Lael Brainard: US economic outlook and monetary policy - an update

Speech (via webcast) by Ms Lael Brainard, Member of the Board of Governors of the Federal Reserve System, at the C. Peter McColough Series on International Economics, Council on Foreign Relations, New York City, 2 March 2021.

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It has been one year since the first wave of the COVID-19 pandemic hit our shores—a year marked by heartbreak and hardship. We are all looking forward to a brighter time ahead, when vaccinations are widespread, the recovery is broad based and inclusive, and services, schools, sports, and social life are in person. The expected path of the U.S. economy has strengthened with the prospect of widespread vaccinations and additional fiscal stimulus, but risks remain, and we are currently far from our goals.[1]

Current Situation

After a dark winter with elevated case counts and setbacks on service-sector jobs, case counts have come down and spending is picking up. Economic forecasts for growth during the first quarter have been significantly upgraded in response to the better-than-expected data.[2] January data for household spending overall came in strong—confirming that the renewal of fiscal support at the end of the year provided a much needed boost to household incomes and spending at the turn of the year. The income support provided by fiscal authorities to hard-hit workers, households, businesses, and states and localities, as well as the actions of the Federal Reserve to promote orderly functioning in financial markets and low borrowing costs for households and businesses, have been providing vital support for the economy.

In recent weeks, vaccinations have been increasing, while weekly cases, hospitalizations, and deaths have decreased. The seven-day moving average of daily COVID deaths, which peaked in mid-January, declined about 35 percent during the month of February, although sadly it is still at high levels.[3] As of yesterday, nearly 77 million vaccination doses had been administered.

While the progress on vaccinations is promising, jobs are currently down by 10 million relative to pre-pandemic levels. Improvements in the labor market stalled late last year after rebounding partway in the summer and fall of 2020. When we take into consideration the more than 4 million workers who have left the labor force since the pandemic started, as well as misclassification errors, the unemployment rate is close to 10 percent currently—much higher than the headline unemployment rate of 6.3 percent.

Labor force participation by prime-age workers stands lower now, on net, than it did in June after it had bounced back partway from the decline in April.[4] The decline in labor force participation relative to last June is largely a result of lower participation by prime-age women, which, in turn, partly reflects the increase in caregiving work at home with the move to remote schooling and the shutdown of daycares due to COVID. On average, over the period from November 2020 to January 2021, the fraction of prime-age women with children aged 6 to 17 who were out of the labor force for caregiving had increased by 2.4 percentage points from a year earlier, while for men the fraction had increased by about 0.6 percentage point.[5] If not soon reversed, the decline in the participation rate for primelage women could have scarring effects, with longer-term implications for household incomes and potential growth.[6]

Roughly 90 percent of the shortfall in private payroll employment relative to the pre-COVID level is concentrated in service-providing industries, with half of these service job losses in leisure and hospitality. The concentration of job losses in services has had a disproportionate effect on the

lowest-wage workers. Workers in the lowest-wage quartile face an extremely elevated rate of unemployment of around 23 percent.[7] The advent of widespread vaccinations should revive in-person schooling and childcare along with demand for the in-person services that employ a significant fraction of the lower-wage workforce.

Realized inflation remains low, although inflation expectations appear to have moved closer to our 2 percent longer-run target. Both core and headline measures of 12-month personal consumption expenditures (PCE) inflation were 1.5 percent in January, well below our longer-run 2 percent inflation goal. Longer-term inflation expectations appear to have moved up in recent months, consistent with the Federal Open Market Committee's (FOMC) new commitment to achieving inflation that averages 2 percent over time. Market-based indicators of inflation expectations increased over recent months, with Treasury Inflation-Protected Securities-based measures of inflation compensation over the next 5 years and 10 years rising about 40 and 30 basis points, respectively, since the end of last year. Some survey measures of inflation expectations have also moved up in recent months, although, on balance, they have only moved up toward their pre-COVID levels.

In many foreign countries, growth moderated at the end of 2020, as a spike in COVID hospitalizations and deaths led to tighter public health restrictions in many economies. Retail sales and measures of services activity weakened even as manufacturing and exports remained more resilient. Foreign activity should strengthen later this year as vaccinations rise, COVID case counts decline, and social distancing eases. It should also be aided by some rundown in the stock of excess savings, continued fiscal and monetary support, and strong U.S. demand. The turnaround in growth in each country will hinge on success in controlling the virus and limiting economic scarring from the past year's downturn, as well as on available policy space, and underlying macroeconomic vulnerabilities.

Outlook

So, what do these developments suggest for the U.S. outlook? Increasing vaccinations, along with enacted and expected fiscal measures and accommodative monetary policy, point to a strong modal outlook for 2021, although considerable uncertainty remains. It is widely expected that we will continue to make progress controlling the virus, reducing the need for social distancing, but variants of the virus, slow take-up of vaccinations, or both could slow progress.

Additional fiscal support is likely to provide a significant boost to spending when vaccinations are sufficiently widespread to support a full reopening of in-person services. Various measures of financial conditions are broadly accommodative relative to historical levels and should remain so. The labor market should strengthen, perhaps significantly, as the virus recedes, social distancing comes to an end, and the service sector springs back to life.

Inflation is likely to temporarily rise above 2 percent on a 12-month basis when the low March and April price readings from last year fall out of our preferred 12-month PCE measure. Transitory inflationary pressures are possible if there is a surge of demand that outstrips supply in certain sectors when the economy opens up fully. The size of such a surge in demand will depend in part on the effects of additional fiscal stimulus, along with any spend-down of accumulated savings, which are uncertain.[8] But a surge in demand and any inflationary bottlenecks would likely be transitory, as fiscal tailwinds to growth early this year are likely to transition to headwinds sometime thereafter. A burst of transitory inflation seems more probable than a durable shift above target in the inflation trend and an unmooring of inflation expectations to the upside.

When considering the inflation outlook, it is important to remember that inflation has averaged slightly below 2 percent for over a quarter-century. In the nine years since the FOMC's announcement of a 2 percent inflation objective, 12-month PCE inflation has averaged under 1-1/2 percent. Readings of 12-month inflation have been below 2 percent in 95 of those 109

months. According to recent research, statistical models estimate that underlying core PCE inflation ranges from one- to four-tenths of 1 percentage point below our 2 percent longer-run target.[9] Recall that at the end of 2019, with unemployment at a multidecade low and after the addition of almost 1-1/2 million workers to the labor force during the previous year, PCE inflation was 1.6 percent for the year.

Monetary Policy

With that outlook in mind, let me turn to monetary policy. After an extensive review, the FOMC revised its monetary policy framework to reflect important changes in economic relationships characterized by a low equilibrium interest rate, inflation persistently below target, and low sensitivity of inflation to resource utilization. The new framework calls for monetary policy to seek to eliminate *shortfalls* of employment from its maximum level, in contrast to the previous approach that called for policy to minimize *deviations* when employment is too high as well as too low. It emphasizes that maximum employment is a broad-based and inclusive goal assessed by a wide range of indicators. In addition, in order to keep longer-term inflation expectations well anchored at our 2 percent goal, monetary policy will seek to achieve inflation that averages 2 percent over time. Consequently, following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time.

These changes mean that we will not tighten monetary policy solely in response to a strong labor market. The long-standing presumption that accommodation should be reduced preemptively when the unemployment rate nears estimates of the neutral rate in anticipation of high inflation that is unlikely to materialize risks an unwarranted loss of opportunity for many of the most economically vulnerable Americans.[10] It may curtail progress for racial and ethnic groups that have faced systemic challenges in the labor force. Instead, the shortfalls approach will enable the labor market to continue to improve absent clear indications of high inflationary pressures or an unmooring of inflation expectations to the upside.

The FOMC has set out forward guidance on the policy rate and asset purchases that implements the new framework. The guidance indicates an expectation that it will be appropriate to maintain the current target range of the federal funds rate until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time. Even after economic conditions warrant liftoff, changes in the policy rate are likely to be only gradual, as the forward guidance notes that monetary policy will remain accommodative in order to achieve inflation moderately above 2 percent for some time so that inflation averages 2 percent over time. In addition, asset purchases are expected to continue at least at their current pace until substantial further progress has been made toward our goals.

In assessing substantial further progress, I will be looking for realized progress toward both our employment and inflation goals. I will be looking for indicators that show the progress on employment is broad based and inclusive rather than focusing solely on the aggregate headline unemployment rate, especially in light of the significant decline in labor force participation since the spread of COVID and the elevated unemployment rate for workers in the lowest-wage quartile and other disproportionately affected groups.[11]

Likewise, while I will carefully monitor inflation expectations, it will be important to achieve a sustained improvement in actual inflation to meet our average inflation goal. The past decade of underperformance on our inflation target highlights that reaching 2 percent inflation will require patience, and we have pledged to hold the policy rate in its current range until not only has inflation risen to 2 percent but it is also on track to moderately exceed 2 percent for some time.

Of course, we will be vigilant in parsing the data. Given the path of inflation to date, our

framework calls for inflation moderately above 2 percent for some time. If, in the future, inflation rises immoderately or persistently above target, and there is evidence that longer-term inflation expectations are moving above our longer-run goal, I would not hesitate to act and believe we have the tools to carefully guide inflation down to target.

Today the economy remains far from our goals in terms of both employment and inflation, and it will take some time to achieve substantial further progress. Jobs are still 10 million below the pre-COVID level, and inflation has been running below 2 percent for years. We will need to be patient to achieve the outcomes set out in our guidance.

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1 I am grateful to Kurt Lewis for assistance in preparing these remarks. These remarks represent my own views, which do not necessarily represent those of the Federal Reserve Board or the Federal Open Market Committee.

2 See, for example, the Federal Reserve Bank of Atlanta's GDPNow, which revised up the estimate for first-quarter growth by 5 percentage points on the release of the retail sales data. The latest estimate is 8.8 percent. The GDPNow forecast is available on the Federal Reserve Bank of Atlanta's website at www.frbatlanta.org/cqer/research/gdpnow.

3 For more information, see the Centers for Disease Control and Prevention's COVID data page, which is available at covid.cdc.gov/covid-data-tracker.

4 See the lower panel of figure 3 in Lael Brainard (2021), "How Should We Think about Full Employment in the Federal Reserve's Dual Mandate?" speech delivered at the Ec10, Principles of Economics, Lecture, Faculty of Arts and Sciences, Harvard University, Cambridge, Mass. (via webcast), February 24.

5 The percentages are staff calculations based on the microdata from the January Current Population Survey. For more information on this analysis, see the box "Disparities in Job Loss during the Pandemic" in Board of Governors of the Federal Reserve System (2021), *Monetary Policy Report* (PDF) (Washington: Board of Governors, February), pp. 12–14.

6 See Olivia Lofton, Nicolas Petrosky-Nadeau, and Lily Seitelman (2021), "Parents in a Pandemic Labor Market," Working Paper 2021–04 (San Francisco: Federal Reserve Bank of San Francisco, February); and Lael Brainard (2020), "Achieving a Broad-Based and Inclusive Recovery," speech delivered at "Post-COVID—Policy Challenges for the Global Economy," Society of Professional Economists Annual Online Conference, October 21.

7 For more information on the analysis on employment by wage quartile, see the box "Disparities in Job Loss during the Pandemic" in Board of Governors, *Monetary Policy Report,* in note 5.

8 For examples of the range of estimates of the effects of the expected fiscal stimulus, see Wendy Edelberg and Louise Sheiner (2021), "The Macroeconomic Implications of Biden's $1.9 Trillion Fiscal Package," Brookings Institution, January 28; Alex Arnon, Daniela Viana Costa, Zheli He, Austin Herrick, Jon Huntley, Marcos Dinerstein, Victoria Osorio, and John Ricco (2021), "Macroeconomic Effects of the $1.9 Trillion Biden COVID Relief Plan," Penn Wharton Budget Model (Philadelphia: Wharton School of the University of Pennsylvania, February 3); and Olivier Blanchard (2021), "In Defense of Concerns over the $1.9 Trillion Relief Plan," RealTime Economic Issues Watch (Washington: Peterson Institute for International Economics, February 18), www.piie.com/blogs/realtime-economic-issues-watch/defense-concerns-over-19-trillion-relief-plan.

9 See the point estimates for 2019:Q2 in table 1 in Jeremy B. Rudd (2020), "Underlying Inflation: Its Measurement and Significance," FEDS Notes (Washington: Board of Governors of the Federal Reserve System, September 18).

10 See Stephanie R. Aaronson, Mary C. Daly, William L. Wascher, and David W. Wilcox (2019), "Okun Revisited: Who Benefits Most from a Strong Economy?" (PDF) *Brookings Papers on Economic Activity,* Spring, pp. 333–75.

11 See Lael Brainard (2021), "How Should We Think about Full Employment in the Federal Reserve's Dual Mandate?" in note 4.