for explaining policy decisions. Data alone cannot tell the story, but the story certainly depends on data. Consequently, the same data can often underpin widely divergent economic narratives. As a policymaker, those narratives are shaped not only by an assessment of the data, but also by experiences. Wisdom and the humility to adjust a narrative is essential, especially when the data make the story increasingly difficult to tell.

Today I would like to look at the data and narratives as they relate to a particular question with important implications for monetary policy: Is the economy tight or slack? The strength of demand and the ability of supply to meet that demand have been significantly impacted by the pandemic and the related policy response. As I talk to contacts in the Kansas City Fed's region, I often hear anecdotes that suggest an economy that has run into constraints, including reports of the difficulty in finding workers and of having to pay much higher prices for materials and transportation. These stories are confirmed by the data, with a record number of unfilled job openings and sharply higher prices for many commodities. At the same time, almost 6 million fewer individuals are working now relative to before the pandemic. This suggests that there remains considerable slack in the labor market.

So, is the economy tight or slack? Prices are telling in making this assessment. An economy operating near or at its productive capacity is likely to display higher prices. On the other hand, slack implies under-utilized resources, such that higher demand can be met without increased prices.

In my remarks today, I'll explore some of the factors that are currently contributing to a tight economy, which is lifting inflation. While there is good reason to think that many of the factors boosting demand and restraining supply will fade over time, the extraordinary events of the global pandemic make this unfolding narrative a complex one, not the least as the course of the virus remains uncertain. Importantly, policymakers must consider not only near-term but also long-run implications of their policy choices and be prepared to adjust as the economy evolves.

A tight economy

You don't have to look hard to spot signs of an economy that has run into constraints. Business surveys are reporting a record number of job openings. In addition, workers are quitting jobs at a record pace, typically a sign of a hot labor market when alternative opportunities are plentiful. Not surprisingly, many firms are reporting raising wages or expecting that they will be raising wages soon.

Strong demand and limited supply are also apparent in depleted inventories. The inventory-to-sales ratio for retailers is at a record low and far below historical norms. The run-down in inventories has been particularly notable in the automotive sector, where the days' supply of available vehicles for sale, at just under 30 days, is less than half its typical level.

Tight supply and high demand are behind the recent increase in price inflation. Prices, as measured by the consumer price index (CPI), increased 5.4 percent over the 12 months ending in July, matching June's increase and remaining at the fastest pace of increase in over a decade. To be sure, some of the increase in prices simply reflects a reversal of price declines recorded earlier in the pandemic, particularly for service categories like airfares and hotels. But the normalization of some prices is not the whole story. Other prices have moved far above pre-pandemic levels. The sharp increase in car prices has been widely reported, not just as it relates to new cars but also used cars and even rental cars. Indeed, durable goods more generally have experienced large increases in prices, sometimes at the fastest pace in decades. Outside of consumer prices, there's also been a sharp rise in commodity prices and transportation costs.

Based on this evidence, the economy shows clear signs of tightness. An important question is: Will this tightness persist with implications for the path of monetary policy?

The evolution of factors contributing to a tight economy

Whether the economy is temporarily tight or more persistently tight will depend on the evolution of the dynamics affecting both supply and demand. Currently, demand is exceptionally strong, boosted by expansive fiscal policy and low interest rates. It is also unbalanced, favoring the consumption of a subset of goods. Supply is constrained by frictions in the labor market and production bottlenecks resulting from kinks in global supply chains.

There is reason to believe that some of the drivers boosting demand and constraining supply will fade over time. In particular, I anticipate four factors that could introduce slack into what is now a tight economy. After discussing these factors, I will turn to a few of the risks around this outlook, including the possibility of economic disruptions related to the Delta variant.

First, notwithstanding the upswing in the virus, I expect to see the continued rotation of consumption from goods to services. More than a year ago, many consumers were forced to avoid contact-intensive services, such as hotel accommodations, concerts, and amusement parks, as well as visits to doctors, dentists, and hair stylists. Stuck at home, consumers rotated their consumption towards goods, often ordered online. This led to a very uneven pattern of demand. At the end of the first quarter of this year, services consumption was 5 percent below pre-pandemic levels, while the consumption of durable goods was a remarkable 34 percent higher on the same basis.

This unexpected shift in demand towards a subset of consumption goods has been behind some of the observed tightness in the economy. For example, purchases of household appliances in the second quarter, including refrigerators and washing machines, were running 12 percent above the level at the start of 2020, in part as the pandemic set off a wave of home remodeling. Reports of long delivery delays proliferated as demand ran up against supply constraints. Not surprisingly, prices for major household appliances have surged, increasing 14 percent in the 12 months to June.

With the advent of widespread vaccination and a lessening of pandemic disruptions through the spring, services consumption has picked up, and goods consumption has stepped down. Still, services consumption remains depressed relative to previous levels, suggesting further room to grow. As consumption rotates from goods to services, some of the pressure should ease for overstretched goods demand, perhaps allowing inventories to rebuild, even as services growth continues to support the overall recovery in the economy.

A second factor is the likelihood that the growth of overall demand will moderate as government supports fade. The tremendous amount of fiscal stimulus provided to the economy since the start of the pandemic, on the order of $6 trillion, has been essential in supporting economic activity. However, much of this stimulus has already been distributed, with the last checks to households going out at the end of March and the Paycheck Protection Program for small businesses closing to new applicants at the end of June. Thus, the peak boost to growth from fiscal policy has likely passed. Some estimates show that fiscal policy, after adding almost

4 percentage points to growth last year, will subtract about 2 percentage points from growth over the next few years.[1] Additional spending bills under consideration could blunt this drag, but seem unlikely to fully offset it.

A third factor focuses on supply-side considerations contributing to near-term tightness in the economy. As it relates to labor supply, temporary factors related to the pandemic are likely contributing to the current tightness in the labor market, importantly reflected in a still-depressed level of labor force participation. Disruptions to schooling and daycare led many workers with small children, primarily non-college educated women, to drop out of the labor force. Enhanced unemployment benefits could also be playing a role, as potential workers sit on the sidelines and assess their options.

As schools reopen, and enhanced unemployment benefits end, these constraints on labor supply should ease. Already we are seeing promising signs that the labor market is healing. The July jobs report, released last week, showed the unemployment rate dropping to 5.4 percent as the economy added close to 1 million jobs. The labor force participation rate, however, remained almost 1½ percentage points below its pre-pandemic level, suggesting further room for recovery.

Finally, supply constraints go well beyond labor markets. A number of materials and inputs to production have also experienced bottlenecks, notably semiconductors and steel, but other aspects of production have been affected as well. In part, these shortages reflect the difficulties of restarting or reorienting production after a year of sharp shifts in demand. The bottlenecks have also arisen from domino effects related to the tight logistical networks that were in place before the pandemic. With a flexible, dynamic economy, firms can be expected to overcome most of these bottlenecks through the rest of the year.

This narrative for why the current supply and demand constraints might be expected to ease over time strikes me as a reasonable baseline. My own expectation is that growth will step down but remain robust; that the labor market will continue to recover at a rapid pace; and that inflation will moderate. But this narrative would be incomplete without acknowledging the risks around these assumptions.

One key risk is the lingering presence of the pandemic. The upsurge in Covid cases related to the Delta variant threatens renewed restrictions on activity or increased caution on the part of consumers and could delay the recovery across many dimensions. Importantly, the effects

[1] See, for example, the [Hutchins Center Fiscal Impact Measure (brookings.edu)]

could be as pronounced on the supply side as the demand side, prolonging the tightness of the economy and maintaining upward pressure on prices. Renewed concern over the virus could impede the recovery in services consumption such that demand remains directed towards sectors of the economy that are near capacity and away from those sectors that have available slack. The surge in the virus could also delay the normalization of the labor market, particularly if schooling and childcare is once again disrupted. The spread of the variant has been particularly disruptive in Asia, where vaccination rates remain quite low. Given Asia's large imprint in global value chains, disruptions in the manufacturing sector there can spill over quickly to other parts of the world, further exacerbating production bottlenecks and shortages, and inflation pressure.

Aside from the economic threats associated with the Delta variant, the assumption that demand will moderate may prove otherwise given the high level of household savings. In particular, a considerable portion of the stimulus transfers to households have been saved, with estimates suggesting that the stockpile of household saving has increased by close to $2.5 trillion. Of course, healthy household balance sheets are positive for the economy, and to the degree that the saving is spent out over time, this could support strong and steady growth for some time. However, if households instead choose to spend rapidly, a burst of demand could keep the economy at capacity, reinforcing bottlenecks and putting continued upward pressure on prices. Households have a lot of firepower, and if and how quickly they choose to spend will be an important factor in how tight the economy remains.

<u>The outlook for monetary policy</u>

What does this mean for monetary policy and the Federal Open Market Committee's long-run objectives for the economy? How should policymakers account for today's "tight" demand and supply dynamics in their decisions about the path of asset purchases and interest rates?

Since last December, the Committee has stated that it expects to keep the policy rate near zero until the labor market has reached levels consistent with maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time. The FOMC also expects to maintain its purchases of Treasuries and mortgage-backed securities until substantial further progress has been made towards these employment and inflation goals.

Without question, the combination of fiscal and monetary policy supports at the onset of the pandemic bridged the economy's transition from a deep contraction to a robust rebound. Now, with the recovery underway, a transition from extraordinary monetary policy accommodation to more neutral settings must follow. Today's tight economy as I described earlier certainly does not call for a tight monetary policy, but it does signal that the time has come to dial back the settings. With year-over-year inflation running well over the Committee's target and steady progress in monthly employment gains, the FOMC's long-run objectives for price stability and employment are in focus.

While recognizing that special factors account for much of the current spike in inflation, the expectation of continued strong demand, a recovering labor market, and firm inflation expectations are consistent, in my view, with the Committee's guidance regarding substantial further progress toward its objectives. I support bringing asset purchases to an end under these conditions.

As this adjustment gets underway, public attention will naturally turn to timing for adjusting the policy rate, though it is important to note the timing of the tapering of asset purchases is not mechanically connected to the timing of any policy rate adjustment. With both upside and downside risks in play, and multiple policy tools in use, judging the achievement of criteria for raising rates is more complicated. One might argue that today's inflation dynamics are likely to keep inflation moderately above 2 percent for some time and align with the Committee's threshold criteria. On the other hand, the criteria for judging maximum employment are murkier.

While it is clear that we remain far from the historic low levels of unemployment achieved pre-pandemic, it is less clear to me that such a benchmark will be the best guidepost in the current expansion. The pandemic introduced a number of frictions into the labor market, many of which are likely to evolve over time. Barring further intensification of the virus, I would expect these frictions to fade, promoting strong job gains and a relatively fast approach to maximum employment. However, the experiences of the past year may well have resulted in a number of structural changes to the labor market, including how, when, and where people work. These changes could affect the assessment of maximum employment in ways that are not yet clear.

As witnessed during the last expansion, it can take some time to draw individuals back into the labor market. This is not an argument for keeping rates unchanged but ensuring accommodation adjusts as the economy expands, avoiding imbalances and instability that can derail such gains.

Needless to say, the road ahead to policy normalization is likely to be a long and bumpy one as we navigate inflation and labor market dynamics in the post-pandemic economy. Considering the financial stability landscape also will be key to the achievement of our goals. Along the way, a careful assessment of the data will be essential in shaping the narratives that guide policy decisions, balancing nimbleness and patience and steering clear of policy errors.