A Bright Outlook for the U.S. Economy

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Introduction

I thank Juhi Dhawan for the invitation to speak with the Boston Economic Club today and to share my thoughts on the economy and monetary policy. Of course, those thoughts will be my own and not necessarily those of the Federal Reserve System or of my colleagues on the Federal Open Market Committee.

What a difference a year makes! The pandemic has made the past year an incredibly challenging one for so many in the U.S. and across the world. In the U.S., the economic effects have fallen disproportionately on those segments of the population whose economic situations make them the most vulnerable: low-income workers, minority workers, and women and working mothers. Many households and businesses continue to struggle. But with the positive developments on the virus front, including widespread deployment of COVID vaccinations throughout the U.S., with continued support from fiscal and monetary policy, and with the remarkable adaptability and resiliency that households and businesses have shown throughout the pandemic, an economic recovery is now clearly underway. The tone of my talk today will be decidedly different from what you would have heard a year ago. While risks remain, the outlook is bright.

Before the pandemic hit early last year, the U.S. economy was on very solid footing. The unemployment rate was at a historically low level, employment growth was strong, participation in the labor force was solid, and inflation was near the FOMC's longer-run goal of 2 percent. But once the pandemic hit, all that changed very quickly. Much of the economy shut down swiftly for public health reasons. Economic activity and employment plummeted, the unemployment rate soared, and prices fell. Real growth fell at an annual rate of over 30 percent in the second quarter of last year. In just two months, March and April 2020, the economy lost over 22 million jobs, about the same number it had added over the previous 11-year expansion. The unemployment rate soared to nearly 15 percent in April of last year, and inflation fell to under 1/2 percent.

While the shutdown was swift, a broad-based recovery is taking more time to achieve. As the public health statistics began to improve in early summer of last year, many parts of the country began to relax some of their stay-at-home restrictions, and the economy entered what I call a reopening phase. There were sharp rebounds in activity and hiring in those parts of the economy that did not involve close physical contact. Real output growth rebounded to over 30 percent in the third quarter of last year, and firms added over 7 million payroll jobs last May and June.

After that initial rebound, the economy entered what I call a pre-vaccination recovery, in which the growth rate of the economy was slower than in the initial reopening phase and the level of activity varied with the course of the virus. Last fall and winter, as the number of virus cases rose, mandatory and voluntary restrictions were reinstated and weighed on economic activity. Businesses had to handle greater variation in their staffing levels. Increased exposure to the virus meant that more workers had to be quarantined or had to tend to children whose schools were closed due to the rise in cases. When the number of cases fell again, these restrictions were relaxed and activity picked back up.

Economic Growth

Since the start of this year, the vaccination rate has increased, the number of new cases has fallen, and the pace of the recovery has accelerated. Over 100 million Americans are now fully vaccinated, which is over 40 percent of adults. The international virus situation makes it clear that the virus still poses a risk to the outlook and that widespread vaccinations are the key to returning to more normal economic and social activity. I am anticipating that efforts to increase the distribution of vaccinations will continue over the next several months and the U.S. economy will enter what I call the post-vaccination phase of the recovery in the third quarter of this year. In this phase, the recovery will broaden over time as those sectors that involve high physical contact see increases in activity.

At present, there is still considerable variation across sectors. Manufacturing activity is approaching its pre-pandemic level. Housing, supported by low mortgage rates and strong demand from households reassessing their living situations, has surpassed its pre-pandemic level of activity. On the other hand, the commercial real estate sector, in particular, the retail and office segments, continues to struggle given the uncertainties over the future of working arrangements and shopping preferences.

Consumer spending has risen robustly this year, partly reflecting pent-up demand. Spending has been buoyed over the course of the recovery by significant federal fiscal support in the form of extended unemployment insurance benefits and economic impact payments. In real terms, the level of consumer spending on goods is about 16 percent higher than it was before the pandemic, while that on services is still about 5 percent below. This isn't surprising, since many things classified as services involve high physical contact. Hard-hit sectors in the economy like hospitality and leisure remain weak but they have recently shown improvement. Looking forward, surveys conducted by Cleveland Fed staff indicate that many higher-income consumers expect to increase their spending on high-contact services that they have avoided over the last year.[1] In addition, many households have accumulated savings, which will support additional spending this year.

Strong consumer and government spending contributed to real output growth of 6 percent at an annual pace in the first quarter of the year. The level of real GDP is nearly back to where it was at the end of 2019, prior to the pandemic. With many people in a position to fulfill their pent-up demand, I expect growth this year to be in the 6 to 7 percent range, the strongest pace since the early 1980s.

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[1] Edward S. Knotek II, Michael McMain, Raphael Schoenle, Alexander Dietrich, Kristian Ove R. Myrseth, and Michael Weber, "Expected Post-Pandemic Consumption and Scarred Expectations from COVID-19" Federal Reserve Bank of Cleveland *Economic Commentary* 2021-11, April 12, 2021. (https://www.clevelandfed.org/en/newsroom-and-events/publications/economic-commentary/2021-economic-commentaries/ec-202111-expected-post-pandemic-consumption-and-scarred-expectations-from-covid19.aspx)

The Labor Market

Along with economic activity, labor market conditions have continued to improve and we will get another read on Friday when the employment report for April is released. The March employment report was very strong. Firms added over 900,000 jobs to their payrolls and the unemployment rate fell to 6 percent. In assessing the health of the overall labor market, it is important to look at levels, not just changes. Employment remains about 8-1/2 million jobs below its level last February and the unemployment rate is 2.5 percentage points above its pre-pandemic level. In addition, there is considerable unevenness across different groups. While employment of high-wage workers is basically back to its pre-pandemic level, employment of low-wage workers is still down almost 30 percent. And while employment in the professional and business services sector is about 5 percent lower than it was at the start of last year, employment in the high-contact leisure and hospitality sector is down by more than 30 percent. The labor force participation rate and the employment-to-population ratio have improved over the recovery, but they also remain considerably below their pre-pandemic levels. So further progress and broader progress need to be made before we are back to the generally strong labor market conditions we had before the pandemic hit.

Labor supply is one of the confounding aspects of this recovery. As the employment data show, firms have been able to increase their hiring. But we are receiving widespread reports from business contacts across sectors that they are having a hard time finding the workers they need. The question is why, given that the unemployment rate is still so high and a number of indicators point to continued slack in the labor market. I believe the answer reflects the unusual nature of the pandemic shock that hit the economy. It is likely that some people with the financial means to do so have been cautious about returning to the workforce because of concerns for their health in the midst of the pandemic. Some others have had to withdraw from the workforce to take care of loved ones afflicted by the virus or to tend to children when childcare facilities closed and schools shifted to on-line teaching. Childcare responsibilities fall disproportionately on women and their labor force participation rates fell more sharply during the pandemic than those of men. The fiscal support likely meant that more people had the financial cushion to remain out of the workforce for these or other reasons. That support may also have shifted some bargaining power over wages to workers after decades of decline. Although the aggregate statistics do not show much acceleration in wages, our contacts say that they are beginning to respond to labor shortages by increasing their wage offers and by considering candidates they may have previously passed over because of minor criminal offenses or other reasons.

As the public health situation continues to improve over the course of the year, I expect that the factors weighing on labor supply will diminish and that there will be strong job gains, with the unemployment rate falling to 4.5 percent or less by the end of the year.

Inflation

Supply constraints are affecting product markets, too. While demand can increase quickly, it takes longer to increase production to meet that demand, especially given the length of this pandemic. Manufacturers and builders report that supply-chain challenges have intensified and are proving to be more persistent than they originally anticipated. Builders face longer lead times to secure various materials, including lumber and steel, and more suppliers are rationing basic materials and parts to their customers. These supply-chain issues are a headwind to production and are leading to significant increases in the prices of many materials and components. Many of our contacts say that they have been able to pass on at least some of their cost increases to their customers in the form of higher prices – which brings me to inflation.

In March, the year-over-year measures of PCE inflation and core PCE inflation moved up to 2.3 percent and 1.8 percent, respectively. I expect that consumer price inflation readings will be significantly higher in the next couple of months. An important reason is simply that the very low readings from last year will fall out of the calculations. Higher energy prices and higher prices of some goods and commodities due to bottlenecks and supply-chain disruptions will also contribute to higher inflation readings, and I expect inflation for the year will be over 2 percent. After that, my baseline outlook is that inflation will move back down next year and then gradually rise above 2 percent the following year, as supply constraints ease, monetary policy remains accommodative, and the factors that have held back inflation for so long, including digitalization, globalization, and the relatively weak relationship between economic slack and inflation, reassert themselves.

Because both demand factors and supply factors are affecting inflation readings, there is added uncertainty to my outlook for inflation and there are some upside risks to my forecast, something that has not been true for some time. The anecdotal evidence suggesting that the supply-chain disruptions could last longer than expected, that firms may have some pricing power, and that workers may have some bargaining power over wages all point to upward pressures on prices. But these factors would not be expected to lead to sustained higher levels of inflation unless they changed the pricing process by increasing inflation expectations, which would affect the economic decisions of households and businesses and support higher actual inflation. Given that inflation has run low for so long, some increase in inflation expectations and actual inflation would be a welcome development.

Monetary Policy

My positive baseline outlook depends on appropriate monetary policy, which, in my view, will need to be very accommodative for some time to support the broadening of the recovery. The Federal Reserve responded swiftly when the severity of the pandemic became apparent. We took actions to restore the smooth functioning of the financial markets, to ensure credit could flow to households and businesses, and to increase monetary accommodation in support of the recovery and return to our monetary policy goals of maximum employment and price stability.

At our meeting last week, the FOMC maintained the target range of the fed funds rate at 0 to 1/4 percent. We indicated that 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 indicated that we will continue to increase our holdings of Treasury securities by at least $80 billion per month and of agency mortgage-backed securities by at least $40 billion per month. And we expect to continue doing so until substantial further progress has been made toward our maximum employment and price stability goals.

The forward guidance in our policy statement is entirely consistent with our revised monetary policy strategy, which was summarized in a statement we released last August and that we reaffirmed in January.[2] The revised strategy has implications for how we will conduct monetary policy in pursuit of our goals. For inflation, we will aim for inflation to run moderately above 2 percent for some time after it has run persistently below 2 percent, so that inflation averages 2 percent over time and inflation expectations are anchored at levels consistent with 2 percent. For employment, in the absence of inflationary pressures or risks to financial stability, we will not react to strong labor market indicators. The revisions to our strategy mean that for a given set of economic conditions, the FOMC will likely set a more accommodative monetary policy than we would have in the past. This does not mean that our strategy will entail more risk than in the past. Pursuit of our goals will still drive our policy decisions, and the new strategy is designed to be more effective given changes to the underlying structure of the economy. In particular, the general level of interest rates is lower than in the past and inflation dynamics have changed so that economic slack plays less of a role and inflation expectations play more of a role in

[2] See FOMC Statement on Longer-Run Goals and Monetary Policy Strategy (https://www.federalreserve.gov/monetarypolicy/files/FOMC_LongerRunGoals.pdf).

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).

determining inflation outcomes.

The FOMC is committed to our new strategy and will be following through on the guidance communicated in our FOMC statement. While it may take some time for supply disruptions to abate, the forces that have weighed on inflation are still with us, we have undershot our inflation goal for a while, and we are aiming for inflation to move moderately above 2 percent for some time. I wouldn't consider the increase in inflation I expect this year to be the type of sustainable increase needed to meet the forward guidance on our policy rate. So I expect to be deliberately patient unless there is clear evidence that inflation pressures will push inflation to exceed our desired path.

The asset purchase forward guidance, which we added to the FOMC statement last December, indicates that we need to see substantial further progress toward our goals before we begin to taper the pace of purchases. In thinking about progress in the labor market, one approach is to look at indices of labor market conditions that summarize a large number of indicators, such as those published by the Kansas City Fed.[3] Another approach is to use a technique similar to the spider chart published by the Atlanta Fed, gauging progress against appropriate benchmarks.[4] Let's consider how far the labor market has traveled back from the dire conditions of April 2020 to the generally strong pre-pandemic conditions of February 2020. Many labor market conditions are useful for tracking the health of the labor market, but let's look at four: payroll employment, the unemployment rate, the employment-to-population ratio, and the labor force participation rate for people ages 25 to 54. (That latter indicator is often called the prime-age participation rate, but I'm not in that statistic and I consider myself still in my prime!)

[3] See the Kansas City Fed Labor Market Conditions Indicators at https://www.kansascityfed.org/data-and-trends/labor-market-conditions-indicators/.

[4] See the Atlanta Fed Labor Market Distributions Spider Chart at https://www.atlantafed.org/chcs/labor-market-distributions.aspx.

Consider employment. Between April and December of last year, when we issued our forward guidance, employment had traveled 55 percent of the way back to its pre-pandemic level. Since December, it has made a bit more progress and is now 62 percent of the way back. The unemployment rate peaked at 14.8 percent last April. By December, it had fallen to 6.7 percent and was 72 percent of the way back to its pre-pandemic level of 3.5 percent. As of now, it is 78 percent back. The employment-to-population ratio was 62 percent back as of December, and now it is 66 percent back. And prime-age labor force participation was 39 percent back in December and is now 48 percent back. These indicators clearly show that things are moving in the right direction and progress has been made since December. But I need to see more improvement before I would consider the conditions of our forward guidance on asset purchases as being met.

Of course, there are several caveats to this type of analysis. First, the labor market conditions in February 2020 were strong along many dimensions, and it is not clear that we should expect every indicator to make it back to the levels we saw then. For example, the longer-run trend in the participation rate is drifting down, reflecting demographics. Moreover, retirement rates increased significantly during the pandemic, and in the past, people who left the workforce through retirement generally didn't return. That's one reason to look at the so-called prime-age participation rate rather than the participation rate of those age 16 and above. Second, while labor markets were generally strong last February, further progress would have been made in some dimensions had the pandemic not hit. For example, the difference in the unemployment rates of Blacks and Hispanics compared to that of whites continued to narrow as the previous expansion progressed; those gaps may have closed further had the expansion continued. Even if we use February 2020 as the benchmark, the unemployment rates for Blacks and Hispanics have made less progress than that of whites.[5] Third, there is a large group of indicators, and the

[5] From their peaks in April 2020, the unemployment rates for Blacks, Hispanics, and whites have traveled 66 percent, 76 percent, and 78 percent, respectively, of the way back to their February 2020 levels.

rates of progress will vary across them. So the judgment of the FOMC rather than a mathematical formula will be needed to assess the health of the labor market and its progress.

I note that even after the FOMC decides that the conditions for tapering have been met, we will still be purchasing assets and monetary policy will remain highly accommodative. I expect it will appropriate to maintain an accommodative stance of monetary policy for some time as we make our way back to maximum employment and price stability. Since highly accommodative monetary policy can engender a search for yield and other investment behaviors that can exacerbate financial stability risks, and since a stable financial system plays a key role in supporting the achievement of our monetary policy goals, I am attuned to risks and vulnerabilities in the financial system. Currently, valuations in equity and residential real estate markets are elevated, reflecting investors' high appetite for risk, low interest rates, and positive prospects for the economy. Changes in risk appetite could bring volatility. Volatility isn't concerning in and of itself, but if accompanied by high levels of leverage, it can elevate financial stability risks. For now, I see financial stability risks and vulnerabilities as moderate. They are less concerning to the extent that we have a resilient financial system.

After the last financial crisis in which banks were front and center, steps were taken to shore up the resiliency of the commercial banking system through higher capital levels, liquidity requirements, and stress testing. These steps paid off because banks were in a strong enough position going into the pandemic to play an important role, with support from their regulators, in ensuring that credit flowed to households and small businesses. The pandemic revealed some structural issues in the Treasury market and in money market mutual funds, and the Fed needed to take actions to reestablish smooth functioning. More recent developments suggest that limited transparency around the risk exposures of hedge funds, family offices, and other leveraged financial entities could pose risks to financial stability. Just as was done with the banking system after the global financial crisis, addressing fragilities in the Treasury market and the nonbank financial sector should be a top priority in raising the resiliency of the overall financial system. If we've learned one thing during the pandemic, it is that things can evolve in a materially different way than expected and it is better to be prepared for whatever comes our way.