Federal Reserve Bank of Boston®

Taking Stock of the Economic Recovery and the Opportunities to Bolster Financial Stability

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Improved Outlook

- One-third of Americans have received at least one dose of vaccine
- Economy is responding to improvements in the public health outlook
  - Payroll employment grew by over 900,000 jobs in March
  - Significant improvement in industries most impacted by pandemic
- Economy still has challenges
  - Unemployment is still relatively high at 6 percent
  - Impact has fallen disproportionately on firms and individuals impacted by social distancing
  - Many firms and households still in significant economic distress

Very Strong Forecasts

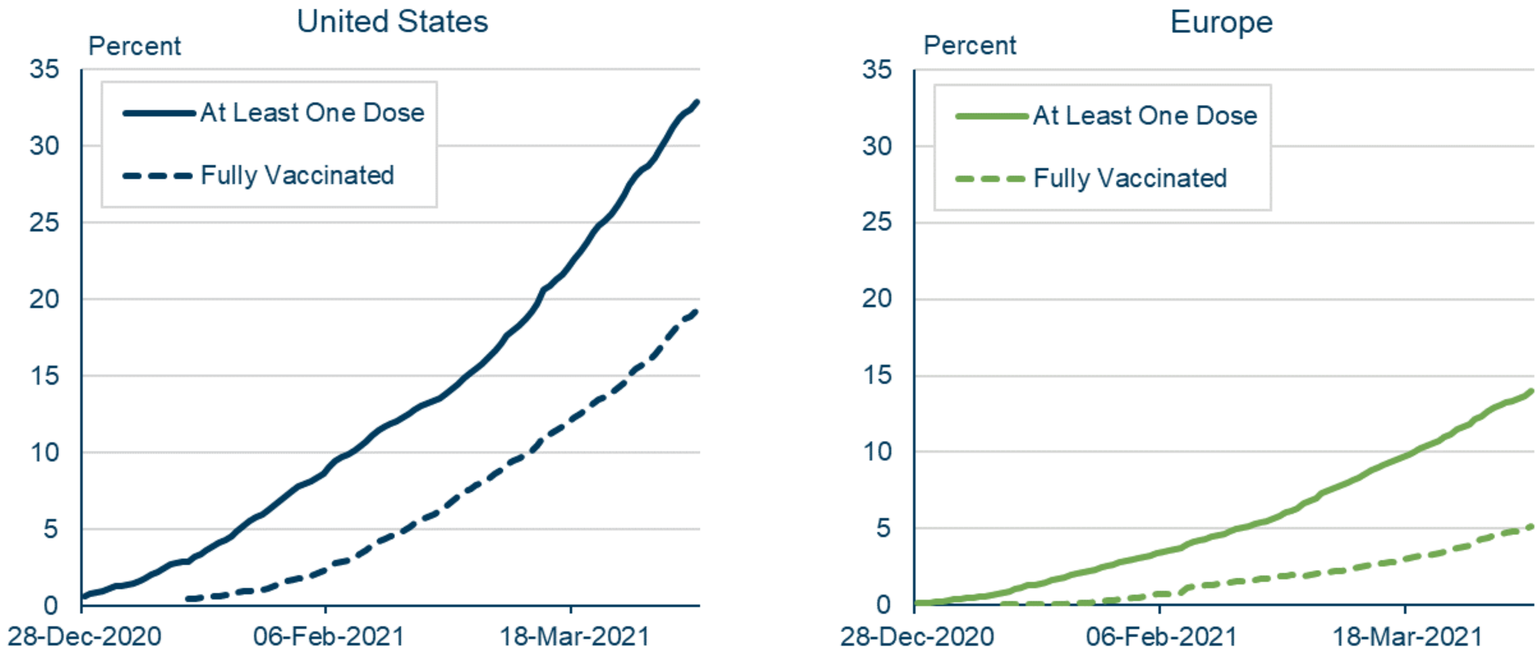
- Federal Reserve policymakers’ median projection reflects a rapidly recovering economy
  - Median forecast of 6.5 percent growth in real GDP
  - Unemployment expected to finish the year more than 2 percentage points lower than at the end of 2020
  - Consumption is expected to be strong (pent-up demand)
- I believe it will still take two years to reach pre-pandemic levels
- Highly accommodative stance of monetary policy is appropriate to return economy quickly to pre-pandemic levels

Running a "Hot" Economy has Risks

- Three important financial stability risks are apparent from the pandemic downturn:
  - Past two recessions – short-term credit markets disrupted by outflows from prime and tax-exempt money market funds
  - Treasury market was disrupted by rapid sales – impacting functioning of this critical market
  - Concerns with credit availability required forbearance for banks and borrowers
- Economy needs to be more resilient – these risks need to be addressed

Figure 1: COVID-19 Vaccinations: Share of Population Receiving At Least One Dose and Fully Vaccinated

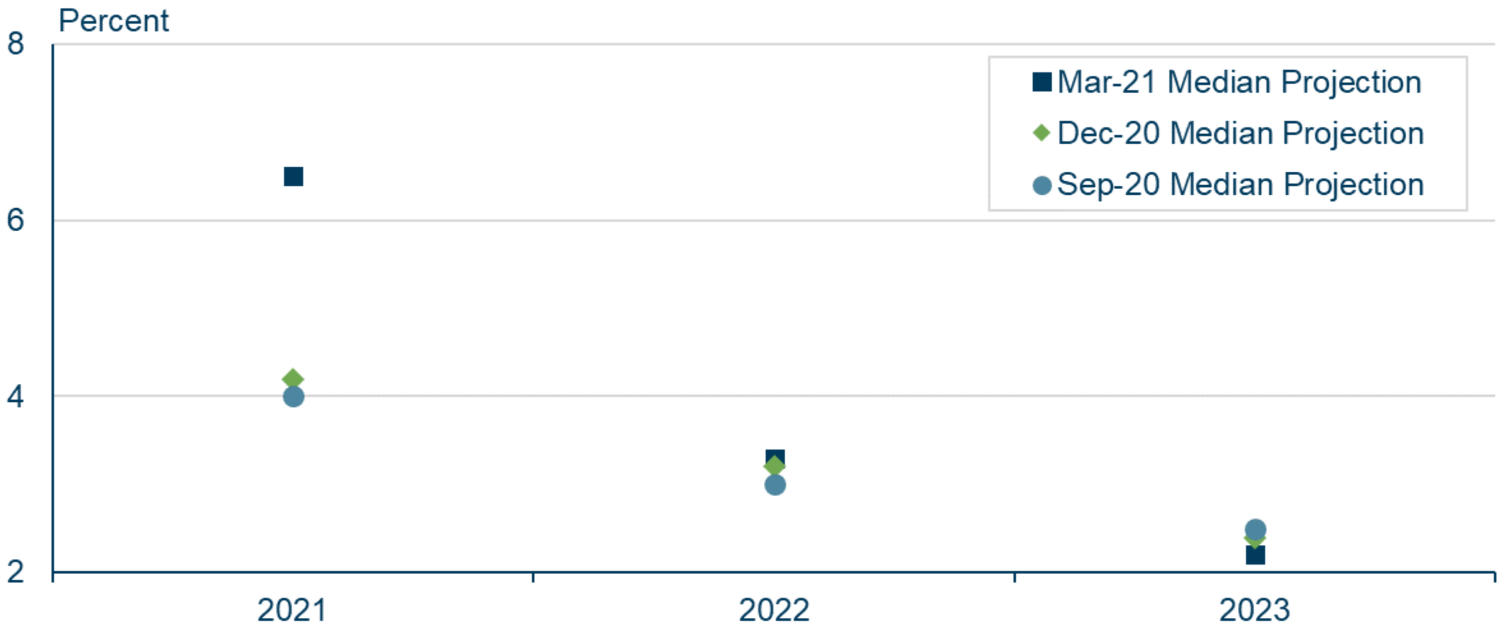
December 28, 2020 - April 7, 2021



Source: CDC, Our World in Data, University of Oxford

Figure 2: Real GDP Growth: Forecasts from the Summary of Economic Projections

2021 - 2023

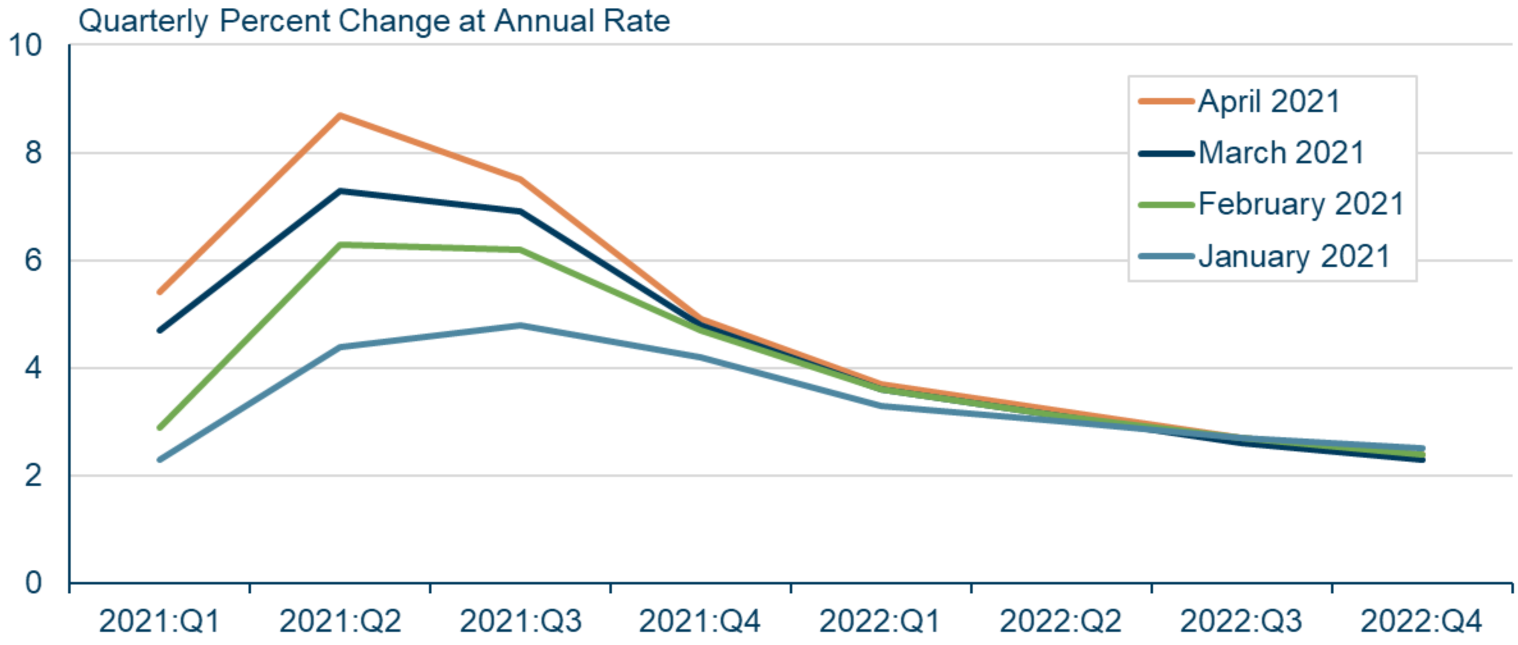


Note: The Real GDP forecast is for the percent change in Real GDP from the fourth quarter of the previous year to the fourth quarter of the year indicated, for 2021 - 2023.

Source: FOMC, Summary of Economic Projections, September 16, 2020, December 16, 2020, and March 17, 2021

Figure 3: Blue Chip Forecasts for Real GDP Growth

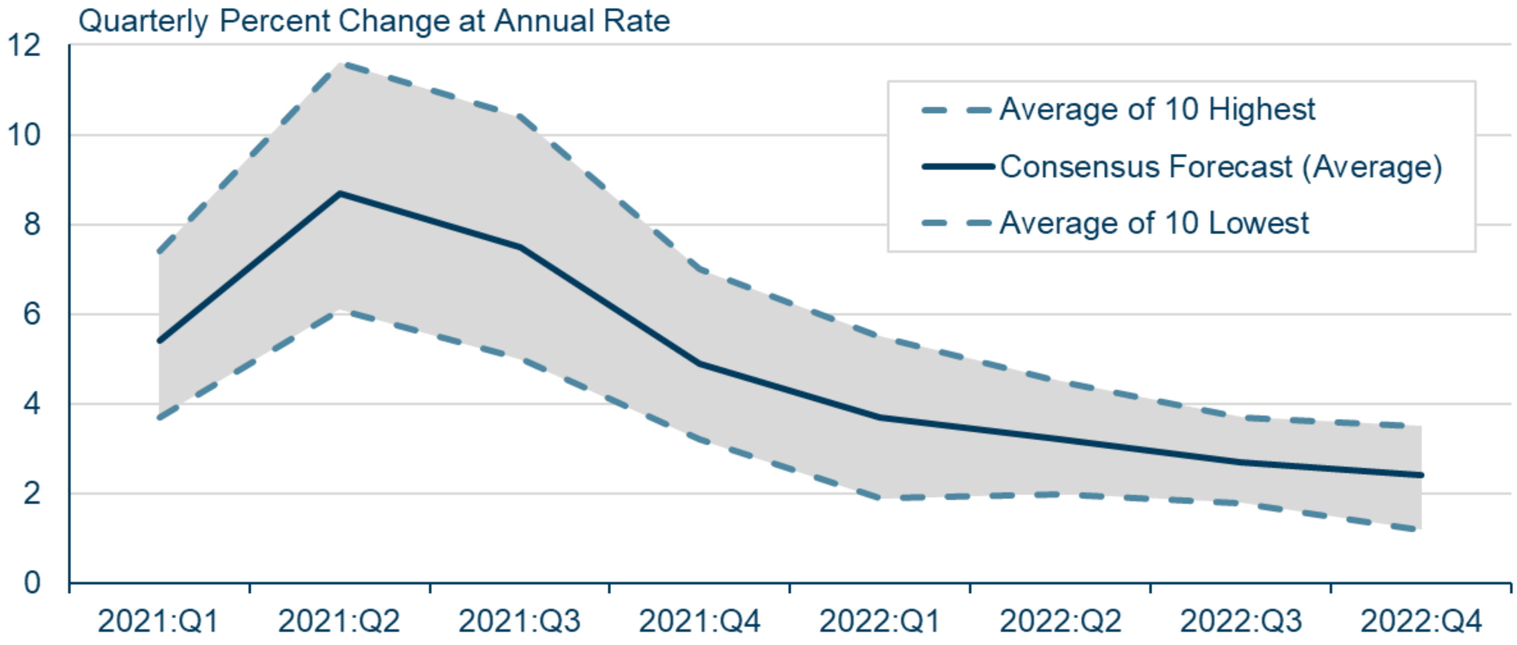
2021:Q1 - 2022:Q4



Source: Blue Chip Economic Indicators, January 11, 2021, February 12, 2021, March 12, 2021, and April 9, 2021

Figure 4: Blue Chip Forecast for Real GDP Growth, April 2021

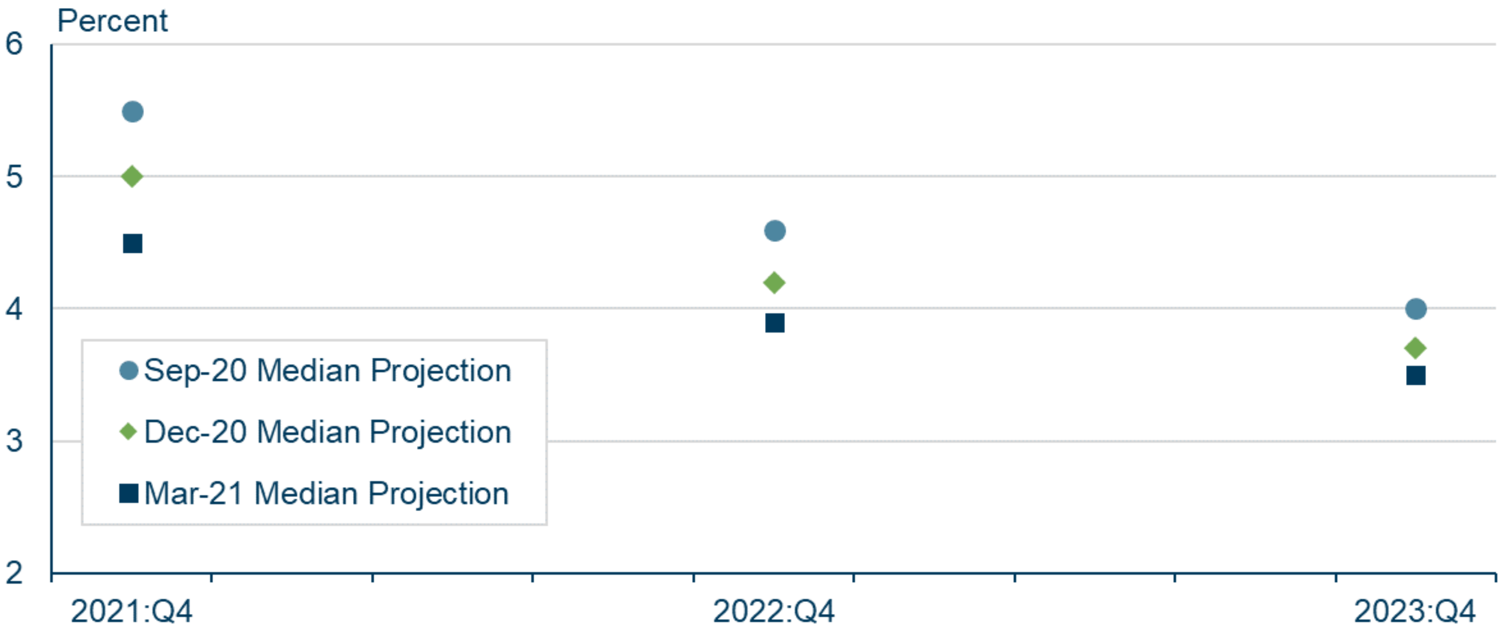
2021:Q1 - 2022:Q4



Source: Blue Chip Economic Indicators, April 9, 2021

Figure 5: Unemployment Rate: Forecasts from the Summary of Economic Projections

2021:Q4 - 2023:Q4

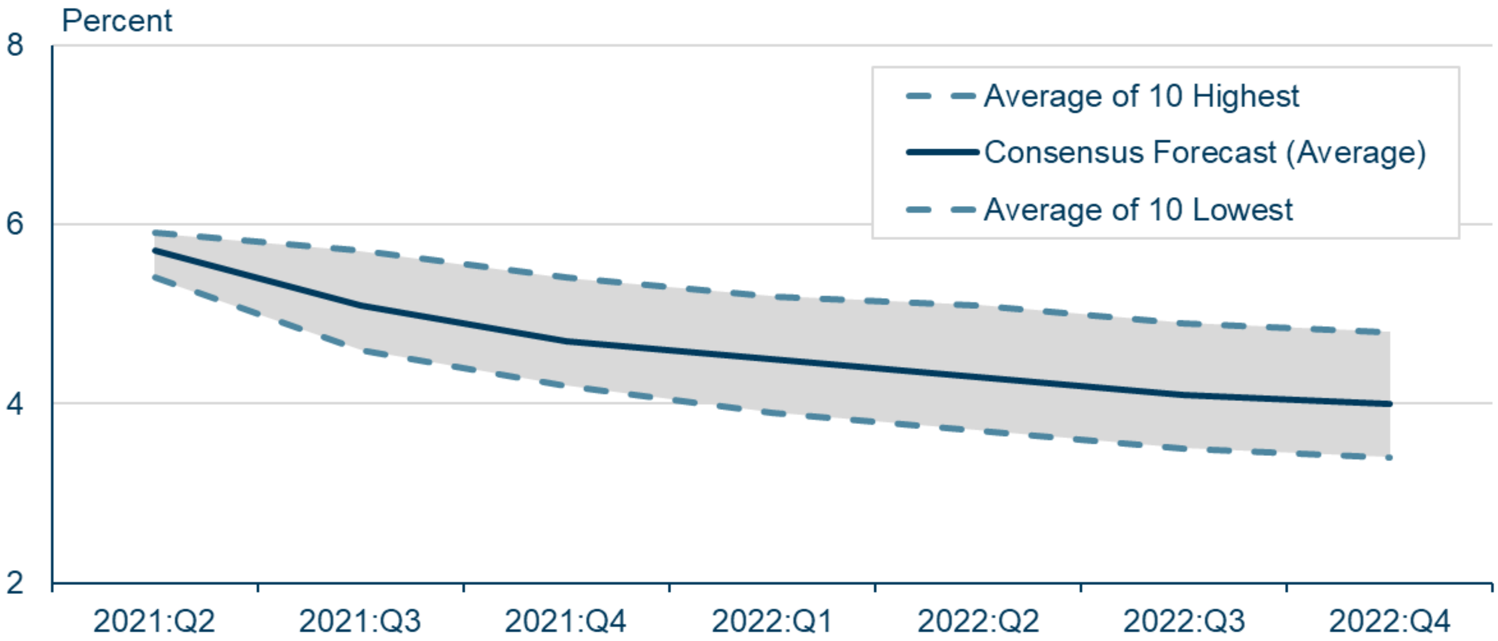


Note: The unemployment rate forecast is for the unemployment rate in the fourth quarter of the year indicated, for 2021 - 2023.

Source: FOMC, Summary of Economic Projections, September 16, 2020, December 16, 2020, and March 17, 2021

Figure 6: Blue Chip Forecast for the Unemployment Rate, April 2021

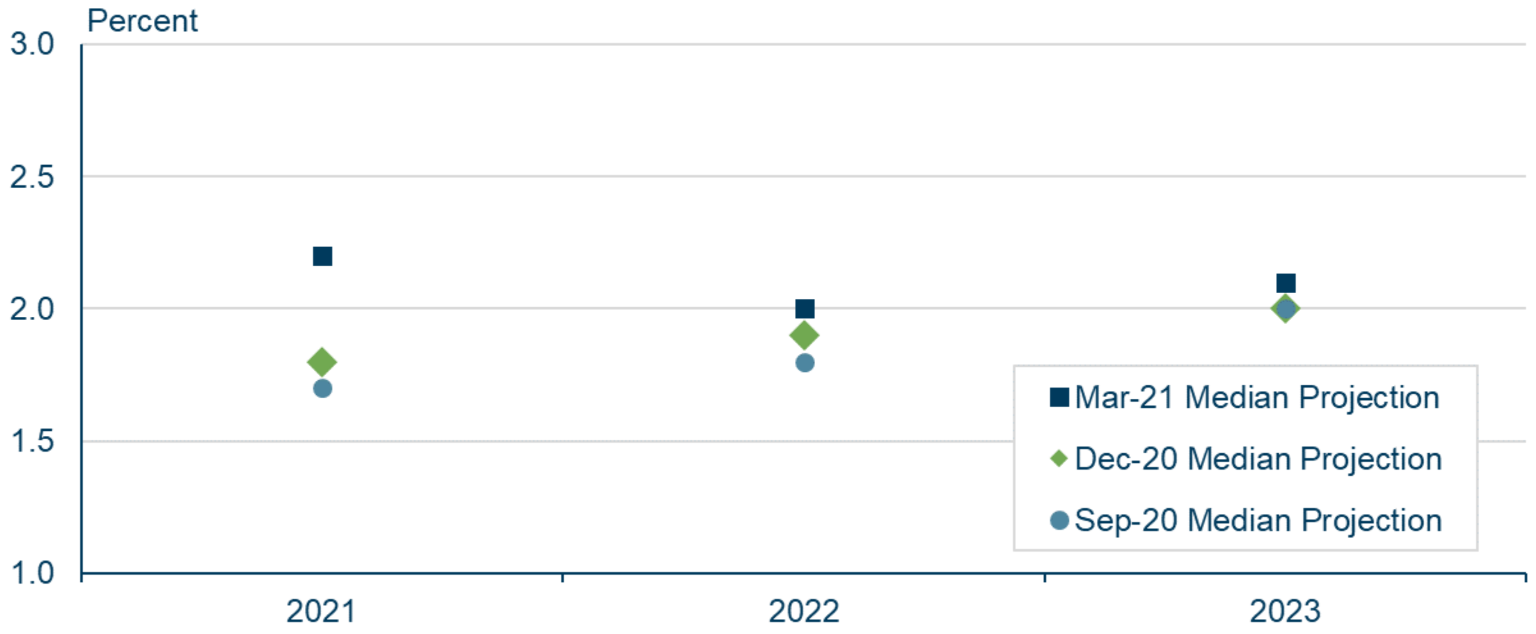
2021:Q2 - 2022:Q4



Source: Blue Chip Economic Indicators, April 9, 2021

Figure 7: Core PCE Inflation: Forecasts from the Summary of Economic Projections

2021 - 2023

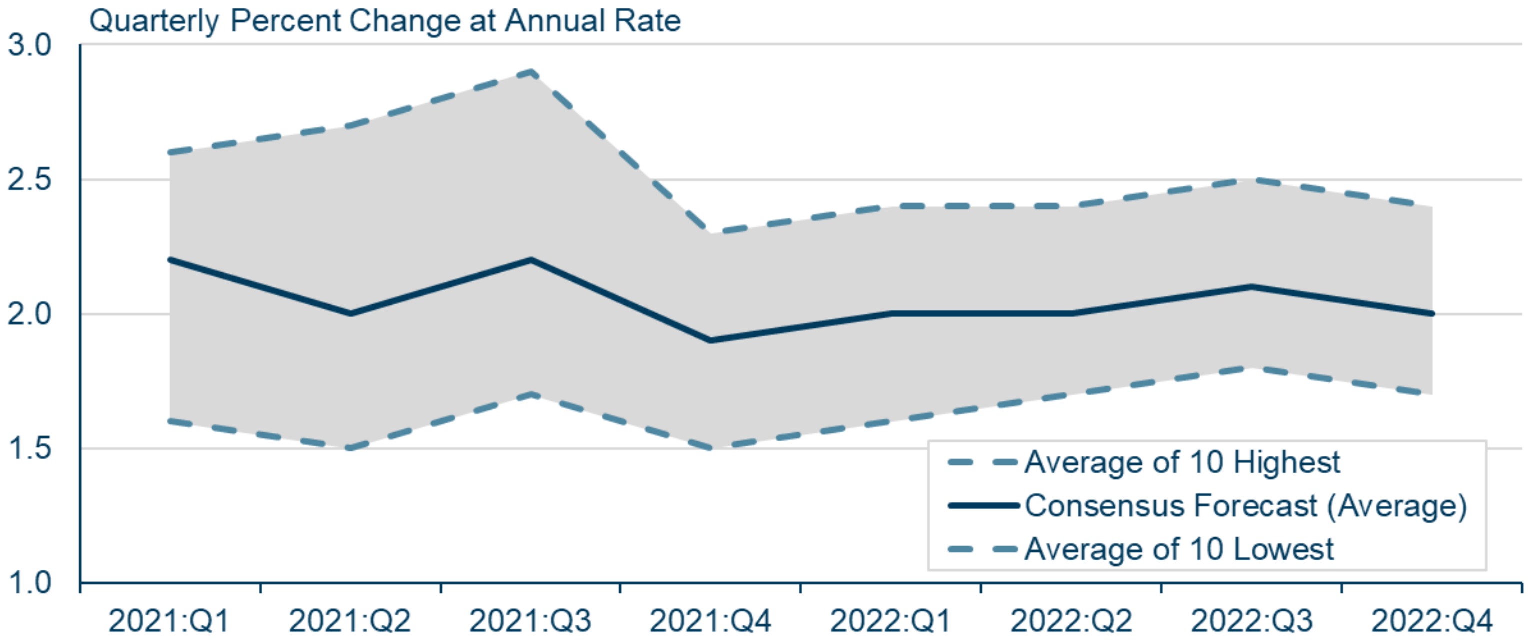


Note: The core PCE inflation forecast is for the percent change in core PCE inflation from the fourth quarter of the previous year to the fourth quarter of the year indicated, for 2021 - 2023. Core PCE excludes food and energy.

Source: FOMC, Summary of Economic Projections, September 16, 2020, December 16, 2020, and March 17, 2021

Figure 8: Blue Chip Forecast for Core PCE Inflation, April 2021

2021:Q1 - 2022:Q4

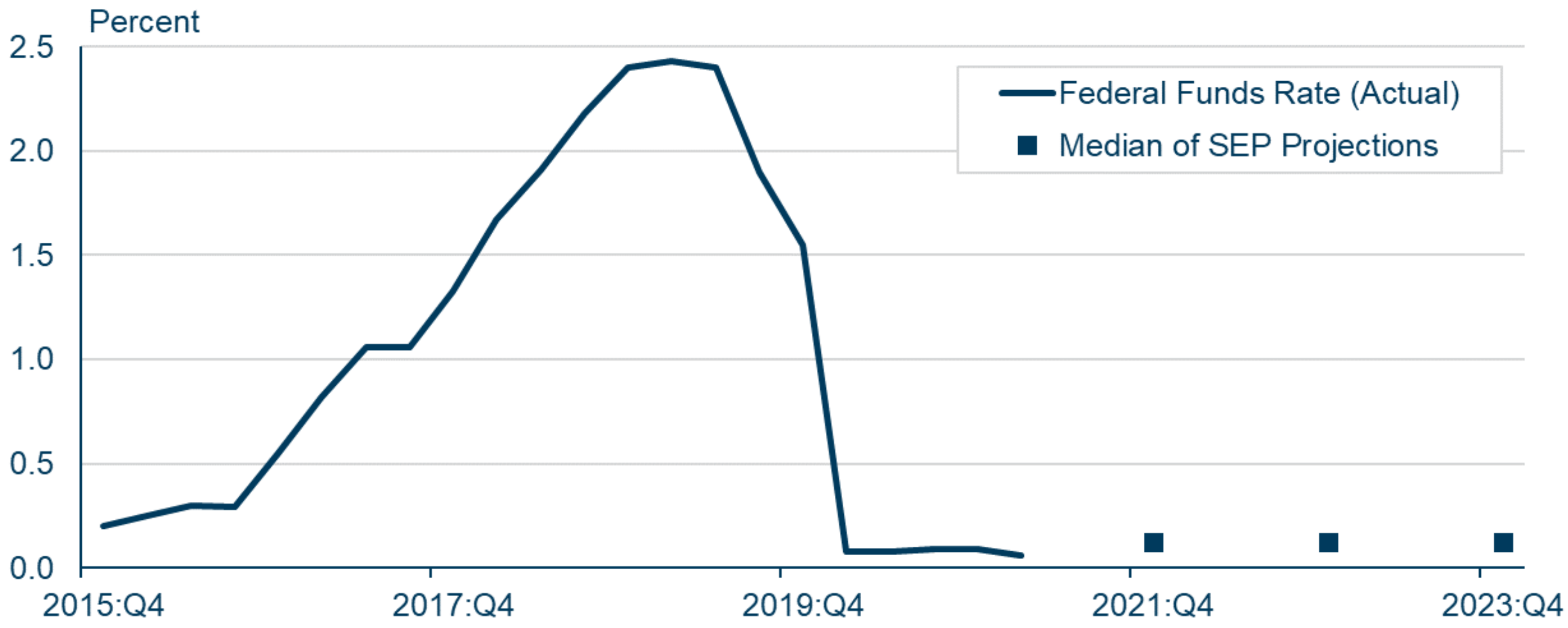


Note: Core PCE excludes food and energy.

Source: Blue Chip Economic Indicators, April 9, 2021

Figure 9: Federal Funds Rate: Actual and Forecast from the Summary of Economic Projections

2015:Q4 - 2023:Q4



Note: Rates are as of end of period. The SEP federal funds rate projections are the midpoints of the target ranges at year-end, for 2021 - 2023.

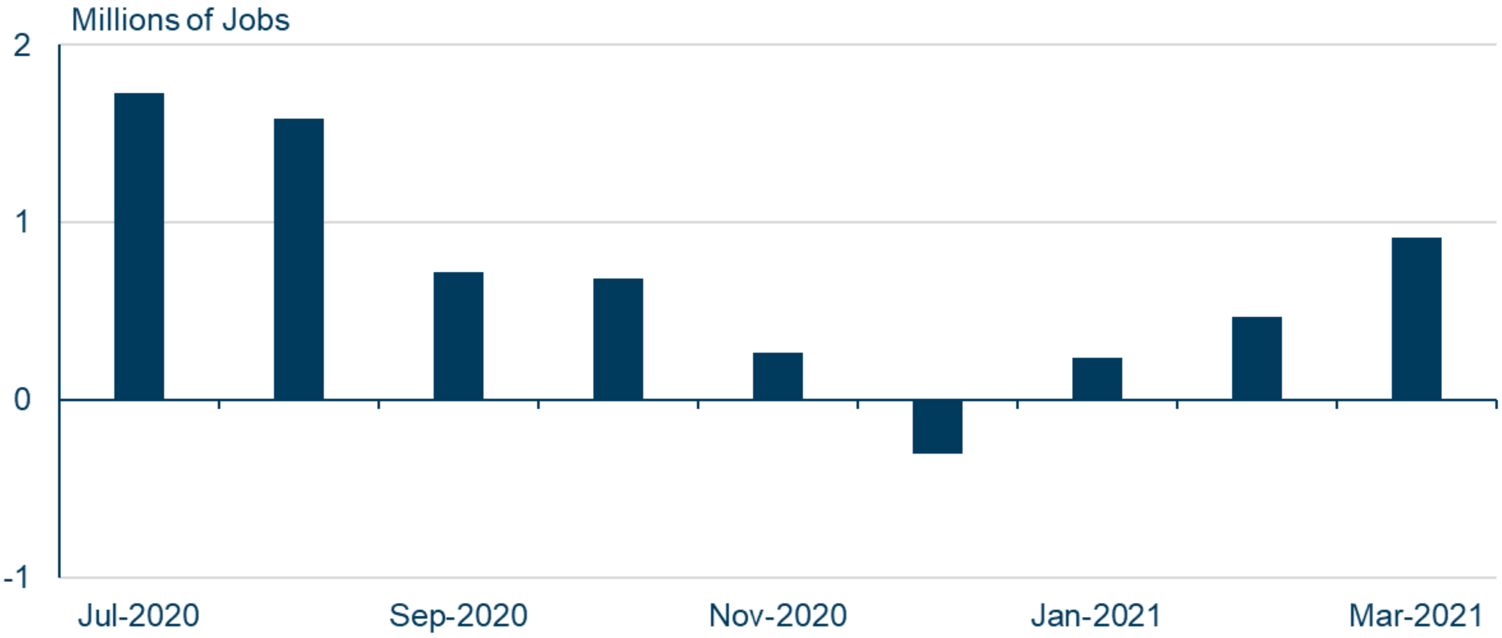
Source: Federal Reserve Board; FOMC, Summary of Economic Projections, March 17, 2021; Haver Analytics

Implications for Monetary Policy of an Optimistic Outlook

- Policy framework was changed to support a return to full employment and two percent inflation more quickly than in the past
- Implies monetary policymakers can be more patient about tightening
- React to outcomes, not just forecasts, of key economic variables before raising interest rates

Figure 10: Change in Payroll Employment

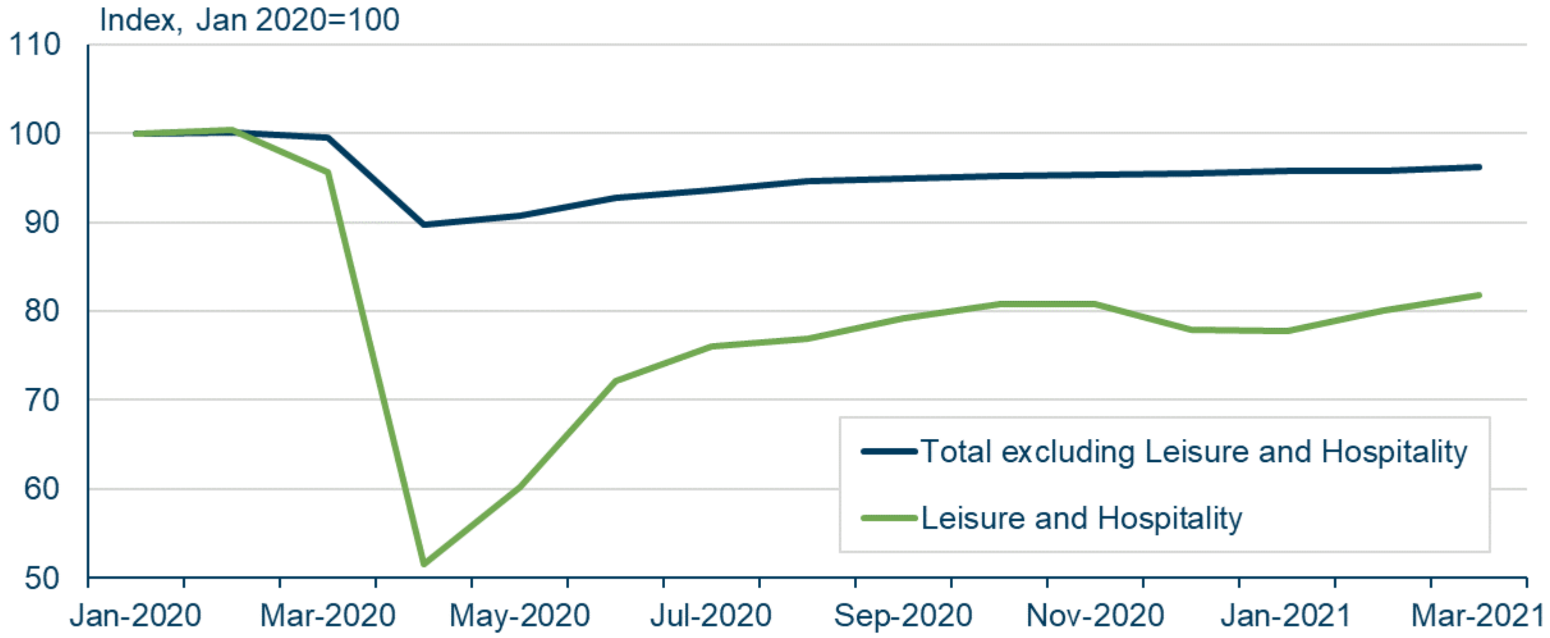
July 2020 - March 2021



Source: BLS, Haver Analytics

Figure 11: Payroll Employment Growth Since January 2020

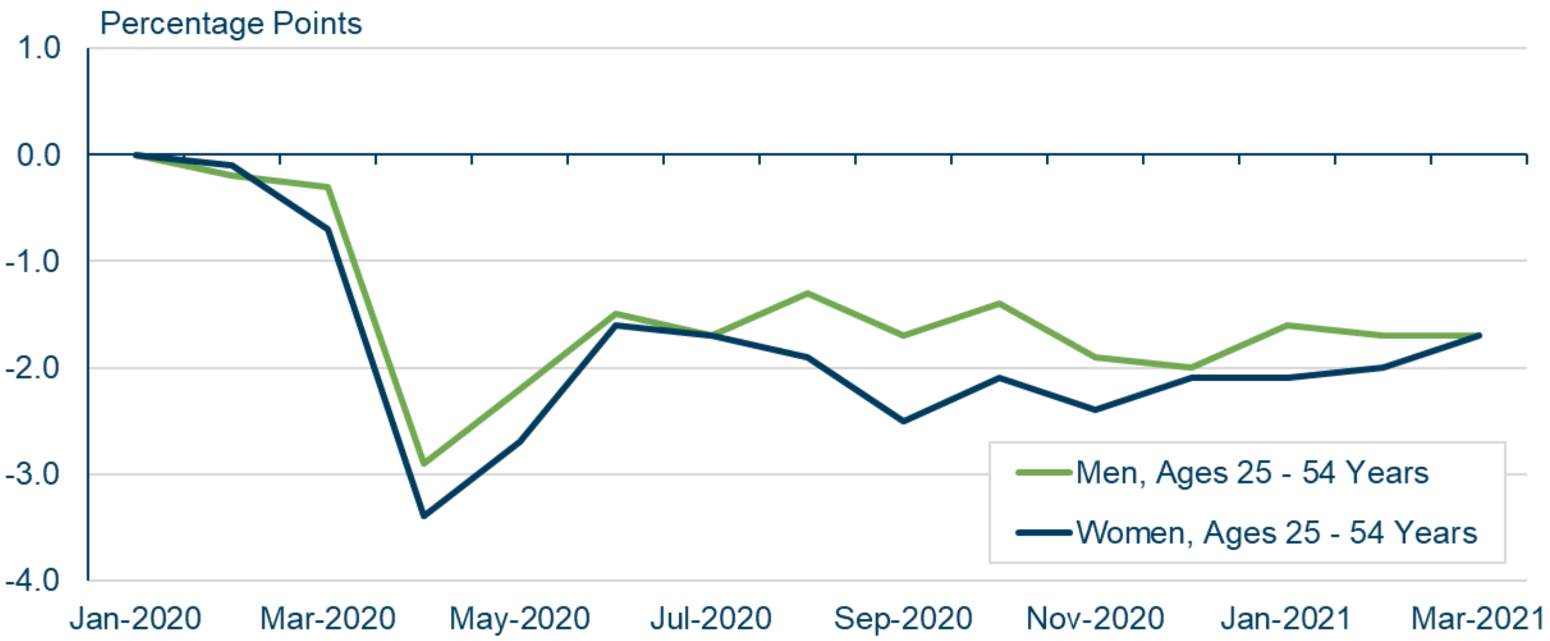
January 2020 - March 2021



Source: BLS, Haver Analytics

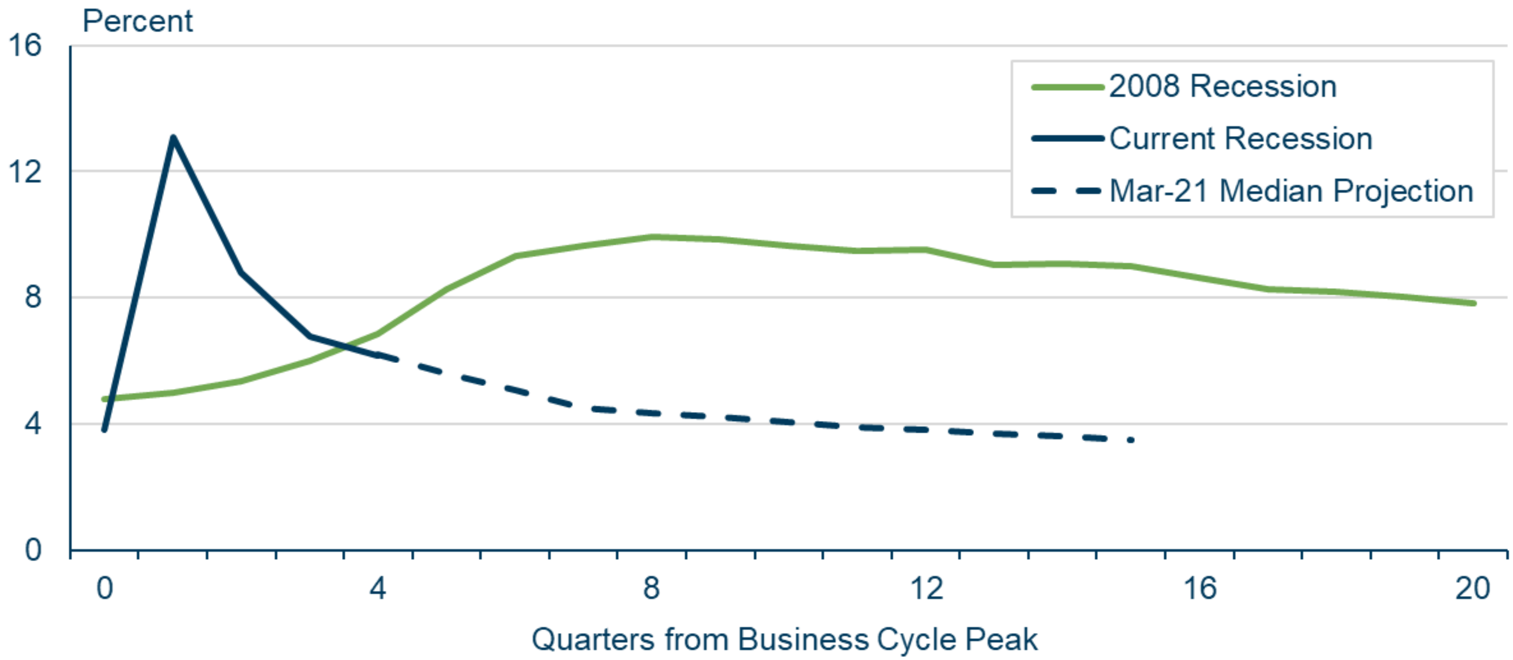
Figure 12: Change in the Labor Force Participation Rate Since January 2020 for Prime Working Age Men and Women

January 2020 - March 2021



Source: BLS, Haver Analytics

Figure 13: Unemployment Rate Path in Current and Previous Recession



Note: Quarters from 2007:Q4 and 2020:Q1. The unemployment rate forecast is interpolated from the median SEP projection for the unemployment rate in the fourth quarter of the year indicated, for 2021 - 2023.

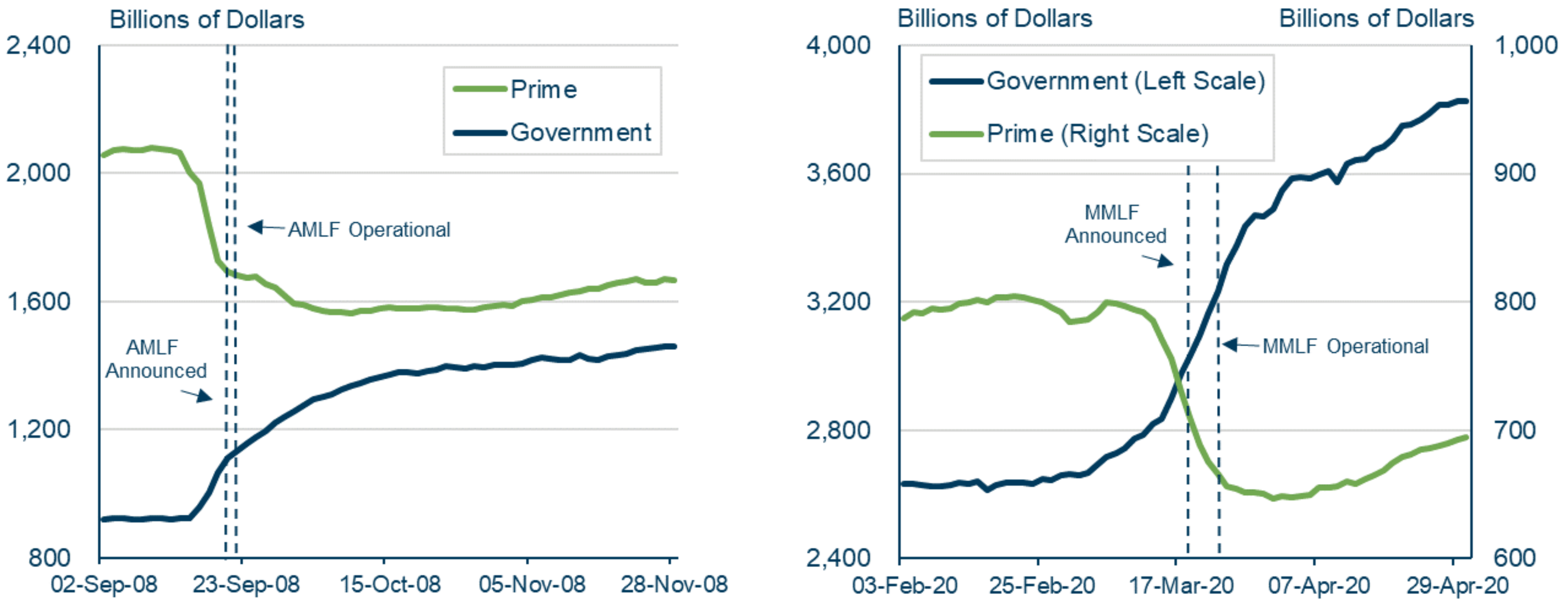
Source: BLS; Federal Reserve Board; FOMC, Summary of Economic Projections, March 17, 2021; Haver Analytics

Policy Supports More Rapid Improvement

- Both monetary and fiscal policy are highly accommodative
- While the economic shock is different, the goal is to recover much more quickly than after the 2008 recession
- The forecasts by Federal Reserve policymakers reflect a policy that encourages a rapid return to full employment
- FOMC participants currently expect the unemployment rate to decline to just under 4 percent within two years

Figure 14: Prime and Government Money Market Fund Assets Under Management

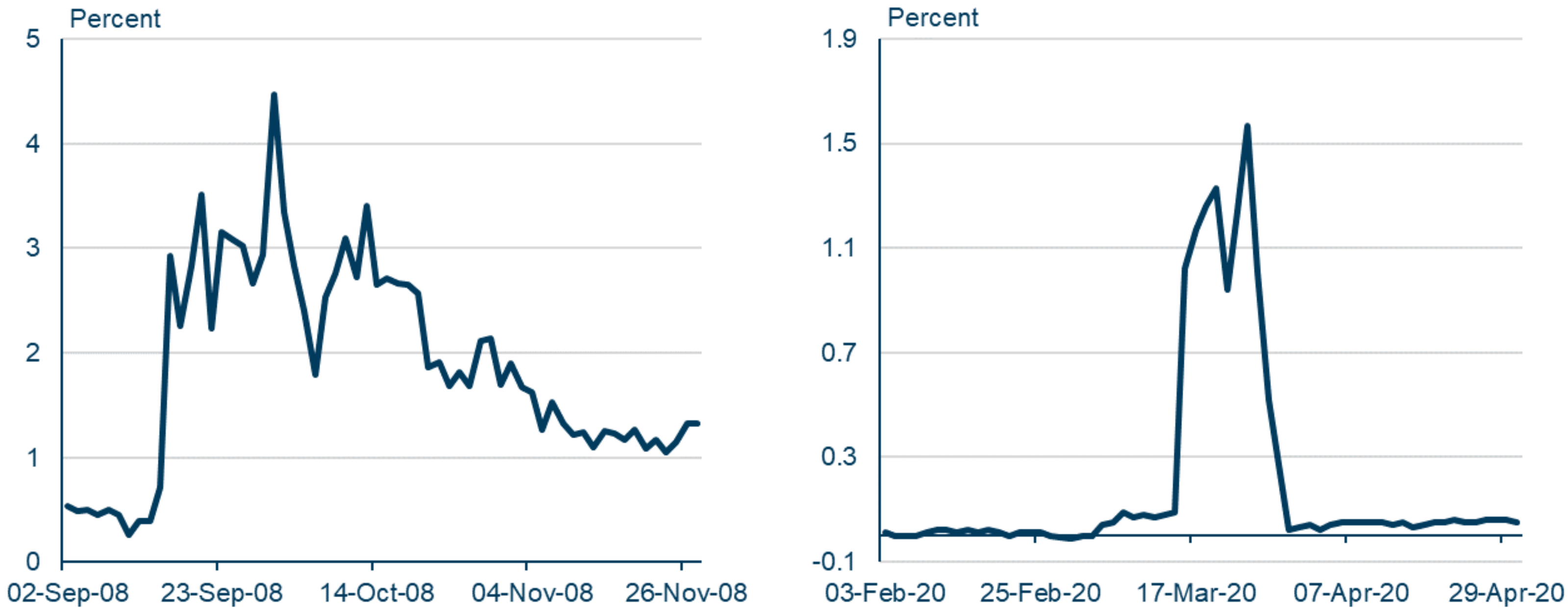
September 2 - November 28, 2008 and February 3 - April 30, 2020



Source: iMoneyNet

Figure 15: Spread Between Highly-Rated Asset-Backed Commercial Paper Rate and the Federal Funds Rate

September 2 - November 28, 2008 and February 3 - April 30, 2020



Source: Bloomberg Finance L.P., Federal Reserve Board, Haver Analytics

First Risk – Short-term Credit Markets

- Past two recessions, have been disrupted by prime and tax-exempt money market mutual funds (MMMFs) due to rapid, large outflows of funds
- Necessitated emergency lending facilities – should not be needed
- Unlike prime and tax-exempt funds, government MMMFs did not experience same problems – instead they experienced large inflows
  - Possible solution: require conversion to government funds
- Remaining structural vulnerabilities in corporate debt MFs, too, which allow daily redemptions
  - Possible solution: require all MFs to adopt swing pricing

Second Risk – "Dash for Liquidity"

- In March 2021 markets buffeted by large volume of sales of Treasury securities by entities seeking to bolster liquidity positions
- Treasury infrastructure relies on broker-dealers which can be challenging when rapid one-sided sell orders occur
- Need structural change that is less reliant on balance sheets of broker-dealers
  - Possible solution: expand central clearing mechanisms for Treasury securities and the financing of Treasury securities

Third Risk – Constrained Credit

- Variety of regulatory relief proposals were implemented to avoid credit constriction by banks
  - Forbearance for borrowers
  - Encouragement for banks to use capital buffers
  - Relaxation of prevailing capital requirements
  - Banks asked to stop share repurchases and limit dividends
- My view: these measures were appropriate
- Bank investors and management would prefer less uncertainty about distributing capital
- Bank regulators would prefer to not suspend bank regulations

Role for Countercyclical Capital Buffer (CCyB)

- More flexibility to respond to economic downturns
  - Buffer built up during recoveries
  - Buffer drawn down during downturns
- More resiliency – CCyB provides a “shock absorber”
- Allow borrower financing to continue without extraordinary and less predictable measures

Concluding Observations

- Economy likely to grow rapidly this year
- Should, over two years, reduce slack in labor market and return inflation to 2 percent
- Need to rebuild economy that works for all Americans throughout the inevitable business cycle
- Combination of accommodative monetary and fiscal policy should more quickly return economy to pre-pandemic conditions
- Many of the disruptive financial stability problems observed during the pandemic still need to be addressed