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# U.S. Monetary Policy: A New Risk

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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

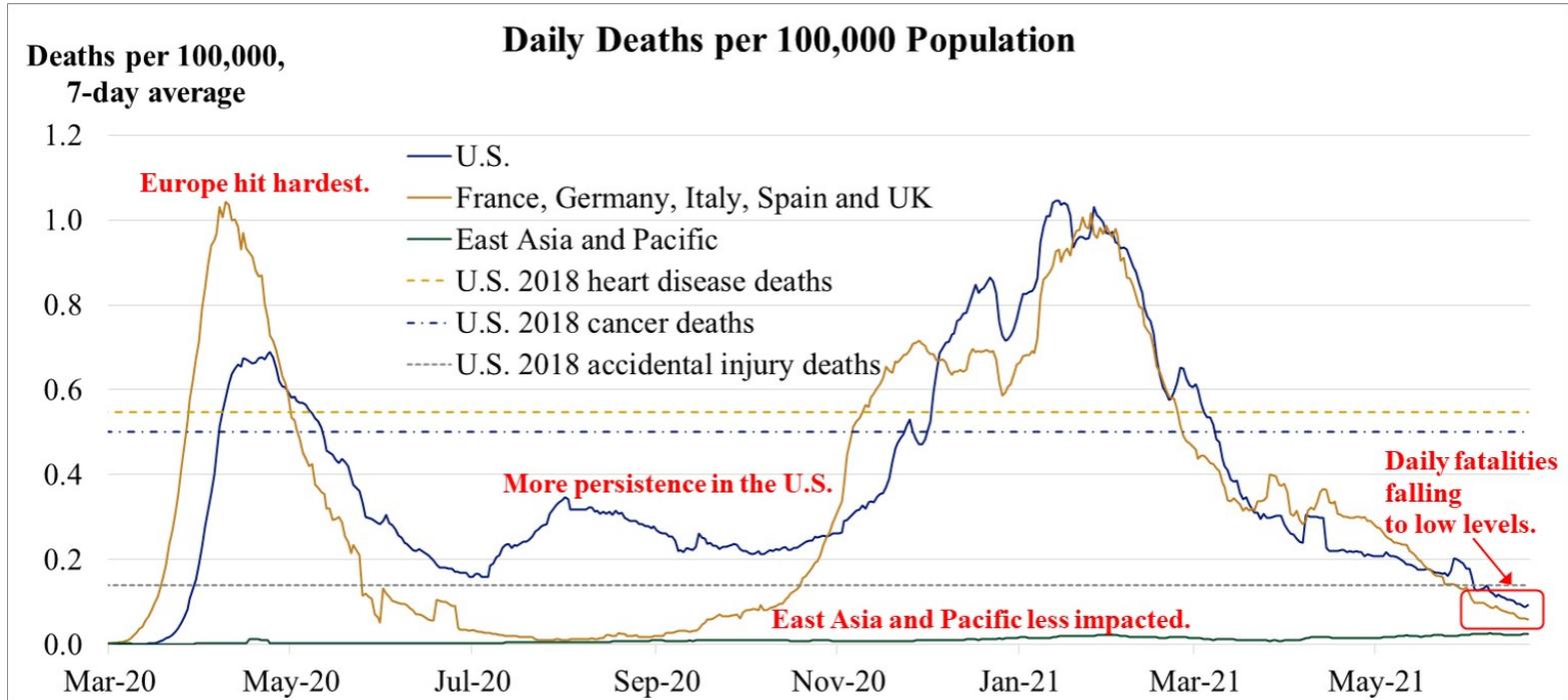
- Pandemic intensity continues to moderate in the U.S. and Europe.
- U.S. real gross domestic product (GDP) appears to have fully recovered to the pre-pandemic peak.
- The “keep households whole” fiscal strategy has been successful well beyond initial hopes.
- The number of unemployed persons per job opening is approaching an all-time low, suggesting an exceptionally strong labor market.
- Inflation is likely to be meaningfully above 2% over the forecast horizon, allowing the Federal Open Market Committee (FOMC) to accomplish a key provision of its new framework.
- A new risk is that inflation may continue to surprise to the upside.

# Health Crisis Waning in the U.S. and Europe

# Fatality rates and economic activity

- Daily fatalities per 100,000 population have continued to decline in both Europe and the U.S.
- East Asia and Pacific countries continue to report daily fatalities per 100,000 population that are lower than those of the U.S. and Europe.
- Some emerging market countries remain vulnerable to the pandemic and will take longer to vaccinate.
- Overall, regions where much of global output is produced appear poised to bring the pandemic under control.

# Pandemic intensity falling in the U.S. and Europe

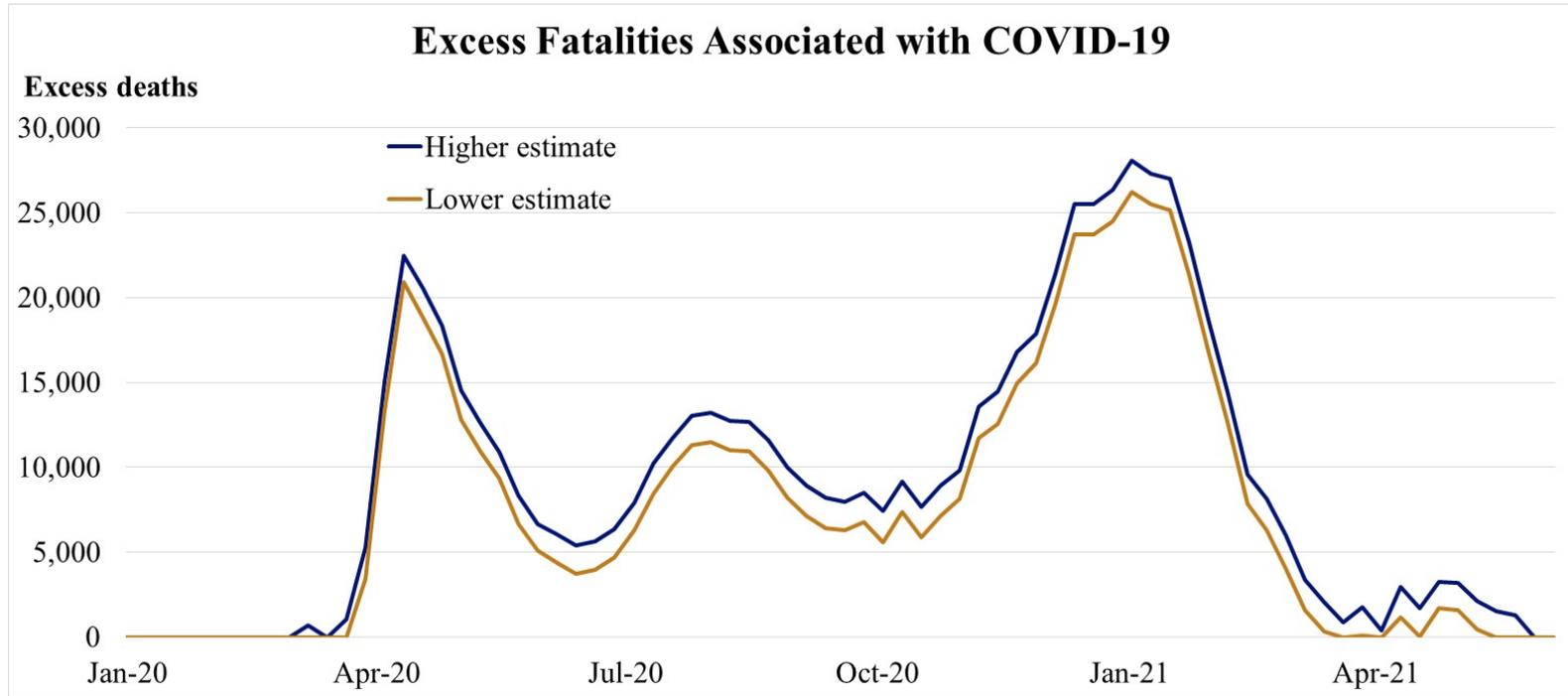


Sources: Center for Systems Science and Engineering at Johns Hopkins University, Centers for Disease Control and Prevention and author's calculations. Last observation: June 21, 2021. For this chart, the East Asia and Pacific region consists of Australia, China, Indonesia, Japan, Malaysia, Myanmar, New Zealand, Philippines, Singapore, South Korea, Taiwan and Thailand.

# Excess fatalities near zero in the U.S.

- Another metric of pandemic intensity is deaths in excess of those that would be expected to occur in a normal year.
- For the U.S., excess fatalities are approaching zero, suggesting that the vaccination strategy is bringing the pandemic under control.

# Excess fatalities in the U.S. are close to zero



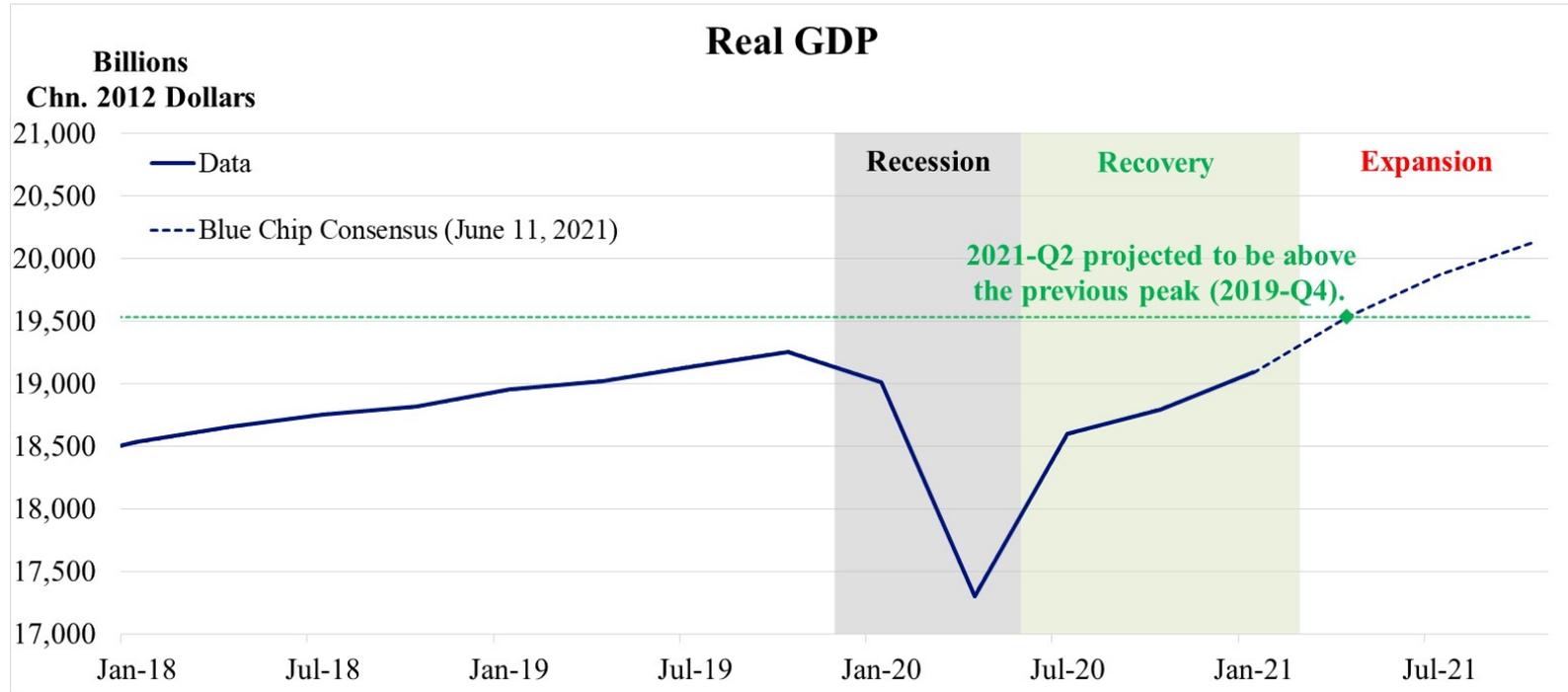
Source: Centers for Disease Control and Prevention. Last observation: Week of June 5, 2021.

# U.S. Real GDP Fully Recovered

# U.S. GDP poised to grow at an above-trend rate

- Business cycles have a clear traditional definition. Periods of declining output are called “recessions.”
- Periods of increasing output following a recession are called “recoveries” until the previous peak is attained.
- Periods beyond the previous peak are called “expansions.”
- During the current quarter, the U.S. is moving into the expansion phase of the business cycle.
- National income appears to be as high as it was at the previous peak and is poised to grow at an above-trend rate.

# Moving into the expansion phase



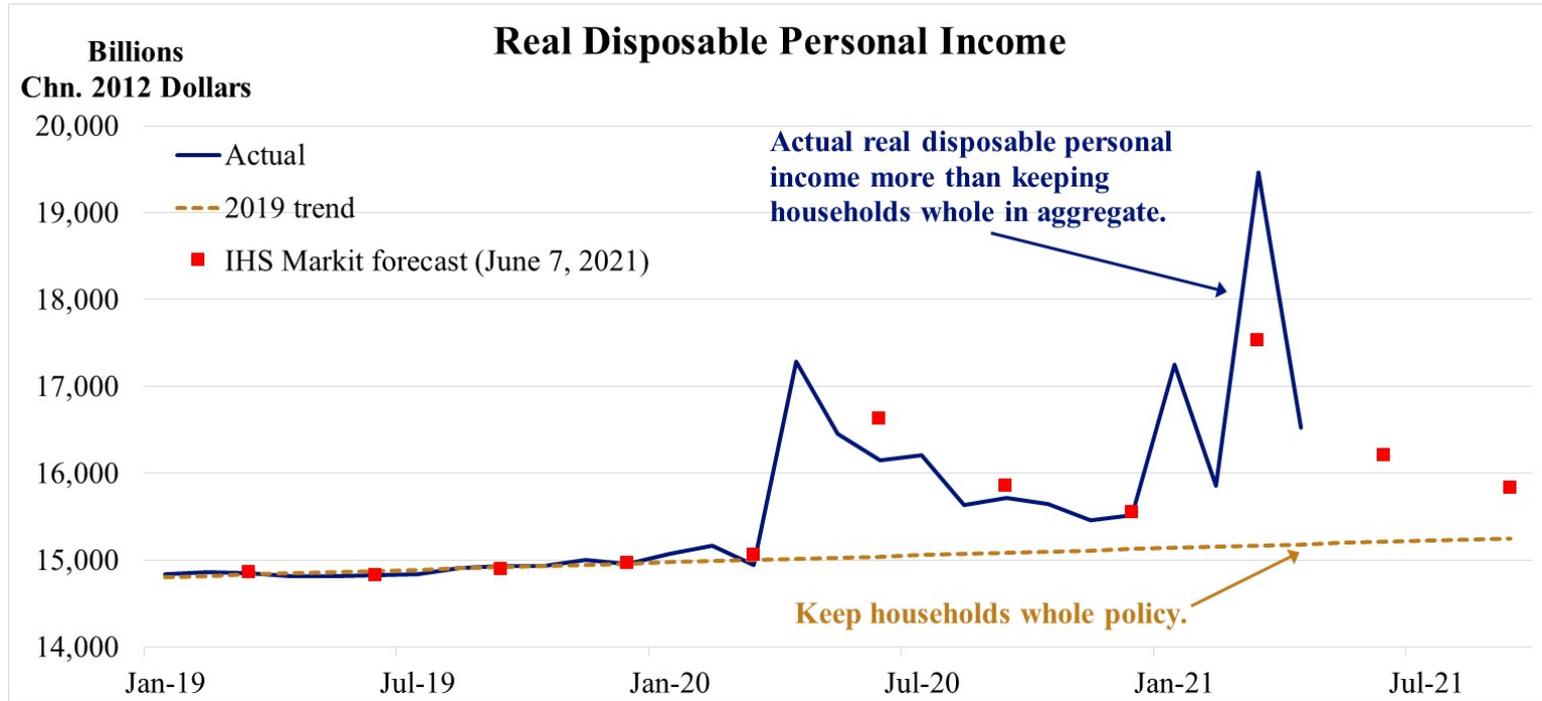
Sources: Bureau of Economic Analysis, Blue Chip Economic Indicators and author's calculations. The gray shaded area indicates U.S. recession, assuming the 2020 recession ended in Q2. Last observation: 2021-Q1.

# U.S. Fiscal Strategy Has Maintained Household Income

# The “keep households whole” fiscal policy

- The nature of the fiscal policy response to the pandemic shock has been to ask some workers in “high physical contact” jobs to stay home to invest in national health.
- The goal of fiscal policy has been to insure these disrupted households by borrowing funds on international markets and using the funds to replace disrupted household incomes.
- I have called this the “keep households whole” policy.
- This policy has been so successful that personal income in 2020 was actually higher than it would have been if the economy had simply remained on the 2019 trend line.

# Personal income above 2019 trend



Sources: Bureau of Economic Analysis, IHS Markit and author's calculations. Last observation: April 2021.

# The payoff to the fiscal strategy

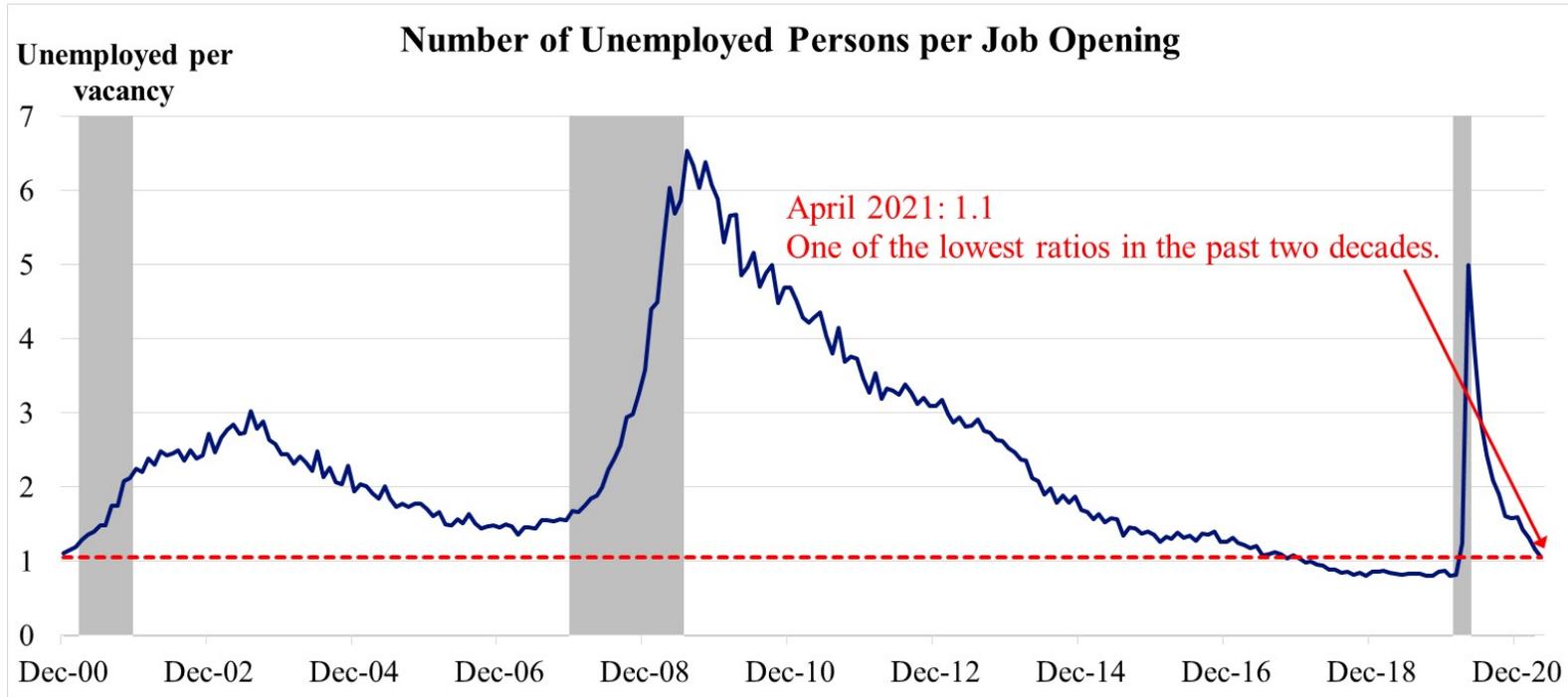
- The fiscal strategy has enabled households to pay ordinary expenses during the pandemic.
- This has kept the economy from suffering additional damage that could have occurred during the pandemic.
- Households are now in a strong position to spend, leading many forecasters to predict rapid U.S. real GDP growth in 2021 that will continue into 2022.

# Tight U.S. Labor Markets

# Unemployed persons vs. job openings

- Anecdotal reports from businesses strongly suggest that attracting workers to available jobs is difficult in the current environment.
- Alternative measures of labor market performance may give a more accurate reading of the state of the labor market than the number of jobs on payrolls or the number of hours worked.
- One alternative measure is the ratio of officially unemployed persons to job openings.
- This measure is approaching an all-time low, suggesting a very strong labor market.

# A tightening labor market

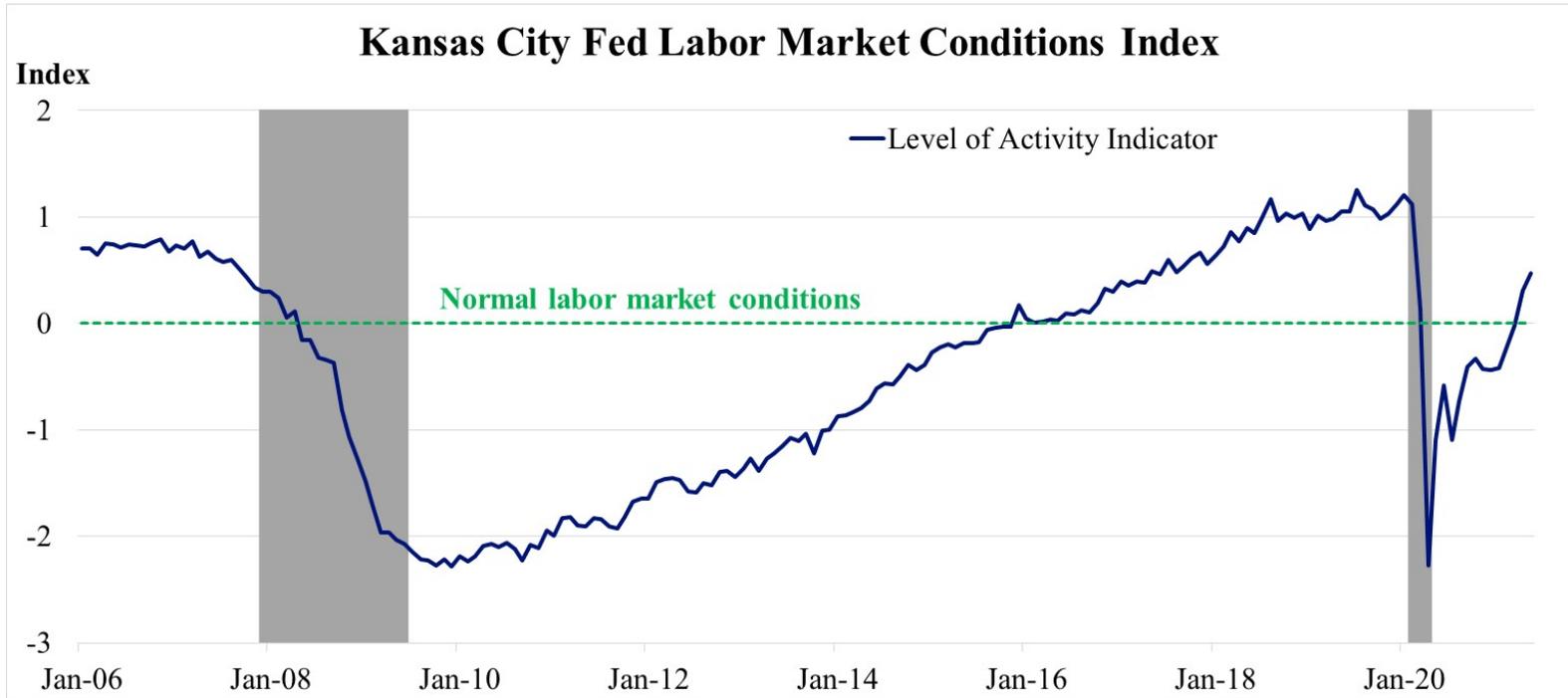


Sources: Bureau of Labor Statistics and author's calculations. Shaded areas indicate U.S. recessions, assuming the 2020 recession ended in April last year. Last observation: April 2021.

# Broader measures of labor market performance

- There are many additional measures of labor market performance other than the official unemployment rate or unemployed persons per job opening.
- These measures can be organized into an indicator of labor market performance that takes multiple aspects into account.
- The Kansas City Fed's level of activity index provides one attempt to organize these data.
- This indicator suggests today's labor market conditions are markedly better than those following the 2007-09 recession.

# Labor market conditions above average



Source: Federal Reserve Bank of Kansas City. Shaded areas indicate U.S. recessions, assuming the 2020 recession ended in April last year. Last observation: May 2021.

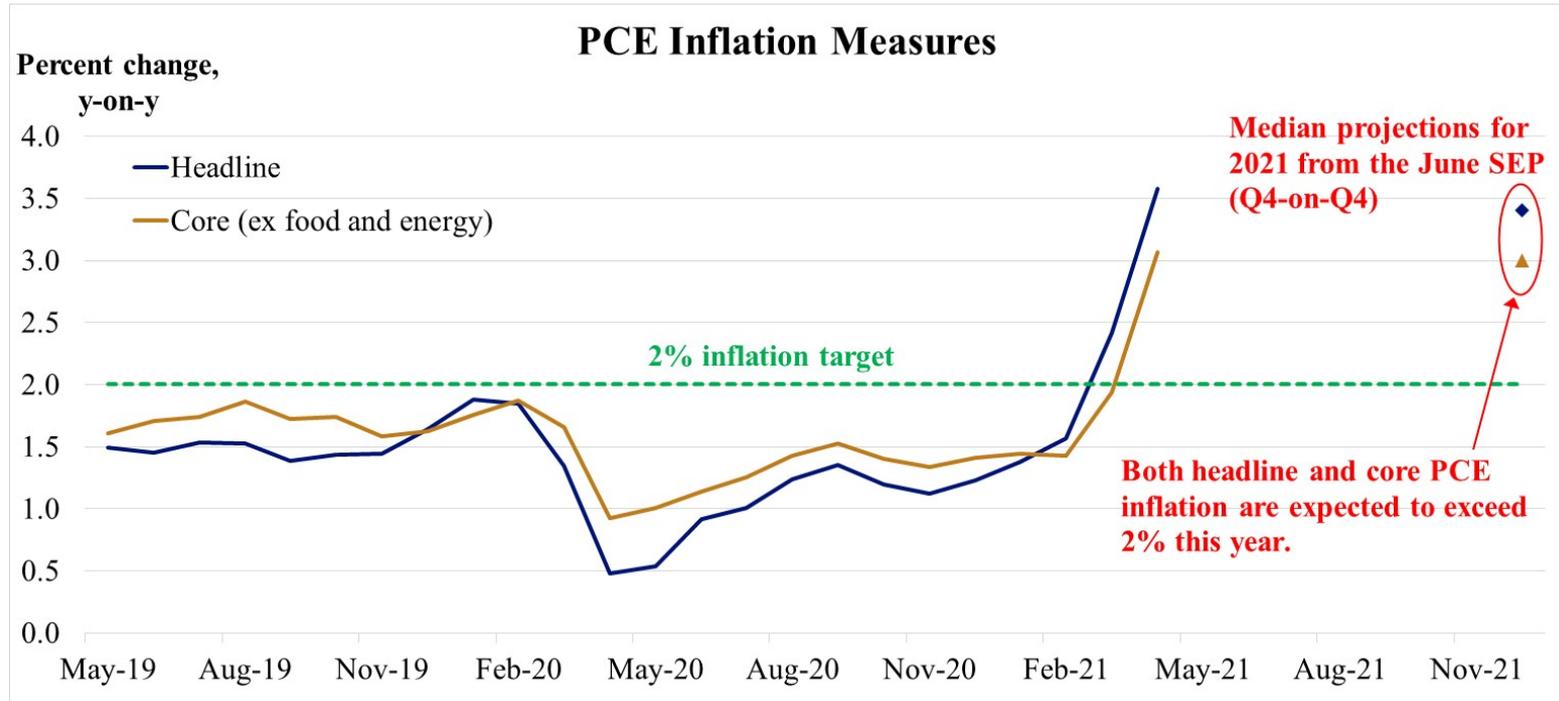
# Inflation Rising

# Inflation surprises to the upside

- Last December, the FOMC median projection suggested that in 2021 real GDP would grow at a 4.2% rate but that core PCE inflation would be just 1.8%.\*
- At the June FOMC meeting just completed, the median projection suggested that in 2021 real GDP growth would be 7% and core PCE inflation would be 3%.
- This year has brought a substantial upside surprise on both real GDP growth and inflation.

*\* These are the median projections of change in real GDP and core PCE inflation. Both measures are percent changes from 2020-Q4 to 2021-Q4.*

# Inflation above target this year



Sources: Bureau of Economic Analysis and Summary of Economic Projections (SEP). Last observation: April 2021.

# The new monetary policy framework

- The FOMC's new policy framework was announced in Chair Powell's Jackson Hole speech in August 2020.
- A key aspect of the new framework is the desire of the FOMC to allow inflation to run above the 2% target for some time to make up for past misses of the inflation target to the low side.
- It now appears that the FOMC will be able to achieve this result with an appropriate monetary policy over the next several years.

# A new risk for the outlook

- A new risk is that inflation may surprise still further to the upside as the reopening process continues, beyond the level necessary to simply make up for past misses to the low side.
- This risk is tangible in part because many are expecting more good news on the U.S. economy during the September-October time frame when schools are back in regular session and work patterns normalize.
- In addition, a global reopening process will follow behind the U.S. process, likely providing additional tailwinds for the U.S.
- Policymakers will have to take this new risk into account in the months and quarters ahead.

# Conclusion

# A booming U.S. economy

- Pandemic intensity continues to moderate in the U.S. and Europe.
- U.S. real GDP is expected to have fully recovered.
- The “keep households whole” fiscal strategy has been successful and has set up households to spend as the pandemic wanes.
- U.S. labor markets are tight according to anecdotal evidence and key labor market metrics.
- Inflation is likely to be meaningfully above 2% over the forecast horizon, so the FOMC can meet a key provision of its new policy framework with an appropriate monetary policy.
- A new risk is that inflation may continue to surprise to the upside.

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