Richard H Clarida: US economic outlook and monetary policy

Speech (via prerecorded video) by Mr Richard H Clarida, Vice Chair of the Board of Governors of the Federal Reserve System, at the Foreign Policy Association, New York City, 16 June 2020.

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It is my pleasure to meet virtually this evening with the members and invited guests of the Foreign Policy Association (FPA).[1] I am truly honored to receive the Foreign Policy Association Medal. Past honorees have included Sheila Bair, Anne-Marie Slaughter, Paul Volcker, Jean-Claude Trichet, and my Federal Open Market Committee (FOMC) colleague John Williams—and so with this award, I am indeed in select company. Although I have been very much looking forward to receiving this award in person, that, of course, is not possible tonight, but I greatly look forward to attending a future dinner to convey in person my genuine appreciation to the members of the FPA for this special honor. Since mid-March, I, along with my FOMC colleagues, have been working from home. Indeed, just last week, we held our scheduled June meeting via secure teleconference. And while I certainly miss the opportunities for face-to-face interactions along the corridors of the Board's Eccles Building, I am grateful to have the ability to work from home and want to convey my deep gratitude to all of those on the frontlines of the crisis, who are working outside the comfort of their homes in grocery stores, hospitals, and other businesses that provide essential services.

Current Economic Situation and Outlook

While the coronavirus (COVID-19) pandemic has taken a tragic human toll measured in terms of lives lost and suffering inflicted, the pandemic has also inflicted a heavy toll on the levels of activity and employment in the U.S. economy, as a direct result of the necessary public health policies put in place to mitigate and control the spread of the virus. Real gross domestic product (GDP) declined at a 5 percent annual rate in the first quarter of the year and will almost surely continue to contract at an unprecedented pace in the second quarter. The unemployment rate, which reached a 50-year low of 3.5 percent as recently as February of this year, surged to 14.7 percent in April, an 80-year high. In May, there was a notable rebound in employment and decline in unemployment, and these developments are certainly welcome. Moreover, in recent weeks, some other indicators suggest a stabilization or even a modest rebound in some segments of the economy. But activity in many parts of the economy has yet to pick up, and GDP is falling deeply below its recent peak. And, of course, despite the improvements seen in the May jobs report, the unemployment rate, at 13.3 percent, remains historically high.

After the extreme turbulence witnessed in March, financial markets across many sectors have normalized and are again serving their essential role of intermediating flows of savings and investment among borrowers and lenders. Bank credit lines are providing liquidity to companies, and corporations with debt rated investment grade and high yield are able to issue, and in size, in the corporate bond market. I believe—and most outside observers agree—that this easing of financial conditions since March is, at least in part, the direct consequence of economic policy responses to the crisis, including the actions the Federal Reserve took at our March 15 meeting and the subsequent announcement and sequential launch of 11 new facilities to support the flow of credit to households and companies. While this easing of financial conditions is, of course, welcome to the extent that it supports the flow of credit to households and firms during this challenging period, it may not prove to be durable, depending on the course that the coronavirus contagion takes and the duration of the recession that it causes. At minimum, the easing of financial conditions is buying some time until the economy begins to recover.

As I speak to you today, there is extraordinary uncertainty about both the depth and the duration of the economic downturn. Because the course of the economy will depend on the course of the virus and the public health policies put in place to mitigate and contain it, there is an unusually wide range of scenarios for the evolution of the economy that could plausibly play out over the next several years. In my baseline view, while I do believe it will likely take some time for economic activity and the labor market to fully recover from the pandemic shock, I do project right now that the economy will resume growth starting in the third quarter. In terms of inflation, my projection is for the COVID-19 contagion shock to be disinflationary, not inflationary, and the data we are seeing so far are consistent with this projection. For example, core CPI (consumer price inflation) prices fell 0.4 percent in April, the largest monthly decrease since the beginning of the series in 1957. Although the decline in core CPI was smaller in May, on a year-over-year basis, core CPI is running at 1.2 percent, the slowest pace in nine years. While the COVID-19 shock is disrupting both aggregate demand and supply, the net effect, I believe, will be for aggregate demand to decline relative to aggregate supply, both in the near term and over the medium term. If so, downward pressure on PCE (personal consumption expenditures) inflation, which was already running somewhat below our 2 percent objective when the downturn began in March, will continue. Moreover, I judge that measures of longer-term inflation expectations were, when the downturn began, at the low end of a range that I consider consistent with our 2 percent inflation objective and, given the likely depth of this downturn, are at risk of falling below that range. The Federal Reserve has a dual mandate from the Congress to pursue policies that aim to achieve and sustain maximum employment and price stability. To me, price stability requires that inflation expectations remain well anchored at our 2 percent objective, and I will place a high priority on advocating policies that will be directed at achieving not only maximum employment, but also well-anchored inflation expectations consistent with our 2 percent objective.

The Policy Response

At the Federal Reserve, we take our dual-mandate obligations of maximum employment and price stability very seriously, and, since March 3, we have deployed our entire toolkit to provide critical support to the economy during this challenging time. In two unscheduled meetings, we voted on March 3 and March 15 to cut the target range for the federal funds rate by a total of 150 basis points to its current range of 0 to 25 basis points.[2] In our FOMC statements, we have indicated we expect to maintain the target range at this level until we are confident that the economy has weathered recent events and is on track to achieve our maximum-employment and price-stability goals.

On March 16, we launched a program to purchase Treasury securities and agency mortgage-backed securities in whatever amounts needed to support smooth market functioning, thereby fostering effective transmission of monetary policy to broader financial conditions. To date, these purchases have totaled more than $2.3 trillion, and, as we indicated at our June meeting, they will continue in coming months at least at the current pace, which should sustain smooth market functioning, thereby fostering effective transmission of monetary policy to broader financial conditions.

Since March 17, the Board has announced the establishment of no fewer than 11 new facilities to support the flow of credit to households and businesses. These programs are authorized under emergency lending powers granted to the Fed under section 13(3) of the Federal Reserve Act and are available only in “unusual and exigent” circumstances and with the consent of the Secretary of Treasury.[3] These facilities are supported with money invested by the Department of the Treasury, drawing on appropriations of more than $450 billion authorized by the Congress in the CARES Act (Coronavirus Aid, Relief, and Economic Security Act) for the specific purpose of investing in Fed programs to sustain the flow of credit to households, firms, and communities during the coronavirus pandemic. With these facilities, we are providing a bridge by stepping in and supporting lending throughout the economy until the recovery takes hold. These programs are designed to offer backstop sources of funding to the private sector, and just the announcement that these backstop facilities would soon be launched appears to have bolstered confidence in capital markets, allowing many companies to finance themselves privately even before the facilities were up and running. But importantly, these are, after all, emergency facilities, and someday—hopefully soon—the emergency will pass. When that day comes and we are confident the economy is solidly on the road to recovery, we will wind down these lending facilities at such time as we determine the circumstances we confront are no longer unusual or exigent.

The Federal Reserve has played a leading role in the global economic policy response to the coronavirus pandemic. Foreign financial institutions borrow and lend in U.S. dollars, and these dollar funding markets seized up when COVID-19 emerged. In globally integrated financial markets such as ours, these strains in dollar funding markets outside the United States affect the flow of credit to U.S. households and businesses. As such, during the week of March 15, the Federal Reserve coordinated with five foreign central banks to enhance its standing dollar liquidity swap lines.[4] In addition, temporary swap lines were reestablished with the nine central banks that had temporary agreements during the Global Financial Crisis.[5] Moreover, to support dollar liquidity to a broad range of countries, the Federal Reserve announced a new program on March 31, the temporary FIMA (Foreign and International Monetary Authorities) Repo Facility. Under this facility, FIMA account holders at the Federal Reserve Bank of New York (which include central banks and other monetary authorities) can enter into overnight repos (repurchase agreements) with the Federal Reserve, temporarily exchanging U.S. Treasury securities in their accounts for U.S. dollars, which can then be provided to institutions in their respective jurisdictions. All of these facilities have had a very constructive effect in calming down dollar funding markets and supporting a return to more normal conditions in global financial markets more generally.

Of course, as members of the FPA, you are well aware that developments in the U.S. economy do not happen in isolation from the rest of the world. We live in a globally integrated economy. With COVID-19, all countries have been hit by a global common shock, not only directly by the virus and the measures necessary to combat it, but also by the economic spillovers from those actions around the world. As in the United States, many foreign authorities have taken swift and forceful actions in response. My colleagues and I have worked closely with others—bilaterally and in international forums like the Group of Seven, Group of Twenty, Bank for International Settlements, and Organisation for Economic Co-operation and Development—to monitor and address the effects of the pandemic. The forcefulness and synchronized timing of actions by fiscal authorities, central banks, and regulators have helped support the incomes of households and firms and reduce market stresses that could have amplified the shock.

Not only is the Federal Reserve using its full range of tools to support the economy through this challenging time, but our policies will also help ensure that the rebound in activity when it commences will be as robust as possible. That said, it is important to note that the Fed's statutory authority grants us lending powers, not spending powers. The Fed is not authorized to grant money to particular beneficiaries, to meet the payroll expenses of small businesses, or to underwrite the unemployment benefits of displaced workers. Programs to support such worthy goals reside squarely in the domain of fiscal policy. The Fed can only make loans to solvent entities with the expectation the loans will be paid back. Direct fiscal support for the economy is thus also essential to sustain economic activity and complement what monetary policy cannot accomplish on its own. Direct fiscal support can make a critical difference, not just in helping families and businesses stay afloat in a time of need, but also in sustaining the productive capacity of the economy after we emerge from this downturn.

Fortunately, the fiscal policy response in the United States to the coronavirus shock has been both robust and timely. In four pieces of legislation passed in just over two months, the Congress voted $2.9 trillion in coronavirus relief, about 14 percent of GDP. Depending on the course of the virus and the course of the economy, more support from both fiscal and monetary policy may be called for.

Concluding Remarks

The coronavirus pandemic poses the most serious threat to maximum employment and, potentially, to price stability that the United States has faced in our lifetimes. There is much that policymakers—and epidemiologists—simply do not know right now about the potential course that the virus, and thus the economy, will take. But there is one thing that I am certain about: The Federal Reserve will continue to act forcefully, proactively, and aggressively as we deploy our toolkit—including our balance sheet, forward guidance, and lending facilities—to provide critical support to the economy during this challenging time and to do all we can to make sure that the recovery from this downturn, once it commences, is as robust as possible.

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1 These remarks represent my own views, which do not necessarily represent those of the Federal Reserve Board or the Federal Open Market Committee. I am grateful to Brian Doyle and Chiara Scotti of the Federal Reserve Board staff for their assistance in preparing this text.

2 See the FOMC statements issued after the March 3 and March 15 FOMC meetings, which are available (along with other postmeeting statements) on the Board's website at www.federalreserve.gov/monetarypolicy/fomccalendars.htm.

3 See Federal Reserve Act, 12 U.S.C. § 343 (1932), quoted text in paragraph 3.A.

4 The swap fee was reduced from 50 basis points to 25 basis points over the U.S. dollar overnight index swap rate. To better target stresses in funding markets for longer-term dollar borrowing, swap operations with a maturity of 84 days were added to the usual 7-day operations by the four central banks that traditionally hold regular auctions—the Bank of England, the Bank of Japan, the European Central Bank, and the Swiss National Bank. Finally, these four central banks announced that they would begin daily auctions. See Board of Governors of the Federal Reserve System (2020), "Coordinated Central Bank Action to Enhance the Provision of U.S. Dollar Liquidity," press release, March 15; and Board of Governors of the Federal Reserve System (2020), "Coordinated Central Bank Action to Further Enhance the Provision of U.S. Dollar Liquidity," press release, March 20.

5 See Board of Governors of the Federal Reserve System (2020), "Federal Reserve Announces the Establishment of Temporary U.S. Dollar Liquidity Arrangements with Other Central Banks," press release, March 19.