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Outlooks, Outcomes, and Prospects for U.S. Monetary Policy

Remarks by

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Outlooks and Outcomes for the U.S. Economy

With the release of the gross domestic product (GDP) data last week, we learned that the U.S. economy in the second quarter of this year transitioned from economic recovery to economic expansion.[1] Given the catastrophic collapse in U.S. economic activity in the first half of 2020 as a result of the global pandemic and the mitigation efforts put in place to contain it, few forecasters could have expected—or even dared to hope—in the spring of last year that the recovery in GDP, from the sharpest decline in activity since the Great Depression, would be either so robust or as rapid. In retrospect, it seems clear that timely and targeted monetary and fiscal policy actions—unprecedented in both scale and scope—provided essential and significant support to the economic recovery as it got under way last year. Indeed, just recently, the National Bureau of Economic Research's Business Cycle Dating Committee determined that the recession that began in March of last year ended in April, making it not only the deepest recession on record, but also the briefest.[2] Moreover, with the development and distribution of several remarkably effective vaccines, the monetary and fiscal policies presently in place should continue to support the strong expansion in economic activity that is expected to be realized this year, although, obviously, the rapid spread of the Delta variant among the still considerable fraction of the population that is unvaccinated is clearly a downside risk for the outlook. That said, under the latest Congressional Budget Office (CBO) baseline forecast, the economy by the end of 2021 will have entirely closed the output gap opened

[1] The views expressed are my own and not necessarily those of other Federal Reserve Board members or Federal Open Market Committee participants. I would like to thank Burcu Duygan-Bump and Chiara Scotti for assistance in preparing these remarks.
[2] See National Bureau of Economic Research (2021).

up by the recession. If so, this would be the most rapid return following a recession to the CBO estimate of the trend level of real GDP in 50 years.

Importantly, while it is customary in business cycle analysis to date the transition from the recovery phase to the expansion phase according to the calendar quarter in which the level of real GDP first exceeds the previous business cycle's peak, in past U.S. business cycles, the recovery in employment has always lagged the recovery in GDP, and this cycle is no exception. Indeed, at the end of the second quarter of this year, even though the level of real GDP was 0.8 percent above the level reached at the previous business cycle peak, the level of employment as measured by the household survey remained about 7 million below the level reached at the previous business cycle peak. So while it is accurate to say we are in the expansion phase of the cycle in terms of economic activity, we remain in the recovery phase of the cycle in terms of aggregate employment.

In June, the Federal Reserve released its most recent Summary of Economic Projections (SEP) for GDP, the unemployment rate, inflation, and the federal funds rate.[3] The SEP provides summary information about the empirical distribution of the individual modal projections at the time of the Federal Open Market Committee (FOMC) meeting submitted by each of the FOMC participants (currently 6 Governors and 12 Reserve Bank presidents). Each individual submits projections for the modal, or most likely, outcome for each variable in the survey under his or her assessment of the appropriate monetary policy path.[4] Of course, if a participant's subjective distributions for possible

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[3] The most recent SEP, released following the conclusion of the June 2021 FOMC meeting, is available on the Board's website at https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm.

[4] "Appropriate monetary policy" is defined as the future path of policy that each participant deems most likely to foster outcomes for economic activity and inflation that best satisfy his or her individual interpretation of the statutory mandate to promote maximum employment and price stability. Additional information is available on the Board's website at https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20210616.htm.

outcomes for GDP, unemployment, and inflation are symmetric, the mode of each distribution submitted by each participant will equal its mean (and median), but in general, there is no presumption that the subjective distributions—or, for that matter, observed empirical distributions—for these variables are symmetric. Indeed, an important addition to the SEP introduced in December 2020 is a set of charts showing the historical evolution of diffusion indexes for the assessment of the balance of risks to the GDP, unemployment, and inflation projections submitted by each participant.

In the June SEP round, my individual projections for GDP growth and the unemployment rate turned out to be quite close to the path of SEP medians for each of these variables over the 2021–23 projection window. Under the "median of modes" outlook in the SEP, GDP growth this year is projected to be 7 percent on a Q4-over-Q4 basis, which, if realized, would represent the fastest four-quarter GDP growth since the 1980s. Under the projections, GDP growth does step down to 3.3 percent in 2022 and further to 2.4 percent in 2023, but to a pace that still exceeds the projected pace of long-run trend growth in all three years of the projection window. Not surprisingly, the projected path of robust GDP growth in the SEP translates into rapid declines in the projected SEP path for the unemployment rate, which is projected to fall to 4.5 percent by the end of this year, 3.8 percent by the end of 2022, and 3.5 percent by the end of 2023. This modal projection for the path of the unemployment rate is, according to the Atlanta Fed jobs calculator, consistent with a rebound in labor force participation to its estimated demographic trend and is also consistent with cumulative employment gains this year and

next that, by the end of 2022, eliminate the 7 million "employment gap" relative to the previous cycle peak I mentioned earlier.[5]

As is the case for GDP growth and the unemployment rate, my projections for headline and core PCE (personal consumption expenditures) inflation are also similar to the paths of the SEP median of modal projections for these variables. Under the projected SEP path for inflation, core PCE inflation surges to at least 3 percent this year before reverting back to 2.1 percent for the next two years. Thus, the modal baseline outlook for inflation over the three-year projection window reflects the judgment, shared with many outside forecasters, that most of the inflation overshoot relative to the longer-run goal of 2 percent will, in the end, prove to be transitory. But, as I have noted before, there is no doubt that it is taking longer to fully reopen a $20 trillion economy than it did to shut it down. Although in a number of sectors of the economy the imbalances between demand and supply—including labor supply—are substantial, I do continue to judge that these imbalances are likely to dissipate over time as the labor market and global supply chains eventually adjust and, importantly, do so without putting persistent upward pressure on price inflation, wage gains adjusted for productivity, and the 2 percent longer-run inflation objective. But let me be clear on two points. First, if, as projected, core PCE inflation this year does come in at, or certainly above, 3 percent, I will consider that much more than a "moderate" overshoot of our 2 percent longer-run inflation objective. Second, as always, there are risks to any outlook, and I believe that the risks to my outlook for inflation are to the upside.

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[5] More information on the jobs calculator can be found on the Atlanta Fed's website at https://www.atlantafed.org/chcs/calculator.

Prospects for U.S. Monetary Policy

In September 2020, the FOMC introduced—and since then has, at each subsequent meeting, reaffirmed—outcome-based, threshold guidance that specifies three conditions that the Committee expects will be met before it considers increasing the target range for the federal funds rate, currently 0 to 25 basis points.[6] This guidance in September of last year brought the forward guidance on the federal funds rate in the statement into alignment with the new policy framework adopted in August 2020.[7] To quote from the statement, these conditions are that "labor market conditions have 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."

While, as Chair Powell indicated last week, we are clearly a ways away from considering raising interest rates and this is certainly not something on the radar screen right now, if the outlook for inflation and outlook for unemployment I summarized earlier turn out to be the actual outcomes for inflation and unemployment realized over the forecast horizon, then I believe that these three necessary conditions for raising the target range for the federal funds rate will have been met by year-end 2022.[8] Core PCE inflation since February 2020—a calculation window that smooths out any base effects

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[6] The FOMC statements containing the guidance (see the fourth paragraph in each statement) are available on the Board's website at https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm.
[7] The revised Statement on Longer-Run Goals and Monetary Policy Strategy, unanimously approved on August 27, 2020, is available on the Board's website at https://www.federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications-statement-on-longer-run-goals-monetary-policy-strategy.htm. For a discussion of the elements that motivated the launch of the review and a summary of the key changes that were introduced, see Clarida (2020, 2021) and Powell (2020).
[8] Of course, data for December 2022 employment and 2022:Q4 GDP and PCE inflation will not be released until January 2023.

resulting from "round trip" declines and rebounds in the price levels of COVID-19-sensitive sectors and, coincidentally, also measures the average rate of core PCE inflation since hitting the effective lower bound (ELB) in March 2020—is running at 2.7 percent through June 2021 and is projected to remain above 2 percent in all three years of the projection window. Moreover, my inflation projections for 2022 and 2023, which forecast somewhat higher inflation than do the SEP medians, would also, to me, satisfy the "on track to moderately exceed 2 percent for some time" threshold specified in the statement. Finally, while my assessment of maximum employment incorporates a wide range of indicators to assess the state of the labor market—including indicators of labor compensation, productivity, and price-cost markups—the employment data I look at, such as the Kansas City Fed's Labor Market Conditions Indicators, are historically highly correlated with the unemployment rate.[9] My expectation today is that the labor market by the end of 2022 will have reached my assessment of maximum employment if the unemployment rate has declined by then to the SEP median of modal projections of 3.8 percent.

Given this outlook and so long as inflation expectations remain well anchored at the 2 percent longer-run goal—which, based on the Fed staff's common inflation expectations (CIE) index, I judge at present to be the case and which I project will remain true over the forecast horizon—commencing policy normalization in 2023 would, under these conditions, be entirely consistent with our new flexible average inflation targeting framework.[10] I note that under the June SEP median of modal projections, annualized

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[9] The Labor Market Conditions Indicators can be found on the Kansas City Fed's website at https://www.kansascityfed.org/data-and-trends/labor-market-conditions-indicators.
[10] The Fed staff's CIE index—which is now updated quarterly on the Board's website—is a relevant indicator that this goal is being met. See Ahn and Fulton (2020, 2021).

PCE inflation since the new framework was adopted in August 2020 is projected to average 2.6 percent through year-end 2022 and 2.5 percent through year-end 2023.[11] In the context of our new framework, it is important to note that while the ELB can be a constraint on monetary policy, the ELB is not a constraint on fiscal policy, and appropriate monetary policy under our new framework, to me, must—and certainly can—incorporate this reality. Indeed, under present circumstances, I judge that the support to aggregate demand from fiscal policy—including the more than $2 trillion in accumulated excess savings accruing from (as yet) unspent transfer payments—in tandem with appropriate monetary policy, can fully offset the constraint, highlighted in our Statement on Longer-Run Goals and Monetary Policy Strategy, that the ELB imposes on the ability of an inflation-targeting monetary policy, acting on its own and in the absence of sufficient fiscal support, to restore, following a recession, maximum employment and price stability while keeping inflation expectations well anchored at the 2 percent longer-run goal.[12]

Before I conclude, let me say a few words about our Treasury and mortgage-backed securities (MBS) purchase programs. In our December 2020 FOMC statement, we indicated, and have reaffirmed since then, that we will maintain the pace of Treasury and MBS purchases at $80 billion and $40 billion per month, respectively, until "substantial further progress" has been made toward our maximum-employment and price-stability goals. Since then, the economy has made progress toward these goals. At

[11] The corresponding annualized average rate of PCE inflation since February 2020 under the SEP median projections is 2.3 percent through 2022 and 2023.

[12] For a theoretical analysis of the fiscal and monetary policy mix at the ELB, see Woodford and Xie (2020), and for studies of the government expenditure multiplier at the ELB, see Woodford (2011); Christiano, Eichenbaum, and Rebelo (2011); and Eggertsson (2011).

our meeting last week, the Committee reviewed some considerations around how our asset purchases might be adjusted, including their pace and composition, once economic conditions warrant a change. Participants expect that the economy will continue to move toward our standard of "substantial further progress." In coming meetings, the Committee will again assess the economy's progress toward our goals. As we have said, we will provide advance notice before making any changes to our purchases.

The outlook I have described in these remarks is, of course, only one of many possible paths that the economy may take. I began by noting that the recovery to date has been surprising, and it is plausible—indeed, probable—that more surprises are in store. The economic outlook is always uncertain, both because new shocks can arrive—which, by their nature, cannot be foreseen—and because our knowledge of the workings of the economy is imperfect. Additionally, the recovery and expansion following the pandemic are unlike any we have ever seen, and it will serve us well to remain humble in predicting the future. In light of these uncertainties, the Committee is rightly basing its judgments on outcomes, not just the outlook. Looking ahead, our policy decisions will continue to depend on the data in hand at the time, along with their implications for the outlook and associated risks.

Thank you very much for your time and attention. I look forward, as always, to my conversation with Adam Posen.

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