

The Great Recalibration of U.S. Monetary Policy



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It is a pleasure to participate in this policy panel at the International Research Forum on Monetary Policy sponsored by the Euro Area Business Cycle Network, the European Central Bank, and the Federal Reserve Board. The Federal Open Market Committee (FOMC) met last week; so in my brief prepared remarks, I will review the FOMC's recent decisions and put them into context. 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.

In making its monetary policy decisions, the FOMC is always guided by its strong commitment to achieving its goals of price stability and maximum employment. At the start of the pandemic in March 2020, the FOMC reduced the target range of its policy rate, the federal funds rate, to 0 to 1/4 percent, to support the economy in the wake of the unprecedented COVID shock. The FOMC also used its balance sheet as a policy tool, buying large quantities of Treasury securities and agency mortgage-backed securities, to reduce the severe strains in financial markets seen early in the pandemic and to support the economy. In March of this year, the FOMC raised its policy rate by 25 basis points. Last week, it raised the fed funds rate by another 50 basis points and indicated that it believes ongoing rate increases will be appropriate. The FOMC also announced that it will begin reducing its balance-sheet assets starting in June.

These actions are part of what I have called the Great Recalibration of U.S. monetary policy: a shift from the extraordinarily accommodative policy needed earlier in the pandemic to a policy stance that is more appropriate for addressing the key challenge facing the U.S. economy: unacceptably high inflation.¹

While liftoff of the funds rate from zero only occurred in March, this recalibration actually began in the autumn of last year. Last September, the FOMC indicated that it would soon be time to taper asset

¹ Jeff Cox, "Fed's Mester Casts Doubt on the Need for 'Shock' Interest Rate Hikes Ahead," CNBC, April 22, 2022 (<https://www.cnbc.com/2022/04/22/feds-mester-casts-doubt-on-the-need-for-shock-interest-rate-hikes-ahead.html>).

purchases, and it announced the beginning of tapering in November. In December, the FOMC sped up the tapering and released projections indicating that participants now expected an earlier liftoff of the policy rate than they had previously anticipated. In January, the FOMC indicated that it would soon be time to raise its policy rate, and then followed through with the first increase in March. Asset purchases also ended in early March.

This recalibration of policy has reflected the evolution of economic conditions, the economic outlook, and the risks around the outlook.

Despite the challenges posed by the pandemic, U.S. economic growth was very strong last year, with real GDP growing at a 5-1/2 percent rate, the highest annual pace since 1984 and well above the trend growth rate, which I estimate to be about 2 percent. The decline in real GDP in the first quarter was driven mainly by declines in net exports, government spending, and a still high but lower level of inventory investment compared to the fourth quarter of last year. Growth in consumer spending and business fixed investment remained solid last quarter and there continues to be positive underlying momentum in demand. Household and business balance sheets are healthy, reflecting high savings accumulated during the pandemic.

Strong demand has occurred in the face of very constrained supply in both product and labor markets. In product markets, differences in virus conditions and virus containment policies have resulted in a cascade of disruptions to the global supply chain. China's zero-COVID policy has further disrupted supply chains and Russia's dastardly invasion of Ukraine has further constrained supplies in energy, metals, and agricultural commodity markets.

Labor markets remain very tight. The U.S. economy added 6.7 million jobs last year. Despite widespread reports from firms about the difficulty of finding workers, monthly payroll gains have

averaged above 500 thousand over the first four months of this year. The unemployment rate has fallen to 3.6 percent, nearly as low as its lowest reading during the pre-pandemic expansion. Labor force participation remains below its pre-pandemic level, but it has improved significantly over time. Still, labor supply has been unable to keep up with the robust demand for labor. Job openings are at very high levels by historical standards: there are almost 2 openings per every unemployed worker; in 2019, this ratio averaged 1.2 openings per unemployed worker.

With demand out of balance with supply in both product and labor markets, prices and wages have moved up. Price pressures have broadened across goods and services, and inflation readings in the U.S. are now at their highest levels in 40 years. Measured year-over-year, in March, total PCE inflation was over 6-1/2 percent, core PCE inflation was nearly 5-1/4 percent, and the Cleveland Fed's median PCE inflation was almost 4-1/4 percent. Wage pressures are also building. The employment cost index for private industry workers accelerated over the three months ending in March, rising at a 5.8 percent annual pace. Higher wages that reflect higher productivity growth are a positive for the economy, and a higher level of wages represents a shift of income share from capital to labor. But the current pace of wage increases is inconsistent with maintaining price stability.

The Fed is committed to using its tools to get inflation under control by bringing excess demand into better balance with constrained supply. It will likely take some time for inflation to reach our longer-run goal of 2 percent because several of the factors that have contributed to the very high inflation readings are supply-side factors, which monetary policy cannot affect, and because inflation tends to be persistent. But as we recalibrate our policy, I will be looking for compelling evidence that inflation is on a downward trajectory toward our 2 percent goal. We will be able to gauge improvement by looking at the monthly changes in inflation readings to see if inflation is beginning to move down. The monthly increase in the core PCE price index in March was little changed from its February reading, and the monthly reading of the Cleveland Fed's median PCE inflation moved down in March. These are positive

signs, but in April, monthly CPI inflation increased, and risks to inflation remain strongly on the upside, especially in the midst of the continuing war in Ukraine and the potential that the zero-COVID policy in China will further disrupt supply chains. I will need to see several months of sustained downward monthly readings of inflation before I conclude that inflation has peaked.

A risk-management perspective argues for such caution because inflation risks are to the upside and because the longer inflation runs above our goal, the higher the risk that long-term inflation expectations will become unanchored, thereby making the return to price stability much more costly. We already see that medium- and longer-term inflation expectations have moved up. The Board staff's measure of common inflation expectations, which summarizes a number of measures, has been rising and is at the upper end of the range of values seen since 2005.² Even though some of the rise has been driven by increases in near-term expectations, I do not think it is prudent to ignore the rise given the serious harm that would be caused were long-term expectations to move above levels consistent with our longer-run inflation goal of 2 percent.³

In my view, the FOMC will need to be resolute and intentional in removing policy accommodation at the pace needed to get inflation under control. 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. If we fail to do what is necessary to get inflation down, we will be jeopardizing sustaining healthy labor markets over the medium and longer run, again hurting lower-income households. So I do not see the current situation as one involving a trade-off between our two goals.

² See Hie Joo Ahn and Chad Fulton, "Research Data Series: Index of Common Inflation Expectations," FEDS Notes, Board of Governors of the Federal Reserve System, March 5, 2021 (<https://doi.org/10.17016/2380-7172.2873>).

³ The Cleveland Fed's measure of year-ahead indirect consumer inflation expectations for the week ended May 9 was 6.7 percent (<https://cebra.org/programs/idd/indirect-consumer-inflation-expectations/>).

The current target range of the federal funds rate is 75 to 100 basis points. This is well below the range of estimates of the longer-run neutral nominal policy rate, which neither stimulates nor restrains economic activity. For example, in the March Summary of Economic Projections of FOMC participants, the range of estimates of the longer-run fed funds rate was 2 to 3 percent. The real fed funds rate is still negative. So given economic conditions, ongoing increases in the fed funds rate are called for, and unless there are some big surprises, I expect it to be appropriate to raise the policy rate another 50 basis points at each of our next two meetings.

At that point, the nominal funds rate will be nearing the lower end of estimates of the neutral rate and balance-sheet reductions will be underway. The FOMC will then be well positioned to consider the appropriate pace at which to continue removing accommodation over the balance of the year and how far above neutral rates will need to go. It will be challenging to remove accommodation at the pace needed to get inflation under control while sustaining healthy labor market conditions. There are likely to be some bumps along the road; growth could slow a bit more than expected for a couple of quarters and the unemployment rate could move up temporarily. Nonetheless, the FOMC will be aiming to calibrate our policy to bring demand better in line with supply, thereby putting inflation on a downward trajectory toward our 2 percent goal. This calibration will entail assessing the various forces that will be affecting the demand and supply sides of the economy. The ongoing war in Ukraine and the COVID lockdowns in China pose upside risks to inflation but downside risks to growth. Broader financial conditions have already tightened considerably, as markets have anticipated further rate increases in light of the Fed's forward guidance. For example, the 30-year mortgage rate was under 3 percent last September and is now about 5-1/4 percent. And the Fed's balance-sheet reduction will soon be underway. These tighter financial conditions will help moderate excess demand. With some luck, supply chain disruptions will begin to abate and labor market participation will continue to rise, helping to ease supply constraints and allowing supply in product and labor markets to come into better balance with demand. But we cannot rely on luck. With both supply and demand adjusting over time, I will be monitoring economic and

financial developments closely to gauge the balance between demand and supply and to determine appropriate monetary policy. If by the September FOMC meeting, the monthly readings on inflation provide compelling evidence that inflation is moving down, then the pace of rate increases could slow, but if inflation has failed to moderate, then a faster pace of rate increases may be necessary.

As I mentioned, in addition to raising our policy rate, we are initiating the balance-sheet reduction in June. This will be done primarily by adjusting the reinvestment amounts of the principal payments the Fed receives on its assets. Starting in June, the Fed will allow up to \$30 billion per month of Treasury securities and up to \$17.5 billion of agency securities to run off the balance sheet. After three months, these caps will rise to \$60 billion per month for Treasuries and \$35 billion per month for agency securities. To the extent that maturing Treasury coupon securities are less than the monthly cap, Treasury bills will make up the rest of the runoff up to the cap.

The plan that the FOMC announced last week did not rule out asset sales, and I would favor the FOMC considering asset sales after balance-sheet reduction is well underway to speed up the return of the portfolio's composition to being primarily Treasury securities. This would be consistent with the FOMC's stated desire to minimize the effect of the Fed's balance-sheet holdings on the allocation of credit across economic sectors.

The plan also did not indicate what size the balance sheet will be when the FOMC ends the reductions, but it did give some guidance. We are implementing monetary policy via an ample reserves operating regime in which reserve levels are ample enough that control over the federal funds rate and other short-term interest rates is executed primarily through setting the Fed's administered rates and active management of the supply of reserves is not needed. The FOMC intends to slow and then stop the reduction in balance-sheet assets when reserve balances are somewhat above the level it judges is consistent with ample reserves. Once runoff has stopped, reserve balances will likely continue to fall for

a time, reflecting growth in other Fed liabilities, until the FOMC judges that they have reached the ample level. At that point, the FOMC will then manage its security holdings to maintain ample reserves over time. The ample level of reserves is uncertain. It 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. So as the process to reduce the size of the balance sheet progresses, we will be monitoring developments in money markets to determine the appropriate level of reserves at which to end balance-sheet runoff, consistent with maintaining ample reserve balances over time.

This concludes my brief remarks about the Great Recalibration of U.S. monetary policy. I look forward to participating in the discussion.