The Economic Outlook and Monetary Policy

Remarks by
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Thanks to the Economic Club of Indiana for inviting me to speak today. I'm pleased to be here in person, something I no longer take for granted after the experience of the past two years, to share my thoughts on the economy during this extraordinary time.

The global pandemic hit the U.S. in full force two years ago and although its effects are still with us, the U.S. economy rebounded quickly. Looking back, 2021 saw several notable economic developments, including the largest increase in employment on record as well as the most significant pick-up in inflation in decades. The effects of a global pandemic and the extraordinary policy response that followed, both fiscal and monetary, drove those outcomes and will likely continue to set the course for the economy this year.

I'll talk about three key dimensions that will influence economic activity in the coming year: the outlook for demand, the outlook for supply, and the outlook for monetary policy.

The Outlook for Demand

The outlook for demand is a positive one. Spending was robust at the end of last year, with retail sales in the fourth quarter almost 20 percent higher than the same period in 2020, the largest annual increase on record. With the new year, the sharp rise in Covid cases linked to the Omicron variant has muddled the picture somewhat. Real GDP increased a solid 6.9 percent in fourth quarter, but the surge in new cases has led many forecasters to revise down their projections for the beginning of the year, even though there is a generally held view that economic activity, and spending in particular, has become more resilient to spikes in the virus.

My own expectation is that the strength of the underlying fundamentals will continue to support solid consumption growth. Notably, household income continues to increase rapidly. Nominal labor compensation has grown roughly 10 percent over the past year amid increases in employment and wages. With a record 6.5 million people added to payrolls last year, more people working means more income and more spending in the economy. This is particularly true for the wage gains going to lower-income workers, a group that has traditionally spent a relatively large share of their paychecks.

Demand growth is also likely to be supported by healthier household balance sheets. Significant fiscal transfers, along with subdued spending early in the pandemic, allowed many to accumulate savings and pay down debt. Households now have over $2 trillion in additional savings relative to pre-pandemic trends, and buoyant asset markets, with both equity and house prices near record highs, have also boosted wealth. While it is possible that households could decide to maintain a higher level of saving and liquidity following the volatility of the pandemic, many have the capacity to spend.

Another factor supporting demand growth is a robust outlook for state and local government spending. With sizeable transfers from the federal government, state budget balances reached record highs in fiscal year 2021. And while fiscal policy at the federal level is likely to turn contractionary as spending and transfers fall back from elevated pandemic levels, state and local spending is expected to expand close to 10 percent in the current fiscal year, the largest increase in 15 years.

Although I expect overall spending to hold up, the persistence of the virus is likely to further delay a normalization of the skewed pattern of consumption we have observed over the past two years. Throughout the pandemic, consumers have favored the purchase of goods, particularly durable goods. For example, additional time at home launched a wave of residential remodeling and upgrading with demand for furniture and appliances. It also inspired purchases of home exercise equipment and bicycle sales. Although durable goods consumption has fallen from its peak, the level remains 10 percent higher than its pre-pandemic trend, and there are indicators it might be even higher if supply constraints weren't limiting purchases. This is particularly true for automobiles, where depleted inventories are likely weighing on sales.

In contrast to goods, spending on services remains considerably below trend, as consumers continue to avoid in-person recreation, including live performances and movies, and have cut back on visits to doctors and dentists. The same is true with business travel still disrupted; hotels and air transportation remain depressed (though it might be hard to tell from the middle seat of an overbooked flight).

The Outlook for Supply

Turning to the outlook for the supply of goods and services, 2021 saw supply lag demand for many categories of consumption, particularly goods. The result was higher prices. With overall demand expected to remain strong, a key question for the outlook is whether supply will be able to keep up, particularly as the ongoing public health concerns related to the pandemic threaten to delay a rotation of consumption from an overheated goods sector to a relatively slack services sector. Whether or not supply is able rise to the occasion in part will be determined by the persistence of pandemic-related disruptions that have weighed on both product and labor markets.

One set of factors constraining supply relates to production bottlenecks and shortages, many originating in the rapid closing and subsequent slow reopening of the economy in 2020. The range of disruptions across factories and across countries has jumbled global supply networks, as have disruptions to transportation networks, including the carefully choreographed movement of shipping containers around the world temporarily collapsing in disarray. Slowly, these disruptions are being dealt with, and there are indications that the worst has passed as shipping rates have peaked and port backlogs are being cleared. Imports and inventories both increased sharply in the fourth quarter, suggesting that supply is on the mend. Reports of supplier delivery delays declined in December even as they remain at historically elevated levels. Still, global supply networks continue to face risks, particularly those going through China where a zero-Covid policy and strict lockdowns are running up against the highly transmissible Omicron variant.

A lack of labor also has been an important constraint on supply. Speaking to contacts in my region, reports of acute labor shortages are prevalent. These reports align with the data, reflecting the ratio of job openings per unemployed person near all-time highs and workers quitting jobs at a record pace. The labor market looks tight, with the unemployment rate falling below 4.0 percent in December and wage growth picking up solidly.

This tight labor market reflects the strength of demand but also constraints on the supply of labor. In December, the labor force participation rate remained 1.5 percentage points below its pre-pandemic level and has shown little movement in recent months. Taking into account the trend decline in labor force participation as the population ages, this amounts to a shortage of roughly 3.5 million workers. Understanding what is keeping these workers out of the labor market, and how persistent these factors are, will be important for determining how quickly the economy will grow, as well as the split between output growth and higher inflation.

So why have workers left the labor market? The pandemic likely remains a key consideration, and one that is likely to fade only slowly. In December, more than a million workers reported not being in the labor force because of Covid, mostly prime-age workers and disproportionately women. Throughout the pandemic, issues in childcare availability surfaced as a key constraint on labor force participation, a concern that is only likely to be prolonged by the recent surge in the virus and renewed school closures. Employment in daycare facilities remains 10 percent below pre-pandemic levels, suggesting that capacity still has some way to recover. However, it is not only children. Employment in nursing and residential care facilities has declined 12 percent relative to the start of 2020, suggesting that there has been a substantial shift in family care responsibilities towards households during the pandemic.

Another contributor to lower labor force participation has been a large increase in the proportion of the population that reports being retired. While these workers are largely not attributing their lack of workforce participation to the pandemic, I would not dismiss its role in elevating the retirement rate. Looking at detailed data, it appears much of the increase in the reported retired population does not reflect workers moving from employment to retirement but rather a sharp slowdown in the number of retirees returning to work. In normal times, there is a regular flow of retired individuals who move back into employment, in some cases out of personal interest or in other cases out of necessity. Today, it appears as though more retirees are deciding to stay retired, perhaps because of concern over illness or as buoyant equity and housing markets have boosted retirement nest eggs and financial security. If concern over illness is a prime motivating factor, some fraction of these workers may decide to return to the workforce as the pandemic fades.

Of course, the pandemic has yet to fade, and the latest Omicron variant has the potential to prolong supply disruptions and to delay a further recovery in labor markets. We are already seeing some signs of its impact on the health of the workforce with absenteeism disrupting business activity and production. This dynamic has been particularly apparent in the airline industry, as a lack of employees led to the cancellation of flights and disrupted travel. It will also likely weigh on labor force participation as potential workers remain on the sidelines waiting for the situation to improve.

The ongoing influence of the virus has obviously added uncertainty to the outlook. However, I don't expect it has changed the overall picture of strong demand continuing to push up on constrained supply.

The Outlook for Monetary Policy

What does this outlook imply for the path of monetary policy? Monetary policy plays an important role in shaping the balance of demand and supply by either encouraging or moderating the growth of demand. When demand looks to overwhelm supply, economic stability and long-run growth prospects are best served by a less accommodative monetary policy that moderates the pace of demand growth. By smoothing out demand growth to allow supply time to catch up, monetary policy can support the strong and steady expansion of economic activity.

Monetary policy is currently providing a historic amount of accommodation to the economy. With the policy rate near zero and inflation elevated, real interest rates, or interest rates adjusted for inflation, are near record lows. In addition to the low policy rate, the Fed has increased significantly the size of its balance sheet, purchasing large amounts of Treasuries and mortgage-backed securities and more than doubling its asset holdings to nearly $9 trillion. By removing securities from the market, these purchases apply notable downward pressure on longer-term interest rates and lower borrowing costs. Asset valuations also respond as investors seek returns in alternative and perhaps riskier investments.

With inflation running at close to a 40-year high, considerable momentum in demand growth, and abundant signs and reports of labor market tightness, the current very accommodative stance of monetary policy is out of sync with the economic outlook. At last week's meeting, the FOMC acknowledged the need to shift its policy settings with interest rate increases and significant reductions in asset holdings on the horizon.

Removing accommodation is easily justified, but it is unavoidably complicated by the use of multiple policy instruments, as it was during the last normalization cycle less than a decade ago. To guide this process, the FOMC released a set of general principles for reducing the size of the Federal Reserve's balance sheet. These principles keep the federal funds rate as the primary tool of policy adjustments with planned significant reductions in the balance sheet to begin after the policy rate had increased. The principles also reaffirm the Committee's ample reserves operating regime and an intention to hold primarily Treasury securities in the long-run, moving away from holding mortgage-backed securities to minimize possible distortions in credit allocation.

These principles establish important guideposts as the Federal Reserve begins to dial back its policy settings. However, they are just a start, and a number of important and difficult decisions remain. In particular, I expect it will be important to consider the interaction between reductions in the size of the balance sheet and increases in the policy rate. What we do on the balance sheet will likely affect the path of policy rates and vice versa. For example, more aggressive action on the balance sheet could allow for a shallower path for the policy rate. Alternatively, combining a relatively steep path of rate increases with relatively modest reductions in the balance sheet could flatten the yield curve and distort incentives for private sector intermediation, especially for community banks, or risk greater economic and financial fragility by prompting reach-for-yield behavior from long-duration investors.

In the previous normalization cycle, the FOMC delayed adjusting the size of the balance sheet until the normalization of the funds rate was "well under way." The rationale for this timing was predicated on the novelty of balance sheet normalization and the desire for space to offset any unexpected turbulence. This rationale seems less compelling now and, from my perspective, discounts the yield curve implications of moving the funds rate higher while maintaining a large balance sheet. All in all, it could be appropriate to move earlier on the balance sheet relative to the last tightening cycle.

Regarding the ultimate size of the balance sheet, the principles state an intention to maintain securities holdings in an amount needed to implement monetary policy efficiently and effectively in an ample reserves regime. I expect that this will be an amount that will be difficult to identify with any precision, particularly as the banking sector's demand for reserves is likely to evolve over time, perhaps in ways that is hard to predict. While it might be tempting to err on the side of caution, the potential costs associated with an excessively large balance sheet should not be ignored.

I would describe those costs in three aspects. One is the distortive effects of the size of the Fed's balance sheet on the financial system. A large Fed presence in markets can displace private activity, even in a market as large and liquid as that for U.S. Treasuries and certainly where the central bank holds roughly 1/4 of the MBS market. This presence can distort price signals, currently most evident in the pricing of duration. By holding long duration assets, the Fed's balance sheet is depressing the price of duration, by lowering longer-term yields by as much as 1.5 percentage points according to some rules-of-thumb, incentivizing reach-for-yield behavior and increasing fragility within the financial system.[1] As we purchased assets, our goal

[1] The summary of estimates reported in Swanson (2021) imply that the Federal Reserve's $6.9 trillion holdings of federal agency and longer-term Treasury debt is depressing the 10-year Treasury yield by roughly 150 basis points.

was in part to artificially depress term premia, pushing down long-run rates and supporting economic activity. In normalizing our balance sheet, we should aim to eliminate this distortion.

Second, and related, maintaining a large balance sheet reduces available policy space in the inevitable next downturn. With the zero lower bound likely to bind for short-term rates, the trend decline in long-term rates has also decreased the amount of policy space we have at the longer end of the curve. Just as increases in the policy rate provide us with space to cut short-term rates, decreasing the size of our balance sheet, and increasing term premia, could provide space to push down long-run yields in the next downturn.[2]

Finally, a large balance sheet has the potential to intertwine fiscal and monetary policy in the public's eyes and could unintentionally pose risks to the Fed's independence and authority.[3] In a rising rate environment, this risk could become more apparent as interest paid on the large stock of reserve liabilities grows.

With these costs in mind, we are likely to face a different set of challenges and consequential decisions than we did with our previous experience with balance sheet adjustments. In following through on these principles for reducing our asset holdings, the differences are notable, considering the current balance sheet is historically large relative to the size of the economy, and the economy itself is in a far different place. In 2015, inflation was well below 1 percent; the unemployment rate was 5 percent; and the economy was growing just under 2 percent annually. The balance sheet was half the size it is today. The starting point for policy

[2] Monetary Policy is one of many factors affecting long-term interest rates, including international developments, the growth outlook, and the quantity and maturity of federal debt issuance.
[3] See "The Importance of Central Bank Independence," remarks delivered virtually at the Conference on "Central Bank Independence, Mandates and Policies," hosted by the Economics and Business School, Universidad de Chile, October 21, 2021.

adjustments in 2022 stands in stark contrast to the 2015 experience with high inflation, tight labor markets, a robust demand outlook, and elevated asset valuations.

Even as the pandemic continues to influence economic activity, monetary policy is transitioning away from its current crisis stance towards a more neutral posture in the interest of meeting its long-run objectives. Policymakers will need to grapple with the appropriate pace and size of adjustments across multiple policy tools in the context of a changing and challenging environment. That transition could be a bumpy one, with the prospect of asset valuation adjustments and the recalibration of supply and demand towards a new equilibrium.