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Remaining Patient as the Outlook Brightens

Remarks by

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It has now been a year since the onset of COVID-19 in the United States. The past year has been marked by heartache and hardship, especially for vulnerable communities, as well as by the resilience and extraordinary efforts of Americans everywhere, particularly those on the front lines. The past year has also seen determined efforts on the part of policymakers—public health, fiscal, and monetary—to do what is necessary and stay the course until we return to full strength.[1]

These determined efforts have contributed to a considerably brighter economic outlook. A comparison between the median of the most recent Federal Open Market Committee (FOMC) Summary of Economic Projections (SEP) and the first projection following the onset of the pandemic, in June of last year, highlights the improvement in the outlook. The change in the SEP median suggests an improvement in the projected level of gross domestic product of 6 percent at the end of 2021 and 2022, a decline in the unemployment rate of 2 percentage points at the end of 2021 and 1-1/2 percentage points at the end of 2022, and an upward revision to the headline inflation rate of 0.8 percentage point at the end of 2021 that narrows to a 0.3 percentage point upward revision at the end of 2022.[2] The expected improvements in the outlook reflect progress on controlling the virus, nearly $3 trillion in additional fiscal support, and forceful and timely support from monetary policy.

Although the outlook has brightened considerably, the fog of uncertainty associated with the virus has yet to lift completely, and current employment and inflation outcomes remain far from our goals. The focus on achieved outcomes rather than the anticipated outlook is central to the Committee's guidance regarding both asset purchases and the policy rate. The emphasis on

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[1] I am grateful to Kurt Lewis of the Federal Reserve for his assistance in preparing this text. These are my own views and do not necessarily reflect those of the Federal Reserve Board or the Federal Open Market Committee.

[2] Both the June 2020 and the most recent SEP are available on the Board's website at https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm.

outcomes rather than the outlook corresponds to the shift in our monetary policy approach that suggests policy should be patient rather than preemptive at this stage in the recovery.

Outcomes

Recent data indicate that activity has picked up this year. After a dip in the final months of 2020, personal consumption expenditures (PCE) stepped up considerably so far this year, and spending on durable goods has been particularly strong. This pattern appears consistent with a quick spend-out from the Consolidated Appropriations Act (CAA) stimulus checks at the turn of the year, particularly among lower-income households that may have previously exhausted the funds provided in the CARES Act (Coronavirus Aid, Relief, and Economic Security Act).[3]

Like the spending data, the labor market data turned more positive in January and February following weakness at the end of 2020. Although the unemployment rate has moved down 1/2 a percentage point since December, the K-shaped labor market recovery remains uneven across racial groups, industries, and wage levels.[4] The employment-to-population (EPOP) ratio for Black prime-age workers is 7.2 percentage points lower than for white workers, while the EPOP ratio is 6.2 percentage points lower for Hispanic workers than for white workers—an increase in each gap of about 3 percentage points from pre-crisis lows in October 2019.

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[3] See, for example, the difference in high-frequency indicators of consumer spending between measures of total spending and spending in low-income Zip codes in the weeks following the payment of stimulus under the CAA. Data are available from Opportunity Insights at https://www.tracktherecovery.org. For further discussion of differing spend-out of COVID stimulus payments for different levels of household wealth, see, for example, Ezra Karger and Aastha Rajan, "Heterogeneity in the Marginal Propensity to Consume: Evidence from COVID-19 Stimulus Payments," Working Paper No 2020-15 (Chicago: Federal Reserve Bank of Chicago, May, revised October), https://www.chicagofed.org/publications/working-papers/2020/2020-15.

[4] See Lael Brainard (2021), "Full Employment in the New Monetary Policy Framework," speech delivered at the Inaugural Mike McCracken Lecture on Full Employment, sponsored by the Canadian Association for Business Economics (via webcast), January 13, https://www.federalreserve.gov/newsevents/speech/brainard20210113a.htm; and Lael Brainard (2021), "How Should We Think about Full Employment in the Federal Reserve's Dual Mandate?" speech delivered at the Ec10, Principles of Economics, Lecture, Faculty of Arts and Sciences, Harvard University, Cambridge, Mass. (via webcast), February 24, https://www.federalreserve.gov/newsevents/speech/brainard20210224a.htm.

Workers in the lowest-wage quartile continued to face staggering levels of unemployment of around 22 percent in February, reflecting the disproportionate concentration of lower-wage jobs in services sectors still sidelined by social distancing.[5] The leisure and hospitality sector is still down almost 3.5 million jobs, or roughly 20 percent of its pre-COVID level. This sector accounts for more than 40 percent of the net decline in private payrolls since February 2020. Overall, with 9.5 million fewer jobs than pre-COVID levels, we are far from our broad-based and inclusive maximum-employment goal.

Inflation similarly remains far from the goal of 2 percent inflation on average over time. Both headline and core PCE inflation were below 2 percent on a 12-month basis throughout 2020 and came in at 1.5 percent in January.

Finally, while vaccinations are continuing at an accelerating pace, over two-thirds of the adult population have yet to receive their first dose, and there are risks from more contagious strains of the virus, social-distancing fatigue, and vaccine hesitancy.[6]

Outlook

As the economy reopens, the potential release of pent-up demand could drive stronger growth in 2021 than we have seen in decades. However, it is uncertain how much pent-up consumption will be unleashed when social distancing completely lifts, and how much household spending will result from the new stimulus and accumulated savings. With PCE accounting for roughly 70 percent of the economy, this uncertainty about consumption spending contributes to uncertainty about activity, employment, and inflation.

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[5] For more information on this analysis, see the box “Disparities in Job Loss during the Pandemic” in Board of Governors of the Federal Reserve System (2021), Monetary Policy Report (Washington: Board of Governors, February), pp. 12–14, https://www.federalreserve.gov/monetarypolicy/files/20210219_mprfullreport.pdf.

[6] For more information, see the Centers for Disease Control and Prevention COVID Data Tracker, which is available at https://covid.cdc.gov/covid-data-tracker.

In part, the outcome will hinge on distributive questions that are imperfectly understood. Households accrued considerable additional savings that led to a $2.1 trillion increase in liquid assets by the end of last year.[7] Higher-income households appear to have cut back on discretionary services spending over the past year and increased their purchases of durable goods, which may see some satiation going forward. For moderate-income households that are not cash constrained, it is possible there will be a lower near-term spend-out from the American Rescue Plan payments relative to the CAA payments, given that less than 75 days elapsed between the two rounds of payments. Households whose cash flows were improved by the CAA stimulus may save more of the most recent stimulus for precautionary reasons. That said, there is upside risk if a substantial fraction of stimulus payments and accumulated savings are spent in 2021 rather than more slowly over a longer time period.

On the other side, there is potential for some leakage abroad if, as anticipated, foreign demand growth in some regions is weaker than in the United States. Imports soared during the second half of last year and grew further in January, even with worsening backlogs at U.S. ports. As port congestion and supply chain bottlenecks ease, international spillovers could lead to some slippage between the increase in domestic demand and resource utilization, which has implications for employment and inflation.

In the labor market, as vaccinations continue and social distancing eases, businesses in hard-hit services sectors will increase hiring, accelerating the pace at which workers find employment. The strong and timely support from fiscal as well as monetary policy likely

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[7] According to the Financial Accounts of the United States, liquid assets—defined as the sum of currency, checkable and time and saving deposits, and money market funds—increased by about $2.1 trillion from 2020:Q1 to 2020:Q4. The 2020:Q4 release of the Financial Accounts of the United States is available on the Board's website at: https://www.federalreserve.gov/releases/z1.

reduced the extent of scarring during the pandemic, which should aid the pace of hiring at in-person services establishments once the virus is well controlled.

The speed of further improvement in the labor market following the initial rush of reopening is less clear, however. Some employers may be cautious about significantly increasing payrolls before post-COVID consumption patterns are more firmly established. Others may be implementing measures to stay lean and contain costs. In the December Duke CFO survey, roughly one-half of CFOs from large firms and about one-third of those from small firms reported "using, or planning to use, automation or technology to reduce reliance on labor."[8]

In addition to greater use of technology, there is likely a significant amount of slack on the participation and part-time margins. The EPOP ratio among workers ages 25 to 54 is still a full 4 percentage points below its pre-COVID level, and the number of workers working part time because they cannot find a full-time job is 1.7 million higher than pre-COVID.

Although core and headline PCE inflation came in at 1.5 percent on a 12-month basis in January, the well-anticipated base effects from price declines in March and April of last year will cause inflation to move above 2 percent in April and May. It also seems likely that a surge of demand may be met by some transitory supply bottlenecks amid a rapid reopening of the economy, leading PCE inflation to rise somewhat above 2 percent on a transitory basis by the end of 2021.

Entrenched inflation dynamics are likely to take over following the transitory pressures associated with reopening. Underlying trend inflation has been running persistently below 2

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[8] Details on the CFO survey, which is a partnership of Duke University, the Federal Reserve Bank of Richmond, and the Federal Reserve Bank of Atlanta, can be found on the Richmond Fed's website at https://www.richmondfed.org/research/national_economy/cfo_survey.

percent for many years.[9] In addition, research suggests that although increasing labor market tightness may show through to wage inflation, the pass-through to price inflation has become highly attenuated.[10] These results suggest that businesses tend to respond to increased labor costs by reducing margins rather than increasing prices later in the cycle. Thus, as resource utilization continues to tighten over coming years, recent decades provide little evidence to suggest there will be a material nonlinear effect on price inflation.

Policy

The FOMC has communicated its reaction function under the new framework and provided powerful forward guidance that is conditioned on employment and inflation outcomes. This approach implies resolute patience while the gap closes between current conditions and the maximum-employment and average inflation outcomes in the guidance.

By focusing on eliminating shortfalls from maximum employment rather than deviations in either direction and on the achievement of inflation that averages 2 percent over time, monetary policy can take a patient approach rather than a preemptive approach. The preemptive approach that calls for a reduction of accommodation when the unemployment rate nears estimates of its neutral rate in anticipation of high inflation risks an unwarranted loss of opportunity for many of the most economically vulnerable Americans and entrenching inflation

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[9] Statistical models estimate that underlying core PCE inflation ranges from one- to four-tenths of 1 percentage point below the 2 percent longer-run target. See the point estimates for 2019:Q2 in table 1 in Jeremy B. Rudd (2020), "Underlying Inflation: Its Measurement and Significance," FEDS Notes (Washington: Board of Governors of the Federal Reserve System, September 18), https://www.federalreserve.gov/econres/notes/feds-notes/underlying-inflation-its-measurement-and-significance-20200918.htm.

[10] See, for example, slide 5 of Ekaterina Peneva (2019) "It's All about the Labor Market," presentation at the Brookings Institution (Washington: Brookings, October 3), https://www.brookings.edu/wp-content/uploads/2019/09/Ekaterina-Peneva.pdf. This presentation is based on work originally done in Ekaterina V. Peneva and Jeremy B. Rudd (2017), "The Passthrough of Labor Costs to Price Inflation," *Journal of Money, Credit and Banking,* vol. 49 (December), pp. 1777–802.

persistently below its 2 percent target.[11] Instead, the current approach calls for patience, enabling the labor market to continue to improve and inflation expectations to become re-anchored at 2 percent.

One simple illustration of this difference is the way in which FOMC communications under the new framework have shifted market expectations around the conditions associated with the lift off of the policy rate from the lower bound. This shift is suggested by a comparison of the surveys of primary dealers and market participants conducted by the Federal Reserve Bank of New York in the most recently available surveys, in January 2021, and under the prior policy framework, in March 2015. In the January 2021 surveys, the median respondent expected the unemployment rate to be a bit below 4 percent at the time of liftoff, as compared with 5.3 percent in the March 2015 surveys. Similarly, in the January 2021 surveys, the median respondent expected a 12-month headline PCE inflation rate of 2.2 to 2.3 percent at the time of liftoff, as compared to roughly 0.5 percent in the March 2015 surveys. The most recently available surveys suggest that market participants expect policy to look through the rolling off of base effects as well as possible transitory price increases due to short-term supply-demand imbalances.

The FOMC has stated that in order to anchor inflation expectations at 2 percent, it seeks to achieve inflation that averages 2 percent over time. This language recognizes that the public's expectations of inflation are linked to the experience of inflation outcomes. In the nine years since the Committee formally defined price stability as annual PCE inflation of 2 percent, the average 12-month PCE inflation reading has been 1.4 percent. Persistently low inflation creates

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[11] 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.

the risk that households and businesses come to expect inflation to run persistently below target and change their behavior in ways that reinforce low inflation.[12]

With inflation expected to rise above 2 percent on a transitory basis, I will be closely monitoring a dashboard of indicators to assess that inflation expectations remain well anchored at levels consistent with the Committee's objective. These indicators include survey and market-based measures, along with composite measures like the staff's Index of Common Inflation Expectations.[13] Survey measures have picked up a little but remain around pre-COVID levels. Meanwhile, five- and 10-year TIPS (Treasury Inflation-Protected Securities)-based measures of inflation compensation have moved up almost 1 percentage point since last summer and are now at levels last seen in 2013 and 2014. These changes likely reflect both the improvement in the anticipated outlook and market participants' understanding of the Committee's new reaction function.[14]

The overall price-stability objective of achieving inflation that averages 2 percent over time provides an important guidepost for assessing the path of inflation. Along with realized inflation, I will be monitoring a range of average inflation concepts in the literature to assess the

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[12] 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.

[13] See Hie Joo Ahn and Chad Fulton (2020), "Index of Common Inflation Expectations," FEDS Notes (Washington: Board of Governors of the Federal Reserve System, September 2), https://www.federalreserve.gov/econres/notes/feds-notes/index-of-common-inflation-expectations-20200902.htm.

[14] Expectations surrounding the rate of inflation at liftoff similarly moved higher following the release of the new framework in the Desk surveys of primary dealers and market participants. 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.

path of policy that would be consistent with closing the inflation gap under a variety of make-up strategies.[15]

While the outlook has brightened considerably, with jobs nearly 10 million below the pre-COVID level and inflation persistently below 2 percent, the economy remains far from our goals, and it will take some time to achieve substantial further progress. By taking a patient approach based on outcomes rather than a preemptive approach based on the outlook, policy will be more effective in achieving broad-based and inclusive maximum employment and inflation that averages 2 percent over time. The combination of patient monetary policy, together with accelerating progress on vaccinations and substantial fiscal stimulus, should support a strong and inclusive recovery as the economy reopens fully.

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[15] For instance, even with the strongest SEP inflation projection since the Committee established its 2 percent inflation objective, the median projection from the current SEP is not quite strong enough to generate inflation that averages 2 percent from the time the federal funds rate moved to the lower bound through the end of the forecast horizon, which is a key consideration under a Temporary Price Level Targeting framework. See Ben S. Bernanke, Michael T. Kiley, and John M. Roberts (2019), "Monetary Policy Strategies for a Low-Rate Environment," *AEA Papers and Proceedings,* vol. 109 (May), pp. 421–26.