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Full Employment in the New Monetary Policy Framework

Remarks by

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at

The Inaugural Mike McCracken Lecture on Full Employment
Sponsored by the Canadian Association for Business Economics
(via webcast)

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I want to thank the Canadian Association for Business Economics for inviting me to join you today, particularly president Bonnie Lemcke and past president Armine Yalnizyan. It is a pleasure to be here with Carolyn Wilkins.

I am honored to deliver the inaugural Mike McCracken Lecture on Full Employment.¹ Widely known for his critical contributions in bringing computer modeling to Canadian economic forecasting, Mike McCracken is perhaps best known for his tireless advocacy that “lower unemployment remains the most important goal for the economy,” which is particularly resonant for me, along with his emphasis on thinking critically and expansively about full employment.² A similar theme was highlighted by community and labor representatives as well as educators at our *Fed Listens* events, and it is now reflected in the Federal Reserve’s new monetary policy framework.³

Lifting the lives of working people is at the heart of economic policymaking. The deep and disparate damage caused by the pandemic, coming just over a decade after the financial crisis, underscores the vital importance of full employment, particularly for low- and moderate-income workers and those facing systemic challenges in the labor market.

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

² In his 2012 Galbraith Lecture, Mike McCracken noted, “By ‘full employment,’ I mean that everyone who wants a job can find one that is acceptable in terms of compensation, safety, and other conditions of work.” See Mike McCracken (2015), “The Search for Full Employment” (Ottawa: Informetrica Limited, January), paper originally presented at the John Kenneth Galbraith Prize in Economics Lecture, delivered in the Progressive Economics Forum session at the Canadian Economics Association meetings, held in Calgary, June 2012, <https://progressive-economics.ca/wp-content/uploads/2007/06/McCracken-Galbraith-Lecture.pdf>.

³ See Board of Governors of the Federal Reserve System (2020), *Fed Listens: Perspectives from the Public* (Washington: Board of Governors, June), <https://www.federalreserve.gov/publications/files/fedlistens-report-20200612.pdf>.

Monetary Policy Framework

Two years ago, the Federal Reserve began an in-depth review of its monetary policy framework.⁴ The design of our review process incorporated features from the Bank of Canada’s quinquennial renewal of its inflation-control framework agreement, such as input from stakeholders and the focused research undertaken by staff members, academics, and outside experts.

Our review was prompted by changes in key long-run features of the economy: The recognition that price inflation is much less sensitive to labor market tightness than historically—that is, a flat Phillips curve; that the equilibrium interest rate is much lower than in the past; and that trend underlying inflation has moved somewhat below 2 percent. These developments reduce the amount we can cut interest rates to buffer the economy, weaken inflation expectations, and could lead to worse employment and inflation outcomes over time if not addressed.

In response, we have made changes to monetary policy that can be expected to support fuller and broader-based employment than in earlier recoveries, improving opportunities for workers who have faced structural challenges in the labor market.⁵ Whereas our previous strategy had been to minimize *deviations* from maximum

⁴ See Jerome H. Powell (2020), “New Economic Challenges and the Fed’s Monetary Policy Review,” speech delivered at “Navigating the Decade Ahead: Implications for Monetary Policy,” an economic policy symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyo., August 27, <https://www.federalreserve.gov/newsevents/speech/powell20200827a.htm>; and Richard H. Clarida (2020), “The Federal Reserve’s New Framework: Context and Consequences,” speech delivered at the “Economy and Monetary Policy” event hosted by the Hutchins Center on Fiscal and Monetary Policy at the Brookings Institution, Washington, November 16, <https://www.federalreserve.gov/newsevents/speech/clarida20201116a.htm>.

⁵ See Lael Brainard (2020), “Bringing the Statement on Longer-Run Goals and Monetary Policy Strategy into Alignment with Longer-Run Changes in the Economy,” speech delivered at “How the Fed Will Respond to the COVID-19 Recession in an Era of Low Rates and Low Inflation,” an event hosted by the Hutchins Center on Fiscal and Monetary Policy at the Brookings Institution, Washington, September 1, <https://www.federalreserve.gov/newsevents/speech/brainard20200901a.htm>.

employment in either direction, monetary policy will now seek to eliminate *shortfalls* from maximum employment. In other words, the new framework calls for policy to address employment when it falls short of its maximum level, whereas the previous framework called for policy to react when employment was judged to be too high as well as too low. The new monetary policy framework also eliminates the previous reference to a numerical estimate of the longer-run normal unemployment rate and instead defines the maximum level of employment as a broad-based and inclusive goal for which a wide range of indicators are relevant.

Additional changes address the persistence of below-target inflation and the decline in the equilibrium interest rate. Research and experience indicate that persistent low equilibrium interest rates increase the frequency and duration of periods when the policy rate is pinned close to zero, unemployment is elevated, and inflation is below target.⁶ As a result, actual inflation and inflation expectations will tend to be biased below the 2 percent target, further eroding policy space and exacerbating the effects of the lower bound, risking a downward spiral for actual and expected inflation. From the time of the Federal Open Market Committee's (FOMC) announcement of a 2 percent inflation objective in January 2012 through the most recent data in November, monthly readings of 12-month personal consumption expenditure (PCE) inflation have averaged 1.4 percent and have been below 2 percent in 95 out of the 107 months.

⁶ See Kathryn Holston, Thomas Laubach, and John C. Williams (2016), "Measuring the Natural Rate of Interest: International Trends and Determinants," Working Paper Series 2016-11 (San Francisco: Federal Reserve Bank of San Francisco, December), <http://www.frbsf.org/economic-research/publications/working-papers/wp2016-11.pdf>; and Lael Brainard (2015), "Normalizing Monetary Policy When the Neutral Interest Rate Is Low," speech delivered at the Stanford Institute for Economic Policy Research, Stanford, Calif., December 1, <https://www.federalreserve.gov/newsevents/speech/brainard20151201a.htm>.

To address the downward bias, the new framework adopts a flexible average inflation-targeting strategy (FAIT) that seeks to achieve inflation that averages 2 percent over time in order to ensure longer-term inflation expectations are well anchored at 2 percent. Under a FAIT strategy, appropriate monetary policy aims to achieve inflation moderately above 2 percent for some time to make up for shortfalls during a period when it has been running persistently below 2 percent.⁷

These changes could have a beneficial effect on the robustness of employment as well as the economy's potential growth rate. In current circumstances, where a strong labor market can be sustained without the emergence of high inflation, the conventional practice of reducing policy accommodation preemptively when unemployment nears its estimated longer-run normal rate is likely to lead to an unwarranted loss of opportunity for many workers.⁸ For instance, the labor market healing that took place after the unemployment rate reached the 5 percent median Summary of Economic Projections estimate of the longer-run normal unemployment rate, from the fourth quarter of 2015 until the fourth quarter of 2019, included the entry of a further 3-1/2 million prime-age Americans into the labor force, a movement of nearly 1 million people out of long-term unemployment, and opportunities for 2 million involuntary part-time workers to secure

⁷ See Ben S. Bernanke, Michael T. Kiley, and John M. Roberts (2019), "Monetary Policy Strategies for a Low-Rate Environment" Finance and Economics Discussion Series 2019-009 (Washington: Board of Governors of the Federal Reserve System, February), <https://doi.org/10.17016/FEDS.2019.009>; and Lael Brainard (2019), "Federal Reserve Review of Monetary Policy Strategy, Tools, and Communications: Some Preliminary Views," speech delivered at the presentation of the 2019 William F. Butler Award, New York Association for Business Economics, New York, November 26, <https://www.federalreserve.gov/newsevents/speech/brainard20191126a.htm>.

⁸ Twelve-month PCE inflation was only 1.6 percent in December 2019, when the unemployment rate was 3.5 percent, racial gaps in employment were at historical lows, and labor force participation had increased.

full-time jobs.⁹ The gains in employment may have come sooner and been greater if the new monetary policy framework had been in place throughout the previous recovery.

The new policy approach, by avoiding the need to tighten preemptively, could support labor market conditions that help to reduce persistent disparities. This could, in turn, boost activity and increase potential growth by drawing individuals from groups facing structural challenges into more productive employment.¹⁰ Research and experience suggest the groups that face the greatest structural challenges in the labor market are likely to be the first to experience layoffs during downturns and the last to experience employment gains during recoveries.¹¹ At the October 2019 *Fed Listens* event, Amanda Cage, who now heads the National Fund for Workforce Solutions, observed, “What we see is huge disparities in what unemployment looks like for neighborhoods.”¹² She highlighted the challenges facing those communities where unemployment remains at or above 15 percent even when unemployment falls below 4 percent at the national level.

⁹ These numbers are based on the observed changes in various aggregate labor market statistics between the fourth quarter of 2015 and the fourth quarter of 2019—the last quarter unaffected by the COVID-19 pandemic.

¹⁰ For a discussion of how structural disparities can lead to household underinvestment in areas such as education and business endeavors, see Lael Brainard (2017), “Labor Market Disparities and Economic Performance,” remarks at “Banking and the Economy: A Forum for Minority Bankers,” a conference hosted by the Federal Reserve Bank of Kansas City, Kansas City, Mo., September 27, <https://www.federalreserve.gov/newsevents/speech/brainard20170927a.htm>.

¹¹ Research finds that both unemployment rates and patterns of labor force entry and exit for Black and Hispanic workers are more cyclically sensitive than for White workers. See Tomaz Cajner, Tyler Radler, David Ratner, and Ivan Vidangos (2017), “Racial Gaps in Labor Market Outcomes in the Last Four Decades and over the Business Cycle,” Finance and Economics Discussion Series 2017-071 (Washington: Board of Governors of the Federal Reserve System, June), <https://doi.org/10.17016/FEDS.2017.071>.

¹² See David Wessel, Amanda Cage, Victor Dickson, Russell Kavalhuna, and Robert Reiter (2019), “Monetary Policy Impact on Disadvantaged Workers’ Long-Term Labor Market Prospects,” panel discussion at “Monetary Policy’s Impact on Workers and Their Communities,” a *Fed Listens* event, sponsored by the Federal Reserve Bank of Chicago, Chicago, October 17, <https://www.chicagofed.org/fed-listens/panel-1>.

Recent research indicates that additional labor market tightening is especially beneficial to disadvantaged groups when it occurs in already tight labor markets, compared with earlier in the labor market cycle.¹³ For example, the gap between the Black and White unemployment rates fell to an all-time low of 2 percentage points in August 2019—well below its average of 6.3 percentage points.¹⁴

Outlook and Policy

Late last year, the Committee integrated the framework changes into its monetary policy. The September 2020 FOMC statement adopted outcome-based forward guidance for the policy rate tied to shortfalls from maximum employment and 2 percent average inflation, and the December 2020 FOMC statement adopted outcome-based forward guidance for asset purchases. Our monetary policy approach should support a stronger, broader-based recovery from the deep and disparate damage of COVID-19.

The guidance indicates that the Committee expects the policy rate to remain at the lower bound until employment has 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. The forward guidance reflects the important lesson that, with a significantly smaller scope to cut the policy rate than in past recessions, the Committee can provide needed accommodation by making forward commitments on the policy rate that are credible to the public.¹⁵ The outcome-based

¹³ See Stephanie R. Aaronson, Mary C. Daly, William L. Wascher, and David W. Wilcox (2019), “Okun Revisited: Who Benefits Most from a Strong Economy?” *Brookings Papers on Economic Activity*, Spring, pp. 333–75, https://www.brookings.edu/wp-content/uploads/2019/03/aaronson_web.pdf.

¹⁴ These data are available from the Bureau of Labor Statistics Current Population Survey beginning in 1972. See Bureau of Labor Statistics (2019), “Labor Force Statistics from the Current Population Survey,” <https://data.bls.gov/PDQWeb/ln>.

¹⁵ See Ben S. Bernanke, Michael T. Kiley, and John M. Roberts (2019), “Monetary Policy Strategies for a Low-Rate Environment,” Finance and Economics Discussion Series 2019-009 (Washington: Board of

forward guidance communicates how the policy rate will react to the evolution of inflation and employment. It makes clear that the timing of liftoff will depend on realized progress toward maximum employment and 2 percent average inflation.

The FOMC statement notes that monetary policy will remain accommodative after liftoff in order to achieve “inflation moderately above 2 percent for some time so that inflation averages 2 percent over time.”¹⁶ Even after economic conditions warrant liftoff, changes in the policy rate are likely to be only gradual to support the inflation makeup strategy and maximum employment.

Market expectations appear to have adjusted in response to the changes in the FOMC’s approach. The Survey of Market Participants conducted by the Federal Reserve Bank of New York indicates a shift in expectations following the release of the new monetary policy framework.¹⁷ The median expected rate of unemployment at the time of liftoff moved down from 4.5 percent in the July survey, before the release of the framework, to 4.0 percent in the September and subsequent surveys, following the release of the new framework. Similarly, the median level of 12-month PCE inflation

Governors of the Federal Reserve System, February), <https://doi.org/10.17016/FEDS.2019.009>. In addition, see analytical work developed as part of the framework review, such as Jonas Arias, Martin Bodenstein, Hess Chung, Thorsten Drautzburg, and Andrea Raffo (2020), “Alternative Strategies: How Do They Work? How Might They Help?” Finance and Economics Discussion Series 2020-068 (Washington: Board of Governors of the Federal Reserve System, August), <https://doi.org/10.17016/FEDS.2020.068>; and James Hebden, Edward P. Herbst, Jenny Tang, Giorgio Topa, and Fabian Winkler (2020), “How Robust Are Makeup Strategies to Key Alternative Assumptions?” Finance and Economics Discussion Series 2020-069 (Washington: Board of Governors of the Federal Reserve System, August), <https://doi.org/10.17016/FEDS.2020.069>.

¹⁶ See Board of Governors of the Federal System (2020), “Federal Reserve Issues FOMC Statement,” press release, December 16, <https://www.federalreserve.gov/newsevents/pressreleases/monetary20201216a.htm>.

¹⁷ See Ryan Bush, Haitham Jendoubi, Matthew Raskin, and Giorgio Topa (2020), “How Did Market Perceptions of the FOMC’s Reaction Function Change after the Fed’s Framework Review?” Federal Reserve Bank of New York, *Liberty Street Economics* (blog), December 18, <https://libertystreeteconomics.newyorkfed.org/2020/12/how-did-market-perceptions-of-the-fomcs-reaction-function-change-after-the-feds-framework-review.html>.

anticipated at the time of liftoff rose from 2 percent in the July survey to 2.3 percent in the September survey and beyond, following the introduction of FAIT.¹⁸

The forward guidance adopted in December expands the goals of the asset purchases beyond market functioning by establishing qualitative outcome-based criteria tied to realized progress on our employment and inflation goals. This approach integrates the forward guidance on the policy rate and on asset purchases, rather than establishing distinct criteria. The December guidance clarifies that the pandemic asset purchases will continue at least at the current pace until substantial further progress is made on our employment and inflation goals. In assessing substantial further progress, I will be looking for sustained improvements in realized and expected inflation and will examine a range of indicators to assess shortfalls from maximum employment.

If we look ahead, effective vaccines and additional fiscal support are important positive developments, but the near-term outlook is challenging due to the resurgence of the pandemic, and the economy remains far from our goals. The most recent spending indicators point to a considerable loss of momentum late in the fourth quarter. Sales of consumer durable goods—such as furniture, electronics, and appliances—declined in November, after surging since the spring.¹⁹ The rise in cases in November and the associated social distancing resulted in a decline in already low services consumption, with sales at restaurants and bars falling by 4 percent, the largest drop since April. Continued social distancing over the cold winter months is likely to generate a significant

¹⁸ The shift in the median appears to reflect an upward shift in the distribution: In the interquartile range of values between the 25th and 75th percentiles, inflation of 2.2 percent moved from the top of the range in July to the bottom of the range in September.

¹⁹ Through much of the recovery, spending on durable goods far exceeded the rates of growth that had been observed before the COVID-19 crisis. As a result, households may curtail their purchases going forward in order to bring the stock of consumer durables back in line with long-run levels of demand.

drag for spending on services that require personal contact. Additionally, state and local income and sales tax and gaming and energy-related revenues remain depressed, and the most recent payrolls report indicates that state and local governments are having difficulty sustaining employment levels as the virus persists.

Inflation remains very low; core PCE inflation ran at 1.4 percent over the 12 months ending in November. Even though some of the survey-based measures of inflation expectations have picked up recently, they still remain close to the lower end of their historical ranges. Market-based measures of inflation compensation have also picked up. While disentangling inflation expectations from liquidity and term premiums is imprecise, staff models attribute a significant portion of the movement in inflation compensation to an increase in expectations, bringing them up from the lows seen in March but still below their historical averages. Inflation may temporarily rise to or above 2 percent on a 12-month basis in a few months when the low March and April price readings from last year fall out of the 12-month calculation, but it will be important to see sustained improvement to meet our average inflation goal.

The COVID-19 pandemic is exacerbating disparities, and employment remains far from our goals. Last Friday's payroll report highlighted the effects of the resurgence of the virus, with the first overall decline in payrolls since April and a stark 498,000 decline in leisure and hospitality jobs. Overall, payroll employment is still nearly 10 million jobs below its February level. If we adjust the 6.7 percent headline unemployment rate for the decline in participation since February and the Bureau of Labor Statistics estimate of misclassification, the unemployment rate would be 10 percent, similar to the peak following the Global Financial Crisis.

The damage from COVID-19 is concentrated among already challenged groups. Federal Reserve staff analysis indicates that unemployment is likely above 20 percent for workers in the bottom wage quartile, while it has fallen below 5 percent for the top wage quartile.²⁰ Black and Hispanic unemployment stood at 9.9 percent and 9.3 percent, respectively, in December, while White unemployment was 6.0 percent. Labor force participation for prime-age workers has declined, particularly for parents of school-aged children, where the declines have been greater for women than for men, and greater for Black and Hispanic mothers than for White mothers.

The K-shaped recovery remains highly uneven, with certain sectors and groups experiencing substantial hardship. All told, real gross domestic product likely declined by about 2-1/2 percent in 2020, with the damage concentrated disproportionately among some groups of workers and sectors as well as smaller businesses. Fortunately, fiscal support looks set to resume playing a vital role in the form of stimulus payments and extended unemployment benefits, particularly for the cash-constrained households that make up a significant fraction of the population. The additional Paycheck Protection Program financing will be a vital support for the many hard-hit small businesses facing continued revenue shortfalls and declining cash balances.

The damage would have been much greater in the absence of substantial fiscal and monetary support. The unprecedented scale and composition of fiscal support made a vital difference in replacing lost income and supporting demand in the middle of last year and is expected to do so again in the months ahead. The unprecedented speed and

²⁰ 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 (2020), *Monetary Policy Report* (Washington: Board of Governors, June), pp. 8–9, https://www.federalreserve.gov/monetarypolicy/files/20200612_mprfullreport.pdf.

breadth of the monetary policy response through an expanded set of tools is supporting lower borrowing costs along the yield curve for households and businesses as well as better inflation and employment outcomes.

The outlook will depend on the path of the virus and vaccinations. While the number of new cases is high and rising, the distribution of multiple effective vaccines is under way.²¹ Spending on in-person services is likely to return to pre-pandemic levels only as conditions around the virus improve substantially. Most forecasts predict a significant rebound in aggregate spending this year. And there is some risk to the upside if the efficient delivery of vaccines across many jurisdictions ultimately results in a globally synchronized expansion.

We are strongly committed to achieving our maximum-employment and average-inflation goals. It is too early to say how long it will take. The Committee has stated clearly that it needs to see substantial further progress toward our goals before adjusting purchases. The economy is far away from our goals in terms of both employment and inflation, and even under an optimistic outlook, it will take time to achieve substantial further progress. Given my baseline outlook, I expect that the current pace of purchases will remain appropriate for quite some time. Of course, the outlook is highly uncertain, and forecasts are subject to revisions—a key reason why our forward guidance is outcome based and tied to realized progress on our goals.

The recovery thus far has been uneven, and the path ahead is uncertain. We remain far from our goals, with core PCE inflation only at 1.4 percent and payroll employment nearly 10 million below its pre-pandemic level. The Committee's forward

²¹ See the Centers for Disease Control and Prevention COVID Data Tracker, available at <https://covid.cdc.gov/covid-data-tracker/#vaccinations>.

guidance will help keep borrowing costs low along the yield curve for households and businesses, improve inflation outcomes, and enable the labor market to heal, leading to a broader-based and stronger recovery. The strong support from monetary policy, together with fiscal stimulus, should turn the K-shaped recovery into a broad-based and inclusive recovery that delivers full employment, as Mike McCracken would have wished. Thank you.