Economic Outlook

Despite widespread worker shortages, the U.S. economy added 850,000 jobs in June amid declining COVID-19 cases, a reopening economy, states lifting restrictions and increasing vaccinations.

Other measures of labor-market slack, such as the labor-force participation rate, or the unemployment rate rising to 5.9%, also remain far from compatible with the Fed's goal of maximum employment.

Those measures again confirm grounds for Fed officials to remain committed to their highly expansionary monetary policy even as other elements of the report have the potential to heat up the discussion regarding wages and inflation, the other key elements guiding Fed policy.

For quite some time now, unreliable evidence has been pointing to a shortage of available skilled labor which has been misinterpreted as difficult labor-market conditions.

Recent reports have indicated that a certain degree of tightness, reflected in moderately increasing average hourly earnings, has been particularly evident in industries associated with the economic reopening.

The question that arises is whether there is a sustainable shift in wage dynamics, or just a temporary discrepancy between the potential number of employees unwilling to go back to work, for one reason or another, and the increasing hiring needs of companies.

While there is no straightforward answer to this question, a combination of generous fiscal support during the pandemic, ongoing extended unemployment benefits and some pandemic-related distortions to everyday life have played an important role.

A recent survey indicated that many people are still hesitant to return to work because of fears of the virus. Approximately 48% want to be vaccinated and 35% want all their co-workers to be vaccinated.

Another possibility is that people have used the time off during lockdowns or spent working at home, to question their previous career path, eventually leading to the decision to take a new direction in their lives. Some may now be seeking other opportunities.

The good news is that, for about a third of the population, the resulting lower supply of labor in some industries, the pandemic has turned out to be an opportunity to improve their lives.

That figure shows high levels of personal savings which means people may have more scope to make life changes. And for the other two-thirds, the findings highlight still more need for the vaccination campaign to get the job done and guarantee a safe return to work.

An additional piece of the puzzle could be that we are experiencing an adjustment in wages that has been lacking for some time and the current situation is enabling people to obtain higher wages which is another implication of a high turnover rate.

The overall mixture of motivations is likely to imply further wage pressures soon. This pressure should fade out as more and more people feel comfortable returning to work, whether it be to their former job, improved wages, or something new.

Inflation should follow a similar path to wages. The current friction in labor markets will increase prices, as will disrupt global supply chains and increase prices for raw materials. All these factors should be temporary.

What we are witnessing now is fiscal intervention on a scale not seen before in peacetime, a wartime level of intervention, supported by highly accommodative monetary policy. Once those massive fiscal impulses fade, inflation should return to its normal dynamics.

The view that inflation will be transitory does have its risks. There could be a renewed escalation of the trade war with China, for example, or potential radical changes to economic policy targeting ecological sustainability.

These changes might not be rooted in domestic policy-setting. A first move toward a global minimum corporation tax of 15%, as just recently agreed upon by the Group of Seven (G7), demonstrates that powerful global forces are driving change these days.

While acknowledging these risks, economist continue to forecast that inflation will eventually recede over the next 12-18 months, but the new balance for inflation might be somewhat above the levels experienced before the pandemic.

Temporary effects from pent-up demand, the return to work and the reallocation of labor might last longer than initially thought.

Some production of critical infrastructure like microchips might be repatriated and now well-established forms of telecommunications have the potential to increase productivity, warranting somewhat higher wages and therefore prices.

Eventually, those effects should generate a healthy level of inflation, consistent with labor markets at maximum employment.

The belief that transitory inflation will not disappear quickly, however, does not change the expectation that the Fed will remain quite satisfied about money.

One of the Fed's favorite measures of inflation, inflation expectations, remains well within the Fed's comfort zone and therefore can be described as well anchored.

The Fed is progressing further toward a discussion of tapering in late summer. Most likely it will hint that the economy is making "sufficient progress" toward their goals during the Jackson Hole Symposium in late August.

Actual tapering, however, is unlikely to start before late 2021 or early 2022, followed by a first-rate hike in 2023.

In line with the advent of temporally higher inflation, there is good progress to report. The gross-domestic-product (GDP) growth projections for 2021 has been raised to 7.2% year-over-year (Q4/Q4).

The economy has proven more resilient to Covid-19 than was generally expected, helped by the extraordinary level of stimulus and fast progressing vaccinations.

What remains in question is the longer term, when monetary stimulus is tapered, and the government starts to address a fiscal deficit expected to exceed 15% of GDP this year.

The bottom line is the pandemic bills will eventually have to be paid.