An Uneven Recovery and the Path Ahead

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The views expressed today are my own and not necessarily those of the Federal Reserve System or the FOMC.

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Introduction

I want to thank the Metals Service Center Institute for inviting me to discuss my outlook for the U.S. economy at this pivotal time. My remarks today will focus on a few points.

- I'll begin with where the economy stands today. The pandemic and efforts taken to contain its spread have taken a heavy toll on the lives and livelihoods of many of our neighbors, friends, and coworkers. Though growth has resumed in recent months, we are still far from the robust economy we had prior to the pandemic. And inflation is far below our 2 percent objective, as it has been for quite some time.
- The economic fallout across households and businesses also has been uneven. Some sectors of the economy have found ways to adjust to the pandemic, while others continue to suffer significant disruptions. Furthermore, these disparate effects are worsening some of the long-standing inequalities in our country.
- Looking ahead, a full recovery likely will take some time. The median forecast from the Federal Reserve Bank presidents and governors doesn't see the unemployment rate returning to near pre-pandemic levels or inflation returning to 2 percent on a sustainable basis until 2023. And there certainly are many risks and uncertainties surrounding this outlook.

- For its part, the Federal Reserve is committed to using its full range of tools to support the U.S. economy in this challenging time. I will conclude my remarks today by discussing recent changes the Federal Open Market Committee (FOMC) has made to its long-run monetary policy strategy and my views on what they imply for monetary policy and the economy in the months and years ahead.

Before continuing, I should note that these views are my own and do not necessarily represent those of my colleagues on the FOMC or others in the Federal Reserve System.

Though improving, activity and inflation remain weak, and the recovery has been uneven

As 2020 opened, the fundamentals for the U.S. economy were solid with unemployment at 3-1/2 percent and strong consumer spending.[1] Then the Covid-19 virus hit and activity plummeted, as we and much of the rest of the world locked down in order to fight the pandemic. In April, unemployment soared to 14.7 percent, and might have actually been closer to 20 percent after certain measurement issues are taken into account. Inflation fell owing to the effects of weak demand for a range of goods and services far outstripping price increases for food and a few other products.

Today, the economy is forging its way back, in spite of virus flare-ups and a horrific death toll of over 200,000 in the U.S. Indeed, the performance of the economy has been

[1] Monetary policy had been repositioned, moving from a tightening cycle to being on hold because of 18 months of rising uncertainties related to difficult and erratic foreign trade negotiations and their effect on business sentiment and spending.

surprisingly more resilient than I and many other analysts would have expected under these health circumstances. Large portions of the business sector have successfully adapted to operating safely in the current environment, and individuals have taken to wearing masks and embraced social distancing in response to the outbreaks. These changes have helped us recover a modest measure of normalcy as we go about our daily lives. Still, the U.S. economy has a long way to go. The unemployment rate is just under 8 percent; about 12-1/2 million people are unemployed; and inflation is far from reaching our 2 percent goal on a sustained basis.

Some households and firms have the benefit of working arrangements and business models that can be adapted to allow for remote work, social distancing, and safe production. Others, however, are not able—or cannot afford—to take the actions required to operate safely and successfully in the current health situation. These businesses and individuals face real disadvantages, and as a result, we see the pandemic intensifying some of the long-standing disparities in our society.

Let me highlight some of the sectors that are doing somewhat better.

I regularly talk with a range of business and community leaders to help get underneath the numbers and better gauge the state of the economy. A number of manufacturers have reported that they've successfully adapted production processes and operations to function safely. As one example, a major manufacturer told me how they now require the use of masks, provide extensive screening and testing, and follow strict medical protocols. When workers test positive and safety has been compromised, they shut down facilities for sanitization and then only allow non-exposed employees with negative tests to return once the facility is reopened. Employees view these quick responses favorably, and the practices have been important for building confidence and morale in the workforce. But the measures they've taken are expensive to implement.

I've heard a variety of reports about other unplanned costs that the pandemic has imposed. There is increased absenteeism, due in large part to virus exposures and the difficulty workers have in finding reliable and safe childcare. And with so many schools providing remote and hybrid learning models, childcare needs are even greater. Some firms are overstaffing daily in order to keep full shifts running, often using temporary workers. And when the business case allows, many are implementing more flexible work schedules or giving additional paid leave to help employees manage their family responsibilities to children and elderly relatives.

Whether these expenses are worthwhile ultimately depends on the strength of customer demand. Here, too, we see disparate effects of the pandemic.

Under the current circumstances, the auto industry has fared relatively well: Higher-income households have continued to purchase new cars, and the demand for used vehicles has been boosted by fiscal stimulus payments and the desire to avoid public transportation. In addition, the industry has successfully turned to e-commerce, socially distanced dealer operations, and used-car auction platforms.

A pivot to e-commerce has boosted sales for many retailers—especially those who already had or were working toward an online presence. Other retailers have adapted by offering curbside pickup, limiting the number of shoppers inside establishments, and implementing enhanced cleaning protocols and social distancing rules.

Some businesses have benefited from pandemic-induced changes in consumer spending patterns. For example, recreational vehicle sales have risen as more families avoid air travel and turn to alternative modes of transportation for vacation travel. Households are also spending more on home improvements, furniture, and electronics as time spent at home has increased. And by many measures, the housing market has surpassed recent pre-pandemic levels, bolstered by low interest rates.

Other businesses and households have been more severely disrupted by the virus, and their climb back is much steeper. These include many service sectors, such as travel, leisure, hospitality, and those that provide close, in-person services, like hair salons. Airlines have been particularly hard hit, as passenger travel is down almost 80 percent from last June and there is no indication that lucrative business travel is returning any time soon.

Many brick-and-mortar retailers are struggling, particularly smaller ones. Their business models may not be amenable to e-commerce and social distancing; these enterprises may not have the financial resources and scale to make the necessary operational changes; or demand for their products may have dwindled.

Education clearly is a sector where significant disruptions have caused hardships for students, their families, and their teachers. For children, the lost learning and socialization costs are potentially enormous. When weighing the competing needs of family health, income, schooling, and child supervision, many parents may be forced to reduce work hours or quit work altogether. Teachers also face many challenging issues.

Educational institutions have taken costly measures to adapt. One contact at a large university explained that both in-person and remote-only education models are costly alternatives that require substantial investments and training to be successful. Providing a mix of both options—the hybrid model that many universities, as well as primary and secondary schools, are using—is the most expensive alternative of them all.

An additional worrisome aspect is that many of the industries hardest hit by the pandemic employ a disproportionate share of females, minorities, and younger workers. Moreover, many minority-, female-, or immigrant-owned businesses operate in these sectors. As a result, we are seeing disparate impacts on health and economic outcomes across income, racial, and ethnic groups and between small and large firms, which magnify the long-standing inequalities among these segments of our society.

These are grave challenges, and poor progress in reducing these inequalities will not be in the social or economic interest of the nation. I fear that the gulf is widening and not easily reversed. One poignant example came from that same higher education contact I just mentioned. Although the university's enrollment for the fall session was better than expected, the diversity of their incoming students declined significantly. If such developments are widespread and persist, it would represent a troubling step back in the educational progress minorities have made.

My baseline outlook[2]

I expect a full recovery will take some time, though I do have a less pessimistic forecast than I did around midyear.[3] I anticipate gross domestic product (GDP) at the end of 2020 will be about 3-1/2 percent below its year-ago level, rather than the roughly 7 percent drop I projected in June. I think growth will be about 4 percent next year and trail down to around 2-1/2 percent by 2023. I see the unemployment rate ending this year at about 7-1/2 percent and falling steadily to 4 percent by the end of 2023, when it will be slightly below my estimate of longer-run unemployment. Readings on inflation are likely to be volatile for a while given the large price swings associated with the pandemic;[4] cutting through those, I expect underlying inflation to pick up steadily and to reach 2 percent by the end of 2023. This forecast assumes that intermittent outbreaks of the virus will hold back a full recovery until health solutions are widely in place; my placeholder for that is the second half of 2021. It also assumes additional fiscal support is forthcoming.

These assumptions highlight some of the many uncertainties and risks to the outlook. The path of the virus is clearly a big unknown, especially as colder weather and the flu season arrive. So, too, is the speed with which a vaccine will become widely available

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[2] My outlook is very similar to the projections made by my colleagues on the Federal Open Market Committee. Four times a year the FOMC releases its Summary of Economic Projections, or SEP, which presents forecasts of key economic variables over the next three years and for the longer run made by the Federal Reserve's District bank presidents and governors—or, in shorthand, the FOMC participants. The SEP includes assessments of the appropriate monetary policy that supports these forecasts. The most recent projections were made in September and released following our scheduled FOMC meeting. See Federal Open Market Committee (2020a) for the most recent SEP.
[3] See Federal Open Market Committee (2020d) for the June 2020 SEP.
[4] In particular, year-over-year inflation readings could temporarily be above 2 percent next spring as the large drops in prices this year fall out of the annual calculations.

and used. The public's willingness to reengage more fully in the retail, leisure, and hospitality sectors is still unclear. There also is much to learn about the effect of schools reopening on workforce participation and productivity, as well as the long-term effectiveness of remote work in often cramped spaces not designed for it.

A number of business cycle dynamics also are in play, such as the degree to which the destruction of business and human capital and bankruptcies might impede the recovery and how the uncertain economic environment will affect business investment and household precautionary savings. These factors also depend on the degree to which additional fiscal support may be forthcoming to help households, firms, and, importantly, state and local governments navigate through these difficult times.[5]

As I mentioned, I expect inflation to sustainably reach 2 percent by 2023. I'm thinking a little further ahead than that, though, and projecting inflation to run moderately above 2 percent for a time beyond 2023, which is the end of our official SEP forecast period. Indeed, the monetary policy assumptions underlying my forecast are designed to achieve this outcome, as I see this overshooting as necessary for inflation to average 2 percent over time and for longer-run inflation expectations to be anchored at 2 percent. So now is a good time to turn to the monetary policy outlook.

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[5] I've spoken extensively about the need for additional fiscal policy support elsewhere. See Evans (2020a, 2020b).

The outlook for monetary policy

Early in the crisis, as the pandemic took hold and economic activity plunged, the FOMC took swift action and reduced the federal funds rate—our main policy rate—to a range of 0 to 1/4 percent, which is as far as we can effectively reduce it when trying to stimulate the economy. Indeed, we call this the effective lower bound on the funds rate, or ELB. We also purchased large quantities of U.S. Treasury and mortgage-backed securities and, with the approval and backing of the Treasury Department, activated a number of special lending facilities to support the flow of credit to businesses, households, nonprofits, and state and local governments.

So what is in store for monetary policy?

Congress has instructed the Federal Reserve to foster economic conditions that achieve both stable prices and maximum sustainable employment. These two objectives are known collectively as our dual mandate. In 2012, the FOMC first issued a statement on longer-run goals and monetary policy strategy, which articulates how it defines and expects to achieve those objectives.[6] This past August, we issued a major revision to this strategy statement.[7]

To me, the biggest reason to update our monetary policy strategy was the undeniable realization that the effective lower bound on the federal funds rate would be a persistent threat to the achievement of our dual mandate goals. As I've been saying for quite a

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[6] Federal Open Market Committee (2012).
[7] Federal Open Market Committee (2020c).

while, for many reasons the long-run equilibrium funds rate is much lower now than it was in the 1980s and ’90s.[8] This means even average business cycle shocks will drive policymakers to set the federal funds rate range at its lower bound.[9] Once at the ELB, further reductions in the federal funds rate are not feasible, and we have to turn to other possibly less effective tools to influence the economy.

The research on the topic was clear and persuasive: Some new thinking about monetary policy was necessary to prevent the ELB from imparting a downward bias to inflation and impeding the achievement of our maximum employment mandate as well. Our revised statement laid out a new strategy for addressing these issues.

On price stability, the FOMC kept our previous inflation target of 2 percent, but we clarified its meaning and adjusted our strategy for achieving it. This was done by stating that the FOMC will seek to achieve inflation that averages 2 percent over time and that 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.

On maximum employment, the new statement emphasized that maximum employment is a broad-based and inclusive goal. It also stated that the FOMC will seek to eliminate shortfalls from maximum employment; in contrast, the old strategy sought to minimize

[8] See, for example, Evans (2016a, 2016b, 2016c, 2017, 2018, 2019). The equilibrium federal funds rate is the funds rate associated with a neutral monetary policy (policy that is neither expansionary nor contractionary).
[9] The enormous shock we received in March 2020 prompted a swift return to the ELB.

both positive and negative deviations from maximum employment, not just shortfalls. This is an important change.

Maximum employment means bringing as many people as possible into the labor force and creating conditions where they can find productive jobs. By using our policy tools to achieve that objective, we can help combat the growing economic divide I just discussed. Importantly, we should not be concerned with what might look like very tight labor markets as long as accommodative monetary policy is not generating unwanted inflation risks.

Of course, this is just a strategy statement. Now that strategy must be put into action. The policy statement we issued after our September FOMC meeting did just that.[10] The September statement specifies that we will maintain the current 0 to 1/4 percent target range for the federal funds rate until we have reached our employment mandate and inflation has reached 2 percent and is on track to moderately exceed 2 percent for some time. This overshooting after a period of sub-2 percent inflation is straight out of the new long-run strategy. The statement also recognizes that our work on inflation is unlikely to be complete when we first begin to raise rates, and so it also indicates that we will maintain accommodative monetary conditions until our inflation averaging goal is met.

As for timing, the SEP includes the FOMC's well-known dot plot, which shows FOMC participants' individual judgments of the appropriate federal funds rate over the next three years that support their forecasts. In September, the median participant did not

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[10] Federal Open Market Committee (2020b).

foresee a change in the federal funds rate through at least the end of 2023.[11] At that time the SEP's median forecast has the unemployment rate just beginning to dip below its longer-run level and inflation just reaching 2 percent. So, in order for inflation to average 2 percent over time, a period of inflation above 2 percent will be necessary after 2023. This explains my earlier comment about my forecast for inflation overshooting 2 percent beyond 2023.

For the sake of argument, here are a couple of simple calculations that illustrate how long it might take to achieve our 2 percent average inflation target. Forget the many years since 2008 of underrunning our 2 percent inflation target, and let's just calculate the average beginning with the price level in the first quarter of 2020. Core PCE inflation in the SEP is projected to be 1-1/2 percent this year and then gradually rise to 2 percent in 2023.[12] Suppose it hits 2-1/4 percent in 2024 and then remains there. In this scenario, average core inflation does not reach 2 percent until mid-2026. That is a long time. If inflation were a bit higher—say, 2-1/2 percent in 2024 and beyond—you can get there about a year quicker. Some, though, might view 2-1/2 percent inflation as an excessive overshoot.

Now, we are not going to follow a strict numerical formula to determine the time of liftoff and how long to keep policy accommodative after liftoff. Still, these calculations illustrate that we likely have a lot of work ahead of us. And it's crucial that we acknowledge the

[11] See Federal Open Market Committee (2020a).
[12] While our objective is stated in terms of overall inflation measured by the Price Index for Personal Consumption Expenditures (PCE), core inflation—which strips out the volatile food and energy sectors—is a better gauge of sustained inflationary pressures and where inflation is headed in the future.

magnitude of the job up front to help lessen the temptation to back off the overshoot too early in the process. It is important for us to be “in it to win it” if we are going to achieve our mandates.

Conclusion

To sum up, the U.S. economy still faces significant challenges in dealing with the Covid-19 virus and the economic fallout from our actions to contain it. With significant effort, many households and businesses are having success working their way back to higher levels of activity. But many others have been less fortunate, and face a tougher road back. For its part, the Federal Reserve is committed to using its full range of tools to support the U.S. economy in this challenging time, thereby promoting its maximum employment and price stability goals. Our new long-run strategic policy statement lays out an important roadmap for achieving those objectives, and it’s up to us to follow through on its principles with actions in the months and years ahead.

Thank you.

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