What’s Driving Growth and Inflation?

Charles L. Evans
President and Chief Executive Officer
Federal Reserve Bank of Chicago

Original Equipment Suppliers Association (OESA)
2021 Automotive Supplier Conference:
Beyond Disruption
Novi, MI
November 8, 2021

FEDERAL RESERVE BANK OF CHICAGO

What's Driving Growth and Inflation?

Charles L. Evans
President and Chief Executive Officer
Federal Reserve Bank of Chicago

Introduction

It's a pleasure to address the Automotive Supplier Conference. The auto sector plays a central role in the Midwest and national economies. This year's event, with its focus on the future of the industry, provides an excellent opportunity to discuss my views on the future of the economy and monetary policy. After my formal remarks, I look forward to answering your questions and, very importantly, to hearing about some of the issues you are facing. Your thoughtful comments contribute to better monetary policymaking. So thank you.

And, speaking of policy, this is the point in the speech where I have to remind you that the views I will express today are my own and not necessarily those of the Federal Open Market Committee (FOMC) or the Federal Reserve System.

Setting the stage

As you know, the Federal Reserve has a congressional mandate to use its policy tools to help promote maximum employment and price stability. The FOMC considers maximum employment to be a broad-based and inclusive goal. For price stability, the

Committee seeks inflation that averages 2 percent over time, as measured by the Price Index for Personal Consumption Expenditures (PCE).[1]

So how are we doing? With the onset of the Covid-19 pandemic in March 2020, the U.S. experienced an extremely deep recession as large swaths of the economy shut down to combat the virus. Although the virus has taken a horrible toll on the health and livelihoods of so many people, economic activity in the U.S. did begin to rebound quickly; and by the second quarter of this year, gross domestic product (GDP) had surpassed its pre-pandemic level and has risen further since. The labor market has improved as well. After peaking near 15 percent in April 2020—which for a variety of reasons was an understatement of the true extent of joblessness—the unemployment rate now stands at 4.6 percent.

Given how dire an event the pandemic has been, this economic progress is remarkable. Households and businesses showed amazing ingenuity in finding ways to operate safely. The health care sector was able to develop and deploy vaccines extremely rapidly. And the government provided crucial support through fiscal and monetary policy actions.

Even so, about 4-3/4 million fewer people are working today than were before the pandemic. Furthermore, the recession fell harder on minorities and women, as higher percentages of them work in industries most affected by the pandemic. Some of these workers are still feeling the extra pinch of the pandemic. So, while good progress has

[1] Federal Open Market Committee (2021c).

been made, we still have a way to go before we meet the FOMC's inclusive employment mandate.

Of course, inflation is the other part of the Federal Reserve's policy mandate. Here, the picture is complex. Sharp declines in demand in sectors heavily hit by the pandemic, such as travel and leisure and hospitality, led to some very weak inflation readings last year. However, this year inflation has picked up sharply. Some of this reflects the normalization of prices in these heavily pandemic-hit sectors. But more generally, the sharp recovery in demand has led to supply chain disruptions and labor shortages. A big question for policymakers today is how much of a mark will these pressures leave on underlying inflation.

Before I get into specifics, I want to emphasize that Covid continues to play a critical role in the economic outlook. The spread of the Delta variant slowed momentum recently. After surging 6.5 percent in the first half of the year, growth in the third quarter decelerated sharply to 2.0 percent. The increases in Covid cases in some countries important to global supply chains also put further pressure on prices.

All of this is a stark reminder that progress on the economy is still very much tied to progress on the virus, and the path forward remains highly uncertain. However, with case counts coming down in the U.S. and further improvements in public health, there's room for optimism. A couple of early readings on business activity in October were strong, and some daily and weekly indicators of consumer spending have ticked up over the past few weeks. Most forecasters are looking for strong growth in the fourth quarter.

The growth outlook remains healthy, though there are risks

So what lies ahead for growth? Four times a year the FOMC releases its Summary of Economic Projections (SEP), which presents FOMC participants' forecasts of key economic variables over the next three years and for the longer run. Participants also provide their assessments of the appropriate monetary policy that supports those forecasts. The most recent SEP projections were made in mid-September.[2] The median FOMC participant expects growth of 5.9 percent this year and 3.8 percent next year and then growth of 2.5 percent in 2023 and 2.0 percent in 2024. Those are healthy numbers. My own outlook is largely in line with the median SEP projection.

However, this is an evolving situation with a great deal of uncertainty. For example, since these forecasts were made, the impact of the Delta variant and supply constraints have become more evident. I've already mentioned the third-quarter GDP number. In addition, manufacturing output fell 3/4 percent in September after a smaller decline in August. The drop was largely accounted for by lower motor vehicle output as a result of the microchip shortage and disruptions to refining and chemical production due to Hurricane Ida. Still, the flatness in factory output excluding these factors is a sign that supply constraints have taken a broader toll on the manufacturing sector. Now these factors probably represent more of a shift in the timing of growth between 2021 and 2022 than a more lasting softening in activity. But that remains to be seen.

In the labor market, the median SEP forecast has the unemployment rate falling to 3.8 percent by the end of next year and settling in around 3.5 percent in 2023. For

---

[2] Federal Open Market Committee (2021b).

comparison, the median projected longer-run unemployment rate is 4 percent. So, by this measure, our full employment goal would be well within sight. Of course, we will be looking at a broader list of labor market indicators when making this assessment. In particular, as I'll discuss in a minute, labor force participation remains depressed, meaning the unemployment rate doesn't tell the whole story about how the labor market is performing.

Supply bottlenecks and labor shortages complicate the inflation situation

But what about our price stability mandate? Is it close at hand? This is a more complicated question to answer. We've all seen higher prices lately—ranging from a variety of materials input costs to what you are paying at the grocery checkout or at the gas pump. For the 12 months ending in September, the Personal Consumption Expenditures Price Index rose an eye-popping 4.4 percent. As I noted earlier, some of these high readings reflect the normalization of prices in sectors where prices had been depressed during the pandemic. And some reflect short-term supply chain disruptions, shortages of many kinds of workers, and other supply pressures that have accompanied the sharp recovery in demand in many sectors. Those associated cost increases are being passed through to higher consumer prices.

So, a $64,000 question for monetary policymakers is, how persistent will these price increases be?[3] I think much of the current surge in inflation is temporary, but that assessment certainly needs explaining. First, the effects on inflation of increases in

---

[3] The first episode of *The $64,000 Question* aired on CBS on June 5, 1955. Today, the top prize for the game show would be worth more than $464,000 after adjusting for inflation.

prices for those goods and services where demand had been depressed during the pandemic will end as those prices return to more normal levels. That story is pretty simple.

The supply side story is much more complicated. But let me give you one example. The pandemic set in motion many changes. With people forced to spend more time at home, households shifted their spending from services, such as travel or dining out, toward goods, such as appliances for home improvement projects or consumer electronics. And many of these items contain a large number of sophisticated microprocessors. At the same time, expecting a severe and prolonged recession, automakers substantially scaled back their production plans. This included ordering fewer microprocessors used in motor vehicles.

Well, we all know how this story turned out. The demand for vehicles recovered much more robustly than most expected. Meanwhile, chip producers had allocated more product to firms manufacturing consumer electronics and other such items. To this add in a fire in Japan at a major chip producer and some other supply disruptions, such as a drought in Taiwan, and then car and light truck production becomes severely curtailed. Auto and truck production had recovered to a 10-3/4 million unit annual rate around the turn of the year; last summer it had fallen to just about an 8-1/2 million unit rate. The supply disruptions also have spurred an associated surge in vehicle prices.

This is just one story, but in many areas we are seeing producers struggling with such supply bottlenecks. In some cases, lean just-in-time production processes have come under pressure from multiple directions simultaneously as the flood of demand has put logistics systems under immense strain. For example, one contact at a conglomerate that manufactures machinery for a global clientele described how difficulties sourcing a simple $2 part could delay shipment of a $10,000 machine. He and others observed that issues such as these are now routine and require careful planning to manage successfully. With many components being sourced from different suppliers often spread around the globe, the potential for delays is compounded. Difficulties in getting shipping containers to the right locations, backups at ports, a trucking fleet impaired by deferred maintenance, and a shortage of drivers have added to the supply pressures.

On top of this, many businesses are reporting difficulties hiring workers. Now, I can't recall a time when managers weren't complaining about hiring difficulties, but in the past that comment has usually been accompanied by the qualification: "And I'm not increasing wages to get them." That's certainly not the case today. We are seeing marked increases in wages, signing bonuses, and benefits as firms try to hire the workers they want.

How is this going to turn out? As introductory economics courses always teach, an increase in demand and reduced supply in a market will cause the price for that good or service to rise. And that increase in price will dampen demand, bring forth more supply, and eventually eliminate the shortage. We have already seen that happen for a few products. For example, the price of lumber more than doubled between February 2020 and this past May as home construction surged late last year. New construction has since softened, and lumber prices have come down about 40 percent since their peak.

Eventually, these adjustments will be behind us and supply and demand conditions will normalize, bringing inflation lower. But how long that process will take is highly uncertain. The issues seem more persistent than many thought they would be a few months ago. And even when the adjustments are done, the prices of some goods and services may be permanently higher. For those whose incomes have not kept pace with inflation, paying higher prices is a hardship.

Let me go into some more detail on supply conditions in the labor market. While there are ample job openings, as I noted, about 4-3/4 million fewer people are employed today than prior to the pandemic. Much of this shortfall reflects people who are on the sidelines right now, not looking for a job.

In economic statistics, the labor force counts how many people are either employed or actively looking for work—so it's a measure of the supply of available workers. Today, about 3 million fewer people are in the labor force than before the pandemic. Given population trends, if the labor force participation rate had held constant, we would have seen an increase of about 1.4 million participants over this time.

What is going on? First, health concerns may still be keeping some people from looking for work. And some workers in leisure and hospitality and other outward-facing industries may be waiting to see that reopening is back for good before committing to a new job. Second, expanded unemployment insurance benefits as well as other fiscal support may have reduced the incentive for some workers to return to the workforce. Third, retirements have surged; my staff estimates that since the pandemic began there have been 1 million or more retirements that cannot be explained by typical demographic trends. Fourth, school closures and childcare concerns have kept some parents of young children out of the labor force.

I do not expect these factors to persist. As public health conditions improve, jobs will become more predictable, as will childcare and school schedules. Expanded unemployment insurance programs have ended, and any savings from other payments will be depleted. Stronger labor market conditions will draw some early retirees—as well as many who now describe themselves as retired—back to work.

So taken altogether, I expect that the currently elevated inflation readings from supply side pressures will eventually fade. That said, I had expected to see more progress by now. And there are some indications that inflationary pressures may be building more broadly. Rents and homeownership costs have accelerated in recent months.[4] And measures such as the Dallas Fed's Trimmed Mean PCE inflation rate that are designed to filter out erratic changes in prices also have picked up recently.[5] These developments deserve careful monitoring and present a greater upside risk to my inflation outlook than I had thought last summer.

Implications for inflation and monetary policy

The big question for the medium- and longer-term inflation outlooks is whether the increases in prices and wages we are seeing today will find their way into the underlying

[4] Rents and owner-equivalent rents that are imputed for households owning their primary residence account for almost 40 percent of the core Consumer Price Index and a much smaller, though still significant, 17 percent share of the core Personal Consumption Expenditures Price Index. Measures of core inflation strip out volatile food and energy components.
[5] The Dallas Fed's Trimmed Mean PCE inflation rate is available online, https://www.dallasfed.org/research/pce.

wage and price setting mentality of households and businesses. In other words, are businesses and workers going to expect continually larger increases in wages and prices, so that we will have transitioned to permanently higher inflation? Or do they interpret the current situation as a reaction to temporary supply side factors, so that once those ease, we will return to an environment more like what we saw prior to the pandemic?

These are difficult questions to answer. But if you look at surveys of households or measures derived from financial markets, longer-run inflation expectations appear either roughly in line with or even a bit below the FOMC's 2 percent average inflation goal. So, with the caveat that none of these indicators are very precise, they signal today's outsized inflation as being temporary.

The median FOMC participant also expects the recent surge in inflation to be temporary. The median SEP projection made in mid-September is for inflation to end the year at 4.2 percent before quickly dropping to 2.2 percent in 2022 and 2023 and moving slightly lower in 2024 to 2.1 percent. And I would note that the stance of monetary policy underlying this forecast is highly accommodative. The median projection for the federal funds rate has one 25 basis point increase occurring next year and then three rate hikes in each of 2023 and 2024.

This path reflects the forward guidance the Federal Open Market Committee has given about interest rates for more than a year and reaffirmed at our meeting last week.[6] That

[6] This forward guidance has been included in FOMC statements since September 2020 (see Federal Open Market Committee, 2020b). For the latest FOMC statement, issued on November 3, 2021, see Federal Open Market Committee (2021a).

is, rates will remain at their current zero to 1/4 percent range "until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time."[7] And even after that, the Committee expects to maintain an accommodative stance until that inflation outcome is in fact achieved.

Of course, since early in the pandemic, the Fed also has been purchasing Treasuries and agency mortgage-backed securities—first to assist key financial markets to function effectively and then to help the recovery by further easing financial conditions. Last December the FOMC stated its intention to continue asset purchases at a pace of at least $120 billion per month until substantial further progress was made toward our maximum employment and price stability goals.[8] At last week's meeting, the Committee judged that the economy had met this test.[9] So later this month, we will begin to gradually reduce the monthly pace of purchases. At the moment, the expected pace of tapering could result in our net purchases ceasing entirely by the middle of next year. However, we are prepared to adjust the pace if warranted by changes in the economic outlook.

Furthermore, this tapering decision does not imply any direct signal regarding our interest rate policy. We continue to articulate a different and more stringent test for the economic conditions that would need to be met before raising the federal funds rate. So, the exact timing of that rate path will depend on economic outcomes. As you can see,

[7] Federal Open Market Committee (2020b, 2021a).
[8] Federal Open Market Committee (2020a).
[9] Federal Open Market Committee (2021a).

there are many uncertainties to the outlook and changing circumstances could lead the FOMC to move up or delay rate increases. But judging from where the economy stands today, it looks like we are in for a low rate environment for some time to come.

Thank you. And now, I look forward to your questions.

References

Federal Open Market Committee, 2021a, “Federal Reserve issues FOMC statement,” press release, Washington, DC, November 3, available online, https://www.federalreserve.gov/monetarypolicy/files/monetary20211103a1.pdf.

Federal Open Market Committee, 2021b, Summary of Economic Projections, Washington, DC, September 22, available online, https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20210922.pdf.

Federal Open Market Committee, 2021c, “Statement on longer-run goals and monetary policy strategy,” Washington, DC, as reaffirmed effective January 26, available online, https://www.federalreserve.gov/monetarypolicy/files/fomc_longerrungoals.pdf.

Federal Open Market Committee, 2020a, “Federal Reserve issues FOMC statement,” press release, Washington, DC, December 16, available online, https://www.federalreserve.gov/monetarypolicy/files/monetary20201216a1.pdf.

Federal Open Market Committee, 2020b, “Federal Reserve issues FOMC statement,” press release, Washington, DC, September 16, available online, https://www.federalreserve.gov/monetarypolicy/files/monetary20200916a1.pdf.