Economic Conditions and the Path of Monetary Policy

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September 29, 2020

The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.

I would like to acknowledge the contributions of Tyler Atkinson, Jackson Crawford, Jim Dolmas, Marc Giannoni, Drew Johnson, Lutz Kilian, Evan Koenig, Karel Mertens, Anthony Murphy, Pia Orrenius, Alex Richter, Kathy Thacker, Jesse Thompson, Joe Tracy and Mark Wynne.

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In the September 2020 Federal Open Market Committee (FOMC) meeting, the Committee left the federal funds rate target range unchanged at 0 to 0.25 percent. The Committee also said that it "expects it will be appropriate to maintain this target range until 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."

I dissented from this statement because, while I expect it will be appropriate to keep the federal funds rate in the current range until the economy is on track to achieve the Committee's dual-mandate objectives, I believe that the Committee should retain greater policy rate flexibility beyond that point. In this regard, I believe that the difference between remaining "accommodative" and keeping rates at zero becomes increasingly important as we approach achievement of our dual-mandate objectives.

Once we have battled and moved beyond the COVID-19 pandemic over the next two to three years, I believe the world is likely to look very different than it does today—in ways that are predictable and ways that are likely not predictable. I would like future Committees to have the flexibility to adapt to those future economic conditions so they can use their best judgment in deciding on the appropriate stance of monetary policy.

In this essay, I will discuss various economic issues, briefly explain the Fed's new policy framework and discuss my views regarding the appropriate stance of monetary policy.

The U.S. Economy—Addressing the Pandemic

As a result of the coronavirus pandemic and the related shutdown, the U.S. economy contracted approximately 32 percent on an annualized basis in the second quarter of 2020, and the unemployment rate rose to 14.7 percent in April.[1] The U-6 measure of unemployment—which takes into account the unemployed, plus workers who have given up looking for a job and those working part-time who would prefer to work full-time—rose to 22.8 percent in April.[2] These figures compare to a prepandemic unemployment rate of 3.5 percent and a U-6 reading of 7.0 percent in February of this year.[3]

In response to the pandemic, the Federal Reserve cut the federal funds rate from a range of 1.5 to 1.75 percent in February to a range of 0 to 0.25 percent by March. In addition, the Committee initiated a program of purchases of Treasury securities and agency mortgage-backed securities (MBS) totaling at least $500 billion and at least $200 billion, respectively, at a pace appropriate to support the smooth functioning of markets for Treasury securities and agency MBS. From mid-March until the end of May, Fed holdings of Treasury securities increased $1.5 trillion and holdings of agency MBS increased approximately $500 billion.[4] Since May, the pace of additional purchases has been $80 billion of Treasuries and $40 billion of agency MBS per month.

The Fed also lowered the rate charged to banks at the discount window from 225 basis points to 25 basis points (reflecting a 150 basis-point reduction in the fed funds rate and a 50 basis-point narrowing in the spread of the primary credit rate relative to the top of the target range) in order to help ensure banks had sufficient liquidity and the ability to lend to customers.

In late March, Congress passed the Coronavirus Aid, Relief, and Economic Security (CARES) Act. This act authorized the Treasury to make equity investments in a range of liquidity and credit facilities established by the Federal Reserve under section 13(3) of the Federal Reserve Act. These programs were aimed at stabilizing money market funds and the markets for corporate bonds, asset-backed securities and municipal bonds.[5] These and other actions helped to restore market functioning and helped to improve access to capital for small, mid-sized and large businesses.

As part of the CARES Act, Congress also authorized the Paycheck Protection Program (PPP). This program, administered by the Small Business Administration, allowed banks to provide forgivable loans to small businesses in order to maintain their payrolls, hire back employees who may have been laid off, and cover applicable overhead. The CARES Act also authorized additional unemployment insurance benefits and one-time cash payments which allowed millions of families to receive vital income support as a result of heightened unemployment amid the economic contraction.

As a result of extraordinary efforts to limit the spread of the virus through lockdowns and adherence to public health protocols, the incidence of the virus declined sufficiently in April and May to allow several states to begin the process of reopening their economies. It is the view of Dallas Fed economists that the U.S. economy likely bottomed out in April and began to grow again in May and June.

However, due to a resurgence of the virus in certain states beginning in June, the rate of growth slowed somewhat in July and August. Through the reimposition of targeted business closures and the heightened emphasis on adherence to public health protocols of social distancing and mask wearing, the rate of transmission of the virus began to moderate in August and September. Even with these reopening challenges, the economy has recovered faster than expected, and Dallas Fed economists forecast that third-quarter gross domestic product (GDP) growth in the U.S. will be approximately 30 percent at an annualized rate.

The Labor Market

The August headline unemployment rate stood at 8.4 percent, and the U-6 measure of unemployment was 14.2 percent.[6] In addition, the labor force participation rate—the rate at which those 16 years old and older are either employed or actively looking for work—was 61.7 percent (this compares with a reading of 63.4 percent in January 2020).[7] However, the overall labor statistics mask much greater hardship among key groups in our society. In particular, the unemployment rates of Blacks and Hispanics increased to 16.7 percent and 18.9 percent, respectively, in April.[8] This outpaced the unemployment rate of whites, which peaked at 14.2 percent.[9] While today the unemployment rate for whites has declined to 7.3 percent, the unemployment rate for Blacks and Hispanics remains more elevated at 13.0 percent and 10.5

percent, respectively.[10] These disparities are indicative of how the pandemic has disproportionately impacted person-to-person service sector jobs, and those with lower levels of educational attainment (*see page 5 of this essay*). These statistics reinforce the need for greater efforts to invest in education and skills training in order to create a stronger and more inclusive labor market and help ensure that key groups of our society are not left behind in this recovery.

Consumer Spending

One of the unusual aspects of this pandemic has been the mix and overall resilience of consumer spending. In spite of the severe damage to employment and small businesses since the start of the pandemic, we have seen that consumer spending on goods has been very strong. While goods spending has exceeded prepandemic levels since June, we are seeing that spending on services has improved but is still below prepandemic levels.

The strength in consumer goods spending is significantly different from prior recessions. In past recessions, consumer spending on services has typically remained steady while durable goods consumption has declined. Dallas Fed economists believe that the resilience of consumer spending during this pandemic has been bolstered by a substantial level of fiscal relief, particularly in the form of one-time payments and supplemental unemployment benefits. As a result, aggregate personal income levels have actually exceeded pre-COVID levels,[11] something unique to this recession. Of course, a key risk we are watching carefully is the potential waning of unemployment benefits and other forms of fiscal relief, which could cause more typical recessionary dynamics to emerge. The emergence of these dynamics would certainly create headwinds for continued recovery.

The Outlook

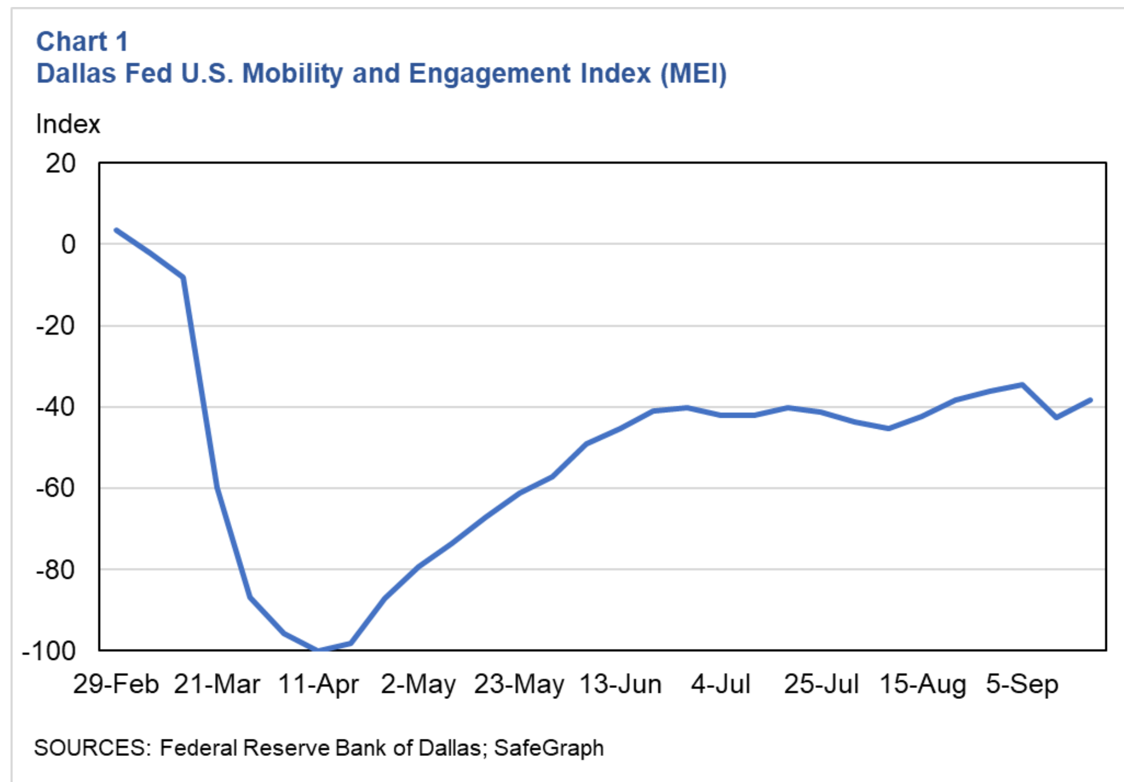
Dallas Fed economists expect continued growth through the rest of this year. We expect that 2020 GDP will show a contraction of approximately 3.0 percent and that the unemployment rate will end the year at approximately 7.5 percent. Inflation, as measured by core personal consumption expenditures (PCE), is expected to be running at approximately 1.6 percent by year-end 2020.[12] We forecast that the U.S. economy will grow by roughly 3.5 percent in 2021 and that the unemployment rate will decline to approximately 5.7 percent by year-end 2021. Inflation is expected to modestly accelerate, increasing to approximately 1.8 percent by year-end 2021. These forecasts are, of course, highly uncertain because they are heavily dependent on the path of the virus and the level of adherence to public health protocols, such as mask wearing and social distancing. They also depend heavily on continued fiscal support, as well as the timing of a potential vaccine that is effective and can be widely administered.

Tracking Mobility and Engagement

A primary determinant of the rate of growth for the remainder of this year and next year will be the incidence of the virus. In order to monitor the impact of the virus on the economy, we track mobility through a metric called the Dallas Fed Mobility and Engagement Index (MEI). This index combines several different measures of the spatial behavior of anonymized cellphone users in order

to gauge the level of engagement of the population in a wide range of activities. This measure has allowed our economists to gain real-time insight into the economic impact of the pandemic. The MEI is measured daily, at the national, state and county levels.[13]

The U.S. measure of this index stood at +3 in the week ended Feb. 29. It began to deteriorate sharply in the week ended March 14. It bottomed out at -100 in the week ended April 11 and then began to improve substantially in late April. The index continued to improve sharply until mid-June (with a reading of approximately -40) and then began to stall out as COVID cases surged in the southern and western portions of the U.S. Since August, this measure has shown modest improvement, and it currently sits at approximately -38. Chart 1 tracks the progression of this index in the U.S. since late-February 2020.



It is our view that this MEI measure is a good proxy for the direct impact of the pandemic on economic activity and highlights trends in the economy. Dallas Fed economists believe that the MEI is highly correlated with the path of the virus, especially when cases are rising. This index highlights the importance of limiting the spread of the virus while maintaining or improving the level of mobility. Our effectiveness in managing this virus will continue to be a primary determinant of economic growth in the U.S. How well do we follow health protocols of social distancing and mask wearing? Will there be a vaccine which can be widely distributed? These questions will help determine how quickly we return to higher levels of engagement and, as a consequence, how fast we recover from this pandemic.

Structural Changes in the U.S. Economy: Demographics, Productivity and Technology-Enabled Disruption

In the months and years leading up to the pandemic, I spoke regularly about some of the key structural challenges facing the U.S. economy (*see the essay "Economic Conditions and the Key Structural Drivers Impacting the Economic Outlook," Oct. 10, 2019*). Sluggish workforce growth due to aging of the population has created a headwind for GDP growth. Finding ways to improve workforce growth is likely to be critical to improving GDP growth in the U.S. Sluggish productivity growth has also created headwinds to economic growth. Our economists believe that addressing lagging early-childhood literacy, improving educational attainment levels, beefing up skills training across the U.S. and creating more access to broadband as well as other targeted infrastructure investments are likely to be key structural changes necessary to improve productivity. These investments will particularly help to improve the future adaptability and employability of those with lower levels of educational attainment.

We have seen in this pandemic that job losses have disproportionately impacted those with lower levels of educational attainment. In April, at the height of the pandemic, those individuals with less than a high school diploma had an unemployment rate of approximately 21.2 percent, while those who had completed college with a bachelor's degree had an unemployment rate of approximately 8.4 percent.[14] This disparity reflects the fact that those with lower levels of educational attainment may be more likely to be employed in person-to-person service sector jobs and, as a consequence, are less likely to be able to work remotely.[15] As a result, these workers have been much more vulnerable to job losses and losses of income. In a world where technology and technology-enabled disruption is accelerating, improving the adaptability of lower-income workers is likely to be a major challenge.

The emphasis on remote work and engagement has meant that people are spending their time and their money in dramatically different ways than before. They are far more likely to be conducting meetings remotely, traveling less, buying goods online and having their purchases of goods delivered. This acceleration in the rate of technology and technology-enabled disruption is changing the competitive landscape in a wide range of industries. Some of these changes may reverse after we have weathered this pandemic, while others are likely to be more lasting.

As was the case leading up to the pandemic, this trend is likely limiting the pricing power of businesses. To respond to this trend, businesses are investing substantially more in technology to replace people, lower their costs and improve their competitiveness. This trend is evidenced by the increasing percentage of nonresidential fixed investment accounted for by investments in computer and peripheral equipment, and spending on software.

Energy Developments

I have spoken throughout this year about the enormous challenges the coronavirus has posed for the U.S. energy industry. In early March, after OPEC-plus failed to reach an agreement on production cuts, Saudi Arabia announced that it would cut its selling prices and increase its crude oil production. This retaliatory announcement was coincident with the beginning stages of an

unprecedented decline in global oil demand as a result of COVID. These events have had significant negative implications for U.S. oil production.

It is the view of our energy economists that U.S. oil production will decline from approximately 12.8 million barrels per day (mb/d) in December 2019 to approximately 10.7 mb/d by December 2020.[16] Oil production from the Permian Basin is expected to decline from approximately 4.7 mb/d in December 2019 to approximately 3.8 mb/d in December 2020.[17] Consistent with this, the number of oil wells completed is projected to fall 50 percent from 2019 to 2020, and overall U.S. exploration-and-development capital spending will likely decline by approximately 50 percent in 2020.[18]

Our economists believe that U.S. oil production growth will likely be flat during 2021. This forecast assumes that new drilling and well completions will be sufficient to replace declining production from existing wells.

Global energy consumption fell to approximately 83 mb/d in the second quarter, a decline of nearly 17 percent from prepandemic levels.[19] During the subsequent recovery, consumption has risen to nearly 90 mb/d.[20] Of course, future levels of demand will be heavily impacted by the timing of when individuals increase their engagement in a broader range of transportation activities, including the extent to which they return to airline travel. Balancing this weakness in demand with a substantial decline in production, it is the view of Dallas Fed energy economists that global excess oil inventories will not be worked off before late 2021.

The Fed's New Monetary Policy Framework

On Aug. 27, the Federal Reserve announced amendments to its monetary policy framework.[21] This announcement was the culmination of a two-year review of its policy framework, which involved three distinct components. First, the Federal Reserve hosted a series of Fed Listens events across the country to engage various stakeholders to hear directly from them about how monetary policy decisions affect their communities. Second, the Federal Reserve convened a research conference at which prominent academic experts addressed economic topics central to the review. Finally, over the course of several meetings, the Committee explored a range of issues that were brought to light during the review. In its new framework, the FOMC made key changes with regard to both parts of its dual mandate—maximum employment and price stability.

On maximum employment, the FOMC emphasized that maximum employment is a broad-based and inclusive goal and reported that its policy decisions would be informed by its "assessments of the *shortfalls* of employment from its maximum level." The original document referred to "*deviations* from its maximum level." The previous expansion demonstrated the benefits of a strong labor market and the difficulty of assessing the level of maximum employment in real time. Unemployment fell to levels previously thought to be unsustainable, and we were able to bring in many workers who had previously been left behind. This occurred against the backdrop of relatively muted inflation. Based on this experience, the Committee decided to change the policy framework to signal that higher employment, in the absence of unwanted increases in inflation or the emergence of other risks, will not by itself be a cause for policy concern.

On price stability, the FOMC adjusted its strategy for achieving its longer-run inflation goal of 2 percent by noting that it "seeks to achieve inflation that averages 2 percent over time." The revised policy states that "following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time." This change was made in an effort to ensure that inflation expectations do not drift down over time and that they remain well-anchored at 2 percent. If inflation expectations were to drift lower, the nominal level of interest rates would be lower, too, leaving less room for the FOMC to cut rates when needed to support the economy.

The Stance of Monetary Policy

The September FOMC Decision

In light of the economic devastation caused by the virus and related lockdowns, I believe it has been appropriate for the Federal Reserve to take extraordinary actions to stabilize markets and to improve access to capital for small, mid-sized and large businesses. In addition, I believe it has been appropriate for the Fed to maintain the setting of the federal funds rate at 0 to 0.25 percent and to purchase Treasury securities and agency mortgage-backed securities to support the smooth functioning of these markets and to provide some additional level of accommodation during the pandemic.

In my September meeting dissent, I emphasized that I believe the current setting of the federal funds rate will be appropriate until the Committee is confident that the economy has weathered the pandemic and is on track to achieve its maximum employment and price stability goals as articulated by the new policy framework. My best judgment is that it will take at least until late 2022 or sometime in 2023 for these criteria to be met. However, beyond that point, I believe that the Committee should retain greater policy rate flexibility to decide on the appropriate stance of monetary policy.

*Accommodative Versus Zero—The Role of R**

There is an important difference between remaining "accommodative" and keeping rates at zero. I believe, after we have fully weathered this crisis, we should be willing to be more accommodative than in the past in order to create a stronger and more inclusive labor market and make progress on achieving our 2 percent average inflation target. However, I am cognizant that as the economy approaches full employment and we are on track to reach our price stability objectives, the equilibrium nominal rate of interest (the federal funds rate at which monetary policy is neither restrictive nor accommodative—often referred to as R*) is likely to increase. This means that as we approach achievement of our dual-mandate objectives, the stance of monetary policy will actually become more accommodative if the fed funds rate were to remain at zero. I can understand why future Committees will want to remain accommodative at that point in order to ensure we achieve our goals, but will they want to be effectively increasing the level of accommodation by keeping the federal funds rate at zero? I would like future Committees to have the flexibility to make this judgment.

Monitoring Excessive Risk Taking

I believe there are real costs to keeping rates at zero for a prolonged period of time. Keeping rates at zero can adversely impact savers, encourage excessive risk taking and create distortions in financial markets. Excessive risk taking and distortions in financial markets could lead to greater fragilities, excesses and imbalances which could ultimately jeopardize the attainment of the Fed's objectives. These fragilities and tail risks are often much easier to recognize in hindsight than in real time. For example, some market observers have commented that the seizing up of financial markets in March was due in part to COVID and related shutdowns but may have also been due, in part, to some amount of forced selling by over-risked market participants. While the Federal Reserve has oversight and visibility regarding banks in the U.S., it does not have supervisory jurisdiction or a high level of visibility regarding the nonbank financial markets.

Adapting to a Changing World

The post-COVID economy is likely to look very different from the economy we are in today. I am reluctant to restrict the ability of future Committees to use their best judgment to adapt to these changes in ways they believe help achieve our dual-mandate objectives. Future Committees will need to assess the implications of acceleration in the rate of new technology adoption and technology-enabled disruption, changes in our views regarding how monetary policy impacts inflation, changes in tax policy, changes in regulatory policy, changes in trade policy, the role of the dollar as the world's reserve currency, and other developments—some foreseeable and some that are hard to predict as we sit here today. One of the great strengths of the FOMC is the gathering of a diverse group of decision-makers who are empowered to share views, energetically debate and ultimately use their best judgment, based on analyses of current and expected economic conditions, in order to make sound policy decisions that are forward looking.

For example, the pandemic has dramatically accelerated investment by for-profit and not-for-profit enterprises in technology and the adoption of new models that accelerate the trend of technology-enabled disruption. These trends are likely to continue to mute the pricing power of businesses. The expected strengthening of this structural trend may well offset the cyclical inflationary impact of a tightening job market. It is unclear to me how these structural forces will interact with the cyclical forces in impacting inflation in the years ahead. In addition, I believe that we will learn a lot over the next two years about the impact of monetary policy on achieving our inflation goals, and I believe more research needs to be done on pricing dynamics and technology-enabled disruption.

The Rationale for Forward Guidance

Forward guidance is communication by the Fed which indicates its intentions regarding the likely future path of monetary policy. It can be a powerful tool that comes with potential benefits and costs. A commitment to keeping rates at zero based on certain conditions being met can, in principle, help lower today's longer-term yields and, thus, provide additional stimulus that could accelerate the economy's return toward our longer-run goals. However, I am skeptical about the

benefits of enhanced forward guidance at the moment because rates are already historically low and, even before this meeting, market expectations were for them to stay low for the next few years. In addition, the latest FOMC Summary of Economic Projections indicated that the bulk of FOMC participants expect the federal funds rate to remain at 0 to 0.25 percent through the end of 2023. Given these expectations, it was my preference to defer using enhanced forward guidance as a tool until a time in the future when the benefits would be more compelling.

Looking Forward

I believe that, today, our primary focus should be on fighting the COVID pandemic and getting the U.S. economy on track to meet our dual-mandate objectives of full employment and price stability. This means keeping the federal funds rate at its current setting, continuing our 13(3) programs until we judge that they are no longer required, and considering use of other tools. In addition, I believe there needs to be continued focus on doing more to help small and mid-sized businesses get access to capital.

While monetary policy will play a critical role in the recovery, we will also need additional fiscal measures that provide relief to the unemployed and those working part time who would prefer to work full time. In addition, fiscal relief would be highly beneficial to state and local governments that are trying to recover from a fiscal hole created in the first and second quarters of this year. Lack of additional fiscal relief would create a key downside risk to my economic forecast for 2020 and 2021.

While appropriate monetary and fiscal policies are critical to recovery, a primary determinant of the rate of recovery will be how well we manage the virus—particularly, wearing masks, social distancing and rigorously following other public health protocols. In addition, we must continue to invest in the development of widespread, rapid and accurate testing as well as work to beef up our ability to do effective contact tracing. Even with an effective vaccine, which will hopefully be approved in the next several months, these measures are likely to be vital until we are able to confidently inoculate the bulk of the population.

I remain confident that the U.S. economy will recover from the COVID crisis as each of us continues to do our part. I am also confident that the Federal Reserve will do all that it can to make sure we successfully recover from this pandemic and move the economy forward toward achieving our full employment and price stability goals.

Notes

[1] Data are from the Bureau of Economic Analysis (BEA), published Aug. 27, 2020, and from the Bureau of Labor Statistics (BLS) as of August 2020.

[2] As of August 2020. Data are from the BLS.

[3] See note 2.

[4] Data are from the Federal Reserve Bank of New York.

[5] See "Federal Reserve Takes Additional Actions to Provide up to $2.3 Trillion in Loans to Support the Economy," Federal Reserve Board of Governors, published April 9, 2020.

[6] See note 2.
[7] See note 2.
[8] See note 2.
[9] See note 2.
[10] See note 2.
[11] Data are from the BEA, published Aug. 28, 2020.
[12] This compares to a 12-month core personal consumption expenditures inflation rate of 1.9 percent in February 2020, according to the BEA. See note 11.
[13] For more information regarding the MEI and its methodology, see "Dallas Fed Mobility and Engagement Index Gives Insight into COVID-19's Economic Impact," by Tyler Atkinson, Jim Dolmas, Christoffer Koch, Evan Koenig, Karel Mertens, Anthony Murphy and Kei-Mu Yi, *Dallas Fed Economics*, May 21, 2020.
[14] See note 2.
[15] See "Working from Home During a Pandemic: It's Not for Everyone," by Yichen Su, *Dallas Fed Economics*, April 7, 2020.
[16] Data are from the International Energy Agency (IEA) and the Federal Reserve Bank of Dallas.
[17] See note 16.
[18] Data are from the Federal Reserve Bank of Dallas.
[19] Data are from the IEA.
[20] See note 18.
[21] See "Statement on Longer-Run Goals and Monetary Policy Strategy," Federal Reserve Board of Governors, amended Aug. 27, 2020.