Monetary Policy amid Changing Labor Market Dynamics

By Raphael Bostic, President and Chief Executive Officer

May 24, 2022

Continuously rising prices make it harder for Americans to make ends meet and plan for the future. At the Federal Reserve, we recognize that inflation is causing real hardship, and tamping it down is our top concern.

The Atlanta Fed's Underlying Inflation Dashboard shows that inflation is quite high across many measures. In the April release, the personal consumption expenditures price index, the Fed's preferred inflation measure, stood at 6.6 percent, well above our 2 percent target.

The Fed's policymaking body, the Federal Open Market Committee, has an overarching goal to return inflation to our target range of around 2 percent without triggering significant economic dislocation. Inflation is too high and must be addressed. You are probably aware of steps the Federal Open Market Committee has taken to drive inflation lower.

This high inflation is a byproduct of an imbalance between aggregate demand and aggregate supply for goods and services. It is an economic truism that high demand and low supply result in rising prices, and that is exactly what we have today. Demand for goods and services has been high because many American families, having slowed consumption during the pandemic, have larger balances in their savings account, and the quick government response left many in a stronger financial position than they would have otherwise been in. That picture could be changing, however, and I'll detail that a bit later in this piece.

On the supply side, firms are struggling to produce goods to meet the surge in demand. This shortfall is due in part to supply chain disruptions triggered by COVID shutdowns in production and transportation,

both in the United States and abroad. Another factor inhibiting supply has been a shortage of workers to produce goods. Along with the Federal Reserve Bank of Richmond and Duke University's Fuqua School of Business, the Atlanta Fed conducts a quarterly survey of chief financial officers at firms across the United States. In the first-quarter 2022 CFO Survey, more than 75 percent of respondents said their firms are having difficulty filling open positions.

The Bureau of Labor Statistics Job Openings and Labor Turnover survey, or JOLTS, is signaling that labor market tightness. From March 2021 through March 2022, the JOLTS report showed that businesses posted an average of over 10 million jobs as open and available. Yet employers filled only 60 percent of those positions, leaving millions of jobs vacant.

Boosting labor supply is key but won't happen easily

Rebalancing the labor market will be crucial to lowering inflation toward the Fed's 2 percent objective. Labor supply and demand can harmonize through increasing supply, decreasing demand, or both. Let's explore the supply half of that equation first.

Expanding the labor force will not be easy. During the pandemic, the pool of potential workers shrunk because of several forces: double the number of normal retirements; fear of contracting COVID; issues finding childcare; caregiving requirements at home; and government fiscal relief programs. A further constraint on labor participation—increased substance abuse—surfaced in new research from Atlanta Fed economist Karen Kopecky and coauthors.

Moreover, business leaders are telling me they figure labor availability will remain their most pressing concern for 2022. Indeed, nearly 60 percent of respondents in a recent Business Inflation Expectations survey reported labor availability was constraining operations.

A labor supply that comes closer to meeting demand would ease pressure on employers to raise wages so aggressively as to risk sparking a wage-price spiral. That happens when workers see pay gains undermined by inflation and thus demand still higher wages. This results in companies raising prices even more to fund higher wages, and so on. That cycle took hold during the United States' last significant bout of inflation, the Great Inflation of the 1970s and ’80s.

To be clear, right now I don’t detect clear signs of a wage-price spiral in the data nor in conversations with business leaders.

Still, wage-price dynamics are among the myriad uncertainties in the economy that bear close watching and demand great caution from monetary policymakers as we recalibrate our policy.

How are businesses responding to the labor supply challenge? Many firms tell us they are increasing wages and salaries, as you'd expect. And consistent with the very competitive market for talent, the Atlanta Fed's Wage Growth Tracker is registering the sharpest nominal increases in wages since 2001. The problem is that higher pay alone may not do the trick.

One of our economists, Julie Hotchkiss, studied the responses of different age cohorts to pay raises. She found that compared to baby boomers, higher wages are only about half as likely to draw generation Xers to the work force and three-quarters as likely to attract millennials. That matters because gen Xers and millennials make up the vast majority of potential prime-age workers.

In the current labor market, Julie estimates that a 6 percent rise in nominal average hourly wages, as reported by the BLS for January, would close just 16 percent of the labor force participation gap in January 2022 compared to immediately before the pandemic.

On the plus side, it appears that perks that supplement higher wages might make a difference and are catching on among employers. We hear growing anecdotal evidence, for example, that firms are allowing employees to fashion their own hybrid remote/onsite schedules; expanding student loan repayment assistance; giving workers Fridays off; and trying to instill a larger purpose into work beyond collecting a paycheck and boosting shareholder value.

Employers alone won't determine labor force participation, of course. Another key determinant will be how families respond as they increase spending and their account balances begin to fall. Evidence from several sources suggests this is happening. The Bureau of Economic Analysis reports that overall consumption spending started catching up to personal incomes last fall and has topped them since January, while the personal saving rate has tumbled below levels that prevailed for a half-dozen years before the pandemic. Meanwhile, credit card issuers are reporting that card debt has risen. So we could start learning soon whether the erosion of savings lures enough people into the workforce to help rebalance supply and demand.

In fact, promising signs in labor force participation have emerged lately. Prime-age labor force participation has climbed since late 2021, and there has been a recent uptick in hiring and employment for people working in hospitality and other service sectors. But like many aspects of today's economy, uncertainty obscures the meaning of those signs. Some economists think we could see a rebalancing of labor supply and demand over the next year or so. Yet other groups, including some of my business contacts, are less sanguine.

A common thread of these supply side considerations is that they are largely outside the reach of monetary policy. But how these factors evolve will be important for determining how hard we need to push on monetary policy to restore a supply-demand balance in both labor markets and the general economy. As we begin removing policy accommodation, we will have to watch closely, so that we understand the evolution of labor supply in the coming months.

Alongside supply, demand for labor could soften if tighter financial conditions dampen overall demand in the economy. If that happens, employers may be able to reduce the numerous vacancies rather than cut actual jobs. This would be a path for a so-called soft landing, which is achievable but far from a given.

Expeditious but cautious—even fire trucks slow down at intersections

As I said, inflation is too high and must be addressed. The Federal Open Market Committee's overarching goal is to return inflation to our target range without triggering significant economic dislocation.

While that will be a delicate undertaking, I believe economic conditions—importantly including the labor market—are strong enough to allow us to achieve that outcome. Still, uncertainties shroud the economic outlook on virtually every front, from the pandemic to war in Ukraine to supply constraints. Monetary policy makers must be mindful of those uncertainties and proceed carefully in tightening policy.

So as we expeditiously return monetary policy to a more neutral stance to get inflation closer to our 2 percent target, I plan to proceed with intention and without recklessness. We have seen throughout the pandemic that events and market shifts can happen quickly and in ways that dramatically alter the prevailing economic dynamic, in both good ways (the rapid rebound in employment right after the initial lockdown) and bad (the rapid rise of the delta and omicron variants). We all must be ready for the unexpected to occur, assess how risks have changed when it does, and stay aware of shifts in the strength of the economy.

Given the very high level of inflation, some might be surprised by my injecting some caution here. But remember this: even firetrucks with sirens blaring slow down at intersections lest they cause further preventable trouble.