Fed Sets the Countdown to Taper Ticking as U.S. Real GDP Recovers Its Pre-Crisis Peak; Eurozone Is Back in Recovery

UNITED STATES: The Federal Open Market Committee kept monetary policy unchanged in its July 28 decision, but signaled that they have started the tapering clock. The committee said that the economy has made “progress” toward their goals of full employment and inflation averaging 2% over the longer run, but not the “substantial further progress” they set in December 2020 as a condition for tapering to start. Specifically, the FOMC said “the economy has made progress toward” their goals of maximum employment and price stability; this is new language compared to the previous statement from June. The Fed will maintain its monthly purchases of $80 billion of long-term Treasurys and $40 billion of mortgage-backed securities until, in the FOMC’s view, the economy has made that “substantial” progress. The FOMC’s sentence on current inflation was unchanged from June: “Inflation has risen, largely reflecting transitory factors.” Fed officials have been consistent in their view that most of the acceleration in inflation in recent months is tied to post-pandemic mismatches between supply and demand, and that these price pressures are likely to be temporary. The FOMC maintained language, in the statement since December, saying that the committee does not expect to raise the federal funds rate, its key policy interest rate, “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.”

The Fed statement gives the FOMC leeway to reduce asset purchases later this year if conditions warrant, but does not commit them to doing so. Chair Powell likely will provide more clarity on what would constitute “substantial further progress” in his speech at the Jackson Hole monetary policy conference at the end of August. PNC expects the FOMC to announce in December that it will start reducing its purchases of long-term Treasurys and mortgage-backed securities at the beginning of 2022, and then gradually reduce those purchases over the course of next year. It is still unclear whether the Fed will reduce its purchases of Treasurys and mortgage-backed securities proportionately, or tilt the taper to slow MBS purchases more.

Real GDP grew 6.5% annualized in the second quarter of 2021, below consensus expectations for growth of 8.4% annualized, and up from 6.3% (revised from 6.4% in the prior report) in the first quarter of 2021 and 4.5% (revised from 4.3%) in the fourth quarter of 2020. In year-over-year terms, real GDP grew 12.2 percent in the second quarter of 2021 after plunging 9.1% in the second quarter of 2020. 6.5% annualized growth doesn’t mean real GDP was actually 6.5% higher in the second quarter than the first. It means that if real GDP grew at the same pace for four quarters, the economy would be 6.5% larger at the end of it.

Personal consumption expenditures grew 11.8% annualized in the second quarter, with spending on services up 12.0% annualized, the fastest services spending growth since the pandemic struck—consumers are patronizing high-contact businesses again as fear of the pandemic recedes. Gross private fixed investment grew a much softer 3.0% annualized in the second quarter, with a 7.0% annualized drop in nonresidential investment in structures and a 9.8% annualized drop in residential investment partially offsetting strong growth in investment in equipment, up 13.0% annualized, and intellectual property, up 10.7% annualized. Supply chain disruptions, surging construction material prices, and labor shortages slowed construction in the second quarter. Business inventories fell a nominal $169 billion in the second quarter, subtracting 1.1% from annualized real GDP growth and providing further illustration of the disarray in business supply chains.
PNC forecasts for the August 6 release of the Bureau of Labor Statistics’ Employment Situation Summary for July to show nonfarm payroll employment up 700,000 from June, the unemployment rate down to 5.7% from June’s 5.9%, and average hourly earnings up 0.4% on the month and 3.9% on the year. The Employment Cost Index, which includes the cost of fringe benefits as well as wages, and which accounts for changes in workforce composition, rose a slower 2.8% from a year earlier in the second quarter of 2021, little changed from its 2.7% increase in the second quarter of 2019. Slower growth of compensation for high-earning workers is offsetting faster-growing compensation of lower-earning workers.

EUROZONE: The Eurozone returned to recovery in the second quarter of 2021, but its more restrained fiscal stimulus has economic activity well below the pre-crisis level, in contrast with the U.S. Real GDP rose 2.0% on the quarter, or about 8% annualized, after contractions of 0.3% in the first quarter of 2021 and 0.6% in the fourth quarter of 2020. Real GDP was up 13.7% from a year earlier in the second quarter of 2021; it contracted 14.4% in those terms in the second quarter of 2020, so real GDP in the latest report is still down 2.7% from the second quarter of 2019. The unemployment rate fell to 7.7% in June 2021 from an unrevised 8.0% in May and 8.1% in March and April; employment by the household survey rose a strong 1.2 million on the month or 0.8% after a 700,000 (0.5%) contraction in May. Employment is down about 1.4% from the pre-crisis peak of June 2019. Surveys show the Eurozone’s solid recovery continued in July; the European Commission’s Economic Confidence Indicator rose to 119.0 from 117.9 in June, and was well above its 2019 average of 103.7. Their consumer confidence index was -4.4 after -3.3 and above 2019’s average of -7.0.

The Harmonized Index of Consumer Prices (HICP) rose 2.2% in July from a year earlier, up from 1.9% in June and the highest since late 2018. Faster year-ago energy price increases are most of the story; they rose 14.1% on the year in July after a 12.6% increase in June. Core HICP excluding food, energy, alcohol and tobacco slowed to 0.7% in year-over-year terms after 0.9% in June—the Eurozone’s weaker recovery is preventing the demand pressures that are fueling inflation in the United States.

CANADA: GDP declined 0.3% in May from April, in line with expectations, following a downwardly-revised 0.5% decrease in April. Eleven out of twenty-two sectors were down in May as restrictions on economic activity were imposed in many parts of the country during the latest coronavirus wave. Goods-producing activity was down 0.4% while services-providing activity fell 0.2%. GDP rebounded 0.7% in June according to Statistics Canada’s preliminary estimate; activity in high-contact industries rebounded as vaccines were distributed, coronavirus caseloads declined, and restrictions lifted. Canada’s economy is on pace to grow around 2.5% in the second quarter on an annualized basis according to Statistics Canada, slightly above the Bank of Canada’s 2% forecast made in their July Monetary Policy Report.

The August 6 release of Statistics Canada’s Labor Force Survey for July will likely show around 170,000 jobs added from June as coronavirus restrictions put in place during the third wave were slowly eased. The unemployment rate is forecast to drop to 7.4% from 7.8% in June.

UNITED KINGDOM: The Confederation of British Industry’s current conditions index rose to 33 in July from 32 in June and was the strongest since 2015; the index measures the share of businesses reporting higher business activity minus the share reporting lower activity. Expectations were similarly strong, at 34, and much stronger for manufacturers (44) and professional services companies (33) than consumer services companies (9). The retailers’ survey was little changed at 23 in July after 25 in June. The qualitative comments collected in the CBI survey report continued supply chain disruptions and labor shortages due to employees required to self-isolate.

BRAZIL: 309,100 jobs were added in June, better than expectations for a 270,000 gain. June marks the sixth straight month of net job gains. Job gains were broad-based with all five sectors showing solid growth. The retail sector led the way with 24% of the jobs added while the construction sector was the weakest gainer with 7.2% of the jobs created. After losing 1.4 million formal jobs between March and June of last year, Brazil’s economy has created about 2.9 million formal jobs. The household survey showed Brazil’s unemployment rate fell slightly to 14.6% in the three months through May from 14.7% in the three months through April. In light of the surge in inflation in recent months and the inflation outlook worsening as Brazil struggles with a water crisis, PNC Economics expects the Central Bank of Brazil to increase the Selic rate by a
full percentage point, more than the 0.75 percentage point increase telegraphed in the June monetary policy statement, to 5.25% when central bankers meet on Wednesday August 4.

**INDIA:** The Reserve Bank of India (RBI) is likely to take a “wait and see” approach and keep interest rates steady when the Monetary Policy Committee meets on August 6. Inflation overshot the central bank’s 2% to 6% target range in May and June, but the central bank will likely wait for a couple of months to see if high inflation persists before changing its monetary policy. The RBI announced an expansion of its quantitative easing program in June as the economy struggled against a rise in coronavirus cases and the economic outlook worsened. Coronavirus caseloads have declined since then, but the vaccine rollout continues to be slow compared to many emerging economies.

**JAPAN:** Japan’s unemployment rate dipped to 2.9% in June from 3.0% in May, but is up from its post-pandemic low of 2.6% reached in March 2021, and up even more from its pre-downturn level of 2.3% reached between May and August 2019. Employment in June 2021 was down 91,000 or 1.3% from its pre-pandemic peak in December 2019.