Rebalancing the U.S. Economy and Monetary Policy

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Introduction

It is a real pleasure to join you again in the European Economics and Financial Centre's Distinguished Speakers Seminar series. I do hope we will be able to meet together in London sometime soon. But regardless of whether it is held in-person or virtually, I always enjoy this speaking opportunity because your questions present interesting perspectives, which I contemplate long after the session is over. So I will try to keep my prepared remarks on the U.S. economy and what's ahead for monetary policy relatively brief. As a reminder, the views I present will be my own and not necessarily those of the Federal Reserve System or of my colleagues on the Federal Open Market Committee.

Economic Activity

In an outlook talk at the beginning of the year, it is usually very safe to say that last year was an interesting one and this year is shaping up to be an interesting one as well. That sentiment definitely fits our current situation. When we met early last year, I said that I thought the prospects were good for a much more favorable U.S. economy in 2021 than we had in 2020. That prediction came to pass, but the improvements in the economy obscure the many challenges households, businesses, and policymakers faced because of the ongoing pandemic. Indeed, economic developments continue to reflect the influence of the virus, as well as the extraordinary fiscal policy and monetary policy put in place in response to the pandemic.

Despite the challenges, U.S. economic growth was very strong last year. Real GDP grew at a 5.5 percent pace, the highest annual pace since 1984. Firms added a record 6.7 million jobs to their payrolls and the unemployment rate moved down to about 4 percent, close to its pre-pandemic level. The economy's strength reflected very robust demand by households and businesses. This demand was supported by extraordinary fiscal policy and monetary policy, as well as the deployment of vaccinations, which allowed the economy to reopen more fully. But this strong demand came at the same time there were constraints on product supply and labor supply. The imbalances between supply and demand have put significant upward pressures on prices and wages. Inflation readings in the U.S. are at their highest levels in nearly 40 years, and nominal wages are accelerating at a faster pace than we have seen in decades.

Although there continue to be risks and uncertainty around the outlook, I expect the strong economic expansion to continue this year. Just as the Delta variant did last autumn, the Omicron variant is weighing on activity in high-contact services such as travel, dining, and leisure and hospitality. This variant has put a strain on hospitals, healthcare workers, and other essential services employees. Because Omicron is so transmissible, it has exacerbated the labor shortages many businesses have been facing, and in response, many have had to reduce their operating hours. Thankfully, Omicron is less virulent than earlier strains, and new case counts and hospitalizations are declining sharply in many parts of the U.S. Since the start of the pandemic, as vaccination rates have risen and households and businesses have learned to navigate the virus, each new wave of the virus has had less of an economic impact. My expectation is that the immediate economic effects of the Omicron wave will be relatively small and short-lived, and that households and businesses will once again prove to be resilient in the face of the virus.

When we get beyond Omicron, demand should rebound quickly. Business balance sheets are healthy. Many consumers have the wherewithal to continue to spend because household balance sheets are also very healthy, bolstered by accumulated savings, higher earnings, and rising net worth. I expect growth to be above trend this year, but to moderate from last year’s robust pace, as the support from the pandemic stimulus programs wanes and financial conditions become less accommodative.

Since the economy reopened, supply has struggled to keep up with demand. While shutting the economy down at the start of the pandemic happened very quickly, starting the economy back up again has proved to be slower and more complicated. Differences in virus conditions and virus containment policies across the globe have disrupted global supply chains. Firms have struggled to get necessary parts and materials through clogged ports and transportation channels and are facing significantly higher costs for available inputs. As last year wore on, rather than abating, the disruptions continued to constrain economic activity. A recent sign of improvement comes from manufacturers in our Federal Reserve District, who report that while lead times remain long, deliveries have become more predictable. Nonetheless, while half of our business contacts expect some easing of the supply disruptions during the second half of this year, more than a third do not expect improvement until 2023.

Labor Market Conditions

By a number of measures, labor markets are very strong and the demand for workers is well outstripping labor supply. Payroll employment is still nearly 3 million jobs below its February 2020 pre-pandemic level, but job gains averaged over 550 thousand per month last year. Despite the effects of Omicron, the January jobs report showed continuing broad-based gains. The unemployment rate is now 4 percent, down nearly 2-1/2 percentage points from a year ago. The job openings rate is considerably higher than it was before the pandemic. According to government statistics, there are about 1.7 job openings per unemployed person.

Pandemic-related factors have contributed to the undersupply of workers. Some people, especially women, left the workforce during the pandemic because of child or elder care responsibilities. Some may be waiting until virus conditions improve before reentering the workforce. Others likely took the opportunity that their accumulated savings gave them to retrain for better jobs. These pandemic-related factors that are holding back labor supply should fade over time, but when and by how much are open questions. Over a longer horizon, participation has been trending down since early 2000 due to demographics. In addition, during the pandemic, many more people retired than predicted solely by demographic factors, and in previous business cycles, retirees have not tended to return to the workforce. This means that it will likely take some time before labor demand and labor supply come into balance.

Businesses cite the shortage of labor as a very significant issue and have responded by raising wages, offering signing and retention bonuses, allowing much more flexible work schedules and locations, and speeding up automation. Average hourly earnings grew nearly 5 percent last year, and upward pressure on wages continues as firms scramble to retain and attract workers. Seventy percent of our business contacts reported increasing wages in the past month, and the share raising their wages has been 60 percent or higher since last July.

Inflation

Currently, the imbalances between demand and supply in product and labor markets are contributing to the very high inflation readings. Firms tell us that they are having little trouble passing on their higher costs to their customers. Measured year-over-year, PCE inflation reached 5.8 percent in December, and core PCE inflation reached 4.9 percent. Both are at their highest levels since the early 1980s. The Cleveland Fed's median PCE inflation, median CPI, and trimmed-mean CPI are useful measures of the underlying inflation trend and all have moved well above 2 percent.[1]

Inflation levels began moving up last year as the economy reopened. At first, inflationary pressures were confined to a handful of the most pandemic-affected categories, like lumber and durable goods. But as the year wore on, the inflationary pressures broadened considerably. In December 2020, one-third of the components used to compute the Cleveland Fed's median CPI measure had inflation rates of 3 percent or more; that share has now risen to three-quarters of the components.

At the end of 2020, many forecasters, including those at the Fed, thought that as the economy reopened more fully in 2021, inflation rates would move up but remain slightly below our 2 percent target for the year. As supply constraints pushed inflation rates above 2 percent early in 2021, most forecasters

[1] These measures are maintained by the Cleveland Fed's Center for Inflation Research and are available at https://www.clevelandfed.org/en/our-research/center-for-inflation-research.aspx.

expected inflation to move back down as constraints eased. But the supply constraints have persisted, demand has been very strong, and inflation has continued to rise. As a result, inflation forecasts had to be revised up over the year.

You can see this in our own FOMC projections. As its name suggests, the FOMC's Summary of Economic Projections – or SEP – gives a summary of the economic projections submitted by each FOMC participant. In the December 2020 SEP, the median projection of what PCE inflation would be in 2021 was 1.8 percent. By the December 2021 SEP, that projection had risen to 5.3 percent. In my view, even with the upward revisions, the risks to inflation are still tilted to the upside.

High inflation imposes a real burden on households and businesses, especially those that do not have the wherewithal to pay more for essential goods and services. The nominal wage increases over the past year have benefited many families, but for many of them, the increases have not kept up with inflation. Allowing inflation to remain at high levels can lead firms, households, and financial market participants to expect higher inflation over the longer term. A rise in longer-term inflation expectations could then spill over into wage- and price-setting dynamics, leading to even more persistent inflation. And persistently high inflation would undermine sustaining a strong and inclusive expansion.

I do expect some improvement in inflation readings later in the year as demand moderates and capacity constraints in both product and labor markets begin to ease. But the timing and magnitude of that easing of constraints remain uncertain. My expectation is that inflation will moderate but remain above 2 percent this year and next, but this forecast is conditional on the FOMC taking appropriate action.

Monetary Policy

Just as demand and supply need rebalancing, so does monetary policy. Inflation has been running well above our 2 percent goal for some time, labor markets are very strong, and solid momentum in underlying demand is expected to continue. So the extraordinarily accommodative monetary policy that was needed earlier in the pandemic is no longer appropriate. Moreover, as inflation rates have risen, real interest rates have moved down, meaning financial conditions have become even more accommodative, further raising demand amid constrained supply. While monetary policy cannot alleviate the constraints on supply, it can help to moderate demand by making broader financial conditions less accommodative, thereby reducing inflationary pressures.

The FOMC is now taking steps toward beginning the process of reducing accommodation. In November, the FOMC started reducing the monthly pace at which it had been purchasing Treasury securities and agency mortgage-backed securities; in December, it sped up the reductions; and in January, it announced that the purchases would end in March. These asset purchases were an important policy response to the severe strains in financial markets seen early in the pandemic, and they have continued to support the economy in the midst of the unprecedented COVID shock. But now, markets are functioning and a solid expansion is underway, so these purchases are no longer needed.

The Fed's main policy tool is the federal funds rate. Since March 2020, the FOMC has maintained the target range of the fed funds rate at 0 to 1/4 percent. This January, the Committee announced that it will soon be appropriate to raise the target range. While the Omicron variant may weigh on activity in the near term, the high levels of inflation and the tightness in labor markets make a compelling case to begin recalibrating the stance of monetary policy. Barring an unexpected turn in the economy, I support beginning to remove accommodation by moving the funds rate up in March.

What about the future course of monetary policy? It is clear that removing the extraordinary monetary policy accommodation is needed to help rebalance the economy. The last time we began such a process was in December 2015, and it was a very gradual process, with the target range of the fed funds rate reaching 2-1/4 to 2-1/2 percent in December 2018. This time, I anticipate that it will be appropriate to move the funds rate up at a faster pace because inflation is considerably higher and labor markets are much tighter than in 2015. In my view, increases in the fed funds rate in the coming months will be needed, but the ultimate path of the fed funds rate in terms of the number and pace of increases will depend on how the economy evolves. For example, if by mid-year, I assess that inflation is not going to moderate as expected, then I would support removing accommodation at a faster pace over the second half of the year. On the other hand, if inflation moves down faster than expected, then the pace of removal could be slower in the second half of the year than in the first half.

In terms of our balance sheet, we currently hold nearly $9 trillion in assets, which is about 36 percent of nominal GDP. This is double the asset holdings at the start of the pandemic. In January, the FOMC released a set of principles to guide the planned significant reduction in the size of our balance sheet. These principles affirm that the federal funds rate is our main tool for adjusting monetary policy, that reductions in the balance sheet will commence after the process of increasing the policy rate has begun, and that we intend to reduce our security holdings in a predictable way over time. The principles also reaffirm that in the longer run, the FOMC will hold primarily Treasury securities in its portfolio to minimize the effect of the Fed's holdings on the allocation of credit across sectors of the economy. Today, as a result of our purchases, about a third of our portfolio, over $2.5 trillion, comprises agency securities. While our principles state that we will reduce balance-sheet assets primarily by adjusting the reinvestment amounts of the principal payments we receive on our assets, I would support selling some of our mortgage-backed securities at some point during the reduction period to speed the conversion of our portfolio's composition to primarily Treasuries.

The FOMC has begun to discuss the plan to implement balance-sheet reduction in accordance with the guiding principles. We have the benefit of having done this once before. In the wake of the Great Recession, the FOMC engaged in sizable asset purchases, increasing its asset holdings to about $4.5 trillion, or about 25 percent of nominal GDP at its peak. In October 2017, nearly two years after liftoff of the fed funds rate from zero and with the target range at 1 to 1-1/4 percent, the FOMC began shrinking its balance sheet at a gradual pace. The reductions lasted until August 2019. While this experience will inform our plans, this time, things are different. First, the balance sheet is about double the size it was then, and even in our ample-reserves operating regime, it is considerably larger than the size needed to implement monetary policy efficiently and effectively. Second, inflation is much higher and labor markets are much tighter than they were then. So in my view, conditions warrant that we start balance-sheet reductions soon and go at a faster pace than we did last time.

When to stop the reductions will depend on the banking sector's demand for reserves, as well as the distribution of that demand across institutions, which will evolve over time. As the process to reduce the size of the balance sheet progresses, we will be monitoring developments in money markets to determine the appropriate levels of reserves and balance-sheet size at which to stop the reductions. We will remain prepared to adjust the plan in light of economic and financial developments, if necessary.

Summary

In summary, in setting monetary policy, the Fed is committed to achieving both parts of its dual mandate: price stability and maximum employment. While the current extraordinarily accommodative stance of monetary policy was needed to support the economy earlier in the pandemic, that stance is no longer appropriate. Strong demand in both product and labor markets is outpacing constrained supply, and inflation is at its highest level in nearly 40 years. Inflation well above our goal undermines sustaining a strong and inclusive expansion. So the task before us is to remove accommodation at the pace necessary to bring inflation under control. Doing so will help sustain the expansion in activity and healthy labor markets.

The process of transitioning to a less accommodative monetary policy stance in the U.S. is beginning. As this process continues, our monetary policy decisions will need to be data driven and forward looking.

Economic and financial developments and their implications for the outlook and the risks around the outlook will inform the pace at which we remove accommodation in pursuit of our goals.

While their actions are not coordinated, other central banks, including the Bank of England, have also begun to move to a less accommodative monetary policy stance as economic conditions have improved and inflation has risen. Policy transitions are often met with some volatility in financial markets, and this time is no exception. Clear communications can help keep the public's policy expectations aligned with those of policymakers during the policy transitions underway. Despite the challenges and risks, my expectations are that these transitions will be successful, inflation will come under control, and the economic expansion will be sustained.