The Outlook for the Economy and Monetary Policy

Remarks by

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Thank you for the opportunity to participate in this year's Kansas Economic Outlook Conference. In my remarks today, I'll offer my thoughts on the U.S. economic outlook and the current stance of monetary policy. I will also describe recent revisions to the Federal Reserve's approach to setting monetary policy and how I see those changes influencing future policy choices.

The Economic Outlook

The recovery from the second quarter's historic fall off in economic activity has been more rapid than expected by me, by financial markets, and by many of our business contacts. Retail sales have bounced back to pre-pandemic levels and the labor market has made up considerable ground, with half of the 22 million jobs that disappeared in March and April having returned.

Two factors have been particularly important in driving the recovery. First, the rebound in activity reflects an evolution in the mechanisms for responding to the virus, as broadly implemented lockdowns shift towards more targeted restrictions and to an increased willingness by the public to engage in certain activities. Second, policy support, both fiscal and monetary, has played an essential role. It is particularly notable that even as wages and salaries fell a record amount in the second quarter, personal income, which includes transfer payments from the government, grew at the fastest pace in U.S. history and reached a new record high.

Monetary policy has also played an important part in buffering the effects of the crisis. The Fed responded quickly and aggressively, cutting its benchmark interest rate to near zero, purchasing Treasury securities and agency mortgage-backed securities at an unprecedented scale, and establishing a number of new credit facilities to promote the flow of credit.

While the recovery has so far been more pronounced than many expected, its gains have not been evenly distributed, due in part to the unequal toll the pandemic has taken across sectors of the economy. Some sectors, such as restaurants, and many other services consumed outside the home, have shown only a partial recovery, with some, such as movie theaters, still virtually shut down. Other sectors, including many durable consumption goods, have more than recovered, with home improvements, personal computers, and bicycles all showing considerable strength. Low interest rates have undoubtedly boosted the purchase of durable goods and underpinned the continued strength of the housing market.

The unevenness of the recovery is evident in the labor market as well. After peaking at 14.7 percent in April, the unemployment rate fell back to 7.9 percent in September; we are moving in the right direction, even if we still have a way to go. However, the sharp loss in jobs has been concentrated almost entirely in service-providing industries, normally a relatively stable part of the economy. Particularly hard hit by the initial disruptions were the retail and leisure and hospitality industries, though I will note that these sectors have also seen the largest gains in subsequent months. Another aspect of unevenness has been the disproportionate effect of the crisis on women. The unemployment rate for women has moved from being below that of men going into the crisis to now being above.

Many of the same dynamics that have been driving the national economy are at play here in Kansas. After spiking to almost 12 percent in April, the unemployment rate in Kansas has since fallen back to below 7 percent; better, but still considerably above the less than 3 percent rate we saw in March. While most of the lost jobs have been in the services sector, manufacturing has also taken a hit. This is most apparent in the aerospace sector, an important industry here in Wichita, where employment has fallen 20 percent from March with no signs of recovery. Given the global outlook for air travel and the airline industry, this weakness could persist for some time.

The crisis has also impacted agriculture. While many segments of the agricultural industry in Kansas had already been under pressure before the crisis, the pandemic has exacerbated the challenges. The prices of many major agricultural commodities produced in Kansas are lower today than before the crisis due, in part, to various disruptions connected to the pandemic. And while government support programs may limit some financial stress this year for Kansas farmers, headwinds in the sector appear likely to remain, and will also depend significantly on the course of the pandemic.

Though I have been encouraged by the pace of recovery, substantial risks to the outlook remain, with two deserving particular attention. First is the virus itself. As the Federal Open Market Committee (FOMC) has noted, the path of the economy will depend significantly on the course of the virus. A resurgence in the virus and the renewed imposition of control measures would likely throw the recovery off track. Already we have seen this dynamic play itself out to various degrees in Europe where cases have spiked again in many countries after falling over the summer. The economy is unlikely to fully recover until the virus no longer interferes with the public's day-to-day decision-making. That seems ultimately to depend on confidence that the virus can be effectively managed, such as with a vaccine.

Second, individuals and small businesses have been able to resume economic activity through substantial fiscal support. As the virus persists, and the funding provided to date dissipates, the recovery could stall. One sector that poses a particular risk is spending by state and local governments that have boosted spending on public health measures, while at the same time experiencing significantly lower tax collections. With deteriorating budget positions, state and local governments are cutting spending, and have already furloughed and laid off workers, leading to over a million fewer jobs in the sector relative to February.

In summary, the recovery has been encouragingly fast, but the risks around the outlook are substantial. We are not out of the woods yet.

The Federal Reserve's Framework Review and the Outlook for Monetary Policy

Before turning to the outlook for monetary policy, I think it is important to provide some background on the recent revisions to the Federal Reserve's monetary policy framework. The revisions marked the culmination of a process that was launched in early 2019, when the Federal Reserve began a review of how to best conduct monetary policy in an economic environment that has undergone some notable changes in recent decades. While the review pre-dated the pandemic and was targeted at longer-run structural changes in the economy, the pandemic has amplified many of these changes.

Two developments in particular have made the conduct of monetary policy more challenging in recent years. First, interest rates have fallen to levels that once seemed almost unthinkable, not just in the United States, but around the world. These lower rates have resulted, at least in part, from structural changes that have increased the amount that households and businesses want to save, while at the same time lowering the amount of desired investment. These changes include sluggish economic growth, coincident with lagging productivity, and an aging population. Regardless of the cause, lower interest rates reduce the capacity of the Federal Reserve to stimulate the economy, when necessary, through the traditional method of lowering the policy interest rate.

The second key development is that inflation dynamics have shifted such that the link between the pace of economic activity and inflation appears to have weakened. For some time, inflation has remained persistently low, even when the economy appeared to produce above its potential. Policymakers have seen that far lower levels of unemployment have been achieved without triggering inflationary pressures. This shift in inflation dynamics has prompted the Federal Reserve to rethink its monetary policy response.

It is intuitive that rising prices are viewed negatively by households unsure of how quickly, or even if, their own incomes will be increasing. And certainly, there is a consensus, backed by considerable historical experience, that *too* high inflation is bad for households and the economy.

Low inflation on the other hand is generally associated with low interest rates, and low interest rates pose a constraint on the Federal Reserve's ability to the stabilize the economy. Furthermore, low inflation can beget even lower inflation, if households and businesses start to anticipate it and shift down their expectations for inflation in the future. Under such conditions, central bankers worry that inflation expectations and actual inflation could spiral dangerously downward, further constraining monetary policy. Without the space to cut interest rates, the Federal Reserve is likely to have to rely more on asset purchases and other non-interest rate policies to address downturns in the economy. Though these policies have been viewed as effective, they can come at some cost. In particular, balance sheet policies have implications for financial imbalances, resource misallocation, and a further expansion of the Fed's footprint in financial markets.

Faced with a changed economy, the Federal Reserve changed its monetary policy framework in two significant aspects. First, the Committee clarified that it will accommodate low rates of unemployment. That is to say, policy would not be tightened in response to low unemployment in the absence of signs of sustained upward pressure on inflation. Prior to the pandemic, unemployment reached historically low levels for some time without causing an undesirable increase in inflation and it had become increasingly clear that defining a precise number for maximum employment was likely not appropriate. As a result, the FOMC's framework would not call for preempting inflation by tightening policy on the basis of tight labor markets alone.

Second, while maintaining its 2 percent inflation target in the longer run, the FOMC will now aim to achieve this objective by targeting an inflation rate that averages 2 percent over time. Thus, following periods when inflation has fallen persistently below 2 percent, the Committee would allow inflation to run above 2 percent for a period of time.

While the change to average inflation targeting may seem quite technical, let me explain how I see this adjustment affecting our policy decisions. My long-held view is that inflation running a bit under 2 percent or a bit above 2 percent is consistent with a longer-run 2 percent inflation objective. Given the volatility of inflation, and the imprecision with which it is measured, I have generally not been concerned by an inflation rate a few tenths off target on either side of 2 percent.

By allowing inflation to move above 2 percent for some time, the framework makes clear that the 2 percent target is not a ceiling on inflation. Monetary policy is most effective at steering inflation at longer horizons. The 2 percent objective provides the public a guidepost for the long-run. While the new consensus statement elaborates that this 2 percent long-run target is viewed through the lens of average inflation outcomes, no timetable for averaging was specified, avoiding a sense of undue precision over inflation outcomes. Instead, I interpret the revised consensus statement as a tolerance — and less as a promise to engineer — for inflation moderately above 2 percent for some time. Moreover, inflation should, in my view, continue to be viewed in the context of broader economic outcomes. Inflation temporarily and moderately above 2 percent is unlikely to warrant a policy response if the economy is otherwise functioning well.

The term "average" has attracted a lot of attention among the cottage industry of Fed watchers. From my standpoint, I see little benefit in getting too tied up in a precise mathematical formulation of "average." The challenge of adopting a precise definition of "average" inflation has familiar parallels to the challenges of adopting precise monetary policy rules. There are reasons why the FOMC has in the past avoided strict adherence to monetary policy rules, so it is unsurprising that the new framework is not a precise prescription for policy actions. The structure of the economy changes over time, as acknowledged by the framework review, and the FOMC's credibility will come from its flexibility in adapting to new circumstances rather than adhering to a formula.

At its September meeting, the FOMC moved to adjust policy in light of its revised framework. In particular, the Committee provided forward guidance that it expects to keep the policy rate near zero until inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time. I view this guidance as consistent with a message of patience. We are signaling that the committee is unlikely to preemptively tighten policy at the prospect that inflation is approaching 2 percent, but rather a willingness to wait until the data confirms its arrival.

Given an unsettled outlook for inflation, it is not yet clear how much patience will be required. The pandemic has affected prices in a variety of ways, and it will be difficult to assess the underlying pace of inflation until the dust settles. While overall inflation has weakened with the pandemic, the decline largely reflects the weight of a few sectors hard hit by a virus-induced collapse in demand. Many other sectors have seen inflation step up, due to supply disruptions or strong demand. In fact, looking at the change in prices across the individual categories that comprise consumer spending, more categories have recorded higher inflation than lower inflation since the onset of the pandemic. Good news on the virus could quickly boost inflation back to, or even above, 2 percent.

However, if the pandemic were to unleash a deeper and more prolonged recession, the drag on prices could be more pronounced. The Committee's recent interest rate guidance would suggest this would lead to a longer period of accommodative policy.

While the Committee has offered relatively explicit guidance for policy rates, it has so far provided only minimal guidance on another aspect of policy; that is the trajectory of our asset purchases, primarily Treasuries and Mortgage Backed Securities (MBS), and its intentions regarding the size and composition of the Fed's balance sheet. Following disruptions in financial markets in March, the Fed began purchasing large quantities of Treasuries and MBS. These actions proved very effective in calming financial markets, even as the pandemic exacted a tremendous toll on the real economy.

With market functioning having largely returned to pre-pandemic conditions, the September policy statement broadened the objective of asset purchases to include fostering accommodative financial conditions. It will be important to provide further detailed guidance on the Committee's intentions regarding these purchases. This is a matter of transparency and accountability, but also an important element of ensuring the effectiveness of the purchases. I look forward to discussing these issues with my colleagues.

Even as the economy continues to recover, the risks that lie ahead cannot be underestimated. The Federal Reserve has been active in its support of the recovery and we will continue to monitor the economy's progress closely.