Why It’s Time to Adjust Monetary Policy

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Introduction

Thank you for inviting me to speak at the Prairie State College Foundation’s annual breakfast. It’s a pleasure to be with you again, and I am very much looking forward to our discussion after my formal remarks. The on-the-ground observations about the economy from community leaders like yourselves are very important inputs into my thinking on monetary policy.

But before I begin, I want to acknowledge the severe hardships the Ukrainian people are enduring as a result of Russia’s invasion. This is just an awful event. May the people of Ukraine and all who are affected by this crisis remain strong and as safe as possible.

And I should note, too, that the views I share with you today are my own and do not necessarily represent those of my colleagues on the Federal Open Market Committee (FOMC) or others in the Federal Reserve System.

The economy today

When I spoke to you last April, vaccines were becoming widely available and there was good reason to be optimistic about the prospects for economic growth. At the same time, while we were seeing large price increases for some items, overall inflation was quite low—only 1.6 percent. In this environment, I expected policy rates to remain low for quite some time. Well, the situation sure has changed since then.

Although the Covid-19 virus continued to take a horrible toll on the health and livelihoods of so many people, my optimism about growth in 2021 was well-founded. Indeed, our progress these past two years was remarkable given how dire an event the pandemic has been. Households and businesses showed amazing ingenuity in finding ways to operate safely. The health care sector was able to develop and deploy vaccines extremely rapidly. And fiscal and monetary policymakers provided crucial support through policy actions.

By the second quarter of last year, real gross domestic product (GDP) in the U.S. had surpassed its pre-pandemic level; and despite new waves of infections during the second half, growth for the year was a quite robust 5.6 percent and the economy appears to have entered 2022 with solid momentum. As for the labor market, after peaking near 15 percent early in the pandemic, the unemployment rate declined quickly and this morning's report for March shows a very healthy 3.6 percent—just slightly above the 3.5 percent low we experienced before the Covid crisis.

Here in the Chicago area the contours are similar. In the midst of the shutdowns, the local unemployment rate soared to almost 17 percent in April 2020—about 2 percentage points higher than the national average. As the economy reopened and growth picked up, the unemployment rate fell quickly and was 5.1 percent in January 2022. Though the rate is still too high—it was at an all-time low of 3.2 percent prior to the pandemic—this improvement is still quite impressive.

If you just look at the national unemployment rate, the labor market appears to have largely recovered from the pandemic. And by a number of other measures, such as unfilled job openings at businesses and the rate at which people quit their jobs for other opportunities, the labor market is downright tight. Many of my business and community contacts complain of difficulties in hiring and retaining workers. However, the number of people actually employed is still well below pre-pandemic trends, as many workers who left the labor force during the pandemic have not reentered the labor market. This is especially true of older workers who retired in unusually large numbers.

In economic statistics, the labor force counts how many people are either employed or actively looking for work—so it's a measure of the supply of available workers. Today, for a variety of reasons about 175,000 fewer people are in the labor force than before the pandemic. However, given population and labor force participation trends, in the absence of the pandemic we would have expected an increase of about 1.3 million over this time. As the pandemic recedes further, strong labor market conditions will likely draw many of those sitting on the sidelines back into the workforce. This should help alleviate some labor market pressures. But the timing and extent of this return are open questions.

Businesses are adjusting to these labor shortages in a number of ways. One thing making this complicated is that the pandemic may have also permanently altered many work arrangements. A wide array of job features is in play. Take, for example, some conversations I recently had with business leaders located in small and medium-sized cities. On the one hand, a number of those running smaller operations talked about the difficulties they were having in retaining back-office staff because these workers are being actively recruited for remote positions with larger employers. On the other hand, an executive at a large manufacturer reported their company had recently hired back a number of high-skilled back-office and digital staff who had left them to take remote positions at West Coast firms, but had not relocated. The executive noted that employees' desire for a more fulfilling in-person culture and the firm's decision to increase salaries were important factors in this reversal.

I find these anecdotes fascinating, as they highlight the many different ways we could see the labor market structure evolve over time. As of today, it is highly uncertain how it is all going to play out.

While these pandemic-related adjustments are on the top of people's minds today, we shouldn't lose sight of some important labor market trends that were in place before the pandemic. The long-run sustainable growth rate of the economy is determined by the pool of available labor and the productivity of that labor. And productivity depends on workers' skills and the technology and capital they use in production. This is simple arithmetic.

Although we should get a temporary boost as the pandemic further retreats, that underlying growth trend in the pool of available workers was quite modest prior to the pandemic and is likely to remain so for some time. This is due to a number of demographic factors, such as the retirement of the baby boom cohort and reduced immigration.

Well, if the pool of available workers isn't growing much, it's very important for that pool to be highly productive if we are going to achieve solid growth. Institutions such as Prairie State College can play an important role in this regard. A well-educated labor force with the skills to work with cutting-edge technology is key for boosting productivity and supporting the kind of sustainable economic growth that is so crucial for achieving broad-based prosperity over time.

In addition to upending the labor market, the pandemic set in motion other significant changes in the economy. Let me give you one example that's illustrative of a more general challenge we are facing today. With people forced to spend more time at home, households shifted their spending from services, such as travel or dining out, toward goods, such as appliances for home improvement projects or consumer electronics. And many of these items contain a large number of sophisticated microprocessors. Well, so do cars. And at the same time, expecting a severe and prolonged recession, automakers substantially scaled back their production plans and ordered fewer microprocessors used in motor vehicles.

As it turned out, the demand for vehicles recovered much more robustly than most expected. But firms manufacturing consumer electronics and other such items had absorbed both chip inventories and new production, leaving fewer chips available for vehicles. As a result of this and other shortages, auto and truck production has been severely curtailed. And with supply curtailed but demand still robust, motor vehicle prices have surged more than 23 percent over the past year.

This is just one story, but in many areas we are seeing producers struggling with such supply bottlenecks. In some cases, lean, just-in-time production processes have come under pressure from multiple directions simultaneously as the flood of demand has put logistics systems under immense strain. The result has been a surge in costs that have been passed through to higher prices for many items.

Market forces should help temper the recent inflation surge

This brings me to inflation. Early last year, as activity began to normalize, prices for goods and services that were especially sensitive to the pandemic, such as hotel accommodations and air travel, adjusted higher. However, as the year progressed, strong demand and continuing supply challenges, including shortages of workers in many sectors, resulted in prices rising across a broader range of goods and services. Inflation for the year was an uncomfortably high 5.8 percent and rose further to 6.4 percent in February.[1] For people whose incomes have not kept pace, higher inflation is a real hardship.

It is important to step back and think about the economic factors behind the massive jump in inflation over the past year. After all, in February 2021, inflation was only 1.6 percent—below the FOMC's objective of inflation averaging 2 percent over time. We often hear commentary that today's inflation is the highest we've seen since the early 1980s. But our experience today is much different. Back then, overly accommodative monetary policy during the 1960s and '70s helped fuel a slow but persistent buildup in long-run inflation expectations—that's economist jargon for the underlying views of wage and price growth that get built into the psychology of households and businesses. Of course, this was the inflation that former Fed Chair Paul Volcker eventually had to address with draconian measures.[2] In contrast, the pickup in inflation over the past year occurred rapidly—and did so after more than a decade of sub-2 percent actual inflation and with longer-run inflation remaining quite low.

As I alluded to earlier, today's surge largely reflects real supply shocks and weakened supply chains and logistics in the face of strong, outsized demand for goods and

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[1] Our preferred measure of inflation is the Price Index for Personal Consumption Expenditures (PCE) from the U.S. Bureau of Economic Analysis.

[2] Paul Volcker was the Chair of the Federal Reserve from August 6, 1979, until August 11, 1987. More on Volcker and his tenure as Fed Chair are available online, https://www.federalreservehistory.org/people/paul-a-volcker.

diminished labor force participation. These have been the strongest forces underlying the past year's rapid increase. As we learned in our introductory economics courses, a shift up in demand and a shift down in supply in a market will cause the price for that good or service to rise. And that increase in price will dampen demand, bring forth more supply, and eventually eliminate shortages.

A broad take-away I get from the data and discussions with business and community leaders is that this market mechanism is working to allocate scarce resources to their most critical uses. We're not there yet, but a reallocation of demand back toward services, an increase in supply in response to higher relative prices and wages, and adjustments in business models to adapt to the evolving environment will eventually alleviate many of the supply-side pressures we face today. In many cases, though, this is going to be a complicated process.

Adjusting monetary policy

That said, as I noted before, since last summer inflation has broadened out to a wide range of goods and services. This is a signal of more general pressure from aggregate demand on today's impinged supply. If monetary policy did not respond to these broader inflation pressures, we would see the expectation of continued high inflation become embedded in economic decisions, and we would have even harder work to do to rein it in. So monetary policy must shift to removing accommodation in a timely fashion, which is what you've seen in the latest actions by and communications from the FOMC.

A few weeks ago, the FOMC announced its decision to raise the federal funds rate target by 25 basis points to a range of 1/4 to 1/2 percent.[3] Furthermore, we indicated we will begin reducing the size of our balance sheet at a coming meeting.

The Committee also released its quarterly Summary of Economic Projections (SEP), which presents FOMC participants' forecasts of key economic variables over the next three years and for the longer run.[4] The projections show that including the initial move in March, the median FOMC participant expected the equivalent of seven 25 basis point increases in the federal funds rate by the end of this year and three more 25 basis point increases in 2023. All told, those increases would put the federal funds rate by the end of 2023 and 2024 at 2-3/4 to 3 percent. This is a bit above the median longer-run estimate of 2.4 percent, and so, it represents a slightly restrictive policy stance.

Again, this is the median projection, and my colleagues hold some range of views as to what exactly constitutes appropriate policy in the current environment. My own baseline assessment is in line with the median projection, though given the great deal of uncertainty we face today, I am well aware that developments may transpire in a way that would cause me to alter my assessment.

For GDP growth, the median projection for this year is 2.8 percent, with growth moderating to near 2 percent in 2023 and 2024. With the longer-term growth trend for the economy seen at about 1-3/4 percent, these GDP numbers are solid ones. The labor market is expected to remain quite strong as well, with the unemployment rate near 3-1/2 percent from the end of this year through 2024.

[3] Federal Open Market Committee (2022b).
[4] Federal Open Market Committee (2022a).

This brings me to the big question for today: What about inflation? As we continue to adapt to and better control the virus, as market forces work to reallocate productive resources, and as monetary policy tightens, we should see a reduction in inflationary pressure. At about 4-1/4 percent, the median forecast for inflation this year is still high, but inflation is expected to moderate as we move through the projection period, eventually coming down to 2.3 percent by the end of 2024. I would note that the general contours of these Federal Reserve projections are shared by most private-sector forecasters.

Needless to say, in the current environment all forecasts are subject to a great deal of uncertainty and risks. Of course, two major sources of uncertainty today are the crisis in Ukraine and waves of the virus that are currently hitting abroad. Both of these present upside risks to inflation and downside risks to growth, and we will be monitoring their impact on the economy very closely. As we move through the year, we will certainly learn more and will be prepared to adjust policy as needed.

Conclusion

To sum up, economic activity and employment continue to strengthen while inflation remains well above our objective. To steer the economy to our dual mandate goals of full employment and 2 percent average inflation, the Fed has begun to reduce the degree of monetary accommodation. Our recent 25 basis point rate hike was the first of what appears to be many this year.

Given all the uncertainty we face today, policymakers need to be cautious, humble, and nimble as we navigate the course ahead. Monetary policy is not on a preset course: Each FOMC meeting’s decision will be based on an assessment of economic and financial conditions at the time, as well as the risks to the outlook. But all of our decision-making will be squarely focused on achieving the Federal Reserve's mandated policy goals of maximum inclusive employment and inflation that averages 2 percent over time.

Thank you.

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