Monetary Policy amid Global Uncertainty

Raphael Bostic
President and Chief Executive Officer
Federal Reserve Bank of Atlanta

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Key Points

- Atlanta Fed president Raphael Bostic is giving the opening keynote address at the 38th Annual NABE Economic Policy Conference on Monday, March 21.
- Bostic addresses the significant imbalance between labor supply and demand that we're seeing in the United States and the additional uncertainty the conflict in Ukraine has introduced to the economic outlook.
- On Ukraine, Bostic says that the conflict, economic sanctions, and other disruptions to global trade and finance will influence virtually every factor the Federal Open Market Committee considers in formulating monetary policy.
- Because of the additional uncertainty, Bostic will be closely observing developments and will adapt policy as appropriate.
- Bostic: "We at the Fed will do all in our power to meet our mandate and make sure that elevated inflation does not become entrenched in the economy for years to come."

Good morning. It is truly a pleasure to address the National Association for Business Economics. Over the years, the Federal Reserve, and the Atlanta Fed in particular, have established a very strong relationship with NABE. This is perhaps most evidenced by the fact that my research director, Dave Altig, is the organization's president. Our connectedness has served the Fed well, as we have benefitted from the organization's good work to advance economic thinking. But it has also served the profession well, as it has allowed us to work together to strengthen the field. Here, I will applaud NABE's efforts to increase diversity among our ranks. Thanks for your commitment to this and other efforts to enhance the field.

As you probably know, speaking invitations like this are made months in advance. When my team and I received NABE's invitation, we thought I would talk about an emerging trend or dynamic that would shape the economy in 2022. As I will discuss shortly, we homed in on labor market dynamics, specifically how the labor market might regain a balance between supply and demand.

Then Russia invaded Ukraine. The conflict, first and foremost, is a human tragedy, and my thoughts and prayers go out to the Ukrainian people and all victims of the fighting. In fact, the conflict is a stark reminder that there are many conflicts—and many victims—across the globe. I am keeping all those who are impacted by this in my prayers as well.

Beyond its terrible human toll, this war on the European continent is reverberating through the global economy. The conflict, economic sanctions, and other disruptions to global trade and finance will influence virtually every factor the Federal Open Market Committee considers in formulating monetary policy. So I think it's only appropriate that I also say a few words on this.

A common theme that connects labor market dynamics and the Russian invasion of Ukraine is uncertainty. Uncertainty enshrouds both, and this requires that we be extra observant and prepared to adapt our thinking about the economy and policy, perhaps even more so than we usually are.

Before I go any further, please keep in mind that the thoughts I express are strictly my own and do not necessarily reflect the views of my colleagues on the Committee or at the Federal Reserve Bank of Atlanta.

Labor market dynamics: Tightness and uncertainty

Let me start where I'd originally planned to by talking about the labor market. While the pandemic has introduced considerable uncertainty, one thing we know is that the labor market is tight. The headline unemployment rate quickly fell to 3.8 percent from a stunning high of almost 15 percent, as 90 percent of the jobs lost when the coronavirus hit US shores have been recovered. This is an extremely fast rebound.

The rapid rebound has translated into another labor market truth: there is currently a significant imbalance between labor supply and demand. The Bureau of Labor Statistics' (BLS's) Job Openings and Labor Turnover survey—you know this as the JOLTS—reported about 11 million job openings a month on average over the nine months through January. Employers filled only about 60 percent of those positions, so each month, roughly four million open jobs have gone unfilled.

These aggregate data are corroborated by respondents in the Atlanta Fed's Survey of Business Inflation Expectations, or BIE. In January, more than 60 percent of respondents cited labor availability as a problem, and more than half of those rated the problem as moderate or severe.

Resolving this imbalance is critical, because the labor shortage is keeping businesses from responding fully to the strong demand for products from US consumers, which is a key driver for the high levels of inflation that we currently see. As a result, we are very closely monitoring labor market developments.

There are many questions to track, and the answers are unfortunately quite uncertain at present. Here are just a few to ponder.

Will some of the wave of excess retirees return to the labor force? What will be the labor market response of families with young children? In this regard, how will childcare rebound, which will be a vital question for mothers, who disproportionately left the labor force? How will families respond now that fiscal and monetary policy supports have expired?

And, of course, there is COVID. We like to think we are mostly past the pandemic, but just this month China locked down some cities including certain manufacturing hubs in moves that could further foul global supply chains. We don't know if there will be another variant, or whether existing vaccines and boosters will be as effective against them as they have been for other strains. We don't know if vaccination rates will continue rising. A further question is whether we have learned enough that, should another variant emerge, we will continue on with minimal economic disruption.

An additional development will be the behavior of firms. We are already getting clues about this. As you know, classical economic theory suggests that an imbalance between weak labor supply and strong demand should translate into a higher price of labor. Well, firms are proving the theory to be correct. The Atlanta Fed's Wage Growth Tracker is showing its sharpest increases in nominal wages since 2001.

February's reading showed a three-month moving average of 5.8 percent median hourly wage growth. Similarly, respondents to our BIE survey reported that they anticipated wage growth this year of about 6½ percent. As an aside, this expectation is consistent with what we are hearing from business leaders across the Southeast.

Interestingly, business decision makers are telling my staff and me that they don't expect a quick cure to this challenge. Research by Atlanta Fed economist Julie Hotchkiss highlights one reason why this might be right. Julie found that higher wages alone may not be enough to draw generation Xers and millennials into the labor force. That is important because those two demographic groups constitute the bulk of the labor force—nearly all prime-age workers. As you're aware, these are workers 25 to 54 years old.

Examining historical labor market behaviors, Julie shows that, compared to baby boomers, a given pay raise is only about half as likely to draw generation Xers to the worker pool and three-quarters as likely to attract millennials. What does this mean for the current labor market? Julie estimates that a 6 percent rise in nominal average hourly wages, as the BLS reported for January, would close just 17 percent of the gap between labor force participation for prime-aged individuals in January 2022 and the rate that prevailed immediately before the pandemic.

This suggests that the efficacy of the "traditional" enticement to draw labor—that is, wages—is lower than it used to be. That said, we are seeing signs that non-wage measures might act as an important supplement to wages. We are hearing growing anecdotal evidence of the appeal of measures such as firms allowing employees to fashion their own hybrid remote-slash-office work schedules; offering more generous dental and vision benefits; providing higher educational allowances and student loan repayment assistance; mandating a four-day workweek; and instilling a larger purpose into work beyond collecting a paycheck and boosting shareholder value.

We will closely track how employers embrace these innovations and the degree to which they help reduce the prevailing imbalance between labor supply and labor demand.

War will increase uncertainty, price pressures, accelerate production shifts

Let me now turn to the tragic war in eastern Europe. While there is much that we will learn about the economic fallout over the coming weeks, there is much we can't foresee. That notwithstanding, I do see three high-level economic repercussions that will almost certainly play out:

- intensified uncertainty;
- upward pressure on prices;
- and further momentum toward reorienting production and supply networks away from pure cost minimization and toward resilience and risk tolerance.

First, the conflict is an extraordinarily fluid situation. In an economic context, the war is supercharging what was already a great deal of uncertainty. Even as we have not completely shed the ambiguity created by the coronavirus pandemic, the events in Europe introduce new and multifaceted risk to the economy and the economic outlook, and thus the making of monetary policy. Uncertainty is inherently, well, uncertain. But we know that nobody likes it, and it will undoubtedly influence the behavior of business leaders and consumers.

If the past is a guide, increased uncertainty is likely to reduce engagement and economic activity by businesses and consumers, especially as it pertains to longer-run investments. I will emphasize that we are not hearing this from our contacts—and we have been explicitly asking this question. But it is still early, so this will bear watching.

In terms of direct effects, the fighting and attendant disruptions are generating upward pressure on the prices of products for which Ukraine and Russia are important global producers, including oil, natural gas, wheat, and fertilizer. These are all basic inputs into numerous consumer goods including gasoline, plastics, heating oil, electricity, and many food products. So the price implications could be broad.

Moreover, the war is exacerbating already significant global supply chain challenges. Closed airspaces and a reluctance to use shipping lanes linked to the Black Sea will be disruptive in the short run, and even possibly into the medium term, and it remains to be seen how far that reach will extend. Let me turn to some specifics here.

Gasoline at the pump has already risen to an average of about $4.35 a gallon across the United States. That is a historic high in nominal terms, though in real terms is lower than pump prices were in 2012 and in the 1970s. The United States does not import much oil and gas from Russia. But as you know, the market for energy is global, and supply, demand, and price are determined accordingly.

The International Energy Agency says Russia is the world's second largest natural gas producer, providing some 40 percent of the European Union's total gas consumption. Russia is the third largest producer of oil behind the United States and Saudi Arabia, and the world's second largest crude oil exporter behind Saudi Arabia.

It appears very likely that sanctions and Russia's own export restrictions will limit Russian oil and gas exports. There are producers who *can* fill the gap. Yet all indications are that it will take time, and in some cases policy changes, to increase production in countries other than Russia.

The European Union is particularly dependent on Russian energy. Disruption in energy supplies and deeper general uncertainty, which figures to be even more acute on the European continent given its proximity to the conflict, could imperil economic growth in the EU. That is another risk we must monitor.

As for US energy production, we probably have room to grow. The United States is actually the world's leading producer of oil and natural gas. In a March 9 report, the US Energy Information Administration projects that US natural gas exports will keep rising through the early 2030s before leveling off.

Increased export activity probably won't happen without some complications, though. Energy industry contacts in our district say that while there are indeed excess supplies of oil and gas, for now we lack enough infrastructure to mine, store, process, and transport it, at least in sufficient quantities to make a difference in the short run. Regarding natural gas, for example, the country lacks sufficient capacity to refrigerate the gas molecules so they can be transported on ships.

We can build infrastructure. The catch is that it is very capital-intensive, it takes years to construct, and there are extensive regulations to navigate.

As for fertilizer, our district's farming contacts tell us their costs for this input had risen substantially before Russia invaded. The BLS's Producer Price Index shows that mixed fertilizer prices rose 33 percent for the 12 months through February. They could climb further because Russia is among the world's leading suppliers of fertilizer ingredients like ammonia, urea, and processed phosphates.

Wheat has a similar story. The United Nations Food and Agricultural Organization ranks Russia the world's largest wheat exporter and Ukraine fifth. With much of Russian and Ukrainian wheat off the global market, prices are likely to climb for bread, pasta, and various packaged foods.

The United States could ramp up wheat production, but again, it's complicated. In recent years, about half of US wheat has been exported. But the USDA reports our share of world exports has declined from around 25 percent a year in the early 2000s to about 13 percent. Likewise, the amount of American farmland devoted to growing wheat has shrunk. US farmers harvested 50 million acres of wheat a year in the early 2000s, but that's down to 38 million acres the past five years.

So, there could be capacity to grow more wheat. But much like building energy industry infrastructure, major shifts in agricultural production do not happen quickly. For example, many crops have only one planting season a year.

In addition to increased uncertainty and rising commodity prices, the third implication I'll note is that the conflict in Ukraine likely will contribute to and accelerate a fundamental shift that is taking place regarding production strategies. Already we have heard an unmistakable message from direct contacts and surveys that global firms are moving away from a ruthless focus on cost minimization in configuring production networks.

Supply chain disruptions caused by the coronavirus pandemic prompted business leaders to start diversifying supplier locations and firms, increasing inventories, and bringing production closer to final markets to maximize reliability. Think of it as a shift to just-in-case inventories from just-in-time. The common thread in these changes is that they increase production costs.

The Russia-Ukraine conflict will trigger similar considerations for producers, albeit for different reasons and in different geographies than was the primary focus of pandemic responses. In short, it's becoming increasingly risky for a company to rely on any part of the world as its sole source of an input to production. This will likely cause more firms to shift their production strategies to more certain, but higher cost, approaches.

I realize the three consequences I've discussed are pretty sweeping. And I realize I've covered them at a high level. Many details remain to sort themselves, but the general direction these trends will take the macroeconomy seems clear. In sum, structural economic forces emanating from the Ukraine conflict appear to be adding upward pressure to costs.

What it means for monetary policy

This all has serious implications for monetary policy. So let me close by saying a few words on this.

As you know, the FOMC releases its Summary of Economic Projections, or SEP, four times a year. One part of the release that receives considerable attention is the dot plot chart detailing how each member projects the appropriate path for the fed funds rate for the next several years. Late last year, I projected that the Committee would increase the federal funds rate three times in 2022.

Since then, the challenging economic conditions we were confronting have only become more challenging and, as I've discussed today, more uncertain.

There is plenty we don't know, but let's look at what we do know. Obviously, the baseline for inflation has moved up significantly. My original outlook was that inflation would likely begin decelerating this spring. That almost certainly won't happen now. Let me say clearly that getting the high rates of inflation under control is the top concern for me for 2022. I could say a lot more about inflation here this morning, but I understand there is another speaker on the program with views on this whom you might be more interested in hearing from. I'll leave that space for him.

In the latest SEP, I penciled in six rate hikes for 2022 and two more for 2023. I recognize that I am toward the bottom of the distribution relative to my colleagues, but the elevated levels of uncertainty are front forward in my mind and have tempered my confidence that an extremely aggressive rate path is appropriate today. Events are shifting rapidly, and we could see marked changes along key dimensions, such as aggregate demand, that could warrant quickly adjusting the trajectory of policy.

Here the risks go both ways. Should demand falter in the face of economic uncertainty or removal of monetary policy accommodation, then the appropriate path may be shallower than I currently project. But there are other developments, such as shifts in supply strategies, that could mean higher costs and thus motivate a steeper policy path than I expect.

This is one reason I and my team have adopted the phrase "observe and adapt" to characterize our approach to policymaking. We are observing closely and will adapt as appropriate. For instance, our research staff currently has surveys in the field—I would mention our Survey of Business Uncertainty as one notable example—to gauge how business leaders are thinking about pricing and production strategies and how they are managing amid compounding uncertainty. The real-time information we gather through these and other means will be critical in helping us position our policy to be maximally effective.

Let me close with this. There is a lot of uncertainty in the economy and world today, but I want you to leave with one notion that is very certain. We at the Fed will do all in our power to meet our mandate and make sure that elevated inflation does not become entrenched in the economy for years to come. Thank you