# President’s Message: Sharing reflections in the wake of an unprecedented year

by:

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Last year was one for the record books. The year had both the largest decline in quarterly GDP on record as well as the largest increase. The unemployment rate hit a 50-year low before climbing to levels not seen since the Great Depression. The equity market set record highs, while the price of oil dropped below zero for

the first time, if only for a moment. The year saw the largest fiscal policy reaction and the most rapid increase in government debt, even as the yield on government securities fell to new lows. The Federal Reserve, for its part, broke new ground in policy accommodation, while expanding its balance sheet to record size. Suffice to say, 2020 was not a typical year.

I am hopeful, as I believe many of us are, that 2021 will mark the beginning of a return to something more like normal. I am generally optimistic that the year will be one of continued economic recovery, though not without bumps and potholes, particularly in the first part of the year, as the virus continues to exact a terrible human and economic toll. Even as the economy recovers, the events of the last year are likely to leave an imprint for years to come.

**Long-term implications of the pandemic**

When thinking about the long-term consequences of 2020, I find it helpful to group the potential factors into three broad categories. First, despite the best efforts of policymakers, there are likely to be scars from the crisis that will take time to heal. Businesses and workers have suffered a tremendous disruption, and while there is some optimism for a quick bounce-back, it would not be unexpected for some of the negative effects to persist. Second, the crisis will leave a lasting impact on business and public sector balance sheets, with governments taking on notably more debt, central bank balance sheets swelling around the world, and corporate borrowing soaring, even as household balance sheets, in the aggregate, have improved. Third, the crisis will likely have a lasting effect on the structure of the economy, both by changing the way that people work as well as what and how they consume.

Starting with the first category, there could be economic scarring that eventually heals, but only after time. For example, at the end of 2020, 10 million fewer individuals were working relative to before the pandemic. Given the notable decline in labor force participation over the same period, it would appear that about half of those workers that lost jobs dropped out of the labor force altogether. Traditionally, it has taken time to bring individuals back into the labor force, and it has often taken a fairly hot labor market to do so.

An additional dynamic with this crisis has been the disproportionate decline in labor force participation among women. In particular, about half of the decline in women's participation is attributable to caregiving, likely reflecting disruptions in child care. While this could suggest a quicker bounce-back once the virus is checked and normal child care options return, it is important to note that even after returning to the job, these workers could suffer interruptions in human capital development and career progression, with unfortunate long-term effects.

Turning to the second category, 2020 has scrambled balance sheets across the economy. While household balance sheets are generally in good shape, this has come at the expense of government finances. The federal government increased its liabilities to fund transfers that, in many cases, have turned into household assets. Again, it must be noted that the relative strength of household balance sheets is in the aggregate. Certainly, the pandemic has led to significant economic hardship for many, as a large number of households struggle to pay bills and purchase necessities. One of the defining features of the pandemic has been the unevenness of its economic impact. There has been substantial variation in how different industries, professions and geographies have been affected, with some sectors reporting record activity even as others have seen demand collapse.

On the business side, nonfinancial corporations have further increased borrowing from already elevated levels, in part to cover pandemic-related holes in revenue but also, for larger corporations, to take advantage of near-zero interest rates and favorable borrowing conditions. These shifts in balance sheets can have long-run impacts. For example, the large increase in government debt could limit a fiscal policy response during some future crisis. Higher levels of business debt could threaten financial stability, increasing the fragility of the financial system to prospective shocks.

Finally, looking at the third category, the pandemic

has likely unleashed, or at least accelerated, structural and technological changes that will continue to play out over years or even decades. These include a shift to remote work, as well as online retail and entertainment. While these changes could ultimately result in increased economic productivity, there will likely be near- and medium-term disruptions as resources shift between sectors. These changes also increase the risks around the value of capital in certain sectors—for example, commercial and retail real estate—which could in turn raise important financial stability considerations.

**Monetary policy**

An exceptionally uncertain economic outlook, with the chance of both downside and upside surprises, creates a complicated and difficult environment for monetary policy. While vaccines promise an eventual end to the virus's hold on the economy, there remains a substantial gap to be bridged before we get there.

Monetary policy is also playing an important role in supporting the economy, as it has since the start of the pandemic. In March 2020, the Federal Open Market Committee (FOMC) cut its policy interest rate to near zero and launched an aggressive balance sheet expansion program, purchasing large quantities of Treasuries

and mortgage-backed securities (MBS). While these purchases were initially directed toward smoothing market functioning, the expansion of the Fed's balance sheet also supports accommodative financial conditions, to the benefit of the overall economy. In September, the FOMC provided forward guidance, consistent with the Fed's new monetary policy framework, that interest rates would remain near zero until the labor market reached levels consistent with maximum employment and inflation had both risen to 2% and was on track to exceed 2% for some time. In December, the Committee further extended its forward guidance to cover its asset purchases, stating that it will continue to increase its holding of Treasuries and MBS by at least the current pace until substantial further progress has been made on its employment and inflation goals. Overall, the outlook is for monetary policy to remain accommodative for some time.

Clearly, in the current environment where the economy continues to heal, an accommodative policy stance is appropriate. It is too soon to speculate about the timing of any change in this stance. The Committee has agreed that further substantial progress in achieving high employment and average inflation at its 2% target is necessary before making adjustments. This wait-and-see approach will guide the trajectory of monetary policy. As the data come in, and the economy evolves, the public and markets should be able to adjust their expectations regarding the policy path. This feature of forward guidance is especially useful now given the heightened uncertainty around the outlook, stemming in large part from the path of the virus. In the near term, the risks are predominately negative, but once the pandemic is behind us, there is considerable scope for a snapback in activity.

However, as the economy recovers and the Committee judges progress toward its mandate for employment and inflation, policymakers will necessarily wrestle with judgments about the appropriate stance of its policy settings. With longer-term implications of the pandemic noted earlier unfolding over time, these deliberations are likely to be challenging. For example, how long lasting will the effects of the pandemic on the labor market be? Should we expect employment to return to its lows of early 2020? Or will changes in the structure of the economy and labor markets shift employment's long-run equilibrium?

Will inflation continue to fall short of central bankers' desired 2% long-run average, or will other dynamics take hold and shift inflation impulses? For example, although aggregate inflation, as measured by the personal consumption expenditure price index, remains muted, a few hard-hit services prices have played a disproportionate role in depressing the aggregate index. To the extent that a post-vaccine bounce-back boosts demand and prices in these sectors, including airfares and hotel accommodation, inflation could move up quickly. Other large contributors to the decline in inflation are a bit idiosyncratic, including owner-occupied housing and financial services. In contrast to these sectors, price inflation for many other categories of consumption (particularly goods) has moved up, sometimes quite sharply. Such a scenario does not suggest higher inflation is a near-term threat, but rather that inflation could approach the Committee's average inflation objective more quickly than some might expect.

Finally, will highly accommodative monetary policy seed imbalances in the economy that increase the fragility of the economy to the next inevitable shock? Will other mechanisms effectively mitigate and balance any destabilizing elements of a low-for-long rate environment?

The experience of the pandemic will undoubtedly leave its mark even as our nation's economy shows its resilience and recovers. Ultimately, the wisdom to understand this unfolding landscape and to respond with appropriate policy adjustments will set the course for achieving our objectives for financial stability, sustainable long-run growth, employment and inflation.

*This message is adapted from a speech President George delivered Jan. 12, 2021, to the Central Exchange in Kansas City.*

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