FRBSF Economic Letter

2020-37 | December 3, 2020 | Research from the Federal Reserve Bank of San Francisco

2020 Lessons, 2021 Priorities

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What lessons should we take from a difficult year—and what should our priorities be for 2021? Overcoming the harsh and uneven economic impacts of COVID-19 and returning to full employment and sustainable 2% inflation will be the Federal Reserve's chief concerns. But success will require us to have confidence in the power of our tools. The following is adapted from a presentation by the president and CEO of the Federal Reserve Bank of San Francisco to the Arizona State University Economic Forecast Luncheon on December 1.

Hello everyone. It's safe to say that 2020 has been a year to remember. Twelve months ago, we were in the midst of the longest economic expansion in U.S. history. Unemployment sat near historic lows, wages and incomes were rising, and inflation was moving gradually back toward our 2% target.

Then COVID-19 hit our shores. And our fortunes changed almost overnight. To date, more than 250,000 Americans have died and countless others have been sick. People have lost jobs, businesses, and livelihoods, and the burden has fallen most harshly on those least able to bear it. This is an enormous human toll.

Although we've retraced some of the initial economic losses, the economy remains far below the levels of employment and output we had prior to COVID-19. And coronavirus cases are once again surging.

So today, I will discuss two important questions. What lessons should we take from this difficult year? And what priorities should we focus on in 2021?

2020 lessons

Let's begin by considering the lessons learned from 2020. There are many, but I will focus on those related to the economy and how it functions. Lessons that can help us build a more prosperous and resilient future.

The first lesson is that we are all interconnected. Our fates are tied together—as individuals, as communities, as states, and as a nation.

COVID-19 has exposed this connectivity in stark relief. I think about my own community, Oakland, California. So many businesses in my neighborhood have had to shutter to fight the virus. Without income, these businesses haven't been able to pay their rent. This has passed through to landlords, who've then had trouble paying the mortgages on the buildings they own. This then spilled onto banks, who had to cover the forbearance or loss, leaving them with fewer funds to lend to other businesses looking for a lifeline. And on and on it goes. The circular flow we all learned about in Economics 101 is real.

But while we are all interconnected, COVID-19 has reminded us that the impact of economic shocks does not fall equally. That's the second important lesson from this year. Not everyone has the same experiences in our society. And far too often these differences in outcomes trace back to race, ethnicity, gender, or socioeconomic position.

You can see this in the data on COVID-19. A disproportionate share of pandemic job losses have occurred among men and women of color (Gould and Wilson 2020, Kochhar 2020). Mothers with children at home have had to leave the labor force altogether to provide schooling and child care (Edwards 2020). And low and moderate income communities across the country have seen an outsized decline in income and wealth at the same time that the basic needs of their citizens have risen (Shrimali, Mattiuzzi, and Choi 2020).

Of course, these are not new issues. But the lens of COVID-19 has vividly and painfully highlighted their costs.

And this leads me to my third lesson of 2020. We are limiting our economic prosperity. Persistent and pervasive differences in outcomes repeatedly leave talent on the table and cost our economy (Cook 2020, Bostic 2020, Hsieh et al. 2019, Daly 2019a).

Looking only at differences in outcomes by race, a recent report found that aggregate economic output since 2000 would have been $16 trillion higher if Black and white Americans had more equal education and wages. To put this in growth terms, the U.S. economy would have grown about two-tenths of a percentage point faster every year since 2000 if these gaps had been closed (Peterson and Mann 2020).

And racial differences in education and wages are only some of the gaps in our society. Differences in credit, wealth, and occupational and investment opportunities by race, ethnicity, and socioeconomic status cumulate to mean less innovation, lower productivity, and ultimately slower growth for everyone (Cook 2014, Cook and Gerson 2019, Hsieh et al. 2019, Matthews and Wilson 2018, Peterson and Mann 2020).

2021 priorities

So what do these lessons imply for policy priorities going forward? There are many to consider, but today I will focus on the ones related to monetary policy and the Federal Reserve.

Sustain the bridge

An important precondition for continued economic recovery is that the virus be well contained. Unfortunately, the public health trajectory is very worrisome, with COVID-19 cases, hospitalizations, and deaths trending higher across the country.

So the Federal Reserve's first priority is to use its tools to help bridge the economy across the disruptions caused by the virus. This means keeping the federal funds rate near zero and continuing to perform our lender of last resort responsibilities. The Federal Reserve established a broad set of emergency lending facilities in March 2020 (Powell 2020). Funding for these programs via the U.S. Department of the Treasury is slated to expire at the end of 2020, and the Federal Reserve has announced plans to return the unused portions of the funds allocated to the CARES Act facilities. As noted there, the Federal Reserve retains additional financing options via the Exchange Stabilization Fund.

Our commitment to maintaining an accommodative stance until the economy is back on stable footing lowers borrowing costs for households, businesses, and state and local governments (Board of Governors 2020a, b). And so far our policies are working. Interest rate-sensitive sectors, like housing and autos, have rebounded sharply in the past six months. Individuals and businesses have been able to refinance debt, initiate new loans, and make investments, which has kept more workers employed in the economy. This translates into stronger income and consumption growth for millions of Americans.

But we must stay vigilant. So the Fed will be ready to respond with our full range of policy tools until COVID-19 is behind us.

Return to full employment and sustainable 2% inflation

Then the real work will begin. COVID-19 will leave a deep hole, and it will take ongoing monetary policy support to bring us back to full employment and average 2% inflation.

So what will that look like? The fundamental road map can be found in the Federal Open Market Committee's new monetary policy strategy announced in late August (Board of Governors 2020c). That document acknowledged that maximum employment is not a fixed target. It is a broad-based and inclusive goal that changes as the economy evolves. The strategy also clarified that achieving our price stability goal—inflation of 2%—requires a new regime: flexible average inflation targeting. In practice, this means we will be willing to accept periods of moderately above 2% inflation, in order to offset sustained periods of below 2% inflation.

Using this strategy document, the FOMC released forward guidance in September, saying that we expect to keep the target range for the federal funds rate at 0–¼% until labor market conditions have reached levels consistent with maximum employment and inflation is on track to moderately exceed 2% for some time. This approach will support the economic recovery and the Fed's dual mandate goals.

Remember that our tools are powerful

So what could get in our way? History points to one important thing: doubts that our tools are powerful enough to achieve our goals (Romer and Romer 2013).

A full and true recovery from COVID-19 will most likely be protracted. And it will be tempting, as time passes, to think that monetary policy has done all that it can. That we no longer have a role to play.

We saw this in the last recovery. There were concerns among some that the Federal Reserve was overstepping its role and using monetary policy to influence long-standing structural problems like skills gaps and permanent job dislocation (Kocherlakota 2010, Lacker 2012, and Phelps 2008; Daly et al. 2012 provide an alternative view). But the data did not support those fears, and monetary policy remained accommodative. The result was the longest expansion in U.S. history, a historically low unemployment rate, and a significant narrowing of wage, income, and wealth gaps in the economy (Aaronson et al. 2019, Robertson 2019, Semega et al. 2020, Bhutta et al. 2020).

The priority going forward will be to *remember*. To remember that workers and firms are flexible, people are resilient, and with a strong economy the labor market is more durable and elastic than we think. To remember that, by supporting strong and sustained growth, monetary policy can help deliver the full employment outcomes we desire.

Of course, the temptation to think we are powerless will be even greater for inflation. After all, we only occasionally brushed against our 2% target in a nearly 11-year expansion. But decades of research have repeatedly shown that inflation in the long run is primarily determined by monetary policy—and central banks have the ability to control where it settles.

Our primary tool for achieving our inflation goal is our credibility. And here the move to flexible average inflation targeting is powerful. It tells households and businesses that we are fully committed to delivering 2% inflation over time and ensures that inflation expectations remain well-anchored around our target.

Going forward, we will need to match these statements with our policies. Hitting or exceeding 2% inflation for a few months does not mean victory. To fully achieve the goal of price stability, we need to see a sustained period of moderately above-target inflation. Only then will the job be complete.

So again, we will need to remember. Remember that inflation is always and everywhere a monetary phenomenon (Friedman 1970, p. 24). That even when progress is gradual the central bank can, with commitment, bring inflation sustainably to target.

Ensure that we can finish

Now the implications of my remarks thus far are that policy rates will likely be lower for longer. This naturally raises concerns about financial stability. In such a low rate environment, investors could reach for yield, asset markets could inflate, and the banking and broader financial system might find itself ill prepared to cope should the economy falter.

While these risks cannot be dismissed, it is not at all clear that conventional monetary policy is the best way to mitigate them. Interest rates are a blunt tool. Moving them to combat financial imbalances has limited upsides and potentially significant downsides, such as derailing an expansion and leaving us short of our maximum employment and price stability goals (Jordà, Schularick, and Taylor 2015, Bernanke 2015, Svensson 2015).

Other, better methods include tools directly targeted on the financial system. Over the past decade, regulators around the globe have developed and strengthened a suite of micro and macro prudential programs designed to keep financial firms well capitalized over the business cycle (Yilla and Liang 2020, Williams 2015). In the United States, these include capital and liquidity stress-testing and tools like the countercyclical capital buffer and the stress capital buffer. The Fed also has the power to restrict banks from paying dividends or doing share buybacks when capital could be at risk, as recently executed in response to the pandemic.

All of these policies are built on the recognition that well-capitalized banks are critical to a healthy financial system and that the best capital banks can get is the capital that they already have.

In coming years, we will need to continue to build out and strengthen our suite of tools to further mitigate risk. The financial system and the economy are constantly changing, and regulatory principles and supervisory approaches must evolve to keep pace. It's easy to see where more may be needed. A growing share of financial intermediation in the U.S. takes place outside of the formal banking system. Understanding this evolution and how it impacts financial stability is critical (U.S. Department of the Treasury 2020). The rising frequency of devastating weather events also demands attention. It highlights the need for further work on climate risk and how it will affect the financial system and the broader economy (Brainard 2019 and Daly 2019b).

Ensure that our work helps everyone

Finally, we will need to do more to ensure that the benefits of low interest rates and rising asset valuations can spread widely throughout the economy.

The COVID-19 response made it clear that our interest rate policies and lending programs do not reach everyone equally. Many businesses and households are outside of the traditional banking system and do not have the same opportunities to refinance or initiate loans (Shrimali, Mattiuzzi, and Choi 2020, Liu and Parilla 2020). We've heard repeatedly in the 12th District and across the country that these differences hampered the pandemic relief, slowing its delivery to many in need.

To solve these issues, and increase the reach of the financial infrastructure, we will need to think outside of the traditional banking box. This could mean developing firmer partnerships with Community Development Financial Institutions and other nonprofit or small dollar lenders. These institutions are already connected to low- and moderate-income communities and are innovating to improve their reach among those most in need. It could also mean taking lessons from recent months and developing blueprints for lending relief programs that can be more equitably deployed next time they are needed.

The bottom line is clear. Building safe and sound ways to increase financial support to all Americans needs to be a top priority (Hangen and Swack 2020, Opportunity Fund 2018).

Summing up

There is no doubt that 2020 has been a challenging year. It's reversed so much of the economic progress we made in the last expansion, and highlighted and magnified the persistent and systemic barriers that prevent us from reaching our potential. But it's also brought us clarity. Clarity of priorities and clarity of purpose.

As we close this year and move on to the next, let's bring that thread with us. The path will not be easy and the journey will not be short. But if we align together and use all of our tools, we will complete the job. And this is what 2021 demands of us. Thank you.

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