An Update on the Economy and Monetary Policy

Loretta J. Mester
President and Chief Executive Officer
Federal Reserve Bank of Cleveland

Keynote Session
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Introduction

I thank Jack Kleinhenz for inviting me to participate in the NABE Foundation's 2020 Economic Measurement Seminar. I last spoke at a NABE conference in February. That was only six short months ago, but it seems like a lifetime. Many things have changed since then, including current economic conditions and the outlook for the economy and monetary policy. I want to compliment NABE for maintaining its important programming throughout the pandemic. It is a demonstration of perseverance and resilience in the face of extraordinary circumstances, traits exhibited by many households, businesses, and organizations over the past several months. Such resilience is a hallmark of the U.S. economy, and it will prove useful as the economy makes its way to a sustainable recovery. Before we turn to the question and answer part of this session, I'll give you a brief update on the economic outlook and monetary policy, and touch on the changes to the FOMC's policy strategy that were announced last week. The views I'll present are my own and not necessarily those of the Federal Reserve System or of my colleagues on the Federal Open Market Committee.

The Economy

In thinking about the economic impact of the pandemic, I find it helps to think in terms of phases. The shutdown phase started in March when the country took aggressive social distancing measures to limit the spread of the virus and to buy some time for the healthcare system to increase its capacity to care for the sick, learn more about the virus itself, and develop testing and treatments. There were swift and severe effects on the economy from the shutdown of nonessential businesses and activities.

The reopening phase started in May, as public health statistics began to improve and many parts of the country began to relax some of their stay-at-home restrictions. Economic activity and hiring in many sectors began to improve in May and June as businesses began to reopen and consumers began to re-engage. Even sectors such as travel and leisure and hospitality saw some improvement, although these sectors are likely to remain weak for some time. Early in the reopening phase, many of our business contacts in the Fourth Federal Reserve District, which includes Ohio and parts of Pennsylvania, Kentucky, and West Virginia, told us that activity was picking up more than they had expected. And some of the official statistics have come in stronger than economists had expected. The housing market has been particularly strong, with both new home and existing home sales now back to or above pre-pandemic levels. Spending on durable goods, including autos, is well above pre-pandemic levels.

This is all good news. But the recovery in activity appears to be a fragile one. The most recent high-frequency data and discussions with regional contacts indicate that the pickup in activity seen in May and June has slowed over the past couple of months. This slowdown has occurred as the number of virus cases began to rise again in some parts of the country in late June, causing some localities to put their reopening plans on pause or to reimpose restrictions on activity. Even in areas where authorities did not change reopening plans, the rise in virus cases seems to have had a dampening effect on activity as people pulled back, out of concern for their safety. The most recent virus data suggest the number of new cases, while still elevated, has turned back down, so I'll be watching to see if the pace of activity picks up again.

Since this is a measurement conference, it seems fitting that I should show you some charts illustrating some of the data. Economists tend to look at growth rates when assessing the economy, but in this unprecedented situation of a shutdown followed by a reopening, looking at the level of activity compared to what it was before the pandemic is helpful in gauging the economic outlook.

[FIGURE 1] The official GDP data clearly show the deep plunge in activity associated with the shutdown. Economic activity peaked in February and the U.S. economy entered a recession. Real GDP fell at a 5 percent annual pace in the first quarter and a record 32 percent annual pace in the second quarter, with nonresidential business fixed investment down 26 percent, and personal consumption down 34 percent, at an annual rate. The level of real GDP in the second quarter was back down to the level it was in 2014 – so we have lost six years of output growth.

The recovery in some sectors, like services, will take longer than in others, and there will be fits and starts, depending on the course of the virus. But I expect the second quarter to be the trough, a strong rebound in growth in the third quarter, and continued positive growth in the fourth quarter, but with the level of output still ending the year somewhat below where it was at the end of last year.

[FIGURE 2] The decline in activity in the first half of the year when the economy shut down put downward pressure on inflation, even though supply disruptions have caused the prices of certain goods and services to rise. During the reopening phase, there has been some recovery in the inflation measures, but I expect inflation to remain below our longer-run 2 percent goal for some time to come.

[FIGURE 3] The shutdown and reopening had clear effects on the labor market. In April there was an unprecedented rise in unemployment and loss of jobs, particularly in sectors where people cannot work from home. Many workers reported that they expected their unemployment spell would be temporary, and as the economy has been reopening, we have seen a rapid decline in the unemployment rate as people on temporary furlough began to be rehired. This is good news. But it is also good to keep these numbers in perspective. The unemployment rate was 10.2 percent in July, still slightly above its peak after the Great Recession. There are still 16 million unemployed workers in the U.S., compared with 6 million in February. This means that about one in 16 Americans over the age of 16 is unemployed, near the level after the Great Recession. Moreover, the deterioration in the labor market has not been evenly shared, with the net increase in the unemployment rate since February being higher for Blacks, Hispanics, and Asians than for whites.

[FIGURE 4] The payroll employment data tell a similar story. In just the two months of March and April, the economy lost 22 million jobs, the same number of jobs it had added over the entire recent expansion that lasted over 10 years. More than three-quarters of those losses were in the sectors paying below-average wages. The good news is that in just three months, the economy has added back over 9 million jobs. Of course, this means we are less than half way back up to the pre-pandemic level of jobs, and the current level of employment is about what it was back in 2014. So like output, about 6 years' worth of job growth has been lost.

Given the unprecedented nature of the pandemic and economic shutdown, many economists, including those at the Fed, have been looking at higher-frequency indicators to track developments. The Cleveland Fed has been surveying our contacts with greater frequency and we have added a nationwide survey of consumers to gauge how the virus has affected their attitudes and activities. These higher-frequency indicators clearly show the rebound in activity that came with the reopening of the economy, but they also show that activity is correlated with data on the course of the virus.

[FIGURE 5] For example, when virus cases began to rise again in late June, the data on mobility, or the percentage of time spent away from home, and the data on restaurant visits began to level off compared to May when reopening began. Our contacts in the restaurant industry also confirmed that the pace of business activity was dampening and some have begun to question the longer-run viability of many establishments, especially those that have not been able to transition to takeout.

[FIGURE 6] As the pandemic has worn on, businesses have begun to change their plans. Early on, many contacts told us that they were not planning to make permanent reductions to their work force; however, they eventually had to let some workers go. In our latest survey, over half of the firms told us that in light of the increase in virus cases since late June, they have made meaningful changes to their plans, including for hiring and capital spending.

Small businesses have been disproportionately affected by the virus, and the smallest of the small businesses particularly so. Data from Homebase show that the strides made since April on employment at small businesses have now begun to stall, with the number of hourly staff down about 20 percent since January. As documented by researchers at the New York Fed, Black-owned businesses have been particularly hard hit by the pandemic, and have been twice as likely to close as other firms during the pandemic. The researchers point to a number of contributing factors including these firms' weaker financial cushions, weaker bank relationships, and funding gaps that existed prior to the pandemic, plus less access to federal relief funds.[1]

[FIGURE 7] The Cleveland Fed's survey data show that both businesses and consumers are thinking differently about the pandemic than they did at the start. In our survey taken in late June, about half of our regional business contacts said it will take at least a year for their firms' activity to return to pre-pandemic levels.

The Cleveland Fed's national daily survey shows that consumers are now more willing to engage in certain activities than they were at the start, but they also believe that the pandemic will last much longer than they originally thought.[2] In March, over 80 percent of respondents thought the pandemic would last a year or less. In early August, only half think that, and the other half thinks it will be two years or even longer.

The Economic Outlook and Policy

The link we've seen between the rise in virus cases and the dampening of activity underscores the fact that the path of the economy depends on the path of the virus. Of course, the path of the virus can be

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[1] Claire Kramer Mills and Jessica Battisto, "Double Jeopardy: Covid-19's Concentrated Health and Wealth Effects in Black Communities," Brief, Federal Reserve Bank of New York, August 2020 (https://www.newyorkfed.org/medialibrary/media/smallbusiness/DoubleJeopardy_COVID19andBlackOwnedBusinesses).

[2] The Cleveland Fed's website provides updates of these survey results each Wednesday on the Consumers and COVID-19 page, https://www.clevelandfed.org/our-research/indicators-and-data/consumers-and-covid-19.aspx. For further results from the survey, see Edward S. Knotek II, et al., "Consumers and COVID-19: A Real-Time Survey," *Economic Commentary*, Federal Reserve Bank of Cleveland, 2020-08, April 17, 2020 (https://doi.org/10.26509/frbc-ec-202008).

affected by our actions. These include public- and private-sector investments in expanded testing, contact tracing, treatments, and vaccines, as well as our own individual actions to safely engage in activity by wearing a mask that covers our noses and mouths, avoiding social gatherings, maintaining distance from others, and washing our hands frequently.

Assuming that we get the virus under control and people feel safe enough and businesses confident enough to re-engage in economic activity, the economy will move from the reopening phase to a more sustained recovery phase. This recovery is likely to take some time because the pandemic was a significant shock to the economy.

Both the federal government and the Federal Reserve took swift and significant actions to provide households and businesses with relief during the shutdown. Fiscal actions have included grants to individuals, certain businesses hit hardest by the pandemic, and states and municipalities; expanded unemployment benefits; and loans to small businesses that became grants for firms maintaining their payrolls.

The Federal Reserve took actions to ensure that financial markets had enough liquidity to continue to function well and that credit could continue to flow to households and businesses, thereby avoiding financial instability on top of the pandemic. These actions have included buying Treasury and agency mortgage-backed securities to address strains in these markets; making sure our central bank counterparties abroad have access to dollar funding; setting up a variety of so-called 13(3) emergency facilities, backed by the U.S. Treasury, that serve as a backstop to other key credit markets and support the flow of credit to households, businesses of all sizes, and state and local governments; temporarily relaxing some of the regulatory requirements on banks so they have greater capacity to lend; and since March, maintaining the fed funds rate target range at 0 to 1/4 percent.

By the end of this year, I expect that output will still be somewhat below its level at the end of last year; that the unemployment rate will remain in the high single digits; and that inflation will be well below our longer-run 2 percent goal. Of course, the uncertainty around this forecast is extremely high: we are in an unprecedented situation and outcomes depend on public health considerations. The outlook also depends on appropriate economic policy. In my view, fiscal policy and monetary policy support are needed to limit lasting damage to the economy and achieve a broader, sustainable recovery. Several key parts of the fiscal policy support already in place are expiring. Given economic conditions, it seems clear that further fiscal support is needed to provide a bridge for households, small businesses, and state and local municipalities that have borne the brunt of the pandemic until the recovery is sustainably in place.[3]

For the Fed's part, the FOMC has indicated that we expect to maintain the fed funds rate target range at 0 to 1/4 percent until we are confident that the economy has weathered recent events and is on track to achieve our maximum employment and price stability goals. Our asset purchases continue to support market functioning and accommodative financial conditions. In addition, clear communications about our policy strategy can also make any monetary policy actions we take more effective. Last week, the FOMC released a revised statement outlining our longer-run goals and monetary policy strategy, which should help clarify and reinforce the FOMC's policy intentions.[4] So let me conclude with a few highlights from this statement. I direct you to Fed Chair Powell's recent remarks for a fuller discussion of the statement.[5]

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[3] Recent Cleveland Fed research shows that there have been sizable declines in activities that typically produce the largest share of state and local government tax revenue, including air transportation and gasoline sales. See Stephan Whitaker, "How Much Help Do State and Local Governments Need? Updated Estimates of Revenue Losses from Pandemic Mitigation," *District Data Brief*, Federal Reserve Bank of Cleveland, June 29, 2020 (https://doi.org /10.26509/frbc-ddb-20200629).

[4] For information about the Federal Reserve's review of its monetary policy framework, including strategy, tools, and communications, see https://www.federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications.htm.

[5] See Jerome H. Powell, "New Economic Challenges and the Fed's Monetary Policy Review," remarks at "Navigating the Decade Ahead: Implications for Monetary Policy," an economic policy symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, WY (via webcast), August 27, 2020 (https://www.federalreserve.gov/newsevents/speech/powell20200827a.htm).

Revised Statement on Longer-Run Goals and Monetary Policy Strategy

For the past year and a half, the FOMC has been engaged in a review of our framework – the strategy, tools, and communications – for setting monetary policy in pursuit of our statutory goals to promote maximum employment, price stability, and moderate long-term interest rates. The review was informed by our experience during and after the Great Recession, by economic theory and empirical analysis, and by consultations with academic researchers and practitioners at research conferences and with the public at large, through a series of Fed Listens events held across the country.

The review, whose main conclusions are captured in the strategy statement, was undertaken in light of changes in the economic environment that have emerged since our first strategy statement was published in 2012. One important change is the decline both here and abroad in the general level of interest rates consistent with sustainable growth and price stability. This decline reflects several factors, including the aging of the population, changes in risk preferences, and slower productivity growth. It means that the level of the fed funds rate consistent with maximum employment and price stability is now lower than it has been in the past. This means that during economic downturns, it is now more likely that the fed funds rate will be constrained by its effective lower bound. In other words, in the wake of a downturn, the FOMC will have less policy space to support the economy using its traditional policy tool. With households, businesses, and financial markets all understanding this constraint, this imparts a downward bias to inflation and inflation expectations, and increases the downside risks to achieving both of our policy goals.

Another change in the economic environment pertains to inflation dynamics. Resource slack has become less correlated with actual inflation than in the past, and inflation expectations now play a larger role in determining inflation outcomes. This makes it even more important that inflation expectations remain well anchored at levels consistent with our longer-run 2 percent inflation goal, especially since inflation running below our goal would result in even less policy space in a low-interest-rate environment.

The first thing to note about the revised strategy statement is that the FOMC has reaffirmed that a longer-run inflation rate of 2 percent is most consistent with our statutory mandate. But our strategy statement is now more explicit about how we will go about achieving this inflation goal. Namely, after periods in which inflation has been running persistently below 2 percent, we will likely aim to have inflation run moderately above 2 percent for some time. Doing so will help anchor inflation expectations, a main determinant of actual inflation, at levels consistent with 2 percent inflation. The new language is a stronger statement than we have made in the past as we have struggled to effectively convey that 2 percent should not be interpreted as a ceiling. We are now clear that after inflation has been running persistently below 2 percent, not only will we tolerate serendipitous shocks that move inflation above 2 percent, but that we will likely set policy with the intention to move inflation moderately above 2 percent for some time.

I have spoken many times on the fact that policy communications should acknowledge uncertainty.[6] The changes made in the strategy statement about our employment goal are an acknowledgment of the uncertainty around assessments of the level of maximum employment. Indeed, the FOMC's assessments of the longer-run unemployment rate have come down significantly over time, and employment growth over the expansion ended up being considerably stronger without generating inflation than past experience suggested was possible. It took time to learn about these structural changes in the economy. And this time-to-learn, combined with the previous strategy statement's references to "deviations" of employment from maximum employment, has been misinterpreted by some as suggesting that the FOMC, at times, takes deliberate policy action to bring employment down independently of our inflation goal. This is not the case. The benefits of a strong labor market in fostering economic inclusion for all Americans are clear and we need to be humble about our abilities to assess maximum employment in real

[6] See, e.g., Loretta J. Mester, "Acknowledging Uncertainty," remarks at the Shadow Open Market Committee Fall Meeting, New York, NY, October 7, 2016 (https://www.clevelandfed.org/newsroom-and-events/speeches/sp-20161007-acknowledging-uncertainty.aspx).

time. The new statement language clarifies that in the absence of inflationary pressures or risks to financial stability, strong employment is not a concern and monetary policy will not react to it.

I strongly believe that clear policy communications are an important part of effective monetary policymaking. The completion of the framework review and the revised strategy statement come at an opportune time, in support of the FOMC’s commitment to doing all that it can to support a sustainable recovery back to maximum employment and price stability in service to the public.

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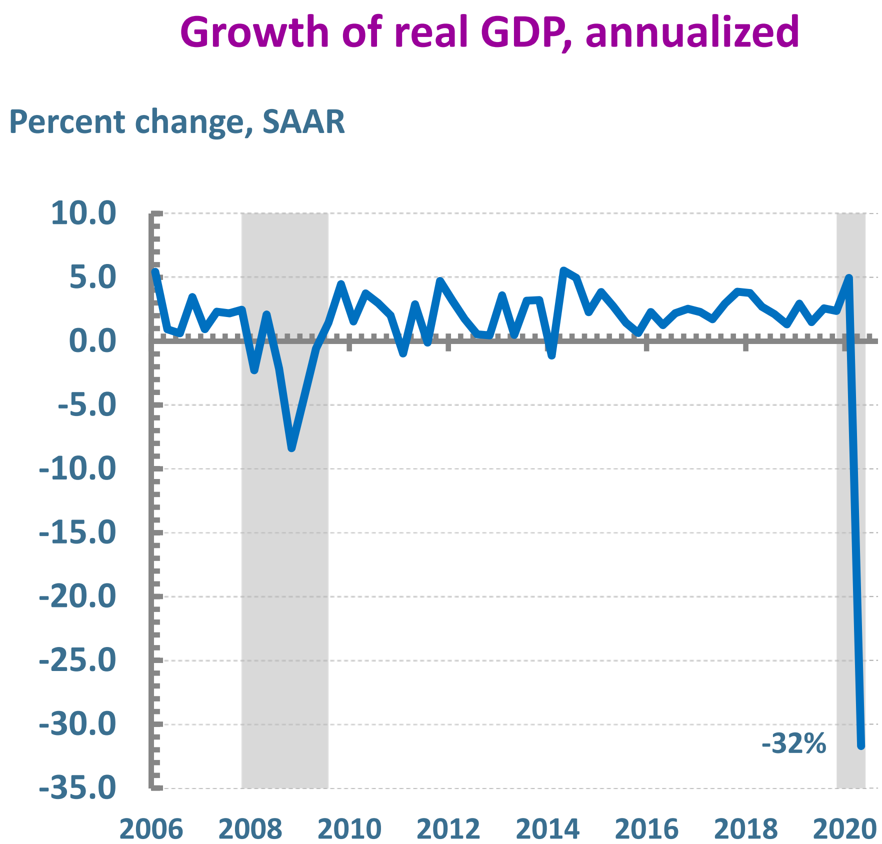
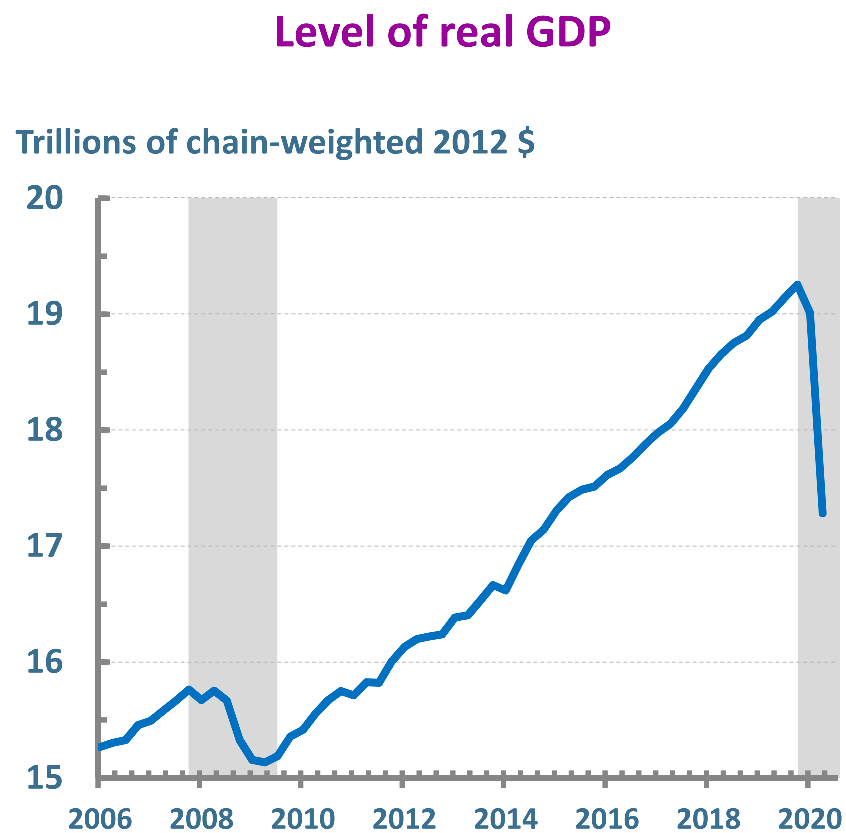
FEDERAL RESERVE BANK
of CLEVELAND

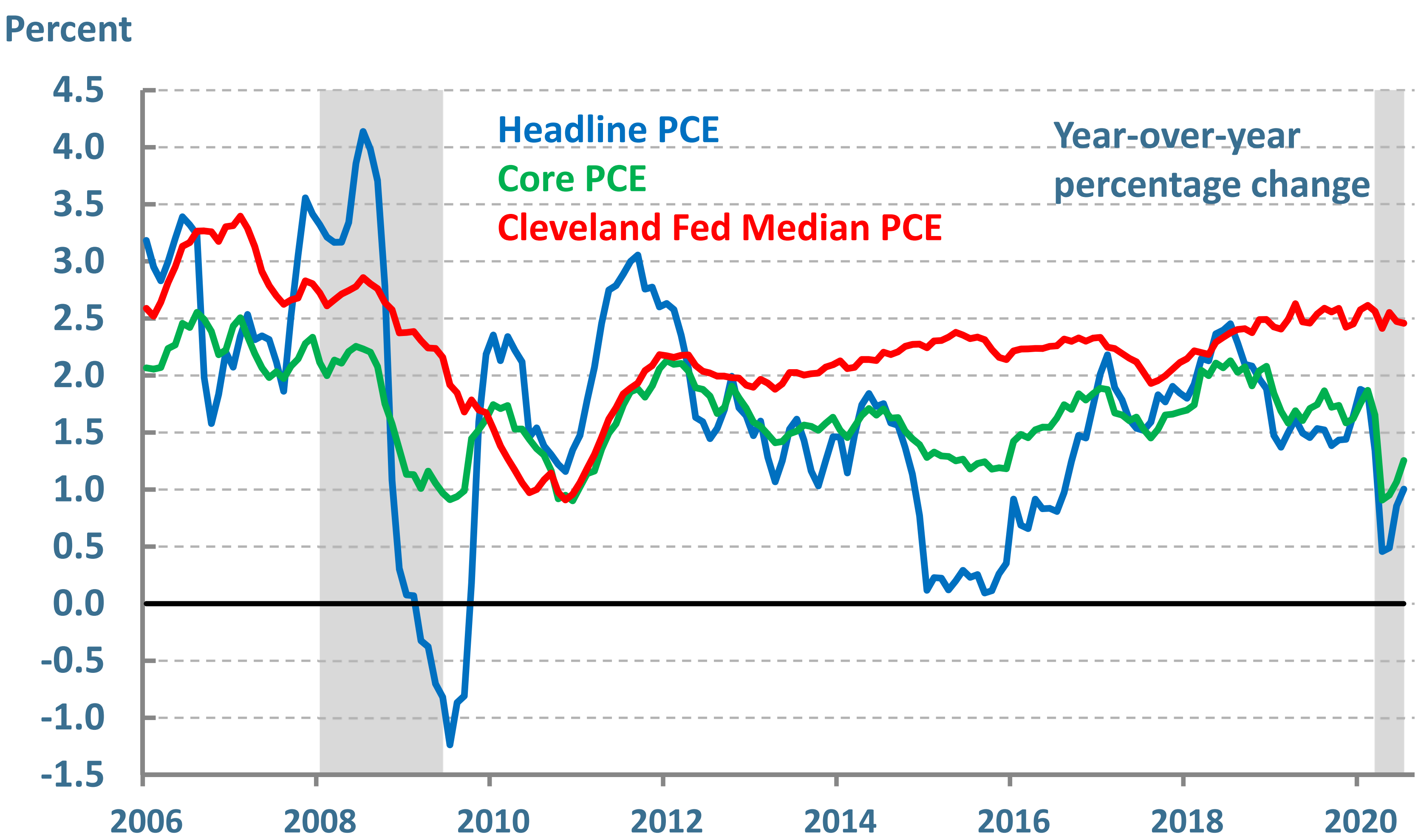
Figure 1. The economic expansion ended in February and output plunged





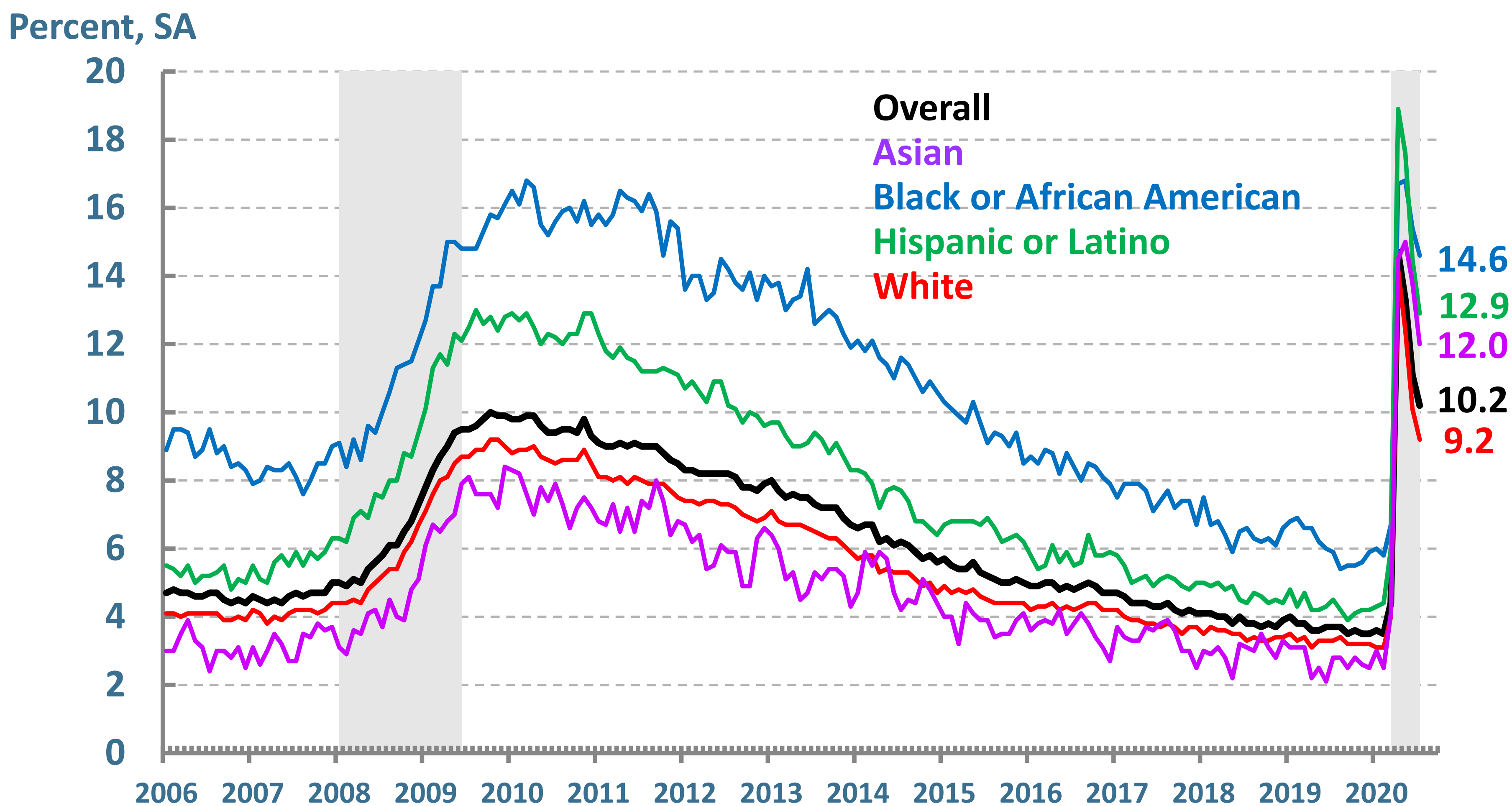
Source: Bureau of Economic Analysis via Haver Analytics
Quarterly data: Last obs. 2020Q2

Figure 2. Inflation moved down as the economy shut down



Source: Bureau of Economic Analysis via Haver Analytics and Federal Reserve Bank of Cleveland
Monthly data: Last obs. July 2020

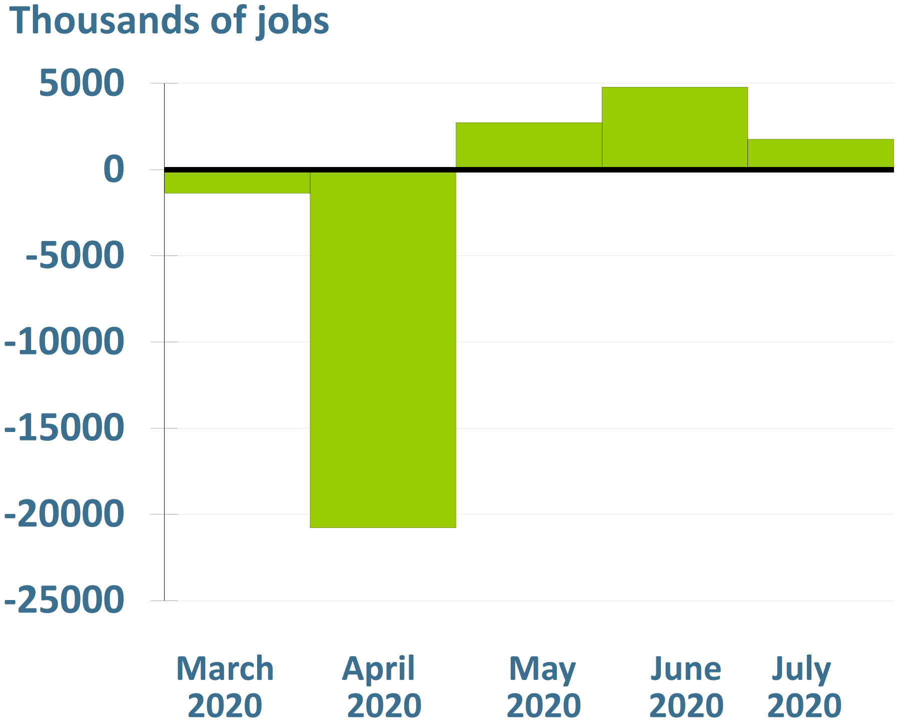
Figure 3. Unemployment rates are down since April but remain very elevated. Net increases since February have been larger for nonwhites than for whites.



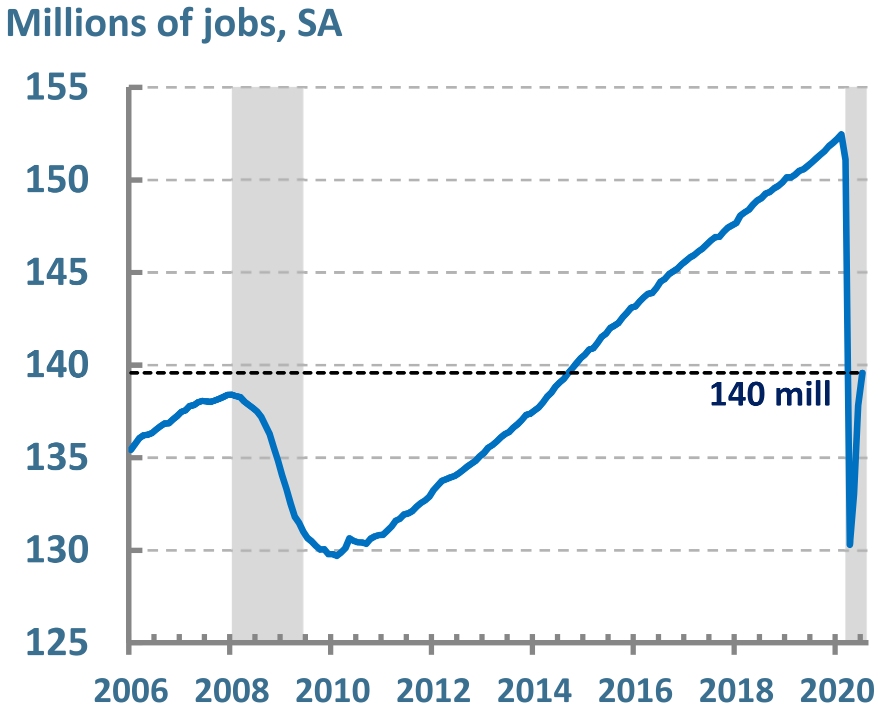
Source: Bureau of Labor Statistics via Haver Analytics
Monthly data: Last obs. July 2020

Figure 4. The economy is adding jobs again but we are still down about 6 years' worth of job growth

Monthly change in payroll jobs

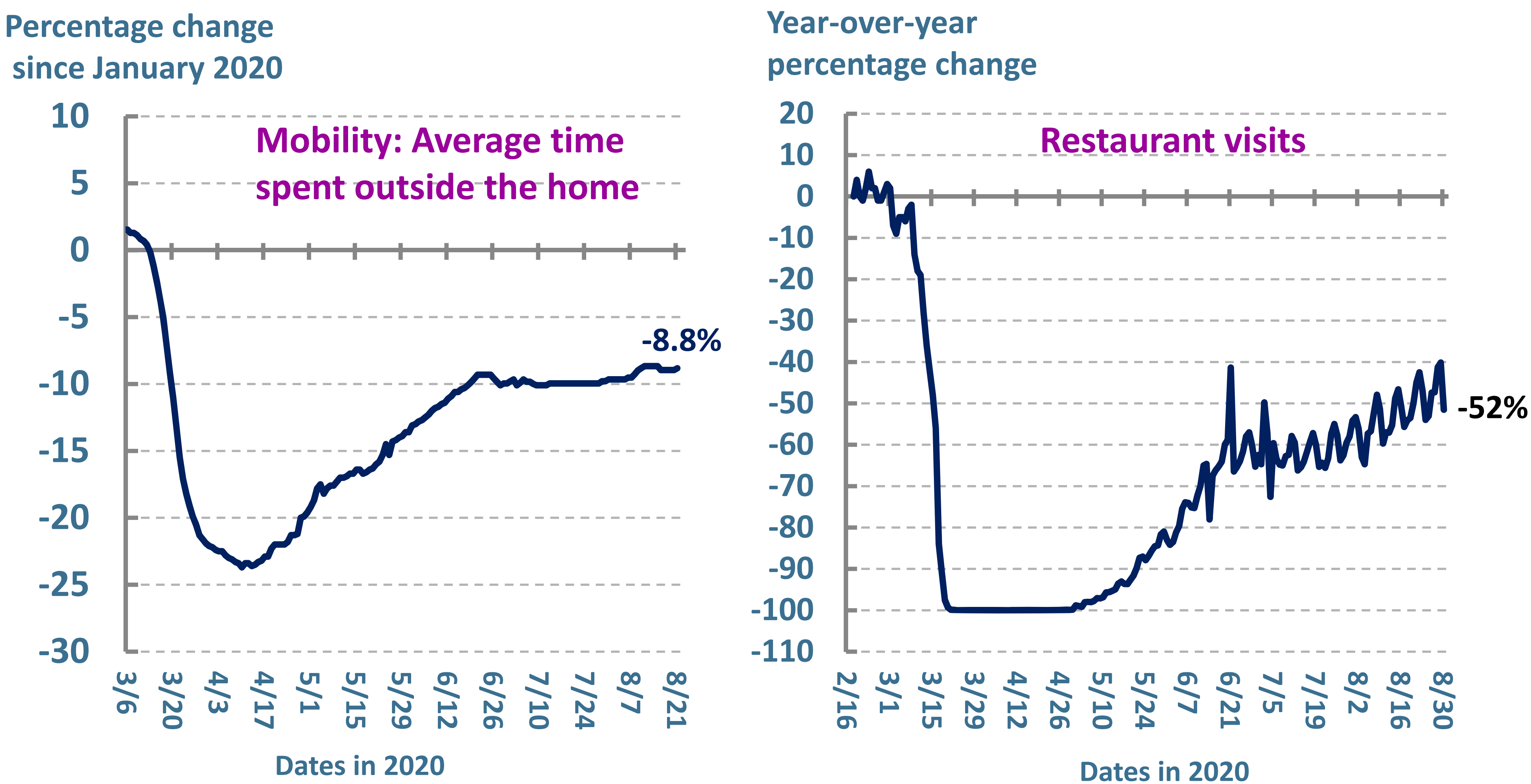


Level of payroll employment



Source: Bureau of Labor Statistics via Haver Analytics
Monthly data: Last obs. July 2020

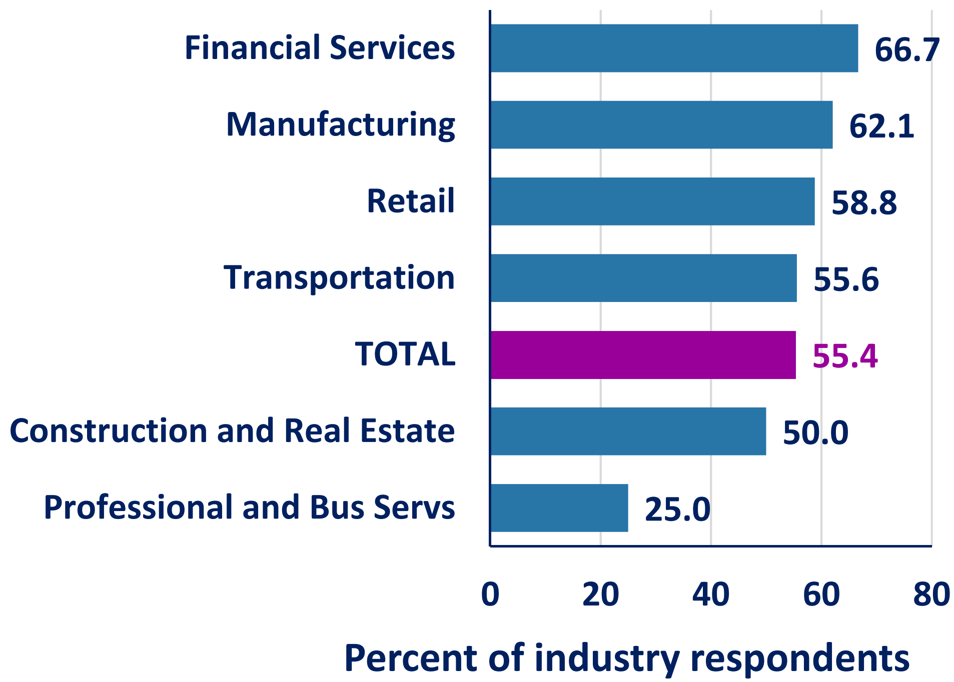
Figure 5. People are re-engaging in activity but the pace has slowed



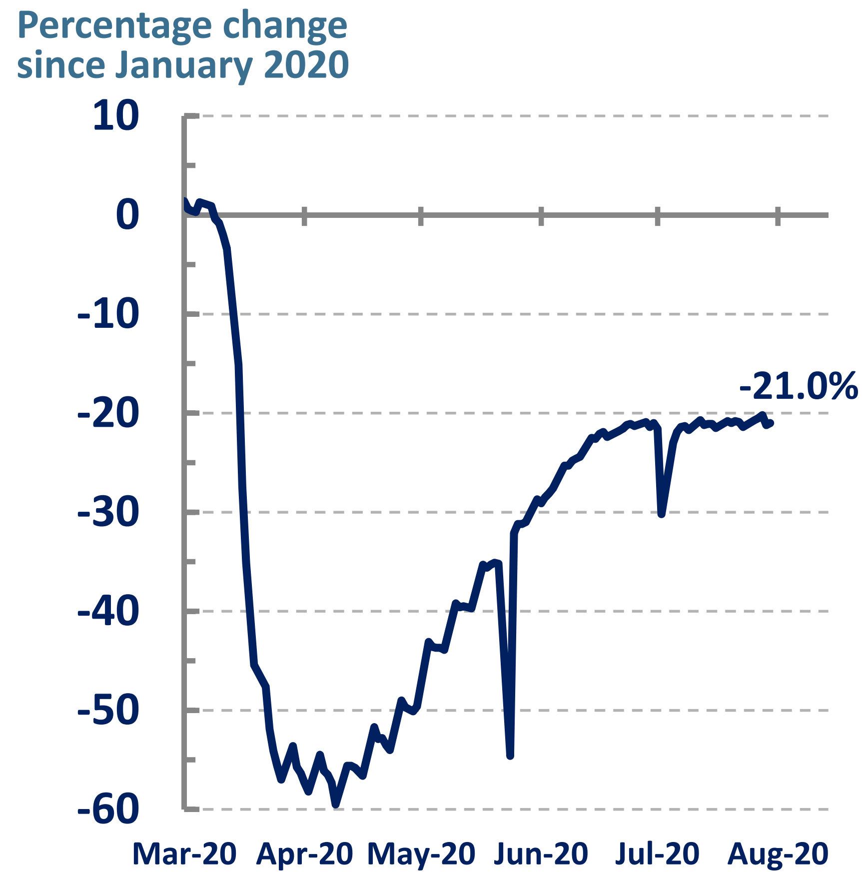
Source for Mobility: Google via Opportunity Insights at www.tracktherecovery.org,
Daily data: Last obs. 8/21/2020
Source for Restaurant Visits: OpenTable, Daily data: Last obs. 8/30/2020

Figure 6. Firms have altered plans in recent weeks

Has your firm meaningfully altered its plans (e.g., hiring, capital expenditures, hours, etc.) in response to the recent increase in COVID-19 cases?

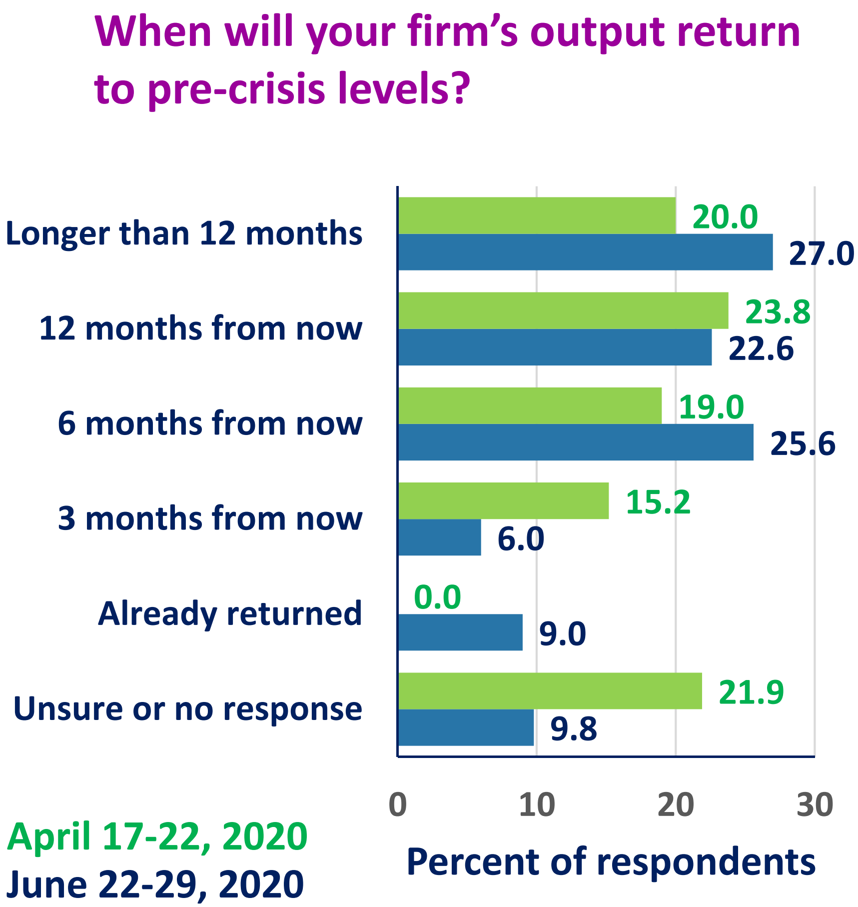


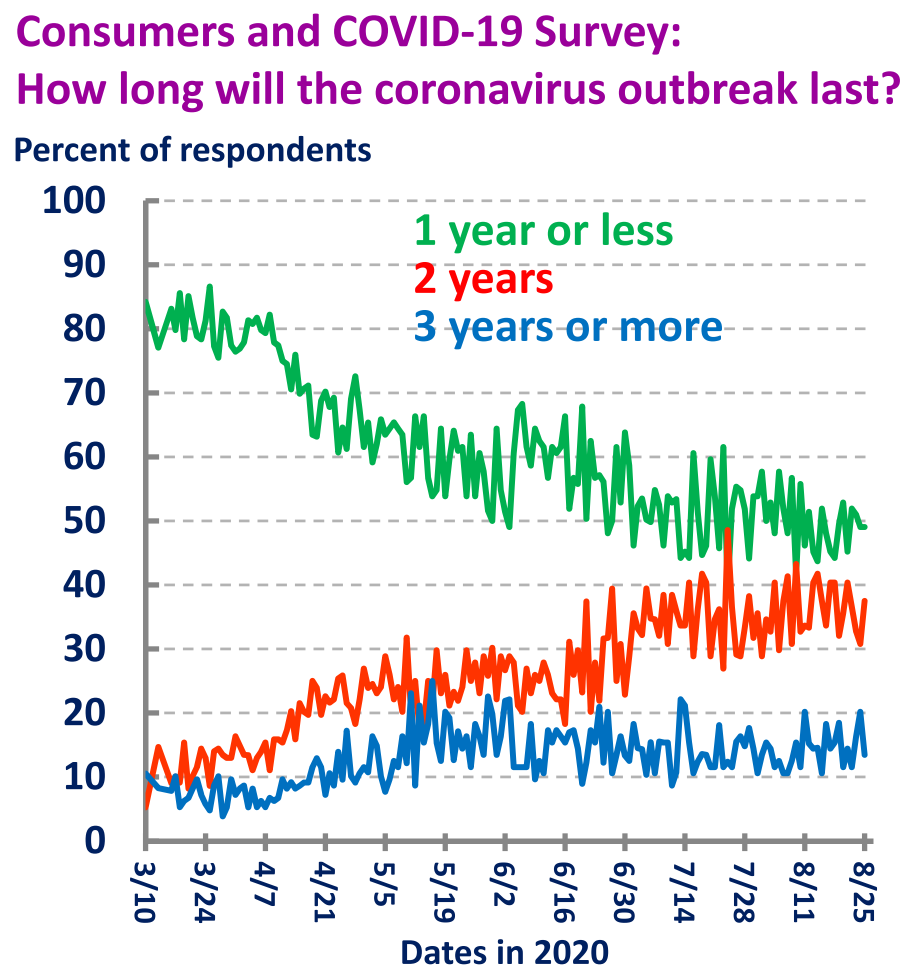
Number of hourly employees of small businesses



Source for Plan Changes: Cleveland Fed, Information collected between 7/13/2020 and 7/20/2020
Source for Hourly Employees: Homebase via Haver Analytics, Daily data: Last obs. 8/1/2020

Figure 7. Business and consumer expectations about the effects of the pandemic have changed over time





Source for firm output: Cleveland Fed, Information collected 4/17-22/2020 and 6/22-29/2020
Source for Consumers and COVID-19 Survey: Cleveland Fed, Daily data: Last obs. 8/25/2020

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