# Transitioning Monetary Policy

**Loretta J. Mester**
**President and Chief Executive Officer**
**Federal Reserve Bank of Cleveland**

**New York University Stern Center for Global Economy and Business**
**New York, NY**
**(via videoconference)**

**February 17, 2022**

**Introduction**

I thank the New York University Stern Center for Global Economy and Business for the opportunity to speak with you this afternoon. I have fond memories of being an adjunct professor of finance at NYU in the late 1990s and co-teaching the Ph.D. Seminar in Financial Institutions. So it feels good to be back in the classroom, so to speak. I am looking forward to the interactive part of today's program, but let me start the session with some remarks about the economy and monetary policy. As a reminder, the views I present today will be my own and not necessarily those of the Federal Reserve System or of my colleagues on the Federal Open Market Committee.

This year will be one of transition for monetary policy. We will be transitioning away from the extraordinarily accommodative monetary policy that was needed earlier in the pandemic and recalibrating policy to today's economic challenges. The FOMC is taking steps to begin that process. Our 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 to support the economy. At our January meeting, the Committee announced that it will soon be appropriate to raise the target range.

Throughout the pandemic, we have also used our balance sheet as a policy tool, buying large volumes of Treasury securities and agency mortgage-backed securities. 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 the FOMC has been winding down these purchases. Last September, the FOMC indicated that it would soon be time to moderate the pace of asset purchases; in November, it began reducing the monthly pace of purchases; and in December, it sped up the reductions. This January, the FOMC announced that the purchases would end in March and released a set of principles it plans to follow as it significantly reduces the size of its balance sheet.

Today, I will frame my remarks about the monetary policy transition around three key points:

1. There is a very compelling case for transitioning monetary policy away from the current emergency levels of accommodation.
2. This monetary policy transition will differ from the last time because the economy is in a very different place.
3. As monetary policy transitions, communications will need to transition as well.

**The Case for Transitioning Away from Emergency Levels of Monetary Policy Accommodation**

The FOMC's policy decisions reflect its strong commitment to achieving its dual-mandate goals of price stability and maximum employment. Despite the challenges posed by the pandemic, economic growth was very strong last year, and the outlook is for continued solid growth this year. Last year, real GDP grew at a 5.5 percent rate, its highest annual pace since 1984. The Omicron variant has weighed on activity in high-contact services and has put a strain on hospitals, healthcare workers, and other essential services employees. But, thankfully, Omicron is less virulent than earlier strains, and new case counts and hospitalizations are declining sharply in many parts of the U.S. Households and businesses are once again proving to be resilient in the face of the virus.

Although there continue to be risks and uncertainty around the outlook, when we get beyond Omicron, demand should rebound quickly because the balance sheets of businesses and households are very healthy. I expect some moderation in demand this year compared to last year, as the support from the pandemic stimulus programs wanes and financial conditions become less accommodative. But the economy should still expand at an above-trend pace despite facing some challenges.

One challenge is the imbalance between demand and supply. The effects of the pandemic on the economy have shifted over time. Early in the pandemic, when the economy shut down, the effects were mainly on the demand side. Now, with the economy reopened, the effects are mainly on the supply side.

Demand is strong and supply is struggling to keep up. It turns out that shutting down the economy can happen pretty quickly but starting the economy back up again is slower and more complicated. And this has implications for both parts of the FOMC's dual mandate.

The pandemic has disrupted global supply chains, and firms are still struggling to get necessary parts and materials through clogged ports and transportation channels. Many businesses are facing significantly higher costs for available inputs. Rather than abating over last year, the disruptions continued to constrain economic activity. Anecdotal reports suggest that some of the constraints may be stabilizing, delivery times appear to be improving, and half of our business contacts tell us that they expect some easing of the supply disruptions during the second half of this year. Still, more than a third of our contacts do not expect improvement until 2023.

Businesses are also struggling to get workers. By a number of measures, labor markets are very strong and the demand for workers is well outstripping labor supply. While payroll employment is still nearly 3 million jobs below its February 2020 pre-pandemic level, job gains averaged over 550 thousand per month last year. The January jobs report showed continuing broad-based gains, with Omicron mainly affecting hours worked and absences. 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, including child and elder care responsibilities and fear of the virus, have contributed to the undersupply of workers. These factors should fade over time, but the precise timing and magnitude are open questions. Over a longer horizon, participation has been trending down since early 2000 due to demographics, and many more people retired during the pandemic than predicted solely by demographics. So labor markets are likely to remain tight for some time. 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.

The imbalances between demand and supply in both product and labor markets are contributing to the very high inflation readings. Measured year-over-year, PCE inflation reached 5.8 percent in December, and core PCE inflation reached 4.9 percent. Earlier last year, inflationary pressures were confined to a handful of the most pandemic-affected categories. As the year wore on, the inflationary pressures broadened considerably. In December 2020, about 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 about three-quarters of the components.

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. Allowing inflation to remain at high levels can lead firms, households, and financial market participants to expect higher inflation over the longer term. Such 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. Nonetheless, I expect inflation to remain above 2 percent this year and next, and I see the risks to inflation as tilted to the upside. My projection of some moderation in inflation is conditioned on the FOMC taking appropriate action to transition away from the current emergency levels of accommodation and recalibrate to an economy in which 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.

**The Economy Is in a Different Place Than During the Last Transition**

This brings me to my next point on what the transition will look like. The last time we began a transition to less accommodative monetary policy was after the Great Recession. The economy is in a very different place now than it was then, so this transition will need to be different, too.

The recovery from the Great Recession was a slow one. While the recession officially ended in June 2009, the FOMC held the funds rate at zero until December 2015, when it raised the rate by 25 basis points. At that time, inflation was running below 1 percent, the unemployment rate was 5 percent, and real GDP growth was under 2 percent. The FOMC did not raise the funds rate again until a year later. Thereafter, the funds rate was gradually raised, with three 25-basis-point increases in 2017 and four more in 2018, the last one in December of that year, bringing the funds rate target range to 2-1/4 to 2-1/2 percent.

With respect to the balance sheet, the FOMC engaged in sizable asset purchases in the wake of the Great Recession, increasing its asset holdings to about $4.5 trillion. The Fed did not begin reducing the size of its balance sheet until October 2017, nearly two years after liftoff and when the target range of the funds rate had risen to 1 to 1-1/4 percent. At that point, the unemployment rate was about 4-1/4 percent, real output growth was near 2.7 percent, and inflation was still running slightly below 2 percent. Gradual reductions in assets continued until August 2019.

This time is very different. Instead of running below target, inflation has been running well above target for some time and is now at a nearly 40-year high. Labor markets are tight and the economy grew at a 5-1/2 percent pace last year. In addition, at nearly $9 trillion in assets, our balance sheet is now about double the size it was when the last reduction process began.

So, barring a material change in the economy, I anticipate that it will be appropriate to move the funds rate up at a faster pace this time and to begin reducing the size of the balance sheet soon and more quickly than last time. In terms of the balance sheet, I would also support selling some of our mortgage-backed securities at some point during the reduction process, something we did not do last time. Sales would help to speed the return of our portfolio's composition to primarily Treasury securities, which would minimize the effect of our balance-sheet holdings on the allocation of credit across economic sectors, one of the FOMC's principles for reducing the size of our balance sheet.

The ultimate path policy takes will depend on the evolution of the economy, which brings me to my final point which concerns monetary policy communications.

**Monetary Policy Communications**

As you know, there was a substantial shift in the FOMC's view of appropriate policy over the last year. In last March's Summary of Economic Projections (SEP), the median path of FOMC participants indicated that no change in the policy rate would be appropriate in 2022. By the December SEP, the median appropriate policy path showed the federal funds rate moving up by 75 basis points this year. This change in projections reflected economic and financial developments and the resulting evolution of the FOMC's economic outlook and the risks around the outlook. For example, last March, the SEP's median projections for unemployment and inflation for 2021 were 4.5 percent and 2.4 percent, respectively, and the majority of participants saw the risks to each as broadly balanced. Instead, by the fourth quarter of 2021, the unemployment rate had actually fallen to 4.2 percent and year-over-year inflation had risen to 5.5 percent. And as indicated in the December SEP, the majority of participants now saw the inflation risks as weighted to the upside. These economic developments informed the change in the FOMC participants' assessments of appropriate policy.

As the FOMC begins the process of reducing accommodation, its communications will need to transition as well. Earlier in the pandemic, in addition to the extraordinarily accommodative settings of our policy rate and asset purchases, we also provided fairly explicit forward guidance about our future policy settings. In extraordinary economic times, forward guidance is more than a communications device. It is also a monetary policy tool that has the potential to increase the degree of monetary policy accommodation, especially when interest rates are essentially at their zero lower bound. By reducing uncertainty about the future path of policy, forward guidance can help lower interest rates by reducing the premiums investors demand to compensate them for interest-rate uncertainty. In addition, at least in theory, if the central bank indicates that the future path of short-term interest rates will be low for a long time – perhaps lower and for longer than would have been consistent with the central bank's past behavior – this can also put downward pressure on longer-term interest rates, thereby spurring current economic activity.

But now, instead of wanting to increase accommodation, the FOMC will be reducing it, so policy communications need to transition away from providing explicit forward guidance. Instead, we will need to convey the overall trajectory of policy and give the rationale for our policy decisions based on our assessment of the outlook and risks around the outlook, which are informed by economic and financial developments. This change in communications will provide a better sense of the FOMC's policy reaction function and should not be interpreted as the FOMC backing away from transparency. Clear communications are a very important part of monetary policymaking. First, to the extent that households, businesses, and financial market participants understand how policymakers are likely to react to economic and financial developments – whether the developments are anticipated or unanticipated – their policy expectations will better align with those of policymakers. This means their decisions will be better informed and monetary policy will be more effective. Second, policy transitions are often met with volatility in financial markets, and this time is no exception. By keeping financial market participants' expectations aligned with those of policymakers, clear communications can mitigate the volatility that would occur if there were a rapid or sizable realignment.

**Summary**

In summary, I believe the case for transitioning monetary policy away from emergency levels of accommodation and recalibrating policy to today's economic challenges in pursuit of our dual-mandate goals is very compelling. While the experience after the Great Recession will inform this transition, the economy is in a very different place, so the transition will be different, too. As monetary policy transitions, our policy communications will also need to transition away from explicit forward guidance and toward conveying a sense of our policy trajectory and explaining the rationale for our policy decisions in terms of economic and financial developments and their implications for the outlook and risks around the outlook.

The task before the Fed is to remove accommodation at the pace necessary to bring inflation under control while sustaining the expansion in economic activity and healthy labor markets. Barring an unexpected turn in the economy, I believe it will be appropriate to move the funds rate up in March and follow with further increases in the coming months. 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. So, the pace at which monetary policy accommodation is removed will need to be data driven and forward looking. The communications challenge will be to convey a good sense of how policy is likely to respond *conditional* on how the economy evolves without implying that policy is pre-committed to a particular path *regardless* of how the economy evolves.