Randal K Quarles: The economic outlook and monetary policy

Speech by Mr Randal K Quarles, Vice Chair for Supervision of the Board of Governors of the Federal Reserve System, at the Hutchins Center on Fiscal and Monetary Policy, The Brookings Institution, Washington DC, (via webcast), 26 May 2021.

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Thank you, David, and thank you to Brookings and the Hutchins Center for the opportunity to lead things off and be part of this very distinguished panel. Today, I will explain why I expect the U.S. economy to continue growing strongly over the remainder of this year and what the implications of that outlook are for monetary policy.1[1]

After the shutdowns and other measures taken in response to the COVID-19 outbreak last spring caused the swiftest and deepest recession in U.S. history, the economy has made a powerful recovery. Households and businesses adapted, supported by the flexibility and inherent strength of our market-based economy, by the continued resilience of our banking system, and by significant fiscal and monetary policy support. Highly accommodative monetary policy by the Federal Reserve has fostered strong growth in interest rate–sensitive sectors of the economy such as housing and durable goods, offsetting some of the historic weakness in the service sector last year. With the service sector reopening while other household and business spending remains strong, I expect rapid growth to continue for some time before slowing to a still robust pace next year.

Inflation is running significantly above the Federal Reserve's longer-run goal of 2 percent primarily as a result of three factors: the surge in demand as more services come back on line while goods spending remains robust, the emergence of bottlenecks in some supply chains, and the very low inflation readings recorded last spring dropping out of the calculation of 12-month inflation. For reasons I will detail in a moment, I expect that a significant portion of that recent boost to inflation will be transitory, and that it will not interfere with the rapid growth driving progress toward the Fed's maximum-employment goal.

We've come a long way since last spring, but reopenings over the past year have been uneven, so it will still be some time before we repair all the economic damage. Supply bottlenecks will likely hinder the quick expansion of production in some industries in the next few months and raise some costs—in some cases significantly. The progress in reopening has been slower in countries that are among our largest trading partners, weighing on U.S. growth by reducing demand for U.S. exports. But even with those impediments, I believe the strong recovery will keep rolling forward. Let me walk through the evidence for that optimistic view.

First, I see increasing recognition by the private and public sectors that a broad reopening can proceed safely.i[2] The Centers for Disease Control and Prevention has dropped most social-distancing recommendations for vaccinated people.2[3] Although local COVID-19 restrictions on schooling and economic activity continue in some areas, most schools are teaching in person at least part time and more than half of states have dropped all capacity constraints on restaurants, bars, and retail establishments. More than a dozen more states are planning to do so over the coming weeks.

With these reopenings, consumer spending, which is two-thirds of gross domestic product (GDP), will remain robust, supported by personal income that has, thanks to significant fiscal support, now surpassed the trend it was on before the COVID event. April's retail sales results were flat, but that came after enormous gains in March that were boosted by the latest round of stimulus checks. Looking beyond the headline numbers, sales were up 13 percent in March and 3 percent in April at restaurants and bars, one of the sectors hardest hit by the COVID-19 event. April and March were the third- and fourth-best months for vehicle sales to consumers in U.S.

history, if you filter out sales to car rental companies, a sector just beginning to recover.

You might expect this bounce will subside after consumption regains the strong trend it was on pre-COVID-19, but one reason I think it will continue is the still high rate at which people have been adding to their savings. Even as personal consumption expenditures rose at a huge 10 percent annual rate in the first quarter of 2021, the saving rate averaged 21 percent over those three months. Again, a lot of that reflected the most recent round of stimulus payments, but as employment grows and people return to normal life and work, the accumulated stock of savings will support spending for many months to come.

Business investment took a big hit in the first half of 2020 but has come back strongly and is now running above pre-pandemic levels. Current indicators of business spending are pointing to continued elevated levels of investment in the months ahead. Supply bottlenecks have depleted inventories for many goods and rebuilding those inventories will be an important supplement for business spending and factory output.

I see two potential headwinds for the economy: the uneven global recovery and the aforementioned supply bottlenecks. Strong U.S. demand is boosting imports, but weaker demand outside the United States, where recovery is slower, is restraining exports, and that problem may not resolve for some time. Supply bottlenecks are more prevalent now, especially in the auto and housing industries, with shortages of inputs leading to slower production that reduces employment growth.

Although I expect employment to rise significantly in coming months, the picture is more mixed for the labor market than it is for spending. The unemployment rate remains at 6.1 percent, compared with 3.5 percent pre-COVID-19, and there are 8 million fewer jobs. Despite recent gains amid reopenings, employment in the travel, leisure, and food services sectors remains well below pre-pandemic levels.

My optimism here reflects the apparent recovery in overall labor demand—by many metrics, job openings are above 2019 levels, including for workers without a college degree, a group especially affected last year. In the Job Openings and Labor Turnover Survey data for March, private-sector job openings as a percentage of total employment increased to 5.6 percent, which is above the previous record for that series set in November 2018.

Job growth of 266,000 in April was a disappointing slowdown from recent months, but good news lurked beneath the headlines: For those who were working, average hours increased; the number of people working part time because they couldn't find full-time jobs decreased significantly; and wage growth was very strong.

The underlying strength in hours and wages lends support to widespread reports that worker shortages are impeding hiring. Labor force participation remains about 3 1/2 million people lower than before COVID-19. Among the many factors driving this shortage, as indicated by the Federal Reserve's report *Economic Well-Being of U.S. Households in 2020,* is parents who need to care for their children because of remote school and aftercare.3[4] We have also seen a wave of retirements by older workers in the past year. And, although the evidence is mixed, we have received plenty of anecdotal reports about the influence of generous unemployment benefits and large cash payments on the willingness of workers to return to work. But those benefits are slated to expire over the summer, and I hope that a fuller reopening of schools in the fall will ease the pressure on parents. The spike in retirements may well moderate in a stronger economy, as we saw in the year or two before the pandemic. So, while labor shortages could weigh on job creation in coming months, I don't yet perceive this development as significantly slowing the U.S. economy beyond the next few months.

Now let's turn to the other half of the Federal Reserve's economic goals, inflation. As I mentioned last week during congressional testimony, I agree with the widespread view among my

colleagues on the Federal Open Market Committee (FOMC) and most private forecasters that the recent rise in inflation to well above 2 percent is driven by temporary factors. I expect inflation to begin subsiding at some point over the next several months and to be running close to 2 percent again at some point during 2022. Market-implied inflation expectations have risen only to the levels that prevailed in the early 2010s, after which inflation never ran consistently above 2 percent, and most survey measures are sending similar signals. Therefore, I consider these recent increases in inflation expectations a welcome development, reversing the large declines seen last spring and perhaps edging up in response to the message in the FOMC's new policy framework. That said, my optimistic outlook for growth and employment places me among those who see the risks to inflation over the medium term as weighted to the upside, relative to my baseline forecast. Broadly speaking, there are three reasons for this.

First, there are wage pressures. A moment ago, I celebrated the upturn in wages in April, but it may be a sign that the torrid growth of the economy and labor supply shortages have begun pushing up wages faster than occurred with the moderate economic growth over much of the past decade. Wages are a large component of business costs that could pass through to prices more readily than increases in the cost of other inputs. It seems like a paradox that there could be labor supply problems and wage pressures at 6 percent unemployment, but it is also a fact. Some of this surprising outcome reflects temporarily lower labor force participation coming out of the enormous economic shock last spring, but some of the Fed's business contacts have said that shortages of skilled laborers—particularly in manufacturing, transportation, and construction—predated COVID-19 and are likely to persist.

Another factor that I referred to earlier—fiscal policy—carries potential costs as well as obvious benefits. Even as the huge amount of stimulus money in people's pockets has been boosting income and spending in eye-popping ways, much of that stimulus was saved. A larger-than-expected or faster release of those accumulated savings while the economy is already growing rapidly could result in output exceeding potential output by more than it has in decades. It is reasonable to ask if the strength of spending stemming from this unprecedented fiscal stimulus will put significant upward pressure on inflation as households and businesses emerge further from the COVID event. But, at least to date, the latest round of stimulus seems to be supporting spending and growth without causing an inordinate rise in interest rates or inflation expectations.

That outcome aligns with the advice of those in the economics profession who have produced research in recent years that leaves them much more comfortable with high deficits and debt, at least in countries with low interest rates, than they used to be.4[5] In 2006, when I was serving as Under Secretary of the Treasury, we were subject to harsh criticism for running a deficit of not quite $250 billion, with total debt held by the public at 35 percent of GDP.5[6] By contrast, in 2021, the deficit is currently projected to be $3.4 trillion, and total debt held by the public at the end of fiscal year 2020 was 100 percent of GDP.6[7]

Further fiscal policy actions are, of course, the purview of the Congress and the Administration. History tells us that once the dreadnought of government spending gathers speed, it is difficult and slow to turn around. Surely the deficits being run to offset the COVID-related shocks have made it even more critical to address the sustainability of government debt in the years ahead.

And, finally, recent monthly readings on import prices, producer prices, and consumer prices have all come in above consensus expectations. These upside surprises cannot be attributed to base effects. It is true that many of the factors driving the April consumer price index report and other inflation surprises continue to be supply bottlenecks, and it is reasonable to conclude that these will ease over time. But clearing some of those supply disruptions will require additional investment and the time to expand production capacity. If these shortages persist into 2022, people may adjust their expectations higher for future inflation, which could make above-target inflation more persistent than we currently expect.

I don't want to overstate my concern—I am not worried about a return to the 1970s. We designed our new monetary policy framework for the very different world we live in now, which involves an equilibrium for the economy with slow workforce growth, lower potential growth, lower underlying inflation, and, therefore, lower interest rates. One of those differences is that the kinds of "wage-price spirals" that characterized inflation dynamics in the 1970s have not been present for a long time. It's quite possible that this situation now prevails because inflation is never high enough for long enough to enter decisionmaking in a material way.

So, what are the implications for monetary policy? I am fully committed to the FOMC's new monetary policy framework and the two pieces of related guidance that we have put in place for asset purchases and the federal funds rate to implement that framework. The conditions required to change the pace of asset purchases and those required to increase the federal funds rate are sequential: The latter requires improvement in the economy that clears a much higher bar. Let me address each of those in turn.

The guidance on asset purchases, introduced in December, commits us to increasing our holdings of securities at least at the current pace until substantial further progress has been made toward the Committee's maximum-employment and price-stability goals. My personal view is that the rise in inflation—even after discounting temporary factors—and inflation expectations since December will prove sufficient to satisfy the standard for inflation in the guidance around asset purchases later this year, but improvement in the labor market has been slower than I would have liked. For instance, the unemployment rate has decreased only 0.6 percentage points to 6.1 percent, and the labor force participation rate is still nearly the same as it was at the time of the December meeting. Therefore, we need to remain patient in the face of what seem to be transitory shocks to prices and wages so long as inflation expectations continue to fluctuate around levels that are consistent with our longer-run inflation goal.

For me, it is a question of risk management. The best analysis we currently have is that the rise in inflation to well above our target will be temporary. But those of us on the FOMC are economists and lawyers, not prophets, seers and revelators. We could be wrong; and what happens then? Part of the calculus in balancing the risks of either overshooting or undershooting our 2 percent goal is that the Fed has the tools to address inflation that runs too high, while it is more difficult to raise inflation that falls below target. If we're wrong, we know how to bring inflation down. But if our assessment is correct that inflation is temporary, it would be unwise for us to take actions that might slow the recovery prematurely by trying to stay ahead of inflation, when our best estimate is that we are not far behind.

If my expectations about economic growth, employment, and inflation over the coming months are borne out, however, and especially if they come in stronger than I expect, then, as noted in the minutes of the last FOMC meeting, it will become important for the FOMC to begin discussing our plans to adjust the pace of asset purchases at upcoming meetings. In particular, we may need additional public communications about the conditions that constitute substantial further progress since December toward our broad and inclusive definition of maximum employment. This standard presents inherent communications challenges because it cannot be summarized by a single labor market indicator, such as the unemployment rate thresholds used in the Committee's interest rate forward guidance between late 2012 and late 2013.

In contrast, the time for discussing a change in the federal funds rate remains in the future.[i] The guidance for the federal funds rate commits to maintain the current rate until labor market conditions are consistent with our goal of maximum employment and inflation not only has reached 2 percent, but also is on track to moderately exceed 2 percent for some time. In the FOMC's most recent Summary of Economic Projections, no participants—even those with optimistic growth forecasts such as I've outlined today—thought it appropriate that liftoff occur before 2022. Perhaps even more important than the timing of liftoff will be the expected trajectory of rate increases afterward, and you can see that even among participants with an earlier

expected liftoff, those paths are quite shallow. Thus, I expect that monetary policy will remain highly accommodative for some time.

Let me conclude with a few thoughts on financial stability. As the Fed's most recent *Financial Stability Report* notes, the bright outlook, ample supply of credit, and accommodative fiscal and monetary policy have pushed some asset valuations to very high levels that could be subject to sharp reversals if expectations are not met. Likewise, business debt is high relative to past experience, which is a good reason to carefully weigh the risks. But the strong economy reassures me here: Earnings are growing, many businesses have ample stockpiles of cash, expected bond defaults are below their long-run medians, and the pace of credit rating downgrades has slowed to a trickle.

When I think about financial stability, I think most directly about resilience to shocks, and it would be hard to imagine a better test of that resilience than what occurred in the spring of 2020. Banks met extraordinary demands for credit last spring from nonfinancial businesses and households while simultaneously providing forbearance on millions of existing loans and building substantial loss reserves, all without significant strains to their overall health. The largest banks at the core of the financial system are better capitalized than they have been in decades, and these institutions are sitting on large amounts of highly liquid assets while relying on relatively low levels of short-term funding. The banking sector is strong.

I also see a resilient household sector. Household credit is primarily owed by borrowers with prime credit scores, rising home prices have most homeowners flush with equity, and, as I noted earlier, households are sitting on a large stock of savings.

It is true that there are structural vulnerabilities in the nonbank financial sector, particularly money funds and hedge funds, and these are being scrutinized by U.S. and international authorities, including the Financial Stability Board under my chairmanship.7[8]

But I believe these risks are manageable, and I come down on the side of the research that concludes these and other concerns are best addressed by targeted financial regulation and supervision rather than the blunt tool of monetary policy.8[9] At a crucial moment in our recovery from the COVID-19 event, the utility of using monetary policy to try to address financial stability concerns would be greatly outweighed by the costs to employment and growth.

Before ending, I'd like to reemphasize that I am quite optimistic about the path of the economy. While prices will run above our 2 percent target this year, I believe most of this increase will be transitory. After an exceedingly difficult year, we are poised to enter a robust and durable expansion.

Thank you again for the invitation to be here today, and I look forward to our discussion.

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[1] All of my remarks today represent my own views and not necessarily those of my colleagues on the Federal Open Market Committee. Return to text

[2] Note: This speech was updated on May 26, 2021 to match remarks made at the Brookings Institution. On page 2, the sentence should read, "First, I see increasing recognition by the private and public sectors that a broad reopening can proceed safely." On page 10, the sentence should read, "In contrast, the time for discussing a change in the federal funds rate remains in the future." Return to text

[3] See Centers for Disease Control and Prevention (2021), "Interim Public Health Recommendations for Fully Vaccinated People," webpage. Return to text

[4] See Board of Governors of the Federal Reserve System (2021), "Federal Reserve Board Issues Report on the Economic Well-Being of U.S. Households," press release, May 17. Return to text

[5] See Olivier Blanchard (2019), "Public Debt and Low Interest Rates," *American Economic Review,* vol. 109 (April),

pp. 1197–229; Lawrence H. Summers (2018), “Secular Stagnation and Macroeconomic Policy," *IMF Economic Review,* vol. 66 (June), pp. 226–50; and Jason Furman and Lawrence Summers (2020), “A Reconsideration of Government Debt in an Era of Low Interest Rates,” presentation to the Hutchins Center on Fiscal and Monetary Policy and Peterson Institute for International Economics, December 1, www.piie.com/system/files/documents/furman-summers2020–12-01ppt.pdf. Return to text

6 For the deficit projection for 2021, see Congressional Budget Office (2021), *The Budget and Economic Outlook: 2021 to 2031* (Washington: CBO, March). Return to text

7 See Federal Reserve Bank of St. Louis (2021), "Federal Debt: Total Public Debt as Percent of Gross Domestic Product," FRED Economic Data (accessed May 21). Return to text

8 See Department of the Treasury (2020), "President’s Working Group on Financial Markets Releases Report on Money Market Funds," press release, December 22; and Financial Stability Board (2020), *Global Monitoring Report on Non-Bank Financial Intermediation 2020* (Basel: FSB, December). Return to text

9 See, for example, Lars E.O. Svensson (2019), "The Relation between Monetary Policy and Financial-Stability Policy," in Alvaro Aguirre, Markus Brunnermeier, and Diego Saravia, eds., *Monetary Policy and Financial Stability: Transmission Mechanisms and Policy Implications* (Santiago, Chile: Central Bank of Chile), pp. 283–310. Return to text