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The Pandemic Endgame Begins

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Power Up Little Rock: U.S. Economy and Monetary Policy
Little Rock Regional Chamber

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Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee.

Introduction

Key themes

- The pandemic has worsened in the U.S. and Europe, but the early arrival of vaccines suggests the health crisis will wane in the months ahead.
- U.S. monetary and fiscal policies have been exceptionally effective and were designed for a larger shock than the one that has occurred.
- U.S. tracking forecasts of fourth-quarter real GDP growth are well above trend.
- Some downside risk remains, and continued execution of a granular, risk-based health policy will be critical to maintain economic momentum.

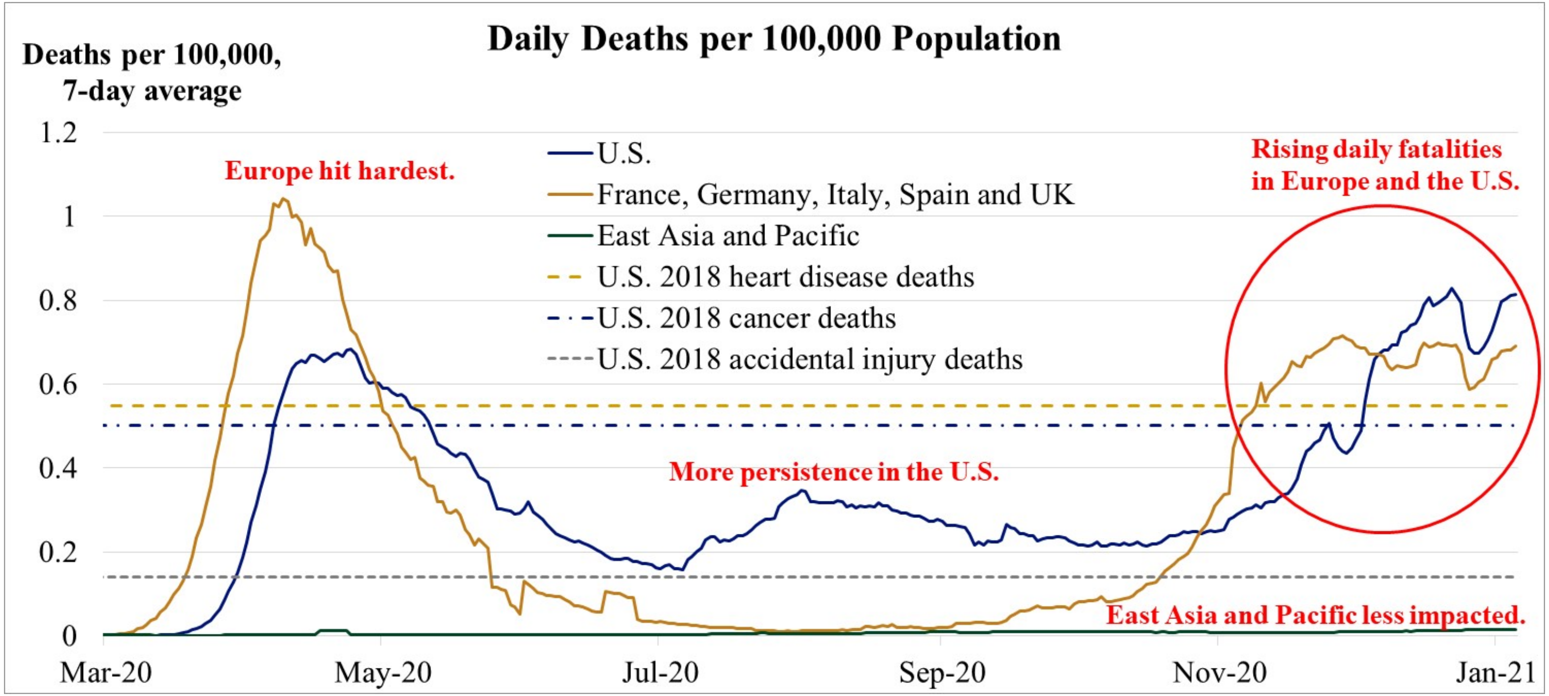
Health Crisis Worsens but Is Expected to Wane

Fatality rates and economic activity

- The global health crisis requires continued daily management.
- Daily fatalities per 100,000 population have increased in both Europe and the U.S.
- East Asia and Pacific countries continue to report daily fatalities per 100,000 population that are an order of magnitude lower than those of the U.S. and Europe.
- Key areas of global production are well past the initial phase of the crisis but must maintain safety protocols.*

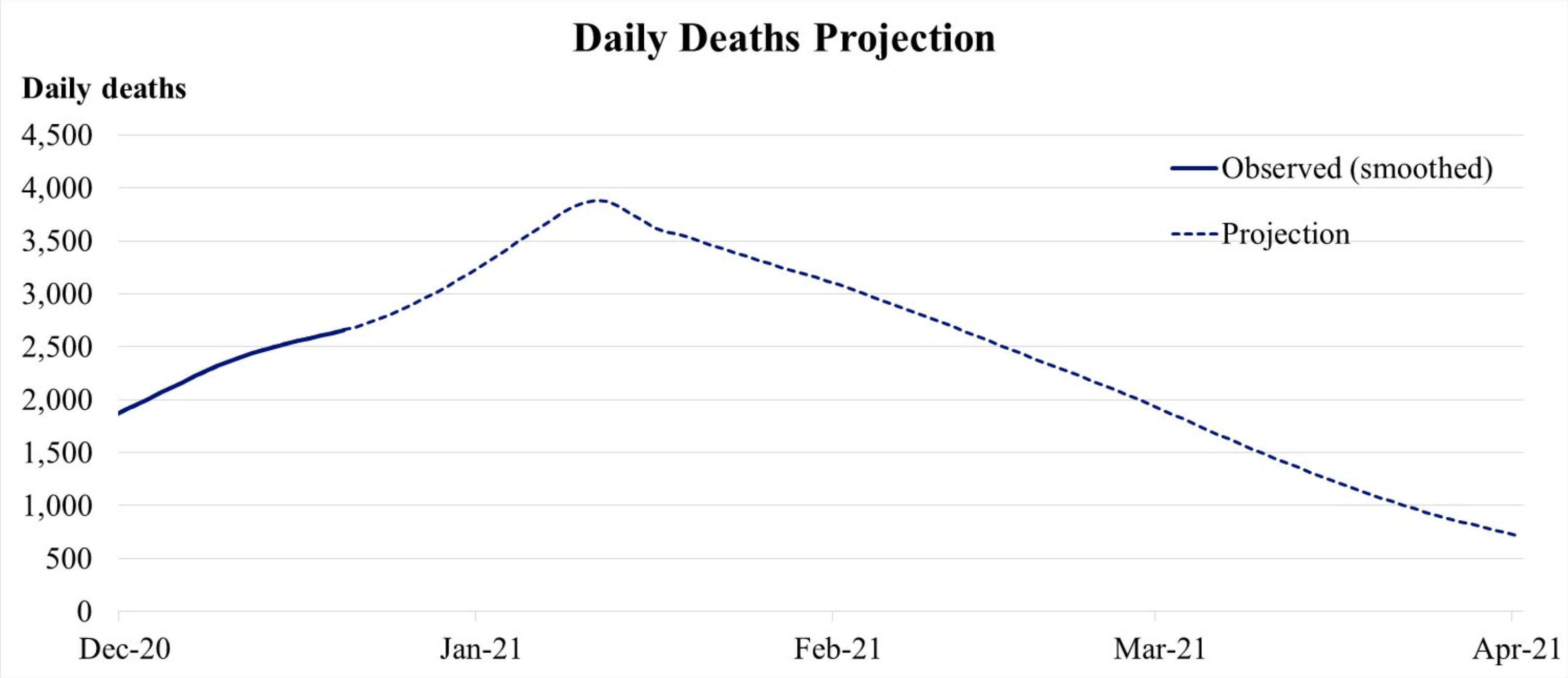
* *For an analysis of fatality rate data worldwide, see A. Atkeson, K. Kopecky and T. Zha, 2020, "Four Stylized Facts about COVID-19," National Bureau of Economic Research, Working Paper No. 27719.*

Health outcomes worsen



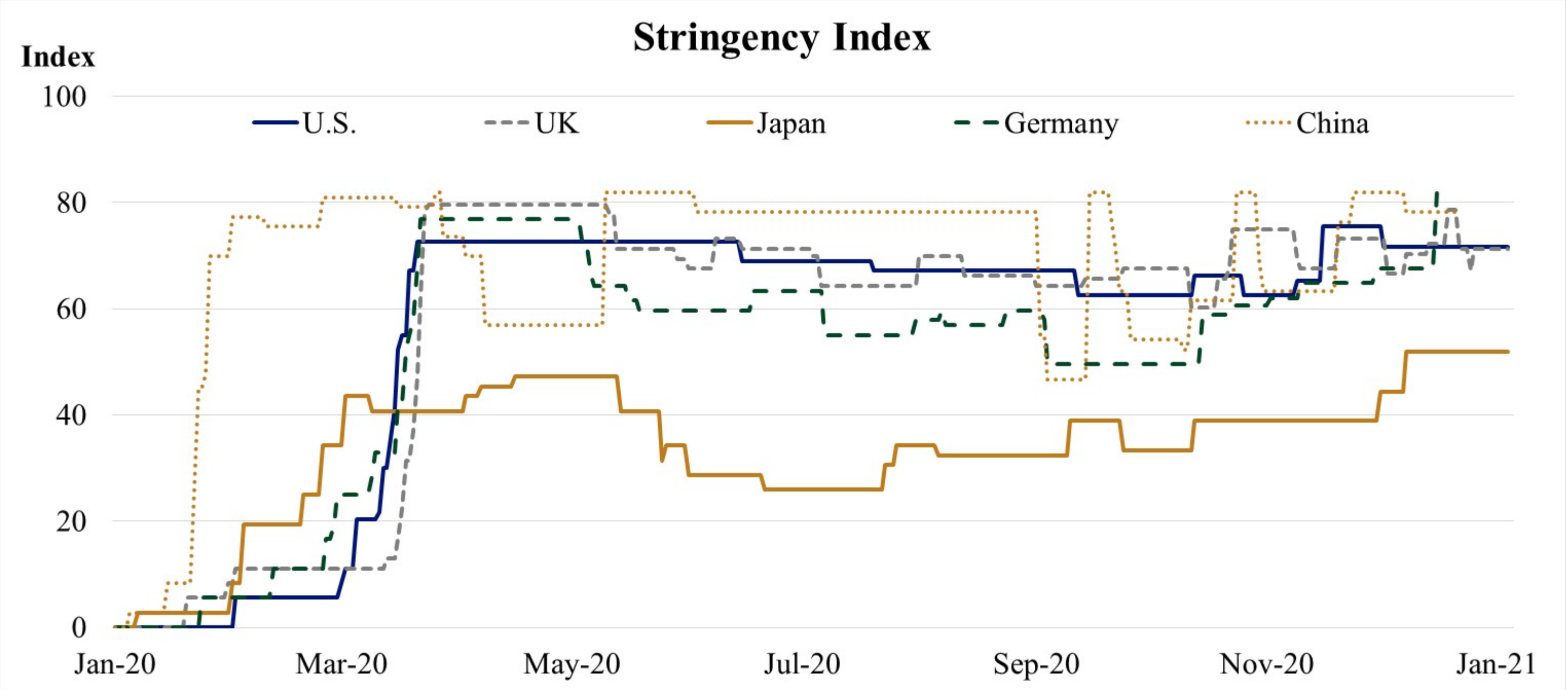
Sources: Center for Systems Science and Engineering at Johns Hopkins University, Centers for Disease Control and Prevention and author's calculations. Last observation: Jan. 5, 2021. For this chart, the East Asia and Pacific region consists of Australia, China, Indonesia, Japan, Malaysia, Myanmar, New Zealand, Philippines, South Korea, Singapore, Thailand and Taiwan.

But U.S. fatalities expected to fall



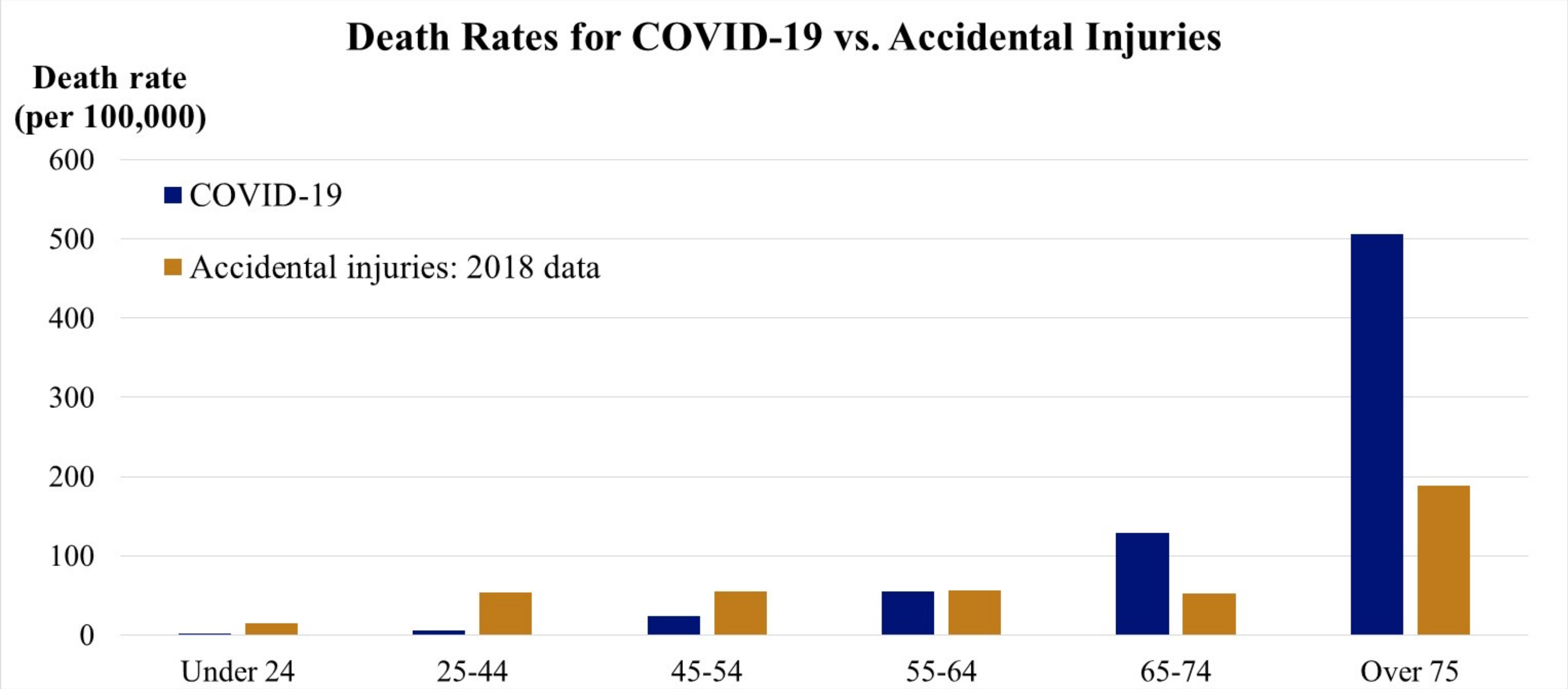
Source: Institute for Health Metrics and Evaluation, University of Washington. Last observation: Dec. 20, 2020.

U.S. public health limits remain stringent



Source: University of Oxford's Blavatnik School of Government COVID-19 Government Response Tracker. Last observations: : Jan. 4, 2021 (U.S., UK and Japan), Dec. 18, 2020 (Germany), and Dec. 21, 2020 (China).

Fatalities skew toward older citizens



Sources: Centers for Disease Control and Prevention and author’s calculations. Last observation: week of Dec. 26, 2020.

Vaccines will help bring the crisis to a close

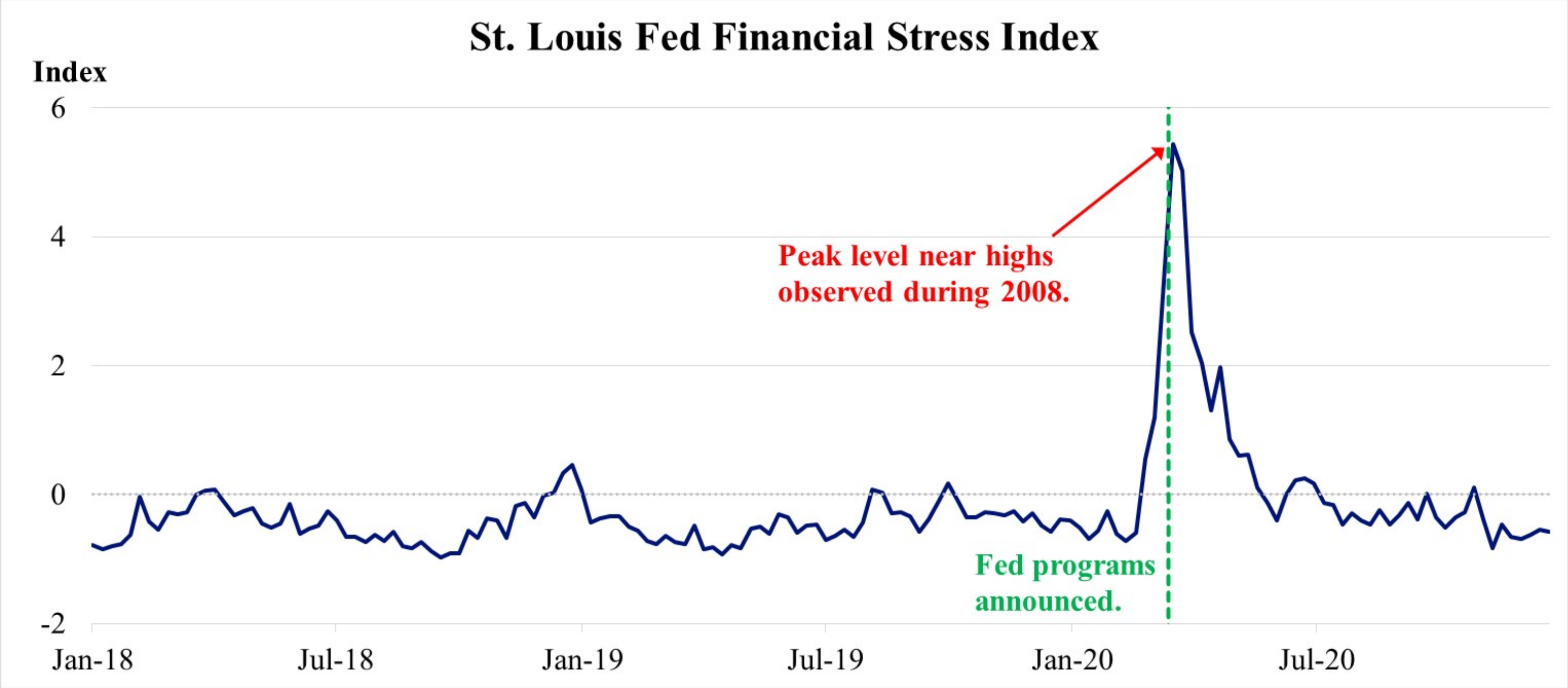
- Vaccine distribution is being directed toward those most vulnerable to COVID-19, suggesting declining fatalities in the months ahead.
- The Oxford stringency index suggests business restrictions today are not too different from what they have been in recent months on a national basis in the U.S.
- Renewed increases in infections in recent months are likely coming more from personal interactions at the household level.
- Many businesses have learned to produce at normal levels despite health restrictions, contributing to rapid economic growth.

Effective Monetary and Fiscal Policies

A policy rate cut and increased liquidity

- U.S. monetary and fiscal policies have been exceptionally effective during the crisis.
- Monetary policy included lowering the policy rate to the effective lower bound and providing liquidity to financial markets through a variety of programs supported by the U.S. Treasury.
- The backstop programs stemmed an incipient financial crisis during the March-April time frame, to the point where current levels of financial stress are at pre-pandemic levels.

Financial stress has abated



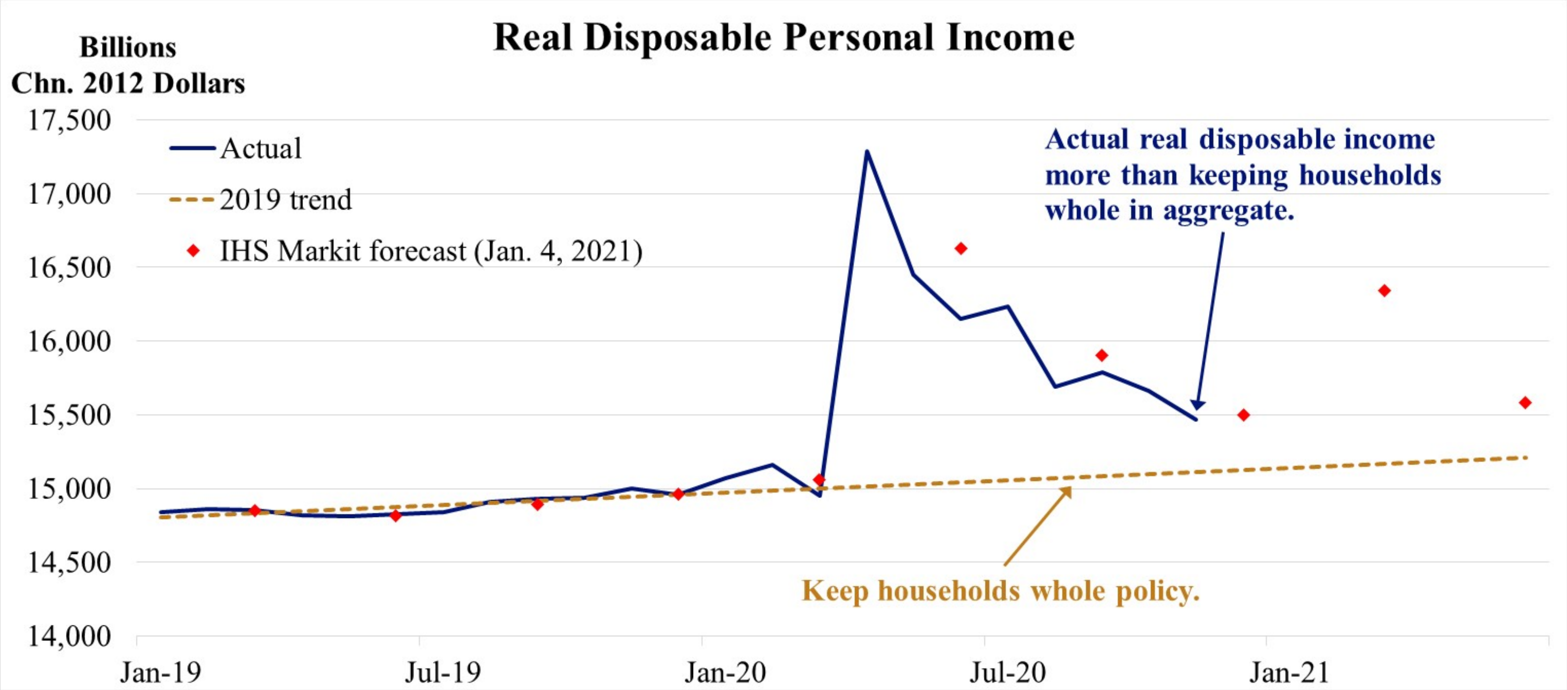
Source: Federal Reserve Bank of St. Louis. Last observation: Week of Dec. 25, 2020.

Fiscal policy response to the pandemic

- In the first 11 months of the year, U.S. fiscal policy included the CARES Act along with additional legislation. In total, this fiscal policy response was valued at about $3.148 trillion.*
- The actual shortfall in U.S. real GDP in 2020, according to forecasters, will likely be closer to 2%-2.5% of GDP, or about $400 billion to $500 billion.
- The fiscal response drove personal income up to an all-time high in the second quarter, the opposite of normal recession dynamics.
- In addition, the Consolidated Appropriation Act of 2021 signed into law on Dec. 27, 2020, includes an additional $900 billion in pandemic relief.

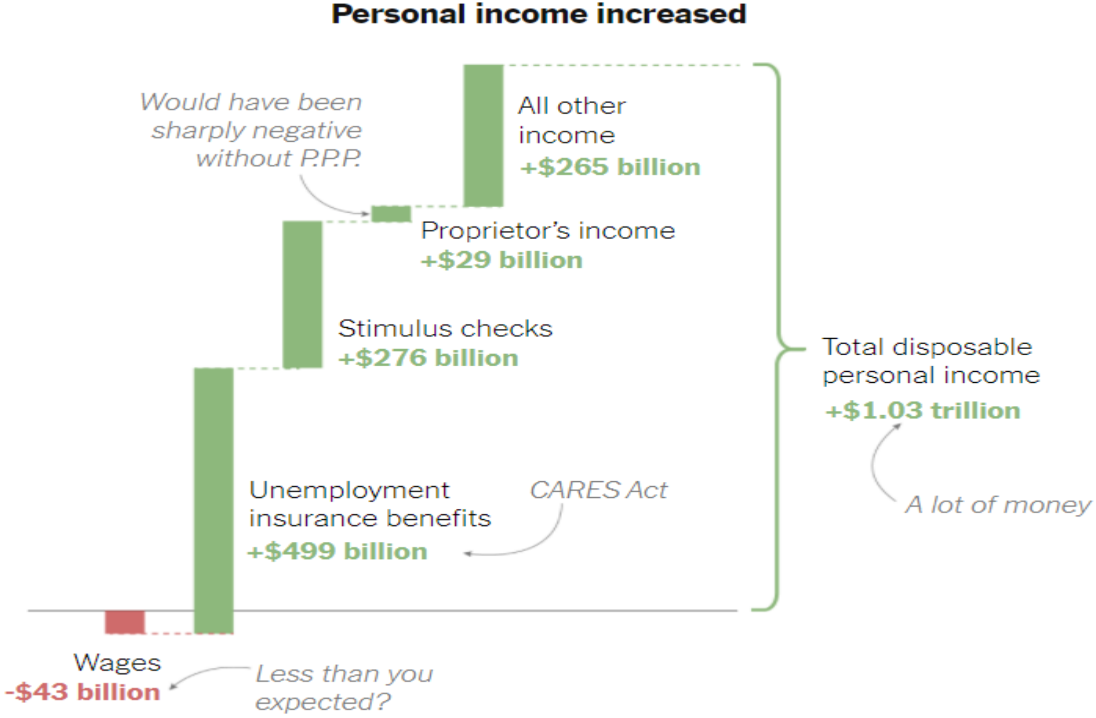
** See the International Monetary Fund's* Policy Responses to COVID-19 *and the Committee for a Responsible Federal Budget's estimates of the cost of President Trump's executive orders.*

Personal income above 2019 trend



Source: Bureau of Economic Analysis, IHS Markit and author's calculations. Last observation: November 2020.

Personal income in 2020 versus 2019



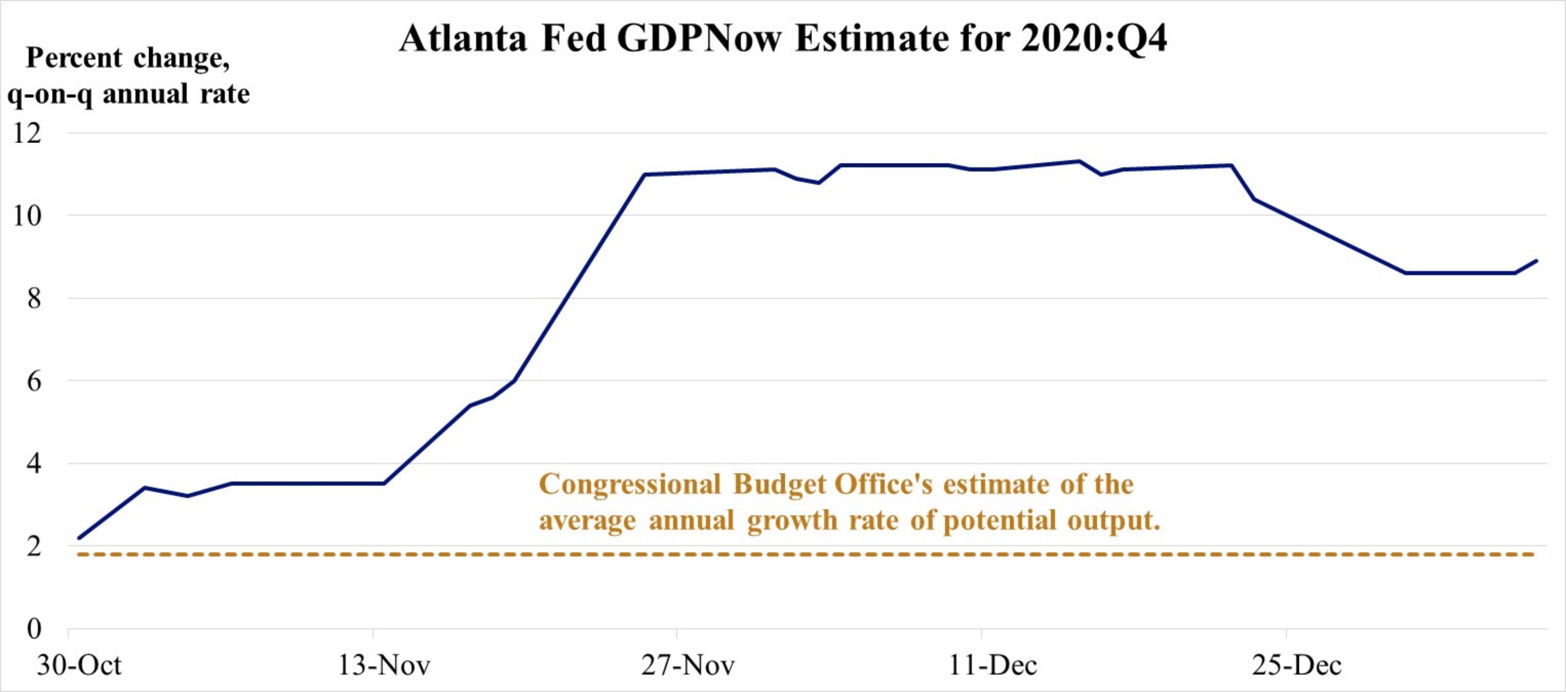
Source: N. Irwin and W. Cai, "Why Markets Boomed in a Year of Human Misery," The Upshot, *New York Times, Jan. 1, 2021. Data from March to November 2020 compared with the same time period in 2019.*

U.S. Recovery Far Ahead of Schedule

Substantial expansion in Q3

- Current macroeconomic data suggest that April 2020 will prove to be the lowest point of the crisis, provided the remainder of the crisis can be managed effectively.
- Third-quarter real GDP growth, at an annualized rate of 33.4%, was the fastest on record.
- For the fourth quarter, real GDP appears to have grown at an above-trend pace, according to forecasts.

Above-trend growth forecasts for Q4



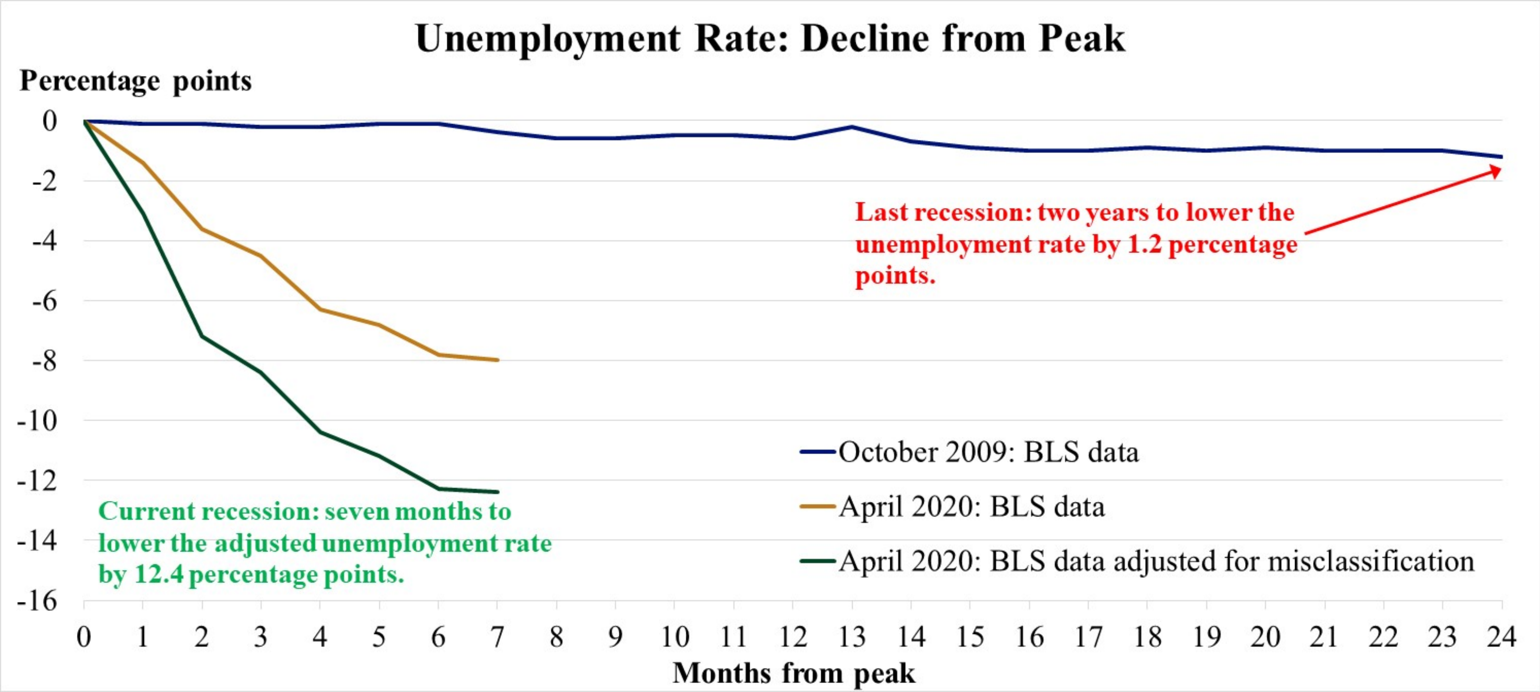
Source: Federal Reserve Bank of Atlanta and Congressional Budget Office. Last observation: Jan. 5, 2021.

Labor markets continue to improve

- Employment has rebounded more rapidly than expected, supporting the idea that many layoffs were temporary as firms adjusted to the pandemic.
- Hall and Kudlyak (2020), in particular, have emphasized that the temporary layoff category of unemployment has been dramatically more important in this recession as compared with previous recessions.*
- As a result, the U.S. labor market recovery is four years ahead of where it was following the 2007-09 recession.

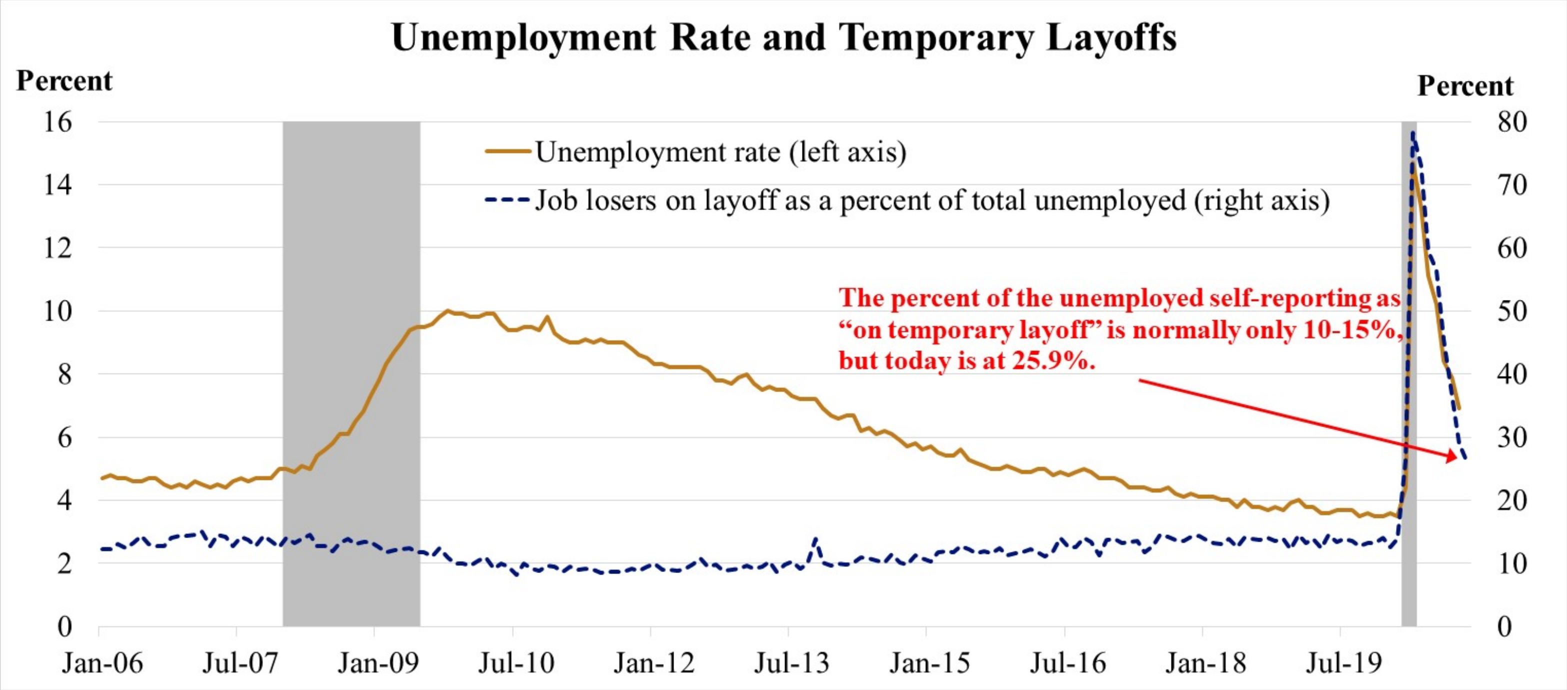
** See R.E. Hall and M. Kudlyak, 2020, "Unemployed With Jobs and Without Jobs," National Bureau of Economic Research, Working Paper No. 27886.*

Unemployment declining more rapidly than after the previous peak



Sources: Bureau of Labor Statistics and author's calculations. Last observation: November 2020.

Unemployment driven by temporary layoffs



Source: Bureau of Labor Statistics. Shaded areas indicate U.S. recessions, assuming the 2020 recession ended in April. Last observation: November 2020.

Potential unemployment declines

- A back-of-the-envelope calculation suggests that there is room for further decline in the official unemployment rate in the months ahead.
- If all those unemployed identifying as “on temporary layoff” are simply recalled and nothing else changes, the official unemployment rate would decline to 5.0%.
- If the “on temporary layoff” category returns to a normal value (e.g., 1 million workers) and nothing else changes, the official unemployment rate would still decline to 5.6%.
- The median U.S. unemployment rate in the postwar era is 5.6%

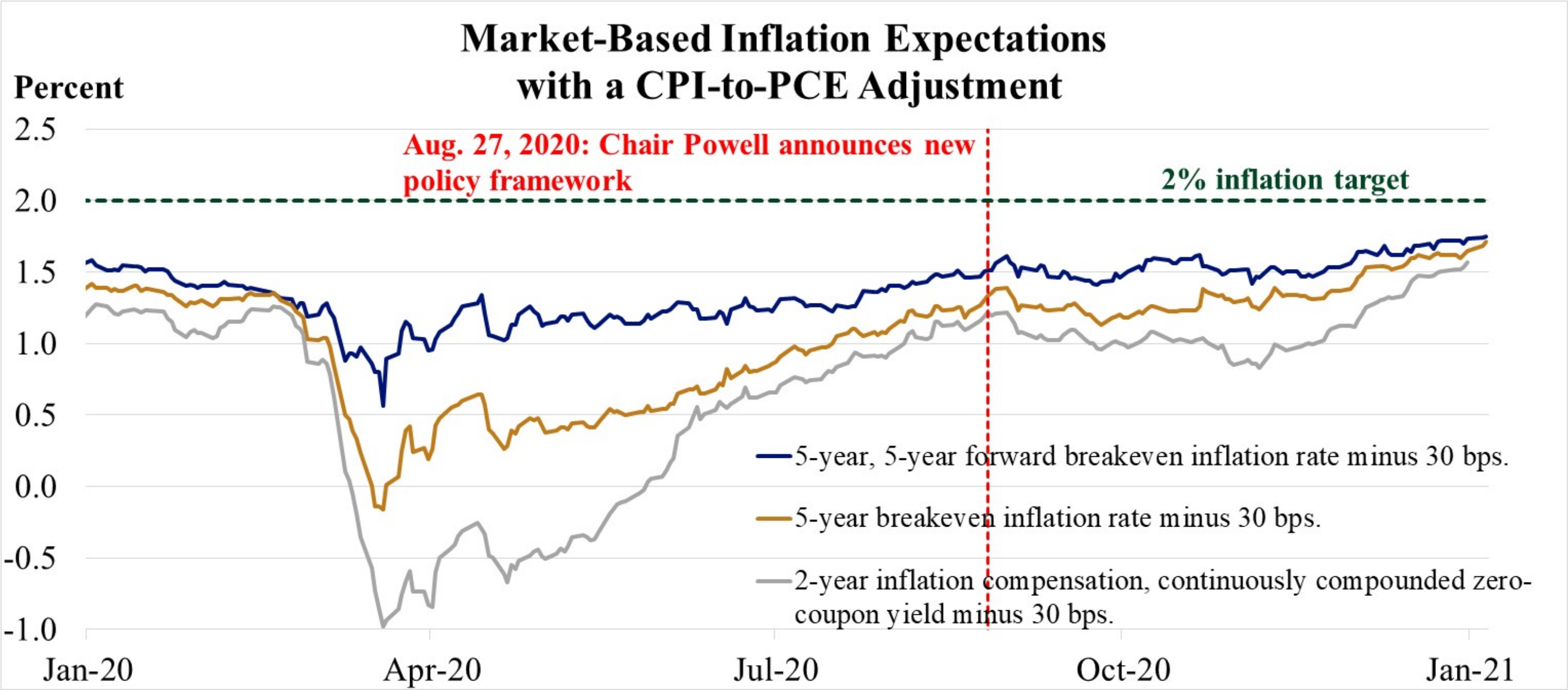
How far ahead of schedule is the U.S. labor market?

	February peak	April trough	November	Percentage Recovered	Months ahead of previous recovery
Aggregate weekly hours (index)	112.0	93.2	105.9	67.6%	49
Civilian employment (millions)	158.8	133.4	149.7	64.4%	49
Nonfarm payrolls (millions)	152.5	130.3	142.6	55.6%	49

Sources: Bureau of Labor Statistics and author's calculations. Last observation: November 2020.

Inflation Expectations Recovering Toward Inflation Target

Inflation expectations improving



Sources: Federal Reserve Board and author's calculations. Last observations: Dec. 31, 2020, and Jan. 5, 2021.

Inflation expectations moving higher

- Market-based inflation expectations have recovered from lows reached during March 2020.
- The FOMC’s new policy framework, announced in Chair Powell’s 2020 Jackson Hole speech, has likely encouraged some of this movement.
- The chart indicates that TIPS-based breakeven inflation, based on CPI inflation measures, could move considerably higher and still be consistent with a PCE inflation outcome modestly above the 2% target.

Conclusion

Light at the end of the tunnel

- The early arrival of vaccines suggests that the global pandemic will wane during the first half of 2021.
- In the U.S., monetary and fiscal policies have been especially aggressive, and the associated macroeconomic outcomes have been considerably better than originally expected at the pandemic onset.
- Aggregate resources available to fund consumption continue to be exceptionally high, suggesting continued recovery in the first half of 2021.
- Some downside risk remains, and continued execution of a granular, risk-based health policy will be critical in the months ahead.

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