

An Uncertain (Though Optimistic) Outlook for an Uneven Economy

Remarks by
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The views expressed by the author are her own and do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives.

Thank you for inviting me to participate in today's program. I appreciate the opportunity to speak with you and look forward to our discussion. Agriculture is a particularly important sector for the region I serve. Today, I will share my observations on the agricultural economy along with the national economic outlook, concluding with some thoughts on monetary policy. As always, my views are wholly my own.

The pandemic continues to set the course for the economy, as it has for almost a year now. As the pandemic unfolded and intensified last spring, contacts across our seven-state region painted a very bleak picture for the state of agriculture. The prices of major ag commodities fell sharply between February and April. A dramatic decline in travel and gasoline consumption cut demand for U.S. ethanol in half, weighing on corn prices. At meatpacking plants, COVID-19 outbreaks caused temporary closures at numerous facilities across the country, disrupting supply chains and putting producers in a seemingly no-win situation with animals ready to be sold. In addition, the closure of restaurants and food service establishments led to an unprecedented shift in consumer buying behavior, adding further pressure to an already-stressed food supply chain.

As economies around the world gradually began to reopen during the summer months, and supply chains began to adapt and recover, economic conditions in agriculture also began to improve. Supported by robust demand from China, corn and soybean prices returned to their pre-pandemic level as the harvest began. Aided by substantial support from various government programs, we began to hear renewed optimism in the farming community through harvest and heading into winter.

By the end of the year, businesses connected to agriculture reported a surge in sales activity as crop prices rebounded to their highest mark since 2013. And, while some industries, particularly livestock, remain under pressure due to drought, higher input costs and persistent

uncertainties—to name just a few—the outlook for agriculture in large parts of the country has improved dramatically. For the first time since the agricultural downturn began several years ago, ag lenders have reported stronger loan repayments and improved liquidity with prospects for an increase in land values this year.

While these recent improvements are encouraging, risks to the outlook remain. Many of those risks and uncertainties are tied to the national economic outlook.

A surge in the virus towards the end of last year left a noticeable impact, slowing consumption and stalling the recovery in the labor market. It is encouraging that this latest wave of cases appears to have crested and that the pace of vaccination has accelerated. But it also remains clear that we are not out of the woods yet, with the risk that infections could pick up once again, perhaps aided by new variants of the virus. This is just to say that the virus remains in the driver's seat. Economic policy can help mitigate the economic effects of the virus, but it is almost impossible to imagine a full economic recovery until the virus no longer impinges on the day-to-day decision making of households and businesses.

The continued drag of the virus is most apparent in the labor market, where we remain about 10 million jobs short relative to before the pandemic. About a third of those missing jobs are in the high-contact leisure and hospitality sector, and are unlikely to return in strength until the virus fades. While the unemployment rate has continued to edge down, falling to 6.3 percent in January from almost 15 percent in April last year, this number likely underestimates the amount of slack in the labor market. In particular, the labor force participation rate remains about 2 percentage points below its pre-pandemic level, suggesting many workers, having lost their jobs, have dropped out of the labor force, or are at least sitting on the sidelines. This is

particularly true for women, with disruptions in child care likely leading to many difficult choices and lower participation in the labor market.

Though we remain short of where we would like to be, the stage is set for a strong recovery once widespread vaccination is achieved. The strength and timing of this bounce back is contingent in my view on three uncertain factors: first, the pace and effectiveness of vaccination; second, the outlook for further fiscal stimulus; and third, whether and to what degree households run down the savings that they have accumulated so far through the crisis.

Starting with the first of these factors, once the virus is suppressed, I expect a strong rebound in demand for many of the most afflicted sectors, including travel, live entertainment, and of particular importance to the agricultural sector, restaurants. In addition, the normalization of child care arrangements could allow for the quick return of some currently sidelined workers. The faster and more effective the vaccination program, the greater the prospects for a faster and stronger economic recovery.

Turning to the second factor, fiscal support has been essential for maintaining economic activity through the pandemic. The Paycheck Protection Program has provided significant support to small businesses, allowing many to avoid the cost and disruption of bankruptcy or closure. Transfer payments to households and enhanced unemployment benefits have supported consumer spending, especially at businesses relatively insulated from the direct effects of the pandemic. With the economy still in the grip of the pandemic, previously enacted fiscal measures continue to play an important role in supporting growth. Further fiscal stimulus, as is currently being discussed, would undoubtedly accelerate growth. However, by exactly how much is uncertain. The package being discussed is heavily weighted towards transfer payments, to

households and state and local governments. Similar to the previous rounds of fiscal support, a substantial portion of these transfers could be saved rather than spent immediately.

Which brings me to the third factor likely to determine the speed and strength of the recovery: how households, in the aggregate, treat the excess saving that they have accumulated during the pandemic. Partly as a consequence of restrictions on activity, but mostly on account of large fiscal transfers, the personal saving rate shot up to a record high in the second quarter. Though it has since fallen back, the saving rate remains about twice as high as it was prior to the pandemic. All told, it has been estimated that over the past year households have increased their savings (or paid down their debt) by about \$1.5 trillion relative to normal levels. A consequence of this accumulation makes aggregate household balance sheets look stronger, even as it masks that many individual households find themselves in a difficult financial position.

This improvement in household finances, which is atypical coming out of a recession, puts households in a strong position to resume spending once the pandemic is in the rearview mirror. This is especially true if the run up in saving reflected an inability to consume due to pandemic-related restrictions. However, given the shock that the pandemic has delivered to the economy and households, there is some uncertainty as to how quickly or forcefully households will want to run off their saving buffer or resume accumulating debt. If households remain relatively cautious given a new understanding of possible health and economic risks, the recovery will be slower and lengthier.

Given the uncertainties around the outlook, monetary policy remains highly accommodative, and is set to remain so for some time in line with the Federal Open Market Committee's (FOMC) forward guidance. The Committee has stated that it expects to keep the policy rate near zero until the labor market has reached levels consistent with maximum

employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time. The FOMC also expects to maintain its purchases of Treasuries and mortgage-backed securities until substantial further progress has been made towards these employment and inflation goals.

Based on this guidance, the FOMC is positioned to be patient as it follows the outlook for the virus and the economy. Certainly, it is too early to discuss pulling back on accommodation given continue elevated unemployment, below-target inflation, and the uncertainties surrounding the outlook. Likewise, the notable recent rise in longer-term interest rates does not in my view warrant a monetary policy response for several reasons.

First, most of the rise in the ten-year Treasury this year appears to reflect an increase in the real yield, that is the interest rate controlling for inflation compensation. Much of this increase likely reflects growing optimism in the strength of the recovery and could be viewed as an encouraging sign of increasing growth expectations. If this is indeed the reason that yields are increasing, they are unlikely to rise to the point of smothering the optimism that led to their increase in the first place, and measures of real yields remain deeply negative and only a touch off all-time lows.

Second, any additional stimulus could exacerbate the unevenness that has been the defining characteristic of the pandemic downturn. Already, although appropriate, it seems likely that easing of monetary policy over the last year has contributed to the observed unevenness. In particular, interest-sensitive sectors, including housing and durable goods consumption have done quite well during the pandemic, supported by accommodative monetary policy, with many of these sectors reporting record years. Less interest-sensitive sectors, including many services,

have benefited less, at least directly, from accommodative monetary policy while also suffering the worst of virus-related disruptions.

It is unusual for a recession to affect services more adversely than goods-producing sectors. In most recessions, interest-sensitive sectors, such as durable goods consumption, are generally hit harder than non-interest sensitive sectors, such as services, and accommodative monetary policy—by lowering interest rates—works to buffer the unevenness of a typical recession. Given the unique nature of the pandemic shock, things are different this time. The shock has hit services spending harder than goods spending, and lower interest rates have likely contributed to unevenness rather than buffered it. In this situation, further monetary stimulus seems unlikely to help close gaps in the most virus-afflicted sectors while simultaneously running the risk of exacerbating imbalances and shortages in interest-sensitive sectors.

A third reason for patience on the part of policymakers, in my view, is the likelihood of a strong bounce back in activity as vaccination proceeds. Monetary policy tends to influence the economy with a meaningful lag, and therefore further monetary stimulus at this point could easily be mistimed.

With a patient stance of accommodative monetary policy, the prospect of a strong rebound in activity, and signals of higher inflation compensation in the ten-year Treasury yield, there has been considerable speculation about the risk of higher future inflation. Right now, the inflation picture is a muddled one.

Last August, the Federal Reserve announced a revised framework for the conduct of monetary policy. One motivation for the revised framework was a desire to firm up inflation expectations at a level consistent with the Fed's 2 percent inflation objective. In this regard, the Committee announced that the Fed would seek inflation that averages 2 percent over time, such

that periods of inflation persistently below 2 percent would be followed by periods of inflation moderately above 2 percent. By shoring up inflation expectations, the Fed hopes to limit further slippage in nominal interest rates and decrease the risk of interest rates hitting zero and constraining monetary policy. In this regard, the recent increase in inflation compensation is a promising signal that markets take seriously the Fed's commitment to stabilize inflation expectations near its 2 percent objective.

Currently aggregate PCE inflation remains a bit short of that objective, running at 1.3 percent over the year ending in December, as the pandemic has hit some prices particularly hard, including airfares and hotel accommodation. Notwithstanding muted inflation in the aggregate, the components of this measure reveal a particularly muddled inflation picture. While some prices are down, other sectors, particularly durable goods, are recording their fastest price increases in decades. In fact, by some measures, the dispersion in inflation across sectors has never been greater, a further indication of the current uneven economy.¹

One consequence of such wide dispersion is that any measure of overall inflation becomes less meaningful. Overall inflation is constructed by averaging inflation across individual sectors weighted by their importance in aggregate consumption. While we would like for overall inflation to reveal the trend in prices across the entire economy, a wide dispersion in inflation across individual sectors makes overall inflation less informative for that trend. As an example of this, with very disparate inflation it is likely that individual households are currently experiencing very different inflation rates dependent on the distinct set of goods and services that they consume. Certainly some households might be surprised to hear that overall inflation is

¹ For example, the product of the fraction of expenditures experiencing two-standard deviation declines in inflation and the fraction of expenditures experiencing two-standard deviation increases in inflation reached a record high in November.

subdued given the particular basket of goods and services that they are consuming. More generally, it is also worth recognizing that overall inflation could firm up quickly post-vaccination as demand for hard-hit sectors recovers.

Monitoring these price signals and progress on employment will remain essential even as the FOMC takes a patient approach to monetary policy. Once the fog of the uncertainties currently obscuring the outlook clears, those policy settings will necessarily be reconsidered.