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The Waning Pandemic and the U.S. Economy

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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

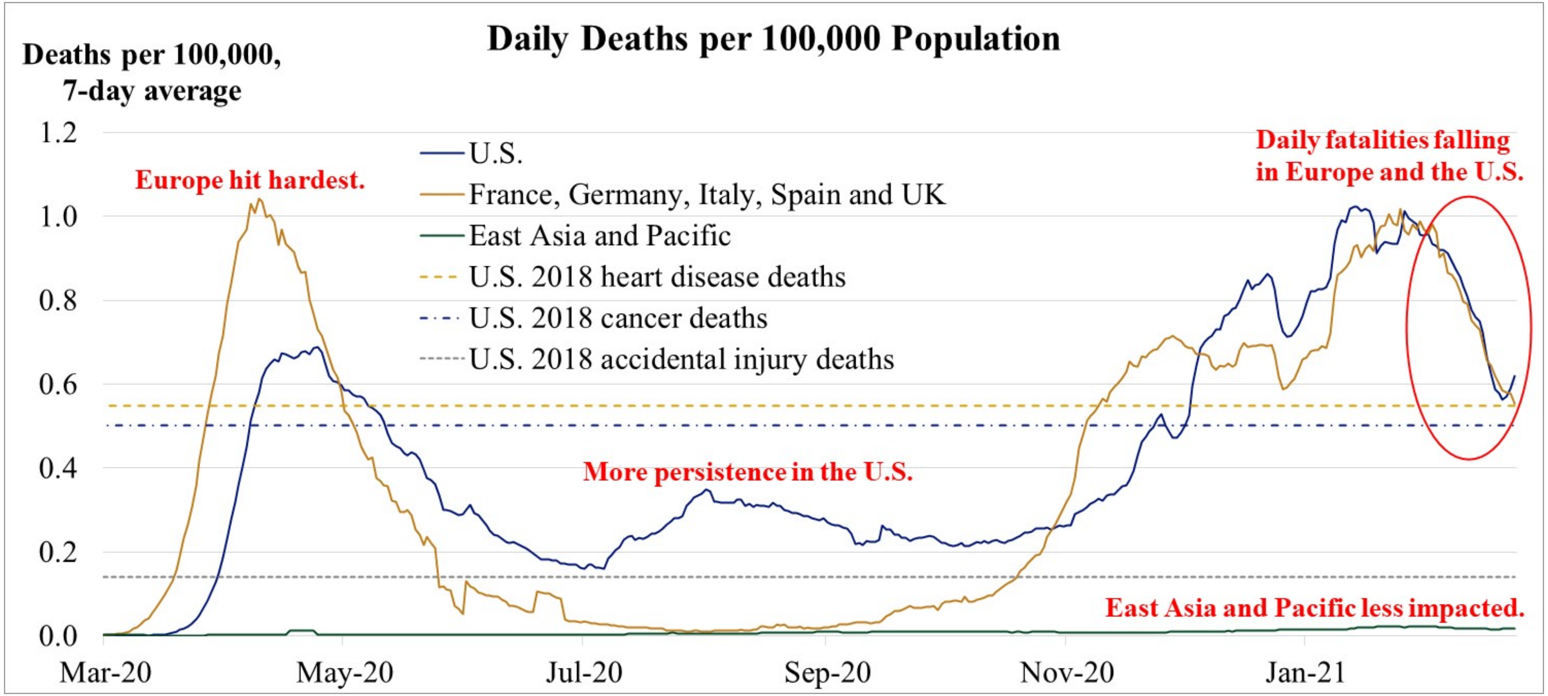
- The pandemic's intensity has moderated in the U.S. and Europe in recent weeks, and ongoing vaccination programs suggest the health crisis will wane in the months ahead.
- U.S. monetary and fiscal policies continue to be exceptionally effective in mitigating macroeconomic damage.
- Macroeconomic forecasts suggest very strong U.S. real GDP growth for all of 2021.
- Downside risk remains, and continued execution of a granular, risk-based health policy will be critical to maintain economic momentum.

Health Crisis Is Expected to Wane

Fatality rates and economic activity

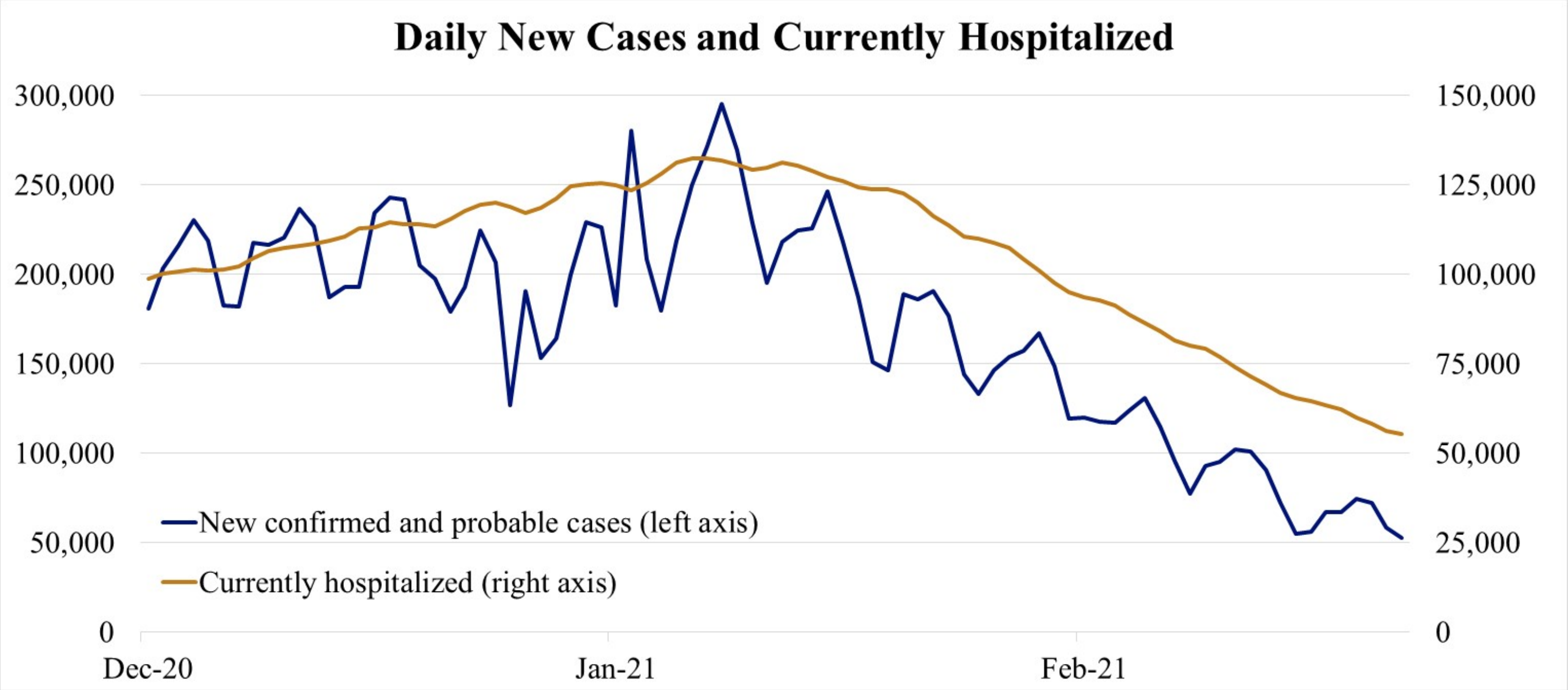
- Daily fatalities per 100,000 population have fallen in recent weeks in both Europe and the U.S.
- East Asia and Pacific countries continue to report daily fatalities per 100,000 population that are an order of magnitude lower than those of the U.S. and Europe.
- Bottom line: Safety protocols must be maintained, but 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



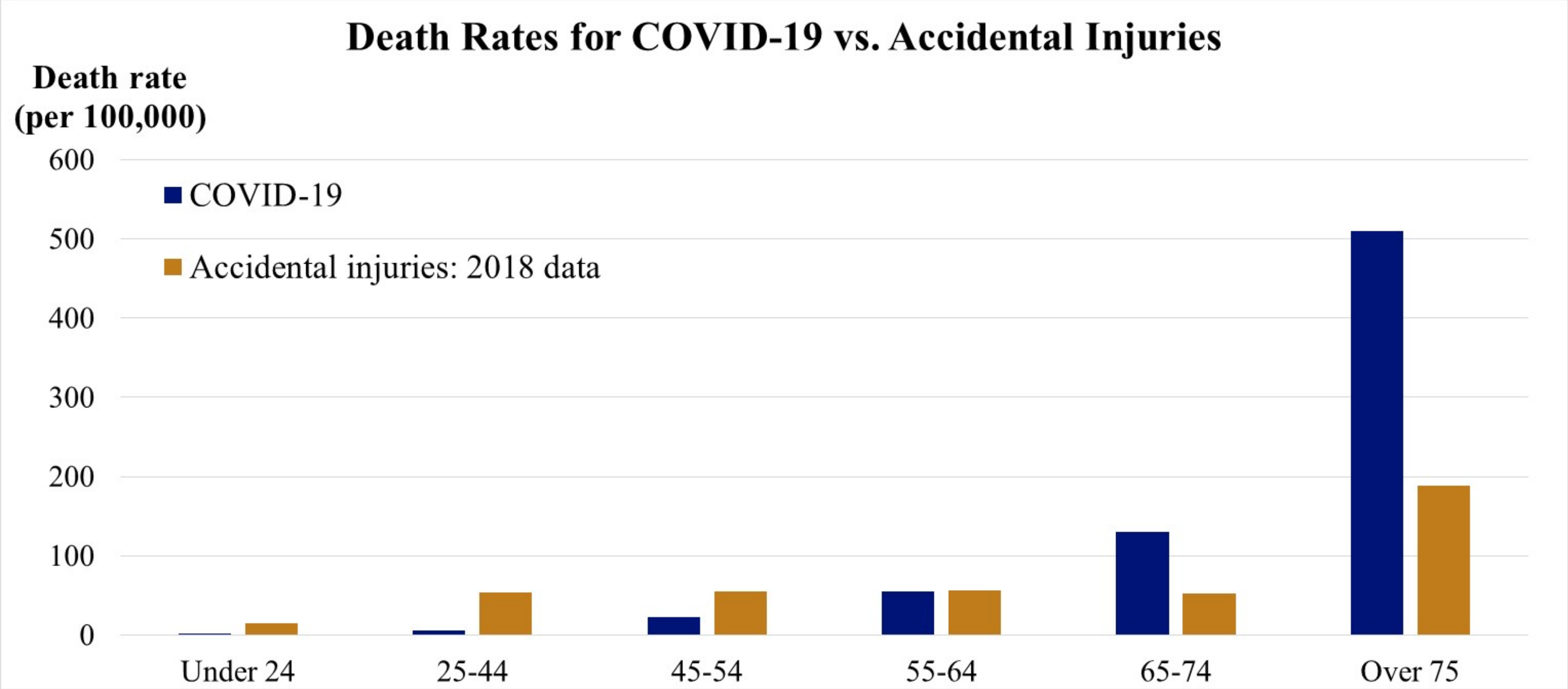
Sources: Center for Systems Science and Engineering at Johns Hopkins University, Centers for Disease Control and Prevention and author's calculations. Last observation: Feb. 23, 2021. For this chart, the East Asia and Pacific region consists of Australia, China, Indonesia, Japan, Malaysia, Myanmar, New Zealand, Philippines, Singapore, South Korea, Taiwan and Thailand.

Declining U.S. cases and hospitalizations



Source: The COVID Tracking Project at The Atlantic. Last observation: Feb. 22, 2021.

Fatalities skew toward older citizens



Sources: Centers for Disease Control and Prevention and author's calculations. Last observation: Week of Feb. 13, 2021.

Vaccines will help bring the crisis to a close

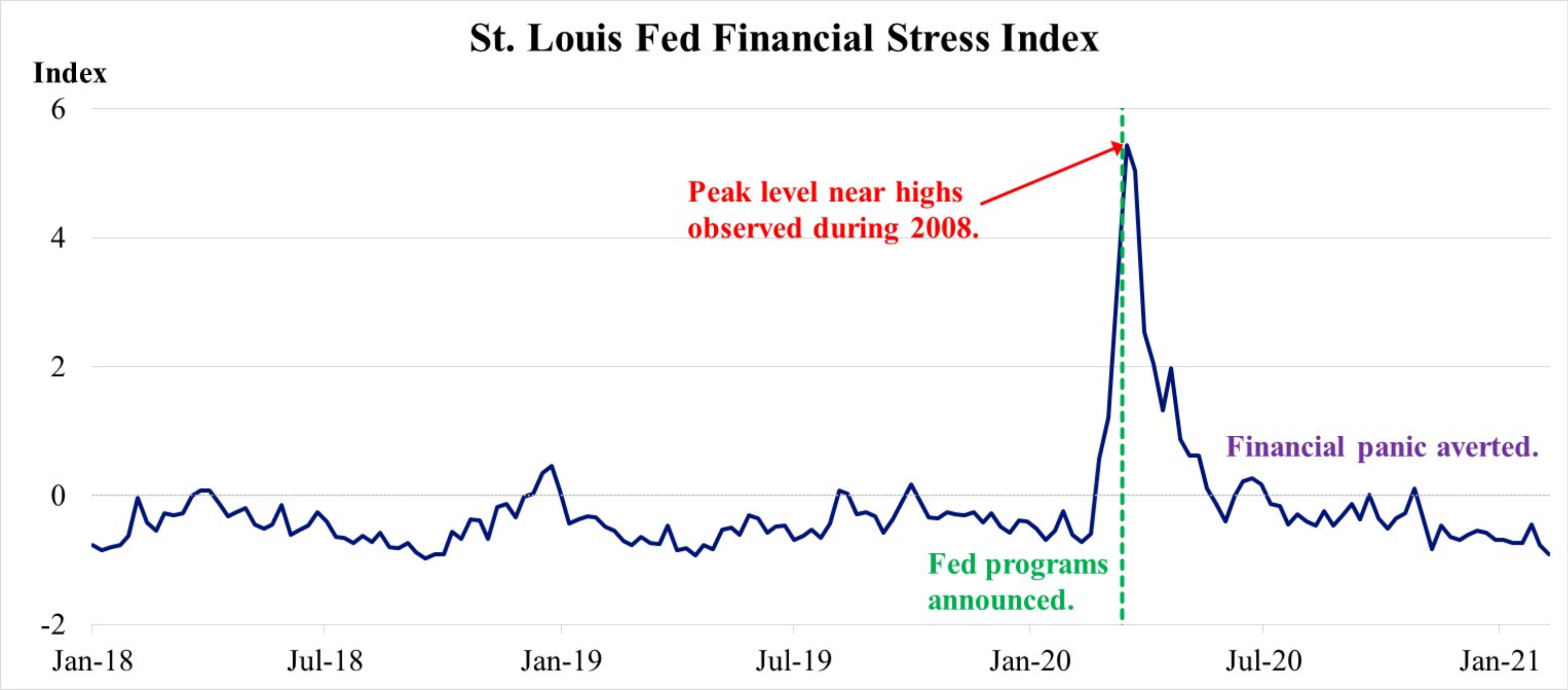
- Vaccine distribution is being directed toward those most vulnerable to COVID-19.
- This suggests fatalities will decline further in the months ahead, even before the pandemic comes under more complete control.
- Virus mutation that renders current vaccines ineffective poses a tangible risk to this scenario.

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 March and April 2020, 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 Feb. 12, 2021.

The size of the fiscal policy response

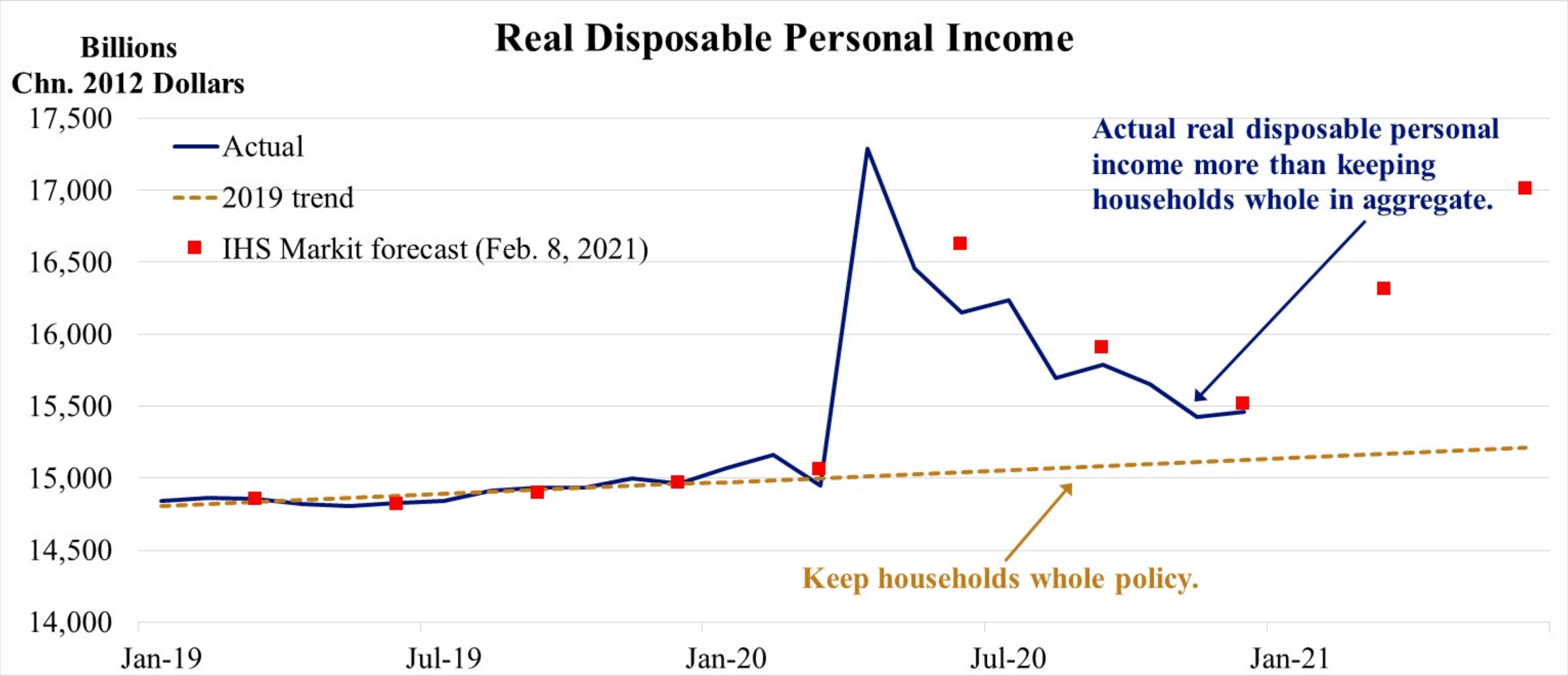
- In the first 11 months of 2020, U.S. fiscal policy included the CARES Act along with additional legislation. In total, this fiscal policy response was valued at about $3.148 trillion.*
- In addition, the Consolidated Appropriations Act of 2021 signed into law on Dec. 27, 2020, includes an additional $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*.

The “keep households whole” fiscal policy

- The nature of the 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

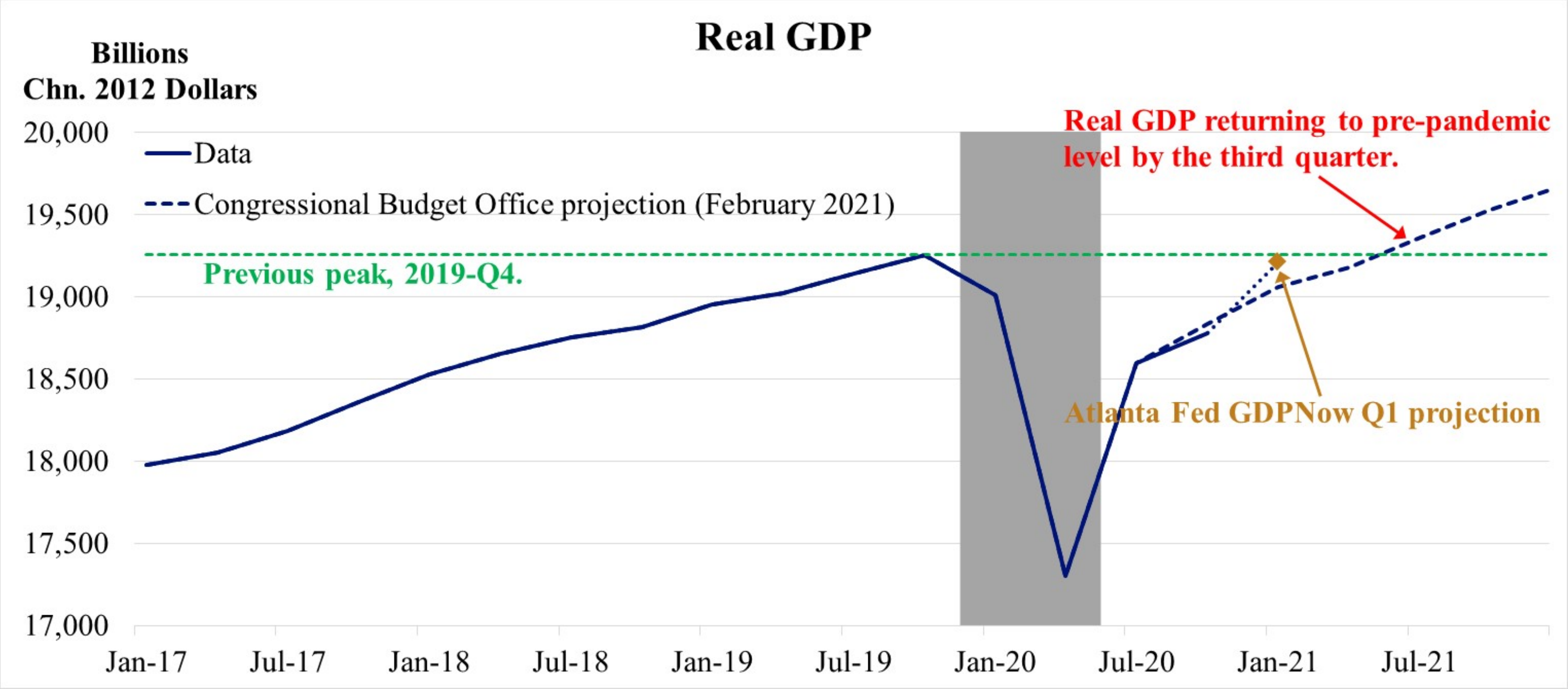


Sources: Bureau of Economic Analysis, IHS Markit and author's calculations. Last observation: December 2020.

The private sector's saving response

- The households receiving federal transfers like stimulus checks often saved much of it.
- This was a rational and prudent response, as households were naturally unsure how long the health crisis would last and whether Congress would appropriate more funds.
- The arrival of vaccines has meant that the probability of the health crisis ending in coming months is rising dramatically.
- This suggests households will be less inclined to save going forward and more inclined instead to spend any federal transfers, leading many forecasters to predict very rapid U.S. real GDP growth in 2021.

The CBO projects GDP recovery in 2021



Sources: Bureau of Economic Analysis, Congressional Budget Office and Federal Reserve Bank of Atlanta and author's calculations. Shaded areas indicate U.S. recessions, assuming the 2020 recession ended in Q2. Last observation: 2020-Q4.

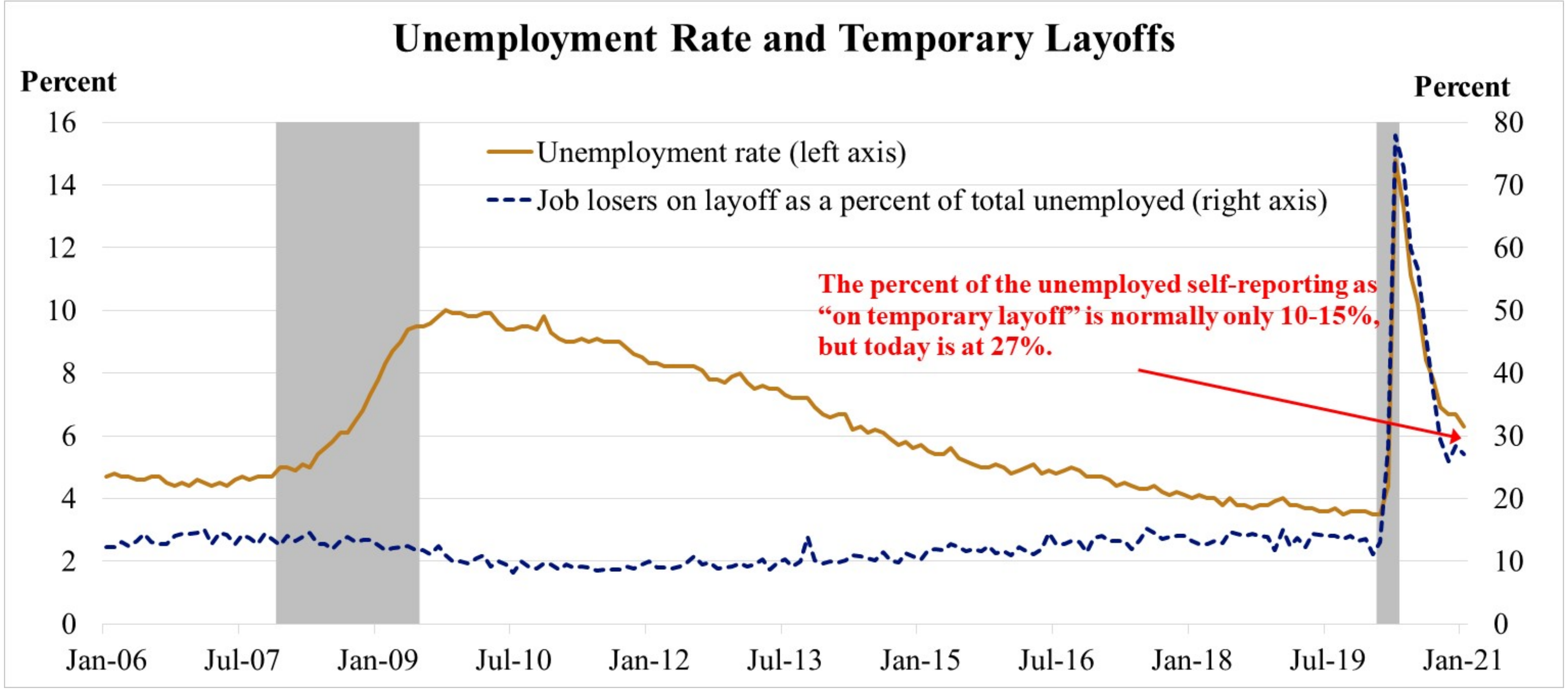
U.S. Labor Market

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.*
- Recent labor market reports have been softer but are likely to be more robust going forward as the pandemic wanes.

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

Unemployment driven by temporary layoffs



Source: Bureau of Labor Statistics. Shaded area indicates U.S. recession, assuming the 2020 recession ended in April. Last observation: January 2021.

Potential unemployment declines

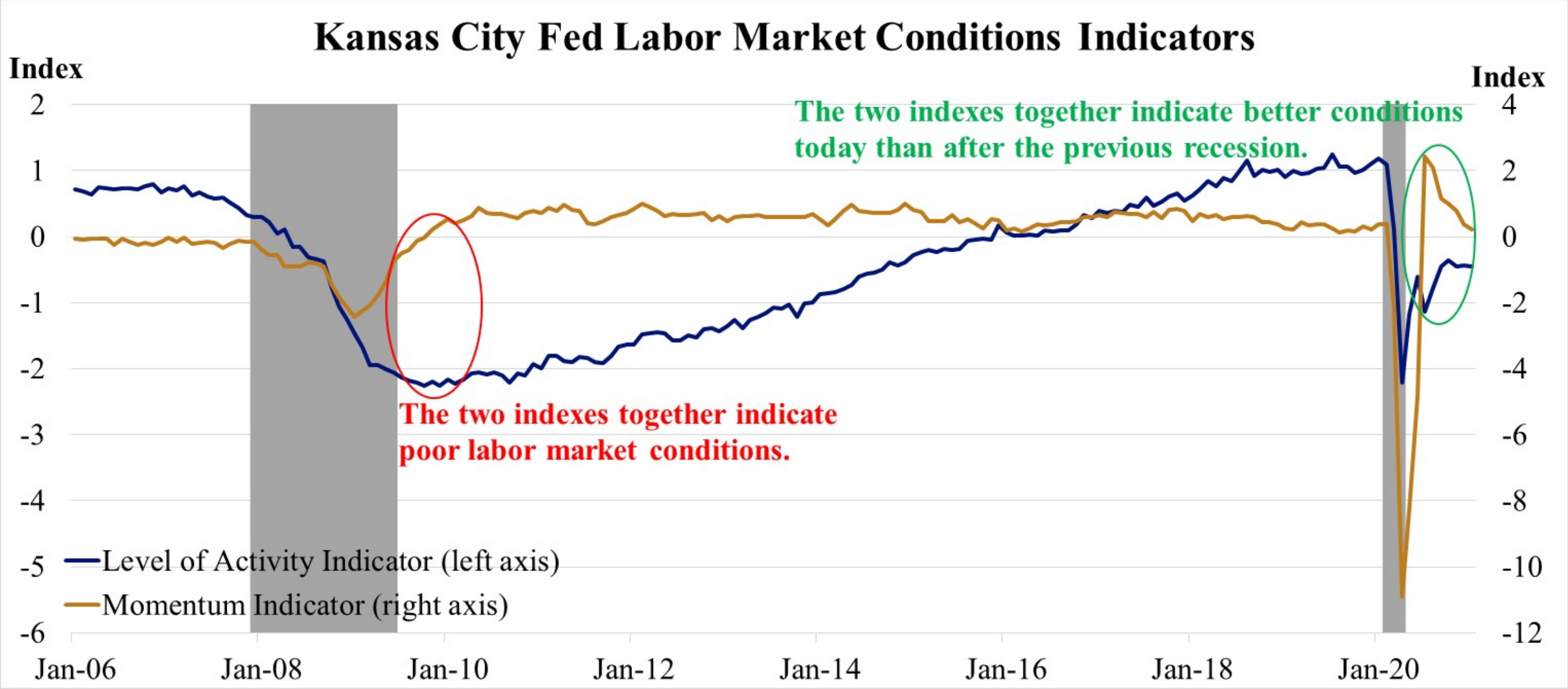
- A back-of-the-envelope calculation suggests that there is room for further decline in the official unemployment rate in the months ahead.
- If all those unemployed identifying as “on temporary layoff” are simply recalled and nothing else changes, the official unemployment rate would decline to 4.6%.
- 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 5.2%.
- The FOMC Summary of Economic Projections (SEP) has unemployment falling to 5.0% by the fourth quarter of 2021.*

** This was the median projection from the December 2020 SEP.*

Broader measures of labor market performance

- As is normal in an economic downturn, many have asked questions about broader labor market performance.
- There are many additional measures of labor market performance other than the official unemployment rate.
- This wide variety of measures can be organized into an indicator of labor market performance that takes all aspects into account.
- The Kansas City Fed's level of activity index and the associated momentum index provide one attempt to organize these data.
- These two indicators together suggest that today's labor market conditions are markedly better than those following the 2007-09 recession.

Better labor market conditions than after the previous recession



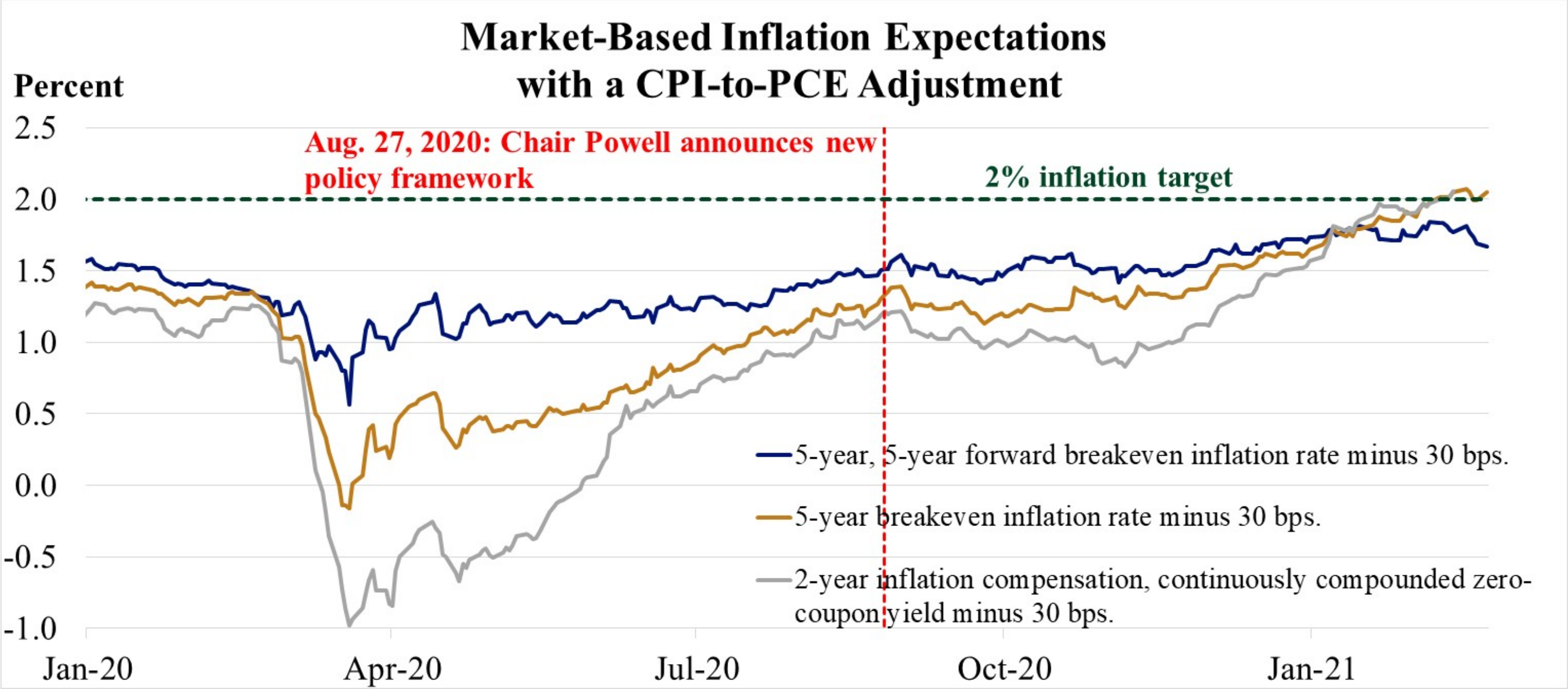
Source: Federal Reserve Bank of Kansas City. Shaded areas indicate U.S. recessions, assuming the 2020 recession ended in April. Last observation: January 2021.

Inflation Expectations Recovering Toward Inflation Target

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.
- 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.
- This would be a welcome development for the FOMC, as inflation has generally been below target for many years.

Inflation expectations improving



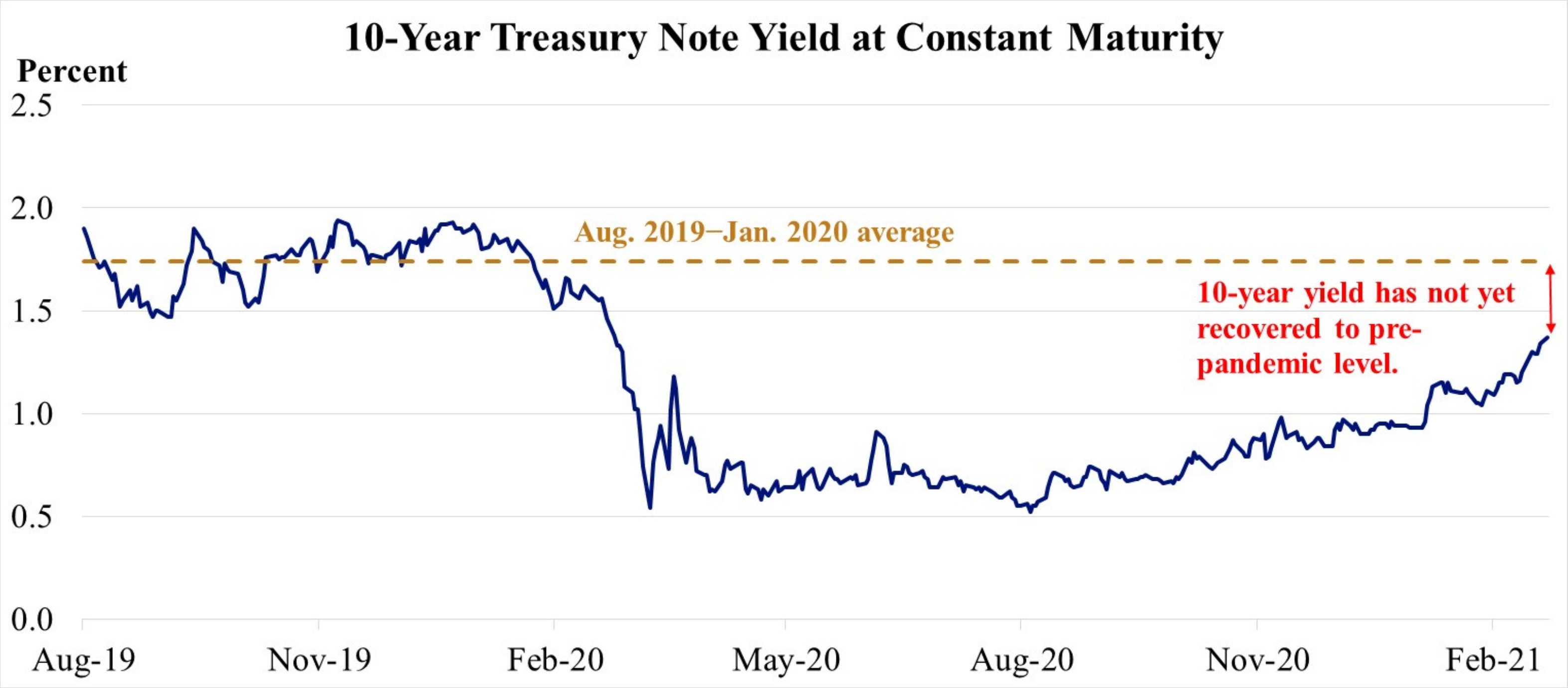
Sources: Federal Reserve Board and author's calculations. Last observations: Feb. 12, 2021, and Feb. 22, 2021.

Longer-Term Interest Rates Rising

Growth prospects and the 10-year yield

- The rising probability of an end to the health crisis is strengthening the prospects for U.S. real GDP growth.
- The FOMC's new monetary policy framework means that the Committee will not be as pre-emptive as in the past in attempting to quell incipient inflation pressures.
- With growth prospects improving and inflation expectations rising, the concordant rise in the 10-year Treasury yield is appropriate.
- The increases so far have not returned the 10-year yield to pre-pandemic levels.

Benchmark 10-year yield also increasing



Sources: Federal Reserve Board and author's calculations. Last observation: Feb. 22, 2021.

Conclusion

Light at the end of the tunnel

- Ongoing vaccination programs suggest that the global health crisis 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, and households are less likely to save fiscal transfers with a rising probability of an end to the health crisis. This suggests GDP is likely to grow rapidly in the current quarter and in the quarters ahead.
- Downside risk remains, and continued execution of a granular, risk-based health policy will be critical in the months ahead.

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