U.S. Economic Outlook and Monetary Policy: Challenges, Resiliency, and Opportunities

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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

Thank you for that kind introduction. It is a great pleasure to join you, albeit virtually. In my remarks today, I'd like to discuss the state of the U.S. economy and share my views on where the economy and monetary policy are likely headed. In addition, I will highlight how even an improving aggregate economy can mask distressingly wide economic disparities.

The Covid-19 pandemic and the efforts to contain it have taken a heavy toll on the lives and livelihoods of many of our neighbors, friends, and coworkers. I cannot stress the costs of this tragedy enough. And, unfortunately, those who have the fewest resources have borne a disproportionate share of these costs.

The pandemic has had devastating effects, and we are still far from the robust economy we had prior to it. Still, many sectors of the economy have shown great resilience in the face of the virus. Indeed, overall economic activity has recovered far more than most analysts had expected in the middle of last year. And I am optimistic about the future. With increased vaccinations and continued support from fiscal and monetary policies, we should make significant strides toward returning to normal levels of economic activity as we move through 2021.

The pandemic also has had an impact on inflation. Even before the pandemic, inflation had been running below the Federal Reserve's target of 2 percent, and today the situation is even worse. I expect it will be some time before inflation is back to where we want it to be—monetary policy still has a good deal of work to do here.

Before I discuss these points in more depth, I should note that the views I will be sharing with you are my own and not necessarily those of my colleagues on the Federal Open Market Committee (FOMC) or others in the Federal Reserve System.

Current state of the economy and outlook

Clearly, last year was unprecedented. The behavior of the economy was not driven by familiar financial and business cycle developments, but rather by the pandemic. Public health mandated shutdowns and individuals' voluntary changes in behavior resulted in a sharp drop in employment and economic activity last spring. We saw a strong rebound in the summer as the most stringent restrictions were lifted, followed by more moderate growth in the fall as the snapback effect faded. Still, all told, the U.S. economy shrank 2-1/2 percent last year.

The toll on workers has been immense. The unemployment rate quickly rose to nearly 15 percent—actually, closer to 20 percent when you account for measurement issues. By the end of last year, it had improved to 6.7 percent. But, clearly, we have a ways to go before we get back to the vibrant economy we had on the eve of the pandemic, when the unemployment rate stood at 3.5 percent and there were nearly 10 million more people on payrolls.

Moreover—and quite disturbingly—the burdens of the pandemic have fallen disproportionately on minorities, women, and low-wage workers. As a macroeconomist and a central banker, I often focus on broad aggregate measures when gauging the performance of the economy. But even as these metrics improve, not all groups may benefit evenly.

For decades, the U.S. has experienced growing disparities in income and wealth across socioeconomic groups. And, sadly, the pandemic has aggravated these long-standing disparities. Monetary policy can help with these problems by fostering a strong macroeconomy that provides more and better job opportunities for disadvantaged segments of society. But it does not have better, more targeted tools that are designed for addressing these issues—those fall under the purview of other government policymakers, as well as the impressive efforts of many in the private sector. And I hope we all can give top priority to eliminating these inequalities.

Let me return now to the macroeconomic outlook. While we still have a lot of ground to make up, the aggregate economy today is much better than I and many other forecasters had projected last spring.[1] Many businesses and consumers were able to adapt to operating safely in the presence of the virus. And, sadly, others simply decided to largely ignore it. The relative resiliency of the economy also owes a lot to fiscal policy, which provided substantial direct support to household income and included a variety of

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[1] In June of last year, the *Blue Chip* forecasts were for real gross domestic product (GDP) to decline by about 6 percent in 2020 and for the unemployment rate to end the year at 10.4 percent (Wolters Kluwer, 2020). The median projection by the FOMC participants at that time were similarly pessimistic for 2020 as a whole, with GDP expected to decline by 6.5 percent and the unemployment rate forecasted to be 9.3 percent (Federal Open Market Committee, 2020d).

programs to aid distressed households and businesses. Furthermore, aggressive monetary policy actions helped by fostering considerably more accommodative financial conditions than would have prevailed otherwise.

So what is in store ahead? Returning to normal requires getting the virus under control. The biggest factor here is vaccinations. Once a sufficient share of the population is inoculated, people will feel safe enough to resume a broader range of activities and the sectors where social contact is so important—such as travel and leisure and hospitality—can recover more robustly. In addition, education can return to normal. As a result, we will see further increases in aggregate spending and employment. At the same time, growth will be boosted by the fiscal policy package enacted in December, potential additional fiscal support, and continued accommodative monetary policy.

All told, my baseline expectation is that the U.S. economy will grow in the range of 5 to 6 percent this year. Once the vaccine-related impetus to economic growth has passed and as the boost from fiscal support wanes, real gross domestic product (GDP) growth is likely to moderate in 2022 and 2023; my forecast has it averaging in the 2 to 3 percent range. Given this path for growth, labor markets will continue to improve, and I expect the unemployment rate will return to close to its pre-pandemic level of 3.5 percent by the end of 2023.

With regard to inflation, there is still a long way to go. In December, inflation, as measured by the core Price Index for Personal Consumption Expenditures, was 1-1/2 percent on a year-over-year basis, well below the Federal Open Market

Committee's goal of averaging 2 percent over time.[2] As I'll elaborate more in a minute, the inflation outlook—particularly in the near term—is complex. But I expect underlying inflation won't be back to our goal until the mid-2020s.

Uncertainties and risks

Economic forecasts always come with uncertainties and risks. But today we have more than the usual number. The main reason is that the principal drivers of the economy over the near term aren't typical business cycle factors, but rather the course of the virus and the actions taken to arrest it.

Here, things could go better—or worse—than expected. More successful vaccine distribution and take-up, as well as other efforts to contain the virus, could pave the road to a faster recovery. Conversely, a slower expansion of vaccination or the spread of more infectious strains of the virus could slow growth. Indeed, several of my contacts in the health care sector have expressed major concerns about some of the public's reluctance to be vaccinated, particularly among certain racial and ethnic groups.

The degree of additional fiscal support that may be coming is also uncertain.
The President has proposed a $1.9 trillion package, but the exact amount that will emerge from negotiations with Congress is unclear. As a placeholder, my forecast assumes a package about half that size will be enacted, which is similar to what many private sector analysts are building into their forecasts. Let me emphasize—strongly—

[2] 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.

that this is not an opinion about the appropriate size for the package or a prediction of the outcome of the budget negotiations. Those are jobs for the Congress and the President's administration. But as a forecaster, I have to make some assumption, and that is all this is.

One thing that is more certain is the continued support from monetary policy. My contacts stress that the current financial environment is extremely beneficial for growth. And I can assure you that the Federal Reserve takes this to heart. We are committed to using all our available tools to support the return to maximum inclusive employment and 2 percent average inflation.

Returning to the long list of uncertainties, another issue is what economists call "sectoral reallocation," or the effects on overall growth and inflation from activity shifting between sectors of the economy. Now, in every business cycle, some sectors do better than others. But as a result of the vast differences in how the pandemic has affected various households and businesses, the degree of sectoral reallocation today is truly extraordinary. For instance, as consumers reduced activities that require close personal contact, restaurants and personal care service providers took huge losses. In contrast, in your hometown, automakers and their suppliers were able to change their production processes to operate safely. Moreover, demand for autos has held up relatively well during the pandemic: 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.

Now, these efforts haven't come cheaply. Automakers and many other manufacturers have overstaffed shifts and relied on temporary workers to cover for increased absenteeism due to the virus. They've also made substantial investments in personal protective equipment (PPE) and other safety protocols. And many have allowed for more flexible work schedules or paid leave to help employees manage family illnesses or child and elder care difficulties.

These sectoral differences have led to an unusual situation in which even though overall unemployment is high and we are not back to pre-pandemic levels of activity, some firms are currently running into supply constraints that might impede their business plans and raise their costs. For example, for some time my business contacts in manufacturing have been saying they face a shortage of workers, and more recently I've begun to hear more about them raising wages.

Another example is a microchip shortage in the auto industry. Several factors are in play, but this is mainly a sectoral reallocation story. When ordering chips early last year, automakers and their parts suppliers underestimated the strength of the recovery. Meanwhile, chipmakers allocated more of their product to consumer electronics producers that benefited from a burst of demand. As a result, today automakers and their parts suppliers are struggling to find enough chips to meet production plans, and they see this shortage persisting for the next three to six months.

In contrast to these stories, sectors hit hard by the virus—such as leisure and hospitality, travel, and commercial real estate—are experiencing excess supply and stranded resources. Of particular concern here are the continued job market woes of many low-wage workers. These workers can't easily transition to those places and sectors where jobs are available. This underscores the importance of continued fiscal support for these individuals to help smooth out the uneven incidence of the pandemic.

How do these factors balance out? Well, with 10 million fewer people employed today than before the pandemic, it's safe to say the problem of excess capacity and unused productive resources is a far greater issue than the supply constraints some firms are facing. But there are still important implications going forward.

The labor shortages we hear about today appear to be largely due to virus-related absenteeism. These constraints should ease as more people get vaccinated, the virus threat abates, and education returns closer to normal. At the same time, the current resource slack in industries heavily impacted by the virus will likely be absorbed as demand normalizes. Taken together, this means we could see aggregate growth numbers bounce around quite a bit as some large, but transitory, swings in activity occur while particular sectors readjust. Until these sectoral adjustments have run their course, it will be challenging to gauge the underlying cyclical dynamics of the economy.

These sectoral developments have implications for inflation as well. As a result of shifting consumption patterns and business plans, we have seen large movements in prices of certain goods and services relative to others in 2020. For instance, in December while hotel prices and airfares were as much as 15 to 20 percent below year-ago levels, consumers were paying 9 percent more to purchase household appliances.

Today, we see supply constraints and price pressures in industries where demand is very strong—such as construction materials, steel, and autos—but continued weak pricing in sectors where the virus has had a big negative impact on demand. Going forward, the unwinding of strong demand in some sectors and a sharp recovery in others could lead to new capacity constraints and higher prices in some parts of the economy. As the recovery gains momentum, it will be important to distinguish such short-lived, sector-specific phenomena from more widespread and lasting resource pressures.

Overall, I expect to see some higher top-line inflation numbers in the spring because of these temporary constraints. In addition, we tend to look at average inflation over the past year, and there will be a mechanical increase in this average when the very low readings from last March and April roll out of the annual calculation. But after these factors have run their course, I expect inflation will settle down and end the year in the range of 1-1/2 to 1-3/4 percent. With continued growth, further improvements in labor markets, and accommodative monetary policy, I see inflation moving up steadily and eventually running moderately above 2 percent for some time in the mid-2020s.
This overshooting of 2 percent is a purposeful design feature of appropriate monetary policy. Let me elaborate.

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 the dual mandate.

In order to achieve these goals, the Fed's response to last year's crisis was swift and strong. The Federal Open Market Committee quickly reduced the federal funds rate—our main policy tool—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. We also purchased large quantities of U.S. Treasury and agency mortgage-backed securities; and with the approval and backing of the Treasury Department, we activated a number of special lending facilities to support the flow of credit to businesses, households, nonprofits, and state and local governments. Although some of the lending facilities have lapsed recently, we have kept the federal funds rate in the 0 to 1/4 percent range and since last spring maintained a steady pace of U.S. Treasury and agency mortgage-backed asset purchases.

Even before the pandemic hit, the Federal Reserve had been in the process of conducting a multifaceted review of our longer-run strategy for achieving our monetary policy objectives. This review was motivated by trends that predated the pandemic: Importantly, because of declines in the underlying trend growth rate of the economy and other factors, the Fed has less room to use its interest rate tools to stimulate the economy than it did in the 1990s and early 2000s. I won't go into the details here, but this means that without a change in strategy, inflation would get mired below 2 percent far too often. It also would be more difficult to achieve our maximum employment goal.

We kept this review going through the pandemic and last August incorporated its findings into a new monetary policy strategy statement.[3] The inflation target remains at 2 percent. But we indicated that we now will seek to achieve inflation that averages 2 percent over time. Furthermore, we said 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.

[3] Federal Open Market Committee (2020c).

We also emphasized that maximum employment is a broad-based and inclusive goal and stated that the FOMC will seek to eliminate shortfalls from maximum employment. In contrast, the old strategy sought to minimize both positive and negative deviations from maximum employment, not just shortfalls. These are important changes. Maximum employment means bringing as many people as possible into the labor force and creating conditions where they can find productive jobs. Importantly, monetary policymakers 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.

We then put these strategies into action. In September, the FOMC provided outcome-based forward guidance on its interest rate policies by saying we will maintain the current 0 to 1/4 percent target range for the federal funds rate until we have achieved our employment mandate and inflation has reached 2 percent and is on track to moderately exceed 2 percent for some time.[4] This overshooting after a period of sub-2 percent inflation is straight out of the new long-run strategy.

The statement also recognized that our work on inflation is unlikely to be complete when we first begin to raise rates. So it indicates that we will maintain accommodative monetary conditions until our inflation averaging goal is met. In December, the FOMC added similar outcome-based forward guidance regarding our asset purchases, stating that the current pace of purchases will be maintained until substantial further progress has been made toward our policy goals.[5]

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[4] Federal Open Market Committee (2020b).
[5] Federal Open Market Committee (2020a).

Note that there is no fixed date attached to these changes in interest rates or asset purchases—the timing will be dictated by the progress made toward our policy goals. Monetary policy will be accommodative as long as it takes to reach them.

When I think about my economic forecast, I am reasonably confident that we will reach our maximum employment goal over the next three years. I am more concerned about the prospects for reaching our inflation mandate, however. Inflation is far too low today. And we have a long way to go to reach the magnitude of overshooting that I see as necessary to satisfy our average inflation objective.

Because businesses and workers do not want to fall behind rising prices, expectations of future inflation have a strong influence on price and wage setting today. So bolstering the inflation expectations of households, businesses, and financial market participants will be key to achieving our goals. The strong pickup in economic activity projected for this year should generate a temporary boost to inflation; but whether this becomes embedded into inflation expectations and produces a more sustained increase in underlying inflation is an open question. To help this process, it will be critical for monetary policymakers to look through temporary price increases and not even think about thinking about adjusting policy until the economic criteria we have laid out have been realized. So I see us staying the course for a while.

Longer-term issues

Before I conclude, I would like to touch on an aspect of the developments over the past year that has potentially large negative consequences for the long-term well-being of our communities. As I mentioned before, the pandemic has amplified a number of long-standing disparities in economic and other outcomes by income, race, ethnicity, gender, age, and geography. These disparities have the potential to inflict long-lasting damage not only on the well-being of our communities, but on the nation's economy overall.

One area of particular concern is the impact of the pandemic on children and young adults who have had their education disrupted. Many of these students have also experienced the trauma that comes from isolation, food insecurity, concerns about housing stability, and uncertain employment prospects for themselves and the adults in their lives. Left unaddressed, these disruptions could easily leave long-lasting scars that would make it even more difficult for these young people to realize their economic potential and other aspirations. This would certainly weigh on the inclusive nature of the Federal Reserve's maximum employment objective, not to mention the individual hardships it would bring.

At the Chicago Fed, through our Project Hometown initiative,[6] we are interested in supporting strategies and programs that research has shown to improve the lives of young people, especially the most vulnerable and those impacted most by the disruptions of the pandemic.

Summer jobs programs are one such promising intervention. Research indicates that by providing disadvantaged youth employment and enrichment opportunities—including soft skills development and access to mentors—summer jobs programs improve educational and employment outcomes and reduce the likelihood that young

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[6] Further details about Project Hometown are available online, https://www.chicagofed.org/hometown.

people become involved with the criminal justice system. Research also indicates that summer jobs programs have higher returns on each dollar invested than some alternative interventions.

Based on these results, we at the Chicago Fed are seeking ways to promote increased participation by at-risk youth and potential employers in summer jobs programs. There are many local organizations—such as Grow Detroit's Young Talent (GDYT) in your area and One Summer Chicago—as well as many private sector businesses that have well-established and effective summer jobs programs.

While the Fed is known primarily for its monetary policy responsibilities, community development and outreach are also key responsibilities. By adding the analytical expertise of our staff and resources to the efforts of community leaders and businesses, we are committed to improving economic opportunities for vulnerable youth and overcoming other long-standing inequities in our society.

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 hit hard by the virus and its fallout, 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 our inclusive maximum employment and price stability goals. We have a ways to go yet. But as I look ahead, I am optimistic that as the virus comes under control, we can return to the more prosperous economic times we were experiencing before the pandemic.

Thank you.

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