

Moving Toward a Broad-Based Sustainable Economic Recovery in the U.S.



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

**The European Economics and Financial Centre
Distinguished Speakers Seminar
London, U.K.
(via videoconference)**

January 12, 2021

Introduction

I thank the European Economics and Financial Centre for the opportunity to share my views on the U.S. economy and monetary policy in the Centre's Distinguished Speakers Seminar series. I last had the honor of speaking to you in July 2019 in London. That was only about a year and a half ago, though time seems to be working differently these days. Someone recently quipped that it's hard to believe that 2020 is over since it started just 12 years ago!

I do wish we could be meeting in person today – not just because London is one of my favorite cities but because it would mean that the scourge of the pandemic was behind us. Unfortunately, we are not there yet. The next few months will be challenging ones, as many countries, including yours and mine, continue to struggle with the increasing number of new cases of the virus as we await wider distribution of vaccines. Nonetheless, as we all turn the page on 2020, the prospects are good for a much more favorable 2021. Today, I will discuss why I think that is the base case. 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.

The Economy

At the start of 2020, before the pandemic, the U.S. economy was on very solid footing. It was the 11th year of the expansion, and things looked quite good from the perspective of our monetary policy goals of maximum employment and price stability. The unemployment rate was at historically low levels, 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 the pandemic changed all of that.

In March, the U.S. 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. As nonessential businesses shut down, there were swift and severe effects across the U.S. economy. Our economy began to reopen 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. During this reopening phase, there were sharp rebounds in activity and hiring in those parts of the economy that did not involve close physical contact. In fact, 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 the ability of the American people to adapt to circumstances.

The U.S. economy is currently in what I call the pre-vaccination recovery phase. The pace of the recovery has slowed compared to last spring and that slowdown is likely to continue in the near term as the current surge in new virus cases has once again led to mandatory and voluntary restrictions on some activities. The recovery, thus far, 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.

Before I turn to the outlook and a discussion of policy, let me show you a few charts to illustrate the phases the U.S. economy has been through.

[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 last February and the U.S. economy entered a recession. Real GDP fell at a 5 percent annual pace in the first quarter of last year and a record 31 percent annual pace in the second quarter. In the third quarter, as the economy reopened, growth rebounded, with real GDP rising at a 33 percent annual pace. 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 rate and employment level] We can see the same pattern in the labor market data. The unemployment rate was a low 3.5 percent in February and it surged to 14.8 percent in April. It rapidly declined as the economy reopened and people on temporary furlough or layoff began to be rehired.

Similarly, payroll employment plunged by 22 million jobs in March and April. To put that into perspective: that was about the same number of jobs the economy had added over the 10-plus years of the previous expansion. When the U.S. economy reopened in May, hiring picked up rapidly. But since the summer, the labor market has cooled. Some of that was expected after the reopening, but more recently, hiring has slowed even more given the re-imposition of some restrictions on activity due to the increase in new virus cases. In fact, payrolls declined by 140 thousand jobs in December and employment remained more than 6 percent, or almost 10 million jobs, below its level in February. A larger share of those currently unemployed are on permanent rather than temporary layoff compared to earlier in 2020, and the unemployment rate remains very elevated, at 6.7 percent in December, unchanged from November.

[FIGURE 3. Change in unemployment by race and education] The disparate nature of the recovery, thus far, can be seen in some of the labor market statistics. In terms of the decline in unemployment rates

since February, there has been less progress for nonwhites and for those without a college education, as seen here.¹

[FIGURE 4. Recovery in jobs by wage level and prime-age labor force participation rate by gender]

Rehiring by employers has been considerably slower for low-wage workers than for high-wage workers, whose employment level has now returned to its pre-pandemic level. Among workers in the prime working ages of 25 to 54, the labor force participation rate of women has recovered less than that of 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. But it also likely reflects the fact that the need to provide childcare for pre-school children or those being schooled remotely is disproportionately affecting women's ability to remain in the workforce or work their usual number of hours. 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. Total and core inflation and durable goods and services 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 last 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. The disparate nature of the recovery is seen in the inflation data, too. High demand has pushed

¹ The net increase in the unemployment rate between February and December was 3.9 percentage points for Blacks, 4.9 percentage points for Hispanics, 3.5 percentage points for Asians, 3.0 percentage points for whites, 4.0 percentage points for those without a high school diploma, 4.3 percentage points for those with a high school diploma without any college, 3.3 percentage points for those with some college but less than a bachelor's degree, and 1.9 percentage points for those with a bachelor's degree or higher.

durable goods inflation to a 25-year high, while the inflation rate for services, which includes the prices of travel, hospitality, and other hard-hit sectors, remains in the bottom of its range over the last decade. Overall, inflation remains below the FOMC's longer-run goal of 2 percent as measured by the year-over-year change in PCE inflation.

The Economic Outlook

That is a brief review of where the U.S. economy has been. Where it is going will largely depend on the path of the virus, which, in turn, is affected by our actions to control its spread, treat it, test for it, and vaccinate against it. It probably goes without saying that there is still a high degree of uncertainty around the outlook, even though some of the worst-case scenarios and downside risks have lessened over time.

Three key factors are shaping my thinking about the economic outlook. The first is the surge in new virus cases, which well exceed those seen last spring and summer and are straining hospital capacity in some parts of the U.S. The surge is exacting a heavy human toll and casting a shadow on the near-term economic outlook.

A second factor shaping my outlook is the positive developments on the vaccine front. These have made me more confident about the economy's recovery over the medium run, notwithstanding the bumpy start to deployment of the vaccines in the U.S. It will take several months for vaccines to be widely distributed and for a large segment of the U.S. population to be vaccinated. But when that happens, economic conditions will look very different from what they look like today.

The third factor shaping my outlook is the fact that while the pace of the recovery has slowed 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 will likely weigh on economic activity this winter as it is managed through social distancing and targeted shutdowns, albeit ones that are less severe than those last spring. But 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, people and businesses will feel it is safe to re-engage in a broad range of activities and I expect a strong pickup in economic activity in the second half of this year.

This post-vaccination phase of the recovery is likely to continue over the next few years, with growth above trend, declines in the unemployment rate, and gradually rising inflation. Given the nature and the severity of the pandemic shock, some sectors will recover slower 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. There may well be persistent changes in consumer preferences with respect to shopping, dining, and housing and firms' demand for office space. Those changes, as well as the need to re-establish more robust supply chains, could necessitate structural changes to the economy that will take time to unfold.

Policy

My modal outlook, which I just described, depends on appropriate policy. Both monetary and fiscal policy have supported the recovery in the U.S. thus far, and in my view, both will continue to be needed to limit lasting damage to the economy from the pandemic and support the achievement of a broad-based sustainable recovery. Since the start of the pandemic, fiscal policy 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. Federal Reserve 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 federal 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 in our December policy statement is entirely consistent with our revised monetary policy strategy, which was summarized in a statement we released last August.² Let me conclude with a few comments on our revised strategy and its implications for monetary policy going forward.

The FOMC's Revised Monetary Policy Strategy and Its Implications for Monetary Policy

The revised strategy statement summarizes the FOMC's conclusions from a review of our monetary policy framework that began in early 2019. The review was undertaken in light of changes in the

² 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>).

economic environment that have implications for monetary policy. One change that has occurred in the U.S. and other advanced economies is the decline 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. So the FOMC will have less policy space to support the economy using its traditional policy tool and during economic downturns, it is now more likely that the fed funds rate will be constrained by its effective lower bound. Households, businesses, and financial markets understand this constraint, so they are likely to think that inflation will remain low because of the lack of policy space. So the constraint imparts a downward bias to inflation expectations and inflation, and so increases the downside risks to achieving our policy goals.

Another change in the economic environment compared to past decades pertains to inflation dynamics. Resource slack in the labor market and in product markets 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 because inflation running below our goal would result in even less policy space in a low-interest-rate environment.

Our revised strategy incorporates these changes in the economic environment. We have reaffirmed that our longer-run inflation goal is 2 percent, but in order to achieve this goal, we will likely aim to have inflation run moderately above 2 percent for some time after periods in which inflation has been running persistently below 2 percent. In other words, not only will we be comfortable with serendipitous shocks that move inflation above 2 percent, but we will set policy to intentionally move inflation moderately above 2 percent for some time. The implication is that, all else equal, monetary policy will be somewhat

more accommodative than in the past when inflation has been running persistently low in order to reach our longer-run inflation goal.

With respect to our employment goal, in the last expansion we learned over time that employment growth could be stronger and the unemployment rate lower without generating inflation than one would have thought possible based on past decades of experience. Our new strategy 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. Indeed, the benefits of a strong labor market in fostering economic inclusion for all Americans are clear.

The approach to monetary policymaking as summarized in our strategy has implications for policy going forward. It is consistent with my view that based on my current outlook and assessment of risks around the outlook, it will be appropriate for monetary policy to be patiently accommodative. 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, there continues to be substantial uncertainty around the outlook, with both upside and downside risks, and policymakers are not prescient. This is why framing our forward policy guidance in terms of the progress the economy is making toward our policy goals of maximum employment and price stability is so important. The past year reminds us that the economy could evolve in a materially different way than expected and risks, including those to financial stability, might emerge that could impede attainment of our monetary policy goals. On the other hand, the resiliency shown by the economy so far suggests there is also the possibility that the post-vaccination recovery could be stronger than expected.

In either case, consistent with our forward guidance, Federal Reserve policymakers stand prepared to respond appropriately to continue to foster a broad-based sustainable recovery.

Charts for “Moving Toward a Broad-Based Sustainable Economic Recovery in the U.S.”

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

The European Economics and Financial Centre
Distinguished Speakers Seminar
London, U.K.
(via videoconference)

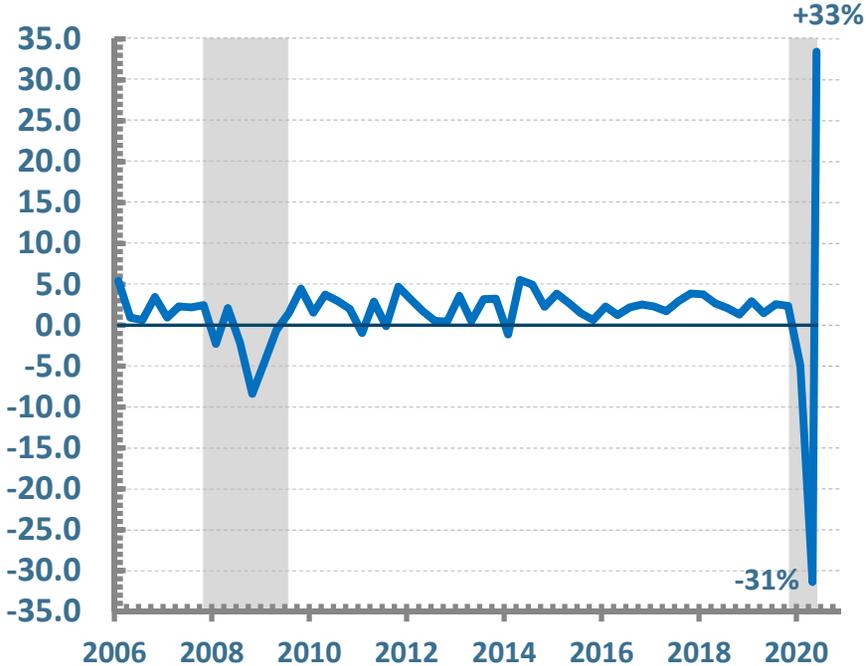
January 12, 2021

*** The views expressed here are my own and not necessarily those of the Federal Reserve System or my colleagues on the Federal Open Market Committee.**

Figure 1. There were dramatic swings in output in 2020

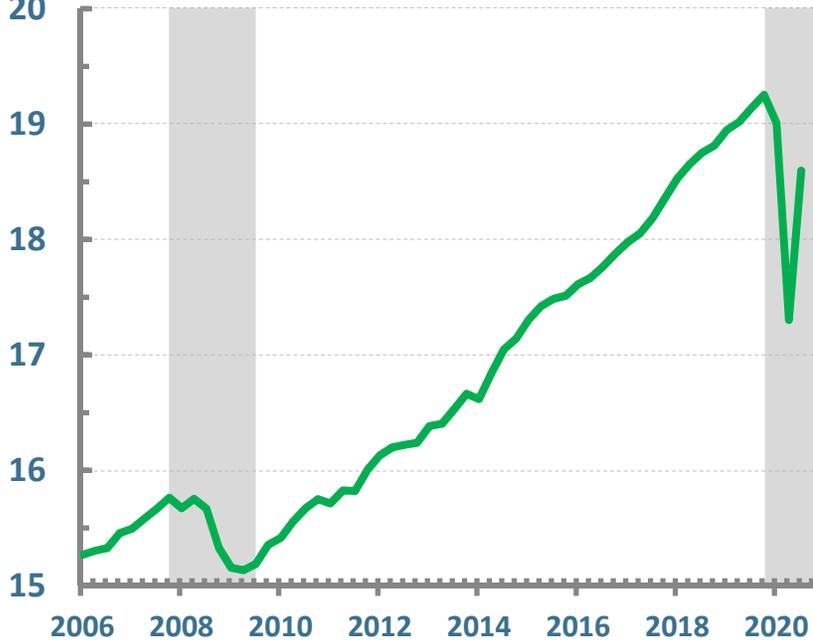
Growth of real GDP, annualized

Percent change, SAAR



Level of real GDP

Trillions of chain-weighted 2012 \$

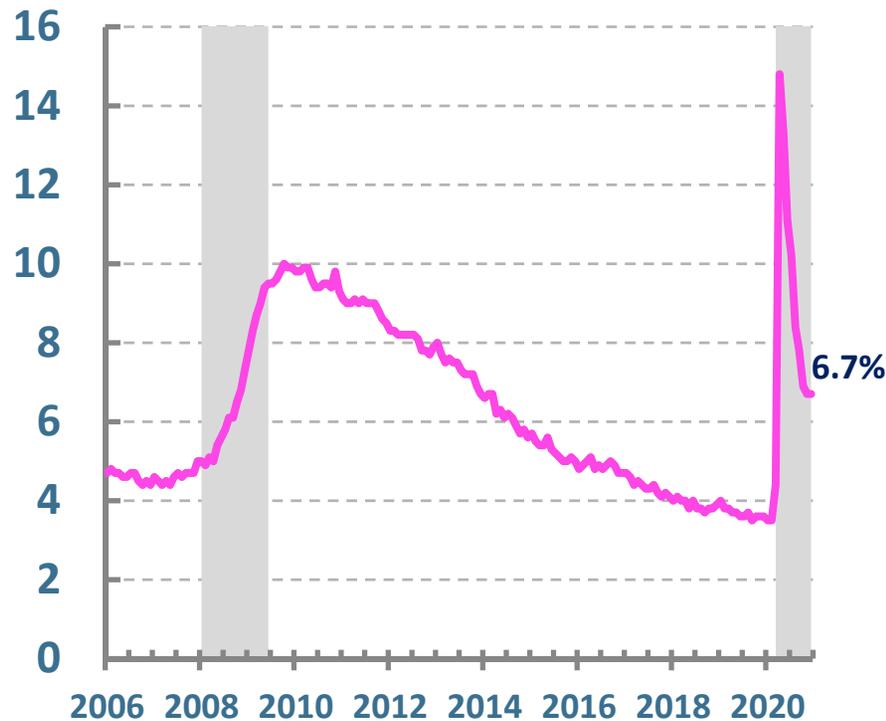


2 Source: Bureau of Economic Analysis via Haver Analytics
Quarterly data: Last obs. 2020Q3

Figure 2. Labor market conditions have improved since April, but the pace of improvement has slowed

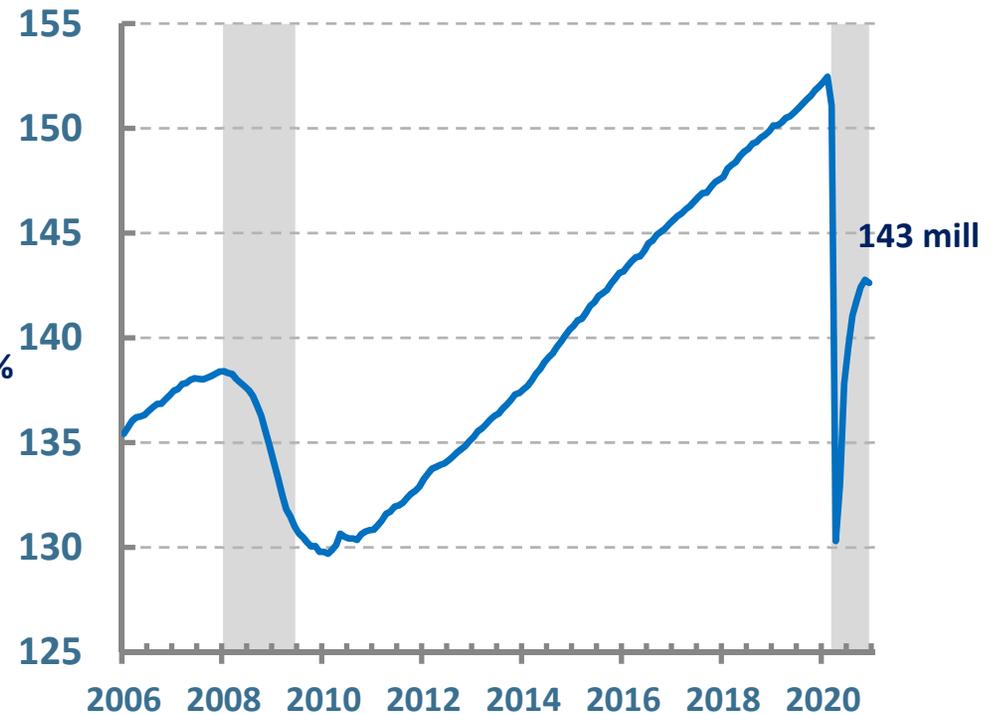
Unemployment rate

Percent, SA



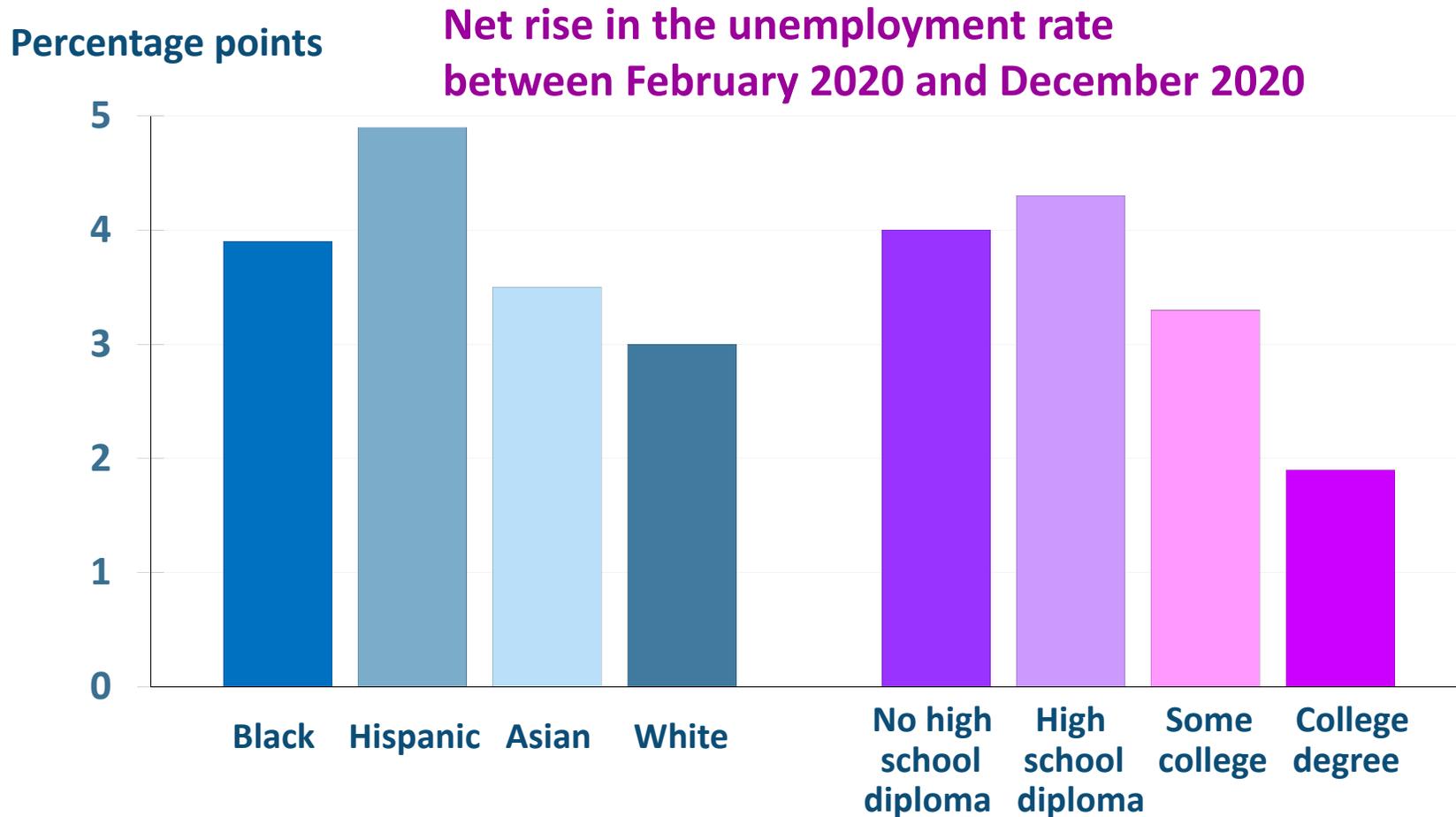
Level of payroll employment

Millions of jobs, SA



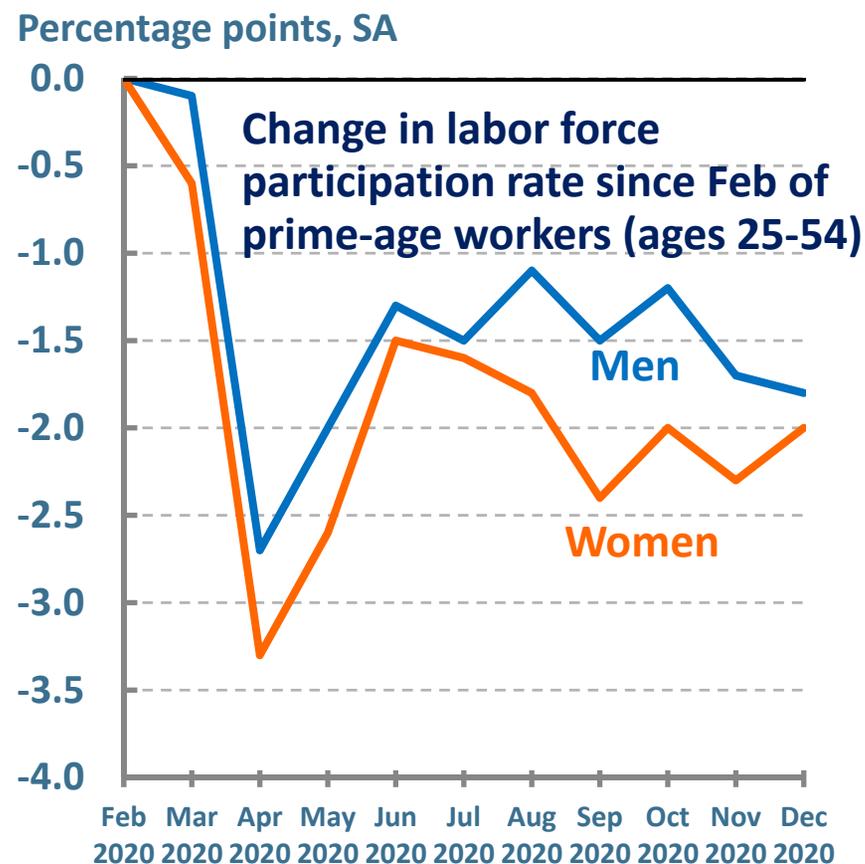
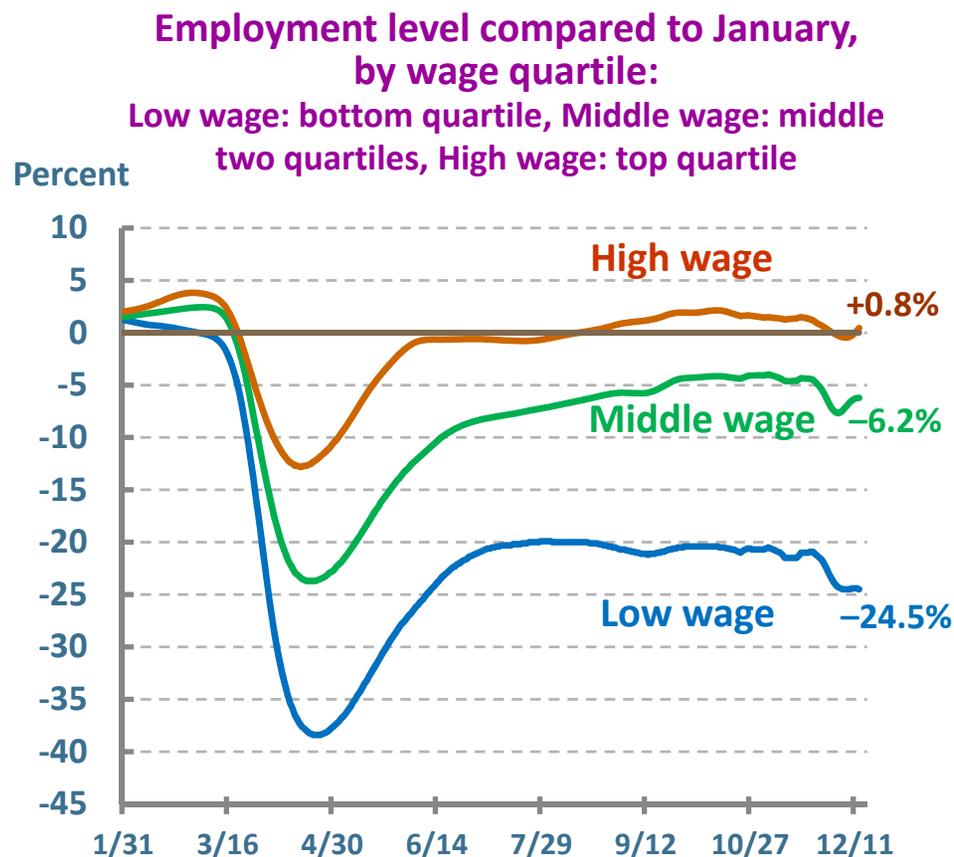
Source: Bureau of Labor Statistics via Haver Analytics
Monthly data: Last obs. December 2020

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



4 Source: Bureau of Labor Statistics via Haver Analytics

Figure 4. Labor market conditions for low-wage workers and women are worse than for high-wage workers and men, respectively



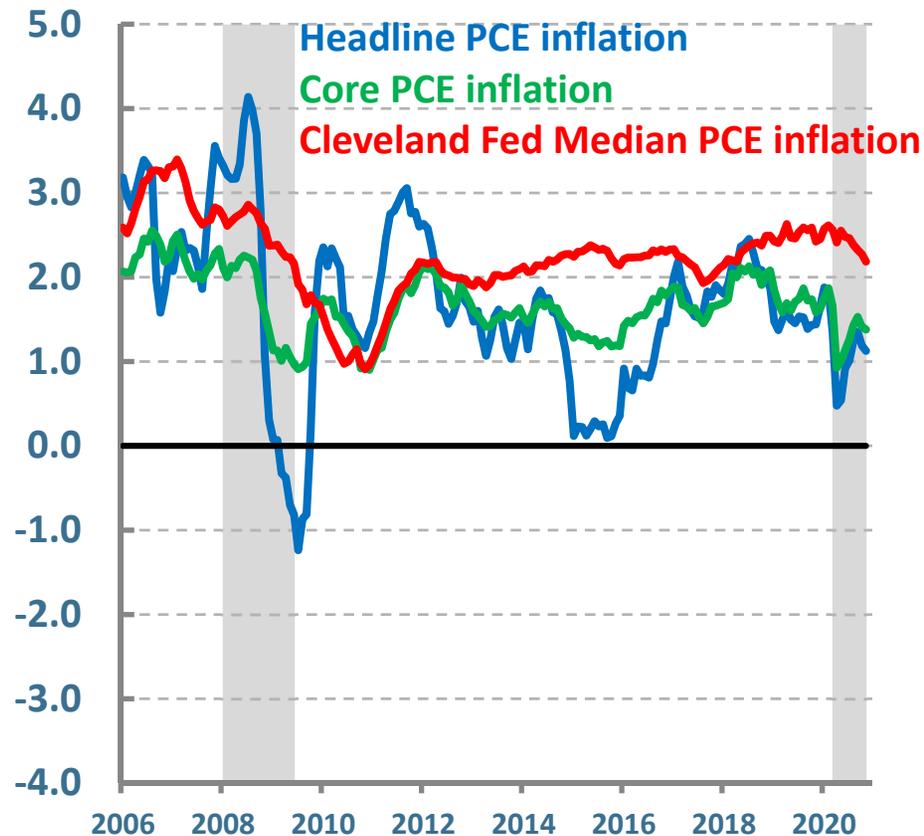
Source: Opportunity Insights, TracktheRecovery.org based on data from Paychex, Intuit, Earnin, and Kronos, daily data through 12/13/2020

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

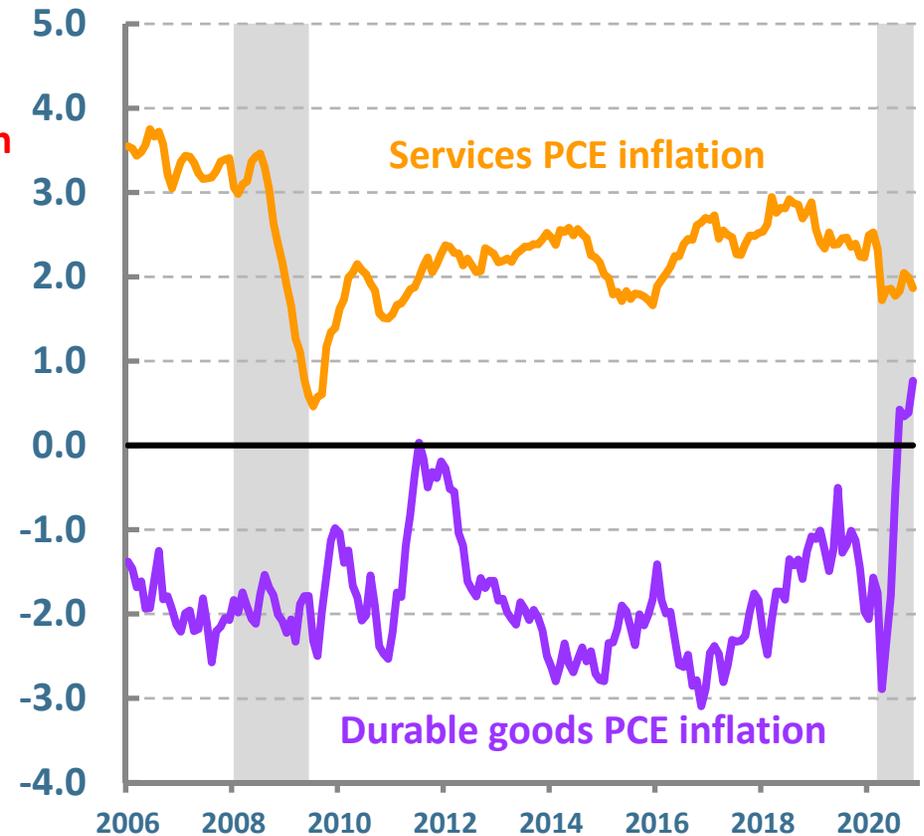
Low wage is approx. < \$13/hour, Middle wage is approx. \$13-\$29/hour, High wage is approx. > \$29/hour

Figure 5. Overall inflation has moved up since the shutdown but is below its pre-pandemic level. Durable goods PCE inflation is at a 25-year high.

Year-over-year percentage change



Year-over-year percentage change



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

FEDERAL RESERVE BANK
of CLEVELAND

Charts for “Moving Toward a Broad-Based Sustainable Economic Recovery in the U.S.”

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

The European Economics and Financial Centre
Distinguished Speakers Seminar
London, U.K.
(via videoconference)

January 12, 2021

* The views expressed here are my own and not necessarily those of the Federal Reserve System or my colleagues on the Federal Open Market Committee.