An Update on the U.S. Economy and Monetary Policy

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Introduction

I thank the Lyons Companies and the University of Delaware for inviting me to speak at today's forum on the outlook for the U.S. economy. I had the opportunity to speak at this event in 2019 and enjoyed being on campus. Hopefully, we will have the opportunity to meet in person soon.

In my remarks three years ago, I characterized 2019 as a year of transition for the economy and monetary policy. At that time, economic growth was expected to transition to a more sustainable pace after above-trend growth in 2018, and we were completing a monetary policy transition that had been underway for some time: a transition away from the emergency monetary policy settings needed in the wake of the Great Recession to more normal policy.

Today, we are at the start of another monetary policy transition, this time away from the extraordinary accommodation that was necessary earlier in the pandemic. I will spend my time discussing the economic rationale for the transition and the implications for monetary policy going forward. As a reminder, the views I present today will be my own and not necessarily those of the Federal Reserve System or of my colleagues on the Federal Open Market Committee.

The Economy

Despite the challenges posed by the pandemic, U.S. economic growth was very strong last year. Real GDP grew at about a 5-1/2 percent rate, the highest annual pace since 1984; firms added a record 6.7 million jobs to their payrolls; and the unemployment rate moved down to about 4 percent, close to its pre-pandemic level. The economy's strength reflected very robust demand by households and businesses. This demand was supported by extraordinary fiscal policy and monetary policy, as well as the deployment of vaccinations, which allowed the economy to reopen more fully. But this strong demand came at the same time that there were constraints on product supply and labor supply. The imbalances between supply and demand have put significant upward pressures on prices and wages. Inflation readings in the

U.S. are at their highest levels in about 40 years, and nominal wages are accelerating at a faster pace than we have seen in decades.

There are risks and uncertainty around the outlook, including those engendered by the geopolitical events unfolding today. My modal outlook continues to be that the strong economic expansion continues this year. Just as the Delta variant did last autumn, the Omicron variant has weighed on activity in high-contact services. But new case counts and hospitalizations are declining sharply, so I expect that households and businesses will once again prove to be resilient in the face of the virus. Once Omicron is behind us, demand should rebound fairly quickly because both business and household balance sheets are very healthy. But compared to last year, demand is likely to moderate this year as the support from the pandemic stimulus programs wanes and financial conditions become less accommodative. Nevertheless, the economy should still expand at an above-trend pace despite facing some challenges.

One challenge is the imbalance between supply and demand I mentioned earlier. While earlier in the pandemic, the economic effects of the virus were mainly on the demand side, now the effects are seen mainly on the supply side. Differences in virus conditions and virus containment policies across the globe have disrupted global supply chains. Firms are struggling to get necessary parts and materials through clogged ports and transportation channels. Many businesses are facing significantly higher costs for available inputs. Rather than abating over last year, the disruptions continued to constrain economic activity. But now, there are some hopeful signs. Anecdotal reports suggest that some of the constraints may be stabilizing and delivery times appear to be improving. We routinely speak with a large number of business and community contacts in our District, which comprises Ohio and parts of Pennsylvania, Kentucky, and West Virginia. Manufacturers take as a hopeful sign that deliveries have become more predictable even though lead times remain very long, and half of our business contacts expect some easing of the supply disruptions in the second half of this year. Still, more than a third of our contacts do not expect improvement until 2023.

Businesses are also struggling to find workers. By a number of measures, labor markets are very strong and the demand for workers is well outstripping labor supply. While payroll employment is still nearly 3 million jobs below its February 2020 pre-pandemic level, job gains have been very strong, averaging over 550 thousand per month last year. Broad-based gains continued in January, despite the effects of Omicron, and the November and December payroll gains were revised up, suggesting continued positive momentum in the labor market. The unemployment rate is now 4 percent, down nearly 2-1/2 percentage points from a year ago. The job openings rate is considerably higher than it was before the pandemic. According to government statistics, there are about 1.7 job openings per unemployed person.

Pandemic-related factors, including child and elder care responsibilities and fear of the virus, have contributed to the undersupply of workers. These factors should fade over time, though the precise timing and magnitude are open questions. Over a longer horizon, labor force participation has been trending down since early 2000 due to demographics, and many more people retired during the pandemic than predicted solely by demographics. So labor markets are likely to remain tight for some time.

In response to labor shortages, businesses have been raising wages, offering signing and retention bonuses, allowing much more flexible work schedules and locations, and speeding up automation. Average hourly earnings grew nearly 5 percent last year, and upward pressure on wages continues, although, in many cases, the wage increases are not keeping up with inflation.

The imbalances between demand and supply in both product and labor markets are contributing to the very high inflation readings. Measured year-over-year, PCE inflation reached almost 6 percent in December, and core PCE inflation reached almost 5 percent. Both are at their highest levels since the early 1980s. The Cleveland Fed’s median PCE inflation measure and the median CPI and trimmed-mean CPI measures are useful indicators of the underlying inflation trend and all have moved well above 2 percent.[1] As inflationary pressures rose last year, they also broadened considerably across a wider range of goods and services. Inflation forecasts were revised up all year. In the December 2020 Summary of Economic Projections of FOMC participants, the median projection of PCE inflation for 2021 was 1.8 percent. By the December 2021 SEP, that projection had risen to 5.3 percent.

I do expect some improvement in inflation readings later in the year as demand moderates and capacity constraints in both product and labor markets begin to ease. Nonetheless, I expect inflation to remain above 2 percent this year and next, and I see the risks to inflation as tilted to the upside. Geopolitical events add upside risk to the inflation forecast even as they put some downside risk to the near-term growth forecast. My projection of some moderation in inflation is conditioned on the FOMC taking appropriate action to recalibrate monetary policy to an economy in which inflation has been running well above our 2 percent goal for some time, labor markets are very strong, and solid momentum in underlying demand is expected to continue.

Monetary Policy

The FOMC's policy decisions reflect its strong commitment to achieving its dual-mandate goals of price stability and maximum employment. The task before the Fed is to remove accommodation at the pace necessary to bring inflation under control while sustaining the expansion in economic activity and healthy labor markets. Monetary policy cannot alleviate the constraints on supply. But it can help to moderate demand by making broader financial conditions less accommodative, thereby reducing inflationary pressures. Doing so will help sustain the expansion in activity and healthy labor markets.

[1] The Cleveland Fed's median PCE inflation measure reached 3.6 percent in December. In January, the Cleveland Fed's median CPI inflation measure rose to 4.2 percent, its highest level since 1991, and its trimmed-mean CPI inflation measure rose to 5.4 percent, its highest level since the series began in 1983. These inflation measures are maintained by the Cleveland Fed's Center for Inflation Research and are available at https://www.clevelandfed.org/en/our-research/center-for-inflation-research.aspx.

The FOMC is beginning the process of reducing accommodation. Since March 2020, the FOMC has maintained the target range of the fed funds rate at 0 to 1/4 percent to support the economy. At our January meeting, the Committee announced that it will soon be appropriate to raise the target range. Barring an unexpected turn in the economy, I believe it will be appropriate to move the funds rate up in March and follow with further increases in the coming months. The ultimate pace at which monetary policy accommodation is removed will need to be data driven and forward looking. If, by mid-year, I assess that inflation is not going to moderate as expected, then I would support removing accommodation at a faster pace over the second half of the year. On the other hand, if inflation moves down faster than expected, then the pace of removal could be slower in the second half of the year than in the first half. The implications of the unfolding situation in Ukraine for the medium-run economic outlook in the U.S. will also be a consideration in determining the appropriate pace at which to remove accommodation.

Throughout the pandemic we have also used our balance sheet as a policy tool, buying large volumes of Treasury securities and agency mortgage-backed securities. These asset purchases were an important policy response to the severe strains in financial markets seen early in the pandemic, and throughout the pandemic, they have helped to support the economy in the midst of the unprecedented COVID shock. But now, markets are functioning and a solid expansion is underway, so the FOMC has been winding these purchases down. Last September, the FOMC indicated that it would soon be time to moderate the pace of asset purchases; in November, it began reducing the monthly pace of purchases; and in December, it sped up the reductions. This January, the FOMC announced that the purchases would end in March and released a set of principles it plans to follow as it significantly reduces the size of its balance sheet.

At nearly $9 trillion in assets, the Fed’s balance sheet is now about double the size it was before the pandemic. The last time the Fed undertook a process to reduce the size of its balance sheet was after the Great Recession. That process started nearly two years after liftoff of the funds rate from zero and when the target range had risen to 1 to 1-1/4 percent; the reduction process went on for almost two years. This time, the balance sheet is much larger and inflation is much higher. So barring a material change in the economy, I support our beginning to reduce the size of the balance sheet soon and to go at a faster pace than we did last time. I would also support selling some of our mortgage-backed securities at some point during the reduction process, something we did not do last time, in order to speed the conversion of our portfolio's composition to primarily Treasury securities. Holding mainly Treasuries minimizes the effect of our balance-sheet assets on the allocation of credit across economic sectors, which is one of the guiding principles the FOMC released in January.

Conclusion

In conclusion, this year the FOMC will be transitioning monetary policy away from the emergency levels of accommodation needed earlier in the pandemic and recalibrating policy to today's economic challenges. Accommodation will be removed at the pace necessary to bring inflation under control while sustaining the expansion in activity and healthy labor markets. As last year clearly shows, the economy can evolve differently than expected. We are not through the pandemic yet and other risks, including unfolding geopolitical events, could affect the U.S. economy. So I will be carefully monitoring economic and financial developments and assessing their implications for the outlook and the risks around the outlook, as the FOMC recalibrates monetary policy in pursuit of its goals of maximum employment and price stability.