Patience Will Be a Virtue in Fostering a Broad-Based Sustainable Recovery

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Maekyung-Korea-America Economic Association Forum
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(via videoconference)

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Introduction

I thank Professor Yoosoon Chang, president of the Korea-America Economic Association, for the opportunity to speak at this year's annual forum. Over the years, the forum has had a number of distinguished speakers and it is truly an honor to speak with you this evening about the outlook for the economy and monetary policy. Of course, 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.

I would like to start with wishing everyone a happy and healthy new year. Wishing someone good health at the start of a new year is a time-honored tradition. But it has taken on a deeper meaning this year as we turn the page on 2020, a year in which the coronavirus pandemic inflicted pain and hardship on people all over the world. The pandemic was an unprecedented shock to global health and to the economy – the largest shock in most of our lifetimes. With the distribution of vaccines now underway and with further fiscal policy relief for households and businesses on the way, the prospects are good for a much more favorable 2021. Nonetheless, the next few months will be challenging ones, as the country continues to struggle with increasing new cases of COVID-19, which are putting strains on our healthcare system and limiting economic activity.

I believe patience will prove to be a virtue as the year unfolds. Until the vaccines have been widely distributed and many people have been vaccinated, we will all need to be patient and continue to follow public health experts' advice to socially distance, wear a mask, and wash our hands to help control the virus's spread. In addition, monetary policy will also need to remain patiently accommodative to support a broad-based and sustainable recovery and achievement of our longer-run goals of maximum employment and price stability.

The Economy

In thinking about the impact of the pandemic on the economy, I find it helps to think in terms of phases.

The pre-pandemic phase at the start of last year found the economy on very solid footing. It was the 11th year of the expansion, and from the perspective of our monetary policy goals, things looked quite good. The unemployment rate was at historically low levels, employment growth was strong, and participation in the labor force was higher than what was expected given the aging of the population. And after several years of running low, inflation was near our longer-run goal of 2 percent.

But the pandemic changed all of that. In March, 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. In this shutdown phase, there were swift and severe effects across the economy as nonessential businesses stopped operating and many activities came to a halt. But as public health statistics began to improve and many parts of the country began to relax some of their stay-at-home restrictions, a reopening phase began in May. This reopening phase saw sharp rebounds in activity and hiring in those parts of the economy that did not involve close physical contact.

As the summer wore on, the economy entered its current phase – a pre-vaccination recovery phase. The economy continued to recover but, as expected, at a slower pace than in the reopening phase. More recently, the pace of activity has also been constrained by the current surge in new virus cases, which has resulted in mandatory and voluntary restrictions on some activities.

In this phase, the recovery has varied considerably across sectors. Interest-rate-sensitive sectors, like housing and autos, have been particularly strong. Sales of single-family homes, both new and existing, are now well above pre-pandemic levels, and so is spending on durable goods, including autos. Spending on food in grocery stores surged in March and has remained elevated. But spending in other sectors, including travel, leisure, and hospitality, which involve more person-to-person contact, is still very constrained compared to pre-pandemic levels. Performing arts institutions continue to struggle and lost a substantial income source with the cancelation of holiday performances. The commercial real estate sector is also feeling the strains as many businesses fight to stay afloat.

These phases of the economy – shutdown, reopening, pre-vaccination recovery – are clearly seen in the data. So I would like to illustrate where things stand with a couple of slides before turning to the outlook. Economists tend to look at growth rates when assessing the economy, but in this unprecedented situation, looking at the level of activity also provides an important perspective.

[FIGURE 1. GDP growth and level] The official GDP data clearly show the deep plunge in activity associated with the shutdown followed by a rebound as the economy reopened. 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 31 percent annual pace in the second quarter. The level of real GDP in the second quarter was back down to its level in early 2015 – a loss of over five years of output growth. Growth rebounded in the third quarter as the economy reopened, with real GDP rising at a 33 percent annual pace; its level was back to where it was in early 2018. The rebound in activity was stronger than many analysts were anticipating, a good reminder that we should never count out the resiliency of the U.S. economy or of the American people. Growth continued in the fourth quarter, but at a slower pace, and I expect 2020 ended with real GDP still somewhat below where it was at the end of 2019.

[FIGURE 2. Unemployment rates] The economic phases are also clearly seen in the labor market data. April saw an unprecedented rise in unemployment and loss of jobs, particularly in sectors where people could not work from home. The unemployment rate hit 14.7 percent in April, up from 3.5 percent in February. But as the economy reopened, there was a rapid decline in the unemployment rate as people on temporary furlough or layoff began to be rehired. The improvement in the labor market was faster than anticipated, but the pace has slowed and the overall unemployment rate remains very elevated, at 6.7 percent in November.

[FIGURE 3. Change in unemployment by race and education] Moreover, some of the disparities in the recovery thus far can be seen in labor market outcomes for different racial/ethnic groups and different educational attainment groups. All groups' unemployment rates surged last spring and have fallen since then but, as of November, there has been less progress for nonwhites and for those without a college education. Relative to their pre-pandemic levels, the unemployment rates of Blacks, Hispanics, and Asians remain higher than that of whites, and the unemployment rate of high school graduates without any college is higher than that of college graduates.[1]

[FIGURE 4. Labor force participation and change for prime age by gender] These unemployment rates would be even higher if people had not left the labor force over the course of last year. As of November, the labor force participation rate for those age 16 or older was almost 2 percentage points lower than it was in February. Among workers in the prime working ages of 25 to 54, women's participation is down 2-1/2 percentage points compared to about 2 percentage points for men. In part, this reflects the types of jobs held by women and men, with a higher share of women working in industries hit the hardest by the pandemic. Reports from regional contacts, as well as survey results from the Cleveland Fed's national daily Consumers and COVID-19 Survey, indicate that the need to provide childcare for pre-school children or those being schooled remotely is disproportionately impacting the ability of women to remain in the workforce or work their usual number of hours. Firms also tell us that maintaining productivity is now harder because of the variability they are experiencing in their workforce levels – on any given day there are some workers who unexpectedly have to stay home because a school is closed or because they have been exposed to the virus.

[1] The net increase in the unemployment rate between February and November was 2.8 percentage points for whites, 4.5 percentage points for Blacks, 4.0 percentage points for Hispanics, 4.2 percentage points for Asians, 4.1 percentage points for those with a high school diploma without any college, and 2.3 percentage points for those with a bachelor's degree or higher.

On a more positive note, our contacts from staffing companies report that while they have few people looking for job placements, they have seen a significant increase in people taking their online training courses. This suggests that people are preparing themselves to re-enter the labor force when their circumstances allow them to do so.

[FIGURE 5. Employment growth and level] The payroll employment data also tell a similar story across the economic phases caused by the pandemic. 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 previous expansion, which lasted over 10 years. More than three-quarters of those losses were in the sectors paying below-average wages. When the economy reopened in May, hiring picked up rapidly. As expected, the pace has slowed since that rebound, and more recently, hiring has slowed even more given the re-imposition of some restrictions on activity due to the increase in new COVID cases. As of November, employment remained more than 6 percent, or almost 10 million jobs, below its level in February, and a larger share of those currently unemployed are on permanent rather than temporary layoff compared to earlier in the year. It will take some time for these workers to get re-employed as they may need to retrain for other occupations.

[FIGURE 6. Inflation] Weakness in economic activity and the uncertain outlook throughout last year put downward pressure on inflation, even though supply disruptions caused the prices of certain goods and services to rise. During the shutdown phase in the spring, total PCE inflation fell to 1/2 percent and core PCE inflation, which excludes food and energy prices, fell to under 1 percent. As the economy reopened and started to recover, inflation firmed. This is especially true for durable goods, where high demand has driven inflation for these goods to a 25-year high. The inflation rates for services, which include sectors hardest hit by the pandemic, including travel and hospitality, have remained near the bottom of their ranges over the last decade. Overall, inflation remains below the FOMC’s longer-run goal of 2 percent.

The Economic Outlook

That is a brief review of where the economy is, but I bet you are even more interested in where the economy is headed. It continues to be the case that the path of the economy depends largely on the path of the virus, which is affected by our actions to control its spread, treat it, test for it, and vaccinate against it. This means there is still a high degree of uncertainty around the outlook, although some of the worst-case scenarios and downside risks have lessened over time. As shown in the December Summary of Economic Projections, fewer FOMC participants see the balance of risks as weighted to the downside than they did in September.[2]

Three key factors are shaping my thinking about the economic outlook. They suggest that the near-term outlook is likely to be weak, while the medium-run outlook is likely to show considerable improvement. First, the U.S. and many other countries are experiencing a surge in new virus cases. The latest data for the U.S. show some tempering over the past two weeks, but new case counts still well exceed those seen last spring and summer. They are straining hospital capacity, necessitating more voluntary and mandated restrictions on activity and casting a shadow on the near-term economic outlook.

A second factor shaping my outlook is the positive developments on the vaccine front, which have made me more confident about the economy's recovery over the medium run. It will take several months for vaccines to be widely distributed and for a large segment of the population to be vaccinated. But widespread vaccinations will create economic conditions that look very different from the current conditions in the midst of the rapid rise in virus cases, hospitalizations, and deaths.

[2] FOMC Summary of Economic Projections, December 16, 2020 (https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20201216.pdf).

The third factor shaping my outlook is the fact that while the pace of the recovery is slowing from the strong rebound seen in the third quarter of last year, so far the recovery has generally been stronger than anticipated. This suggests that we may have been underestimating the economy's resilience and underlying momentum, as well as the ability of households and businesses to adapt to this unprecedented environment.

Taking these factors into account, I expect the recovery to continue, but to be uneven over the year. In the near term, the current surge in virus cases is likely to weigh on activity this winter as the surge is managed through social distancing and targeted shutdowns, albeit ones that are less severe than those last spring. As the surge is brought under control and more people become vaccinated, I expect economic activity to pick up. Assuming that most people are vaccinated by the third quarter of the year, I expect to see a strong pickup in economic activity in the second half of this year as people and businesses feel it is safe to re-engage in a broad range of activities.

I expect this post-vaccination phase of the recovery to continue over the next few years, with growth above trend, declines in the unemployment rate, and gradually rising inflation. Given the severity of the pandemic shock, it will take time to move to a more broad-based sustainable recovery. The recovery will likely remain uneven for some time, as some sectors will recover faster than others. It will take time for some of the workers who have lost jobs to find new ones, either at another firm in their current industry or in a new industry after they retrain. Changes in consumer preferences with respect to shopping, dining, and housing, firms' demand for office space, and the re-establishment of more robust supply chains could all necessitate structural changes to the economy that will take time to unfold.

Policy

My modal outlook, which I just described, depends on appropriate policy. In my view, both fiscal policy and monetary policy will continue to be needed to limit lasting damage to the economy from the pandemic and support the achievement of a broader, sustainable recovery. Monetary and fiscal policy are not substitutes; they are complements and we saw them working together very effectively earlier last year when the pandemic hit. Fiscal policy actions 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 recently passed $900 billion of additional fiscal relief will help support households and businesses hardest hit by the pandemic in the first half of 2021, helping to provide a bridge until the economy improves later in the year. Further investment in vaccine deployment and aid to states responsible for distributing the vaccines would support a broader and faster recovery.

For its part, the Federal Reserve took actions to ensure that financial markets had enough liquidity to continue to function well, that credit could continue to flow to households and businesses, and that the stance of monetary policy was highly accommodative. These actions have included buying Treasury and agency mortgage-backed securities (MBS), implementing emergency facilities to backstop the flow of credit throughout the economy, ensuring our central bank counterparties abroad have access to dollar funding, temporarily relaxing some of the regulatory requirements on banks so they have greater capacity to lend, and lowering the target range of our policy rate, the fed funds rate.

The FOMC has been maintaining the fed funds rate target range at 0 to 1/4 percent since March. We expect it will be appropriate to maintain that range until labor market conditions have reached levels consistent with our assessments of maximum employment, and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time. The FOMC also continues to increase its holdings of Treasury securities by at least $80 billion per month and of agency MBS by at least $40 billion per month. We expect to continue doing so until substantial further progress has been made toward our maximum employment and price stability goals. The forward guidance on our policy rate and asset purchases is entirely consistent with our revised monetary policy strategy, which was summarized in a statement we released last August.[3] The forward guidance ties the stance of monetary policy to progress on our mandated goals.

The guidance is also consistent with my view that policy patience will prove to be a virtue. The current stance of policy is well calibrated to my outlook. A slowdown in the economy in the first part of the year along the lines I am expecting would not require a change in monetary policy so long as the medium-run outlook remains intact. Nor would the strengthening in growth I expect to see later this year necessitate a change in our policy stance because I expect that the economy will still be far from our employment and inflation goals. Of course, if the economy evolves materially differently than expected or if risks, including those to financial stability, emerge that could impede attainment of our monetary policy goals, we would be prepared to respond appropriately.

But given my outlook and assessment of risks, in my view, monetary policy will need to remain highly accommodative for quite some time because achieving our monetary policy goals is likely to be a journey and not a sprint. While achieving our goals will take some time, I do not view this as a failure of monetary policy or a lack of commitment on the part of policymakers to achieve our goals. The economy's intrinsic dynamics suggest that inflation is not going to move up quickly above 2 percent. And the severity of the pandemic shock and its disparate impact across households, communities, and sectors suggest that it will take time to return to strong labor market conditions like those we experienced prior to the pandemic. The FOMC is, and will remain, fully committed to using our policy tools to achieve our goals, in support of a broad-based and sustainable recovery.

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[3] For more information on the new strategy, see Loretta J. Mester, "The Federal Reserve's New Monetary Policy Strategy," 6th Annual Monetary and Financial Policy Conference, Money Macro and Finance Society, London, U.K. (via videoconference), October 21, 2020 (https://www.clevelandfed.org/en/newsroom-and-events/speeches/sp-20201021-federal-reserves-new-monetary-policy-strategy.aspx).

The revised strategy summarizes the outcome of 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).

Charts for "Patience Will Be a Virtue in Fostering a Broad-Based Sustainable Recovery"

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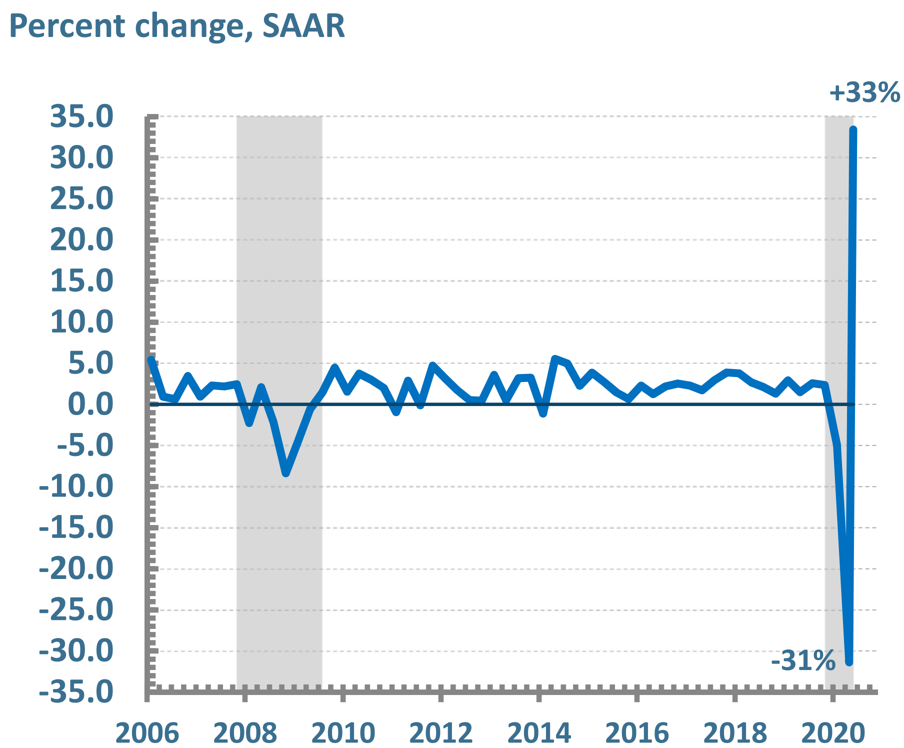
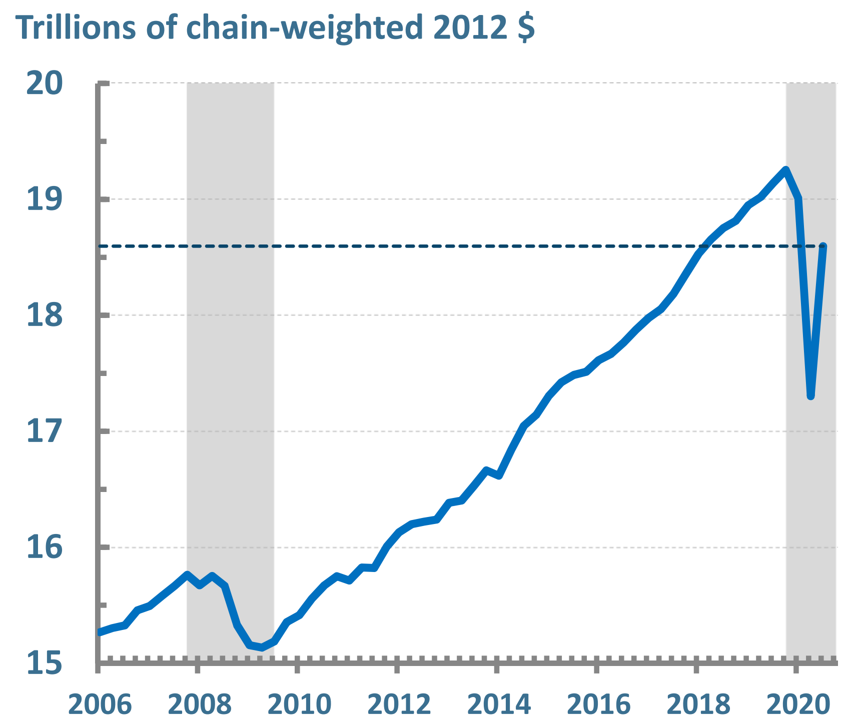
FEDERAL RESERVE BANK *of* CLEVELAND

Figure 1. There were dramatic swings in output in 2020

Growth of real GDP, annualized

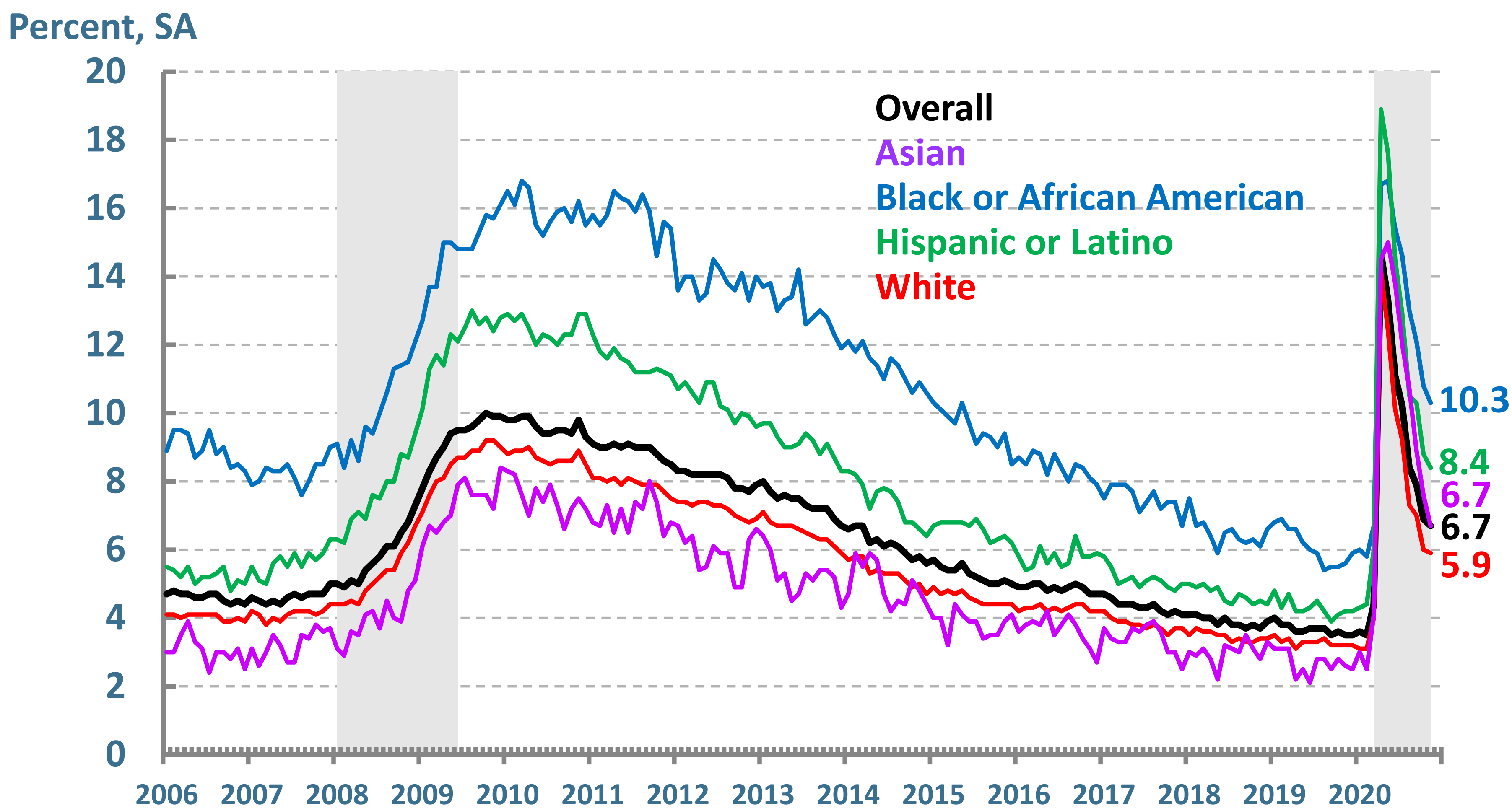


Level of real GDP



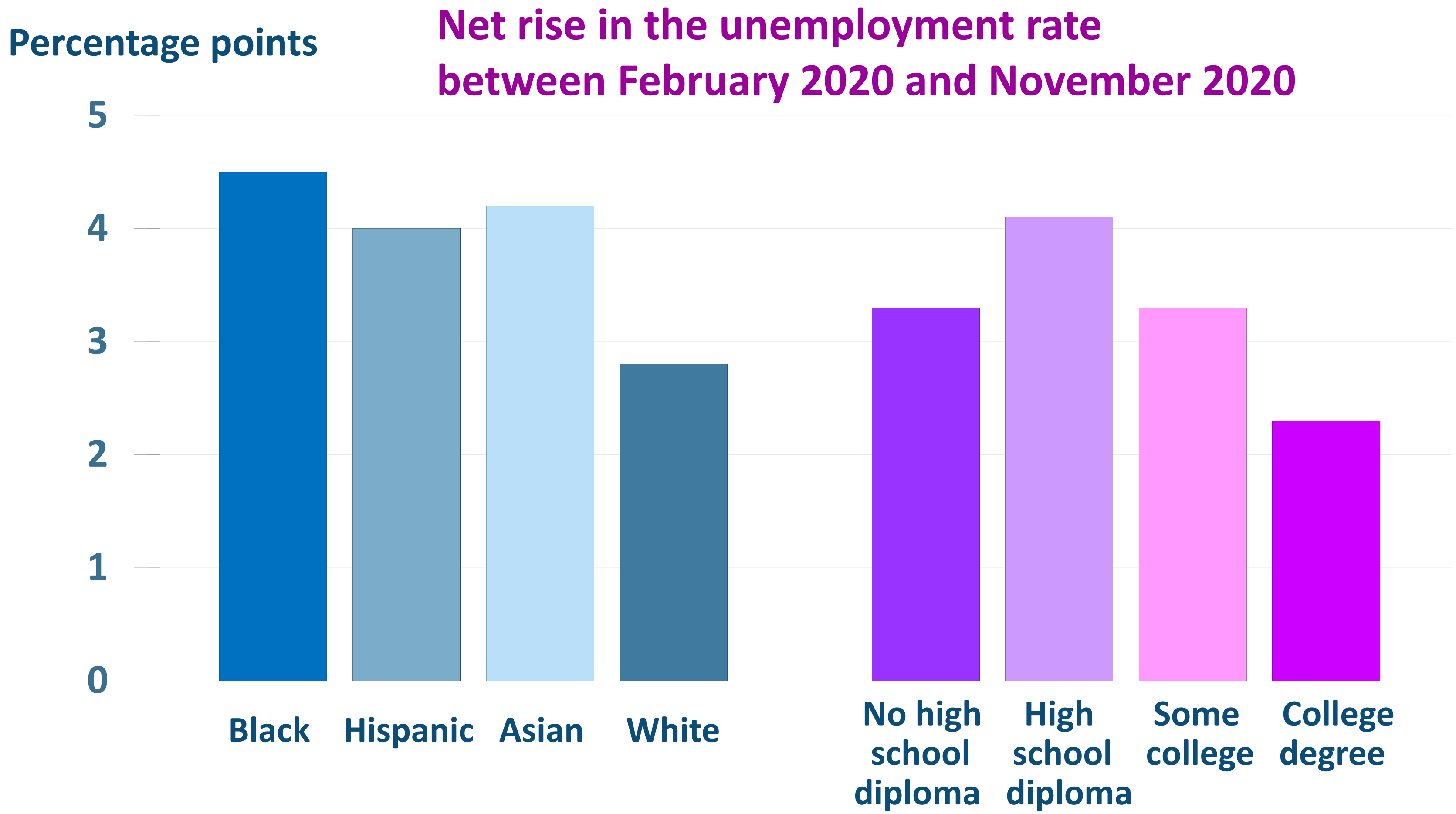
Source: Bureau of Economic Analysis via Haver Analytics
Quarterly data: Last obs. 2020Q3

Figure 2. Unemployment rates have fallen since April but are very elevated relative to their pre-pandemic levels



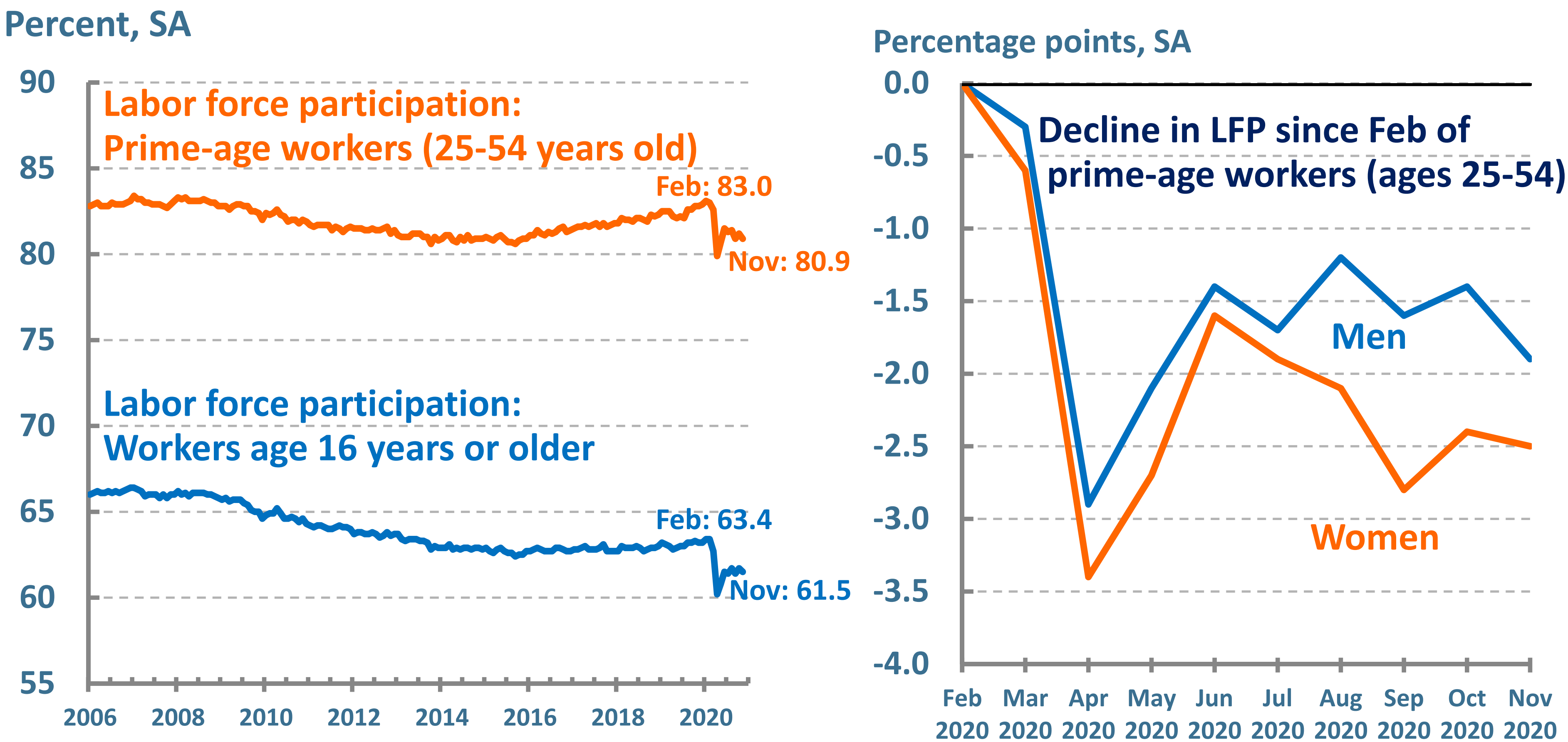
Source: Bureau of Labor Statistics via Haver Analytics
Monthly data: Last obs. November 2020

Figure 3. Less labor market progress has been made for nonwhites and those without college degrees



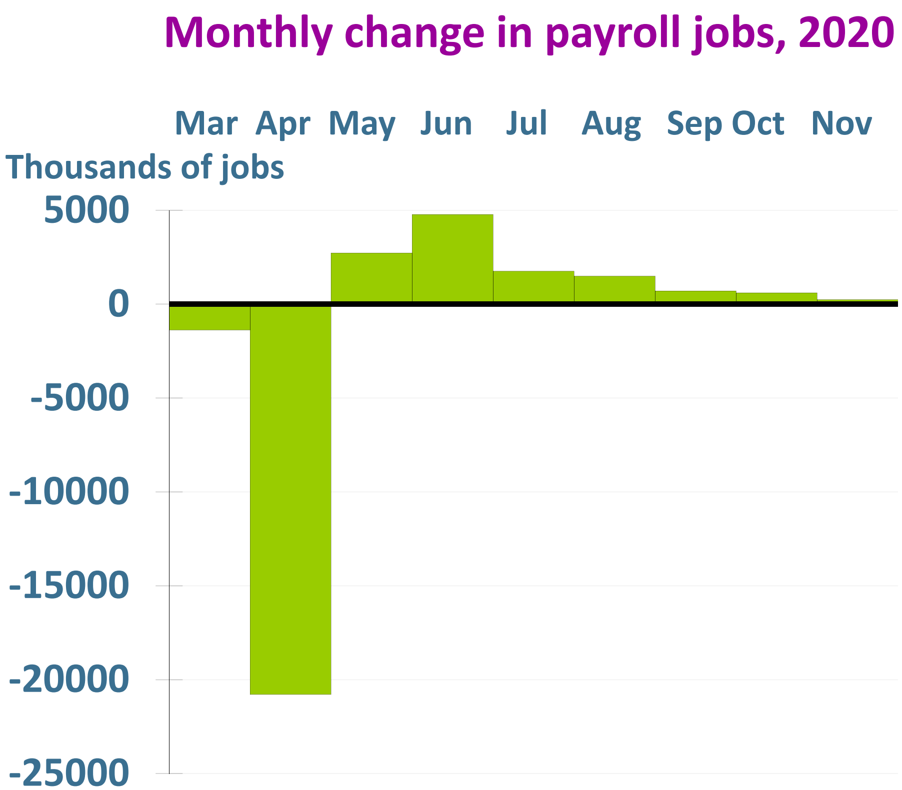
Source: Bureau of Labor Statistics via Haver Analytics

Figure 4. Labor force participation is lower than before the pandemic and more prime-age women have dropped out than men



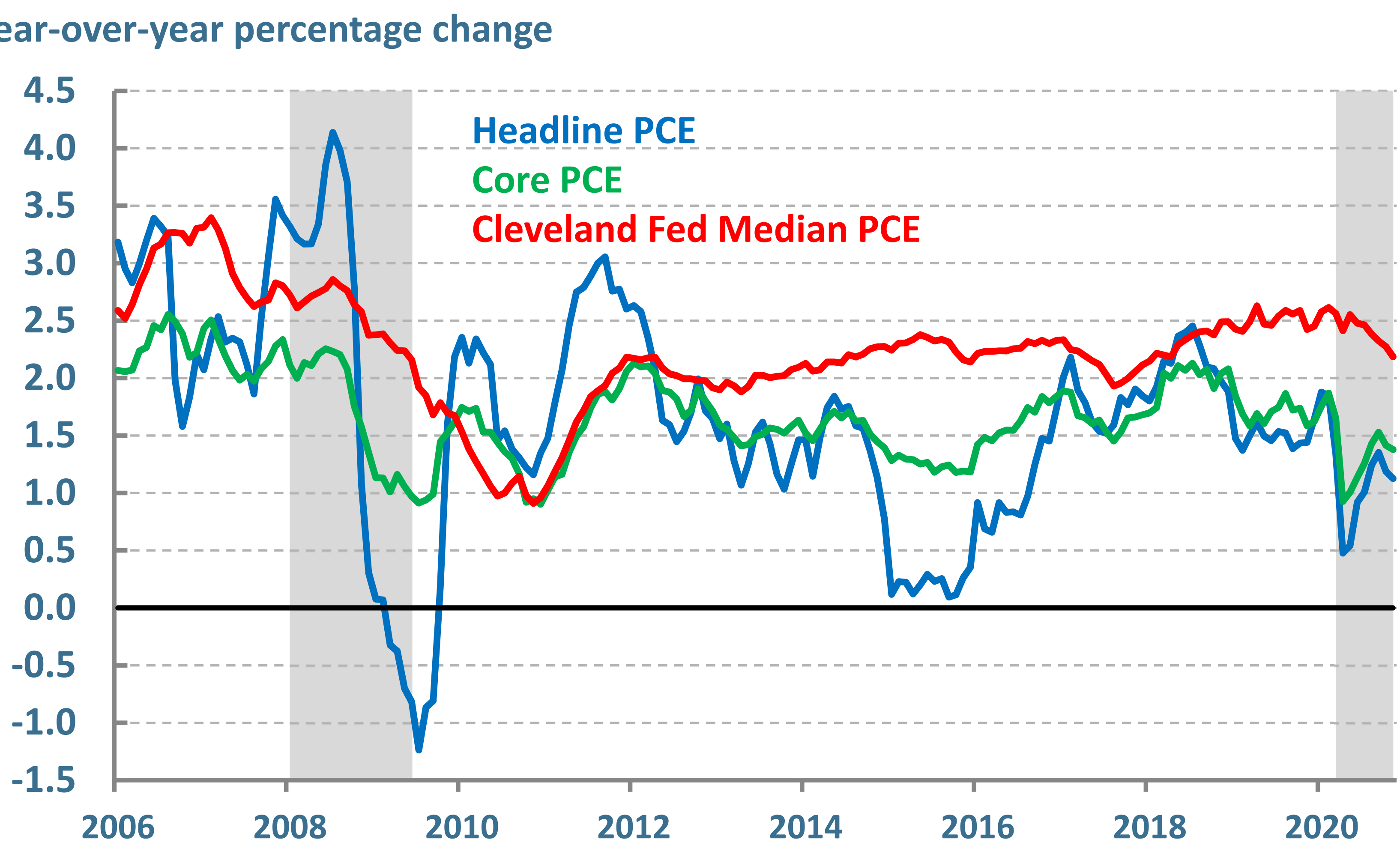
Source: Bureau of Labor Statistics via Haver Analytics
Monthly data: Last obs. November 2020

Figure 5. Job gains have slowed and payrolls remain 6 percent below February's level



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

Figure 6. Inflation has moved up since the shutdown but is below its pre-pandemic level



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

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