# What's Ahead for the U.S. Economy and Monetary Policy?

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

**Ohio Bankers League**
**2021 CEO Symposium**
**Columbus, OH**
**(via videoconference)**

**September 24, 2021**

**Introduction**

I thank the Ohio Bankers League for the opportunity to speak at this year's CEO Symposium. Your theme, "Bouncing Back," seems to sum things up very well, so I could probably end my talk right here. But it is probably better if I take a few moments to discuss my views on the shape of the bounce-back and the implications for monetary policy. Of course, these views will be my own and not necessarily those of the Federal Reserve System or of my colleagues on the Federal Open Market Committee.

When we talk about the economy, it is important to remember that it is made up of households, businesses, including banks, and communities throughout the U.S. All have soldiered on through these extraordinarily difficult and unprecedented times. Ohio bankers have played a very important role in supporting families and businesses throughout the pandemic. You have provided valuable credit, risk-management, and liquidity services. Your significant contributions helped to shorten the recession and they continue to sustain the recovery.

In addition, throughout the pandemic, bankers have been providing me with valuable insights that have helped me in my role as a Federal Reserve policymaker. The Fed collects and analyzes many different statistics and uses many models to assess the economy, but hearing from the bankers on our boards and advisory councils, and bankers throughout the Fourth Federal Reserve District, helped us understand what was really happening on the ground and what might be coming. Timely information like this is always valuable when setting monetary policy, but over the past 18 months, it has been critical in helping us navigate the uncharted waters of the pandemic. I particularly want to recognize and thank the chair of your board, Tom Fraser, who serves on the Cleveland Fed's Community Depository Institutions Advisory Council; OBL director Eddie Steiner, who is currently a Cleveland Fed board member; and OBL director Todd Mason, who is a former Cleveland Fed director. The public service provided by you and the other bankers throughout our District is greatly appreciated and will continue to be important given the elevated risks and uncertainty that will be with us for some time to come.

**Economic Growth**

Before I discuss current conditions and the outlook, its useful to remember where we have been. Before the pandemic hit last March, the U.S. economy had been on very solid ground. 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. All that changed when almost the entire economy had to shut down quickly because of the public health crisis created by the pandemic. The economy fell into the deepest recession since the Great Depression. 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 rose from a pre-pandemic 3-1/2 percent to nearly 15 percent and inflation fell to under 1/2 percent.

But with the remarkable contributions of healthcare workers, the agility and resiliency of households and businesses, and with strong support from fiscal and monetary policy, the economy was able to reopen and last year's recession was the shortest one on record.

A strong economic recovery is underway, but it has been an uneven one and challenges and risks remain. As the rapid spread of the Delta variant reminds us, we have to remain humble when it comes to predicting the future. Unlike in typical business cycles, virus developments and public health considerations have been critical factors determining the pace and nature of the recovery, and they will continue to do so for the foreseeable future. The initial reopening of the economy last year unleashed pent-up demand and resulted in real output growth rebounding to over 30 percent in the third quarter of last year and firms adding back almost half of the jobs lost during the shutdown, or almost 11 million jobs, over May through August 2020. But as virus cases rose last fall and winter, growth moderated and consumers pulled back on their spending.

And then things improved again over the first half of this year. Supported by sizable fiscal stimulus, growth returned to a robust pace of about 6.5 percent as new cases declined and the relatively rapid deployment of vaccinations throughout much of the country gave households and businesses more confidence that it was safe to re-engage in activity.

In recent months, the Delta variant has led to a sharp increase in new cases, particularly among the unvaccinated. Hospitalizations and deaths have not risen to the levels seen earlier in the pandemic because of the efficacy of the vaccines, but these developments have dampened consumer sentiment and have led to a downturn in some activities that require close physical contact. So far, the adverse effects on consumer demand appear to be smaller than those seen in earlier waves of the virus. It appears that as vaccination rates have risen, households and businesses have learned to better navigate changes in virus conditions. I expect that the monthly indicators and pace of activity will continue to ebb and flow with virus developments. The Delta variant will temper consumer spending and growth over the second half of the year, compared to the first half, but I don't expect it to lead to widespread shutdowns of economic activity or to derail the recovery. Nonetheless, continued increases in vaccination rates and the deployment of safe and effective vaccines to children would contribute significantly to lowering risks and broadening the recovery.

The pandemic has not only affected the demand side of the economy; it is having significant effects on the supply side, too. Across a number of sectors, demand is strong, but supply-chain disruptions and bottlenecks are constraining activity. These constraints are now expected to last well into next year, considerably longer than originally thought. Our manufacturing contacts report that orders remain strong but backlogs have grown and lead times for deliveries have risen because of virus-related disruptions to production and at ports. Automakers have had to cut back production in the face of ongoing shortages of semiconductors. In the residential real estate market, low mortgage rates and shifts in housing preferences have increased demand. But homebuilders have not been able to ramp up supply enough to meet this demand, partly due to delays in getting building materials and their elevated cost. As a result, house prices have been soaring.

On balance, I expect growth to be less robust over the second half of this year, compared to the first, but for the year as a whole, growth will be strong, at around 5-1/2 percent, which is well above trend. Next year, I anticipate that the headwinds from supply constraints will begin to ease and the recovery will broaden. Growth is likely to remain above trend but at a more moderate pace of 3-3/4 to 4 percent, as the tailwinds coming from the pandemic-related fiscal support and pent-up demand fade.

**The Labor Market**

The Fed has two monetary policy goals: maximum employment and price stability. So, before I turn to monetary policy, let me discuss the labor market and inflation. Strong output growth this year has been accompanied by strong job growth. Even with the virus-driven slowdown in service-sector hiring last month, payrolls have grown an average of about 585 thousand per month so far this year, and 750 thousand per month over the last three months. The unemployment rate has fallen 1.5 percentage points since last December. Conditions in the labor market have vastly improved since their nadir in April 2020, yet there is still some distance to go. Payrolls are still over 5 million jobs below where they were before the pandemic, the unemployment rate is elevated at 5-1/4 percent, and the labor force participation rate among workers aged 16 to 54 is still about a percentage point below its pre-pandemic level. Despite the progress that has been made, by these measures, it looks like there is still considerable slack in the labor market.

Yet, firms across a wide range of industries and across the country have been reporting for some time that they want to hire but are struggling to find workers. The number of job openings is at its highest level since the start of that data series in 2000, and the statistics show more posted job openings than unemployed workers. So by these measures, labor markets appear to be tight.

Some of our business and labor contacts thought that when the supplemental unemployment insurance benefits ended, the number of job applicants would rise. The state of Ohio stopped paying these benefits in June, but almost half of our contacts looking for workers said they had seen no increase in job applicants since May and over a third said they had actually seen a decline. This indicates that the labor market story is more complex. Labor supply has likely been held back by a perfect storm of factors, many of which reflect the unusual nature of the pandemic. The high cost and scarcity of daycare is likely a factor deterring the return of some parents.[1] Employment of daycare workers is still down about 12 percent from where it was pre-pandemic. That is worse than the 3.5 percent gap across all sectors and the 8 percent gap for the hard-hit food services-restaurant sector.[2] For those with older children, there is uncertainty about whether schools will be able to stay reliably open in the midst of the Delta wave. In addition, some workers are likely reluctant to return to the workforce until virus cases turn back down. The support received during the pandemic has given some workers the financial wherewithal to retrain for better jobs than they had before the pandemic. This is a promising development, but training takes some time.

It is possible that with more firms offering remote working arrangements and technological advances that will keep these arrangements productive, we will end up with more people in the labor force after the

---

[1] Researchers from the Atlanta Fed estimate that women with children under age 6 made up about 10 percent of the pre-pandemic work force but account for almost a quarter of job losses due to the pandemic. See M. Melinda Pitts, "Where Are They Now? Workers with Young Children during COVID-19," Federal Reserve Bank of Atlanta's *Policy Hub*, No. 10-2021, September 2021. (https://doi.org/10.29338/ph2021-10)

[2] For further discussion of current labor market conditions in the child care industry, see Heather Long, "'The Pay is Absolute Crap': Child-care Workers Are Quitting Rapidly, A Red Flag for the Economy," *The Washington Post*, September 19, 2021. (https://www.washingtonpost.com/business/2021/09/19/childcare-workers-quit/)

pandemic than we had before the pandemic. But in the meantime, firms are responding to labor shortages by increasing wages and offering more flexible work schedules and other benefits to attract and retain workers. Even with the uncertainty around the outlook stemming from the virus, my expectation is that, over time, more people will get vaccinated, the public health situation will improve, the factors weighing on labor supply will diminish, and labor supply will come into better balance with labor demand. As this happens, labor market conditions will continue to improve, firms will add to their payrolls, and the unemployment rate will fall. In my baseline forecast, the unemployment rate falls to about 4-3/4 percent by the end of this year and to about 4 percent by the end of next year.

**Inflation**

In addition to higher wage costs, many firms are having to pay higher costs for materials, components, and shipping because of supply-chain challenges. In response to the higher costs of inputs and labor, firms have increased the prices they are charging to their own customers. Measures of inflation have moved up considerably and by more than expected at the start of the year. In July, the year-over-year measure of PCE inflation moved up to 4.2 percent. Core PCE inflation, which omits food and energy prices, and is one of the measures we look at to get a sense of the underlying inflation rate, rose to 3.6 percent. Other indicators of underlying inflation, including the Cleveland Fed's measures of median CPI and trimmed mean CPI, have also increased. As inflation rates have risen, some measures of consumer and business inflation expectations have also risen after being mired at levels below those consistent with our 2 percent inflation goal over much of the previous expansion.

So far, the increases in inflation have mainly been driven by price movements in components affected by virus-related supply constraints or pent-up demand. We have already seen the prices of some of these items stabilize and move back down. Used car prices are an example. My baseline expectation is that inflation will be well above 2 percent this year but will begin to move lower as supply constraints and pent-up demand ease. It will take some time for price pressures to abate, and inflation is likely to remain somewhat above 2 percent over the next couple of years.

Because both demand factors and supply factors are affecting inflation readings, the uncertainty attached to my inflation outlook is particularly high. On the downside, the factors that have held back inflation for much of the last expansion, such as technological change, digitalization, globalization, and a relatively weak relationship between economic activity and inflation, are all still present. The lower level of equilibrium interest rates in the U.S. and other advanced economies also results in a downward bias to inflation. Indeed, offsetting this bias was one reason the Federal Reserve changed its monetary policy strategy to focus on keeping longer-run inflation expectations anchored at levels consistent with our 2 percent goal and aiming for inflation to average 2 percent over time.

But there are also upside risks to inflation, and I see them as outweighing the downside risks at this time, even though I have revised my inflation forecast up since the start of the year. Many businesses report that cost pressures are intensifying and consumers seem to be willing to pay higher prices. The combination of strong demand and supply-chain challenges could last longer than I anticipate and could lead people and businesses to raise their expectations for future inflation more than we have seen so far. Although this is not my base case, if elevated inflation readings were to persist longer than anticipated and inflation expectations were on a trajectory to move higher than levels consistent with our 2 percent goal, monetary policy would need to be adjusted in order to bring inflation and inflation expectations back to our 2 percent goal on a sustained basis.

**Monetary Policy**

Both the federal government and the Federal Reserve took swift and significant actions in response to the pandemic. These actions helped to make last year's recession the shortest on record and to avoid long-term economic scarring. The Fed 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.

At our meeting earlier this week, the FOMC maintained the target range for the federal funds rate at 0 to 1/4 percent and made no change to the pace of our asset purchases. We are currently purchasing $80 billion per month of Treasury securities and $40 billion per month of agency mortgage-backed securities. We indicated that if progress continues broadly as expected, a moderation in the pace of asset purchases may soon be warranted.

The Fed's asset purchases were an important policy response to address the severe strains in financial markets early in the pandemic and to support the economy in the midst of this unprecedented shock. Now, market functioning is restored and a solid recovery is underway. Last December, the FOMC issued forward guidance that we would not begin tapering our purchases until substantial further progress had been made toward our goals of maximum employment and price stability. In my view, the economy has met those conditions, and I support starting to dial back our purchases in November and concluding them over the first half of next year.

The start of asset-purchase tapering should not be taken as a signal that the FOMC plans to raise the fed funds rate any time soon. Even after tapering starts, our balance sheet will be growing and monetary policy will remain very accommodative. As the FOMC said, we expect to keep the funds rate at its current target range of 0 to 1/4 percent until we have reached maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time. Inflation developments suggest that the second condition has largely been met. Inflation is running well above 2 percent and is forecasted to be 2 percent or more over the next couple of years; average inflation over the past 5 years is 2 percent, and measures of inflation expectations have moved up after running low over the last expansion. But in my view, the first condition has not been met: the economy is still some distance from maximum employment. The number of payroll jobs and the labor force participation rate are still well below where they were prior to the pandemic, and unemployment rates are still well above their pre-pandemic levels. But as the recovery continues, labor markets will continue to improve, and I expect that the conditions for liftoff of the fed funds rate will be met by the end of next year. Even after liftoff, to ensure that our goals of maximum employment and price stability are sustainably achieved and maintained, I believe it will be appropriate to maintain an accommodative stance of monetary policy for some time

Economists often say that the only thing certain about an economic forecast is that it will certainly be wrong. If we have learned anything over the past 18 months, it is that things can evolve very differently than anticipated. In these unprecedented times, the uncertainty around any economic forecast – including my own – is particularly high. Uncertainty will remain very high until the path of the economy can be decoupled from the virus. I know that I don't need to tell bankers that in such an environment, it is crucial to monitor risks – and stay humble. I plan to do both. I will reassess my outlook against the incoming data and the economic reconnaissance we gather from businesses, bankers, and community contacts. My policy views will depend on how economic conditions, the outlook, and the risks around the outlook actually evolve. I am prepared to change my views on the economy and appropriate monetary policy as conditions warrant.

Coming back to your theme of bouncing back, I will close by noting that the economy and the people, businesses, banks, and communities that make it work have shown remarkable adaptability and resiliency in unprecedented times. I'm sure that at some point over the past 18 months, we have all felt as if we were bouncing off the walls. But the good news is that over those months, the U.S. economy has bounced back a considerable way and it is poised to make even more progress over the coming year.