Why Removing Monetary Policy Accommodation Is Necessary

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By James Bullard

During the COVID-19 recession, the Federal Open Market Committee (FOMC) reduced the target range for the federal funds rate to near zero and began large purchases of U.S. Treasury securities and agency mortgage-backed securities. Although the recession ended nearly two years ago, U.S. monetary policy settings remain set near peak accommodation—with the policy rate only 0.25 percentage points higher now and the size of the Fed's balance sheet at nearly $9 trillion.

The Federal Reserve has a mandate to promote maximum employment and price stability. The labor market has fully recovered from the recession by nearly every measure, and it has gone beyond pre-recession levels by several measures. Moreover, inflation is running well above the 2% rate that the FOMC equates with price stability, and monetary policy has not been reset for these macroeconomic conditions. That is why it is necessary for the FOMC to remove monetary policy accommodation.[1]

U.S. Economy in Expansion Phase

The U.S. economy has shown tremendous resilience even though the pandemic is ongoing. The macroeconomy, which recovered quickly from the recession, is in the expansion phase of the business cycle, as real GDP is higher than it was at the previous peak (in the fourth quarter of 2019). The same is true for real personal consumption expenditures, which are not only above their level at the previous peak but also above a trend line drawn from 2011-2019.

U.S. labor markets are also very strong, according to key metrics. For example, the unemployment rate has declined rapidly since the recession ended, falling to 3.8% in February. We can also look at broader measures of labor market performance, such as the level of activity measured by the Kansas City Fed's Labor Market Conditions Index, which is above pre-pandemic levels and suggests that labor market conditions are the best they have been in years. Another way to assess the state of the labor market is to look at the ratio of officially unemployed workers to job openings, which has been at all-time lows in recent months. In February, the ratio was 0.56, and there were about 5 million more job openings than unemployed people.

Despite geopolitical risks, the U.S. economy is expected to grow faster than its longer-run potential growth rate and labor markets are likely to continue to improve this year.

Inflation Running Well above Target

Inflation has surprised substantially to the upside since mid-2021. The FOMC's 2% target is based on headline PCE (personal consumption expenditures price index) inflation, which measured from a year ago was 6.1% in January. Core PCE inflation (which excludes food and energy) was 5.2% during that period. Both of these measures are well above 2% and at their highest values in nearly 40 years, as shown in the FRED figure below.

Given the FOMC's focus on achieving an inflation rate of 2% on average over time, we can look at a five-year centered average inflation rate using actual data from the last three years and the median projections from the FOMC's March Summary of Economic Projections (SEP) over the next two years, for instance.

Based on those numbers, the average from 2019-2023 would be 3% for headline PCE inflation and 2.9% for core PCE inflation—both above 2%.

Initial Monetary Policy Response

How did U.S. monetary policy initially respond to the inflation shock? At its November 2021 meeting, the FOMC announced that it would begin reducing the pace of its asset purchases that month. Then in December, the FOMC agreed to speed up the pace of reduction and end the asset purchases earlier (in mid-March) and also projected more policy rate increases for 2022 in the December SEP than it had previously.

The monetary policy settings hadn't changed much at that point, but the FOMC's forward guidance was reflected in financial market pricing—for example, with two-year and five-year Treasury yields increasing about 100 basis points from early October until the invasion of Ukraine by Russia in late February. This put us in a better position to control inflation over the next few years.

Next Steps for Monetary Policy

The FOMC must now follow through with policy rate increases and balance sheet runoff. Otherwise, we risk squandering policy credibility with respect to the 2% inflation target.

In March, the FOMC decided to raise the policy rate from near zero with ongoing increases likely to be appropriate. Although the FOMC voted to increase the target range for the federal funds rate by 0.25 percentage points, I advocated an increase of 0.5 percentage points.[2] Furthermore, the latest SEP indicated that the median FOMC participant is now projecting an even higher policy rate at the end of this year and the next two years than before. In particular, the median federal funds rate projection for 2022 is 1.9% in the latest SEP (compared with 0.9% in December) and 2.8% for both 2023 and 2024 (compared with 1.6% and 2.1%, respectively, in December). And as noted in the post-meeting statement and in Fed Chair Jerome Powell's press conference, the FOMC expects balance sheet reduction to start at a coming meeting.

In my view, getting underway with the removal of accommodation was appropriate given the strong real economy and the ongoing inflation shock. I believe that the FOMC should raise the policy rate to 3% by the end of the year and implement a plan to quickly reduce the size of the Fed's balance sheet. Going forward, the extent and pace of these actions can be adjusted if macroeconomic conditions evolve differently than we expect today. And, of course, we must monitor risks, such as developments in the Russia-Ukraine war and their potential impact on the U.S. economy and inflation. But forthright and transparent monetary policy actions designed to keep inflation under control will give the U.S. economy the best possible chance at a long and durable expansion.