The Path to Price Stability

Remarks by
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The views expressed by the author are her own and do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives.

My thanks to the Economic Club of New York for the invitation to speak. I look forward to today's conversation.

The economy is emerging from the shadow of the pandemic. Public health restrictions are being lifted, workers are commuting again, and things are beginning to return to normal, even if there is a good chance that "normal" isn't quite the same normal that we left behind. Over the past two years, there was an unprecedented use of the word "unprecedented" to describe the economy. And understandably so. We had a record decline in jobs, then a record rebound. A historic drop in output followed by a historic gain. All supported by a previously unimagined level of fiscal and monetary policy support. That it was an "unprecedented" time in the nation's economy is no exaggeration.

Now as many of us return to our offices after a two-year hiatus and dust off our desks, the economy faces yet another challenge: high inflation. Instead of calling it unprecedented, however, I often hear people suggest that the current economy has an uncomfortable resemblance to that of the 1970s with inflation now running at a pace not seen since that era. Without elaborating on what I view as important differences between now and the 1970s, the focus on high inflation is undebatable.

For policymakers, understanding the nature of today's inflation dynamics is essential. How will the extraordinary shock of the pandemic play out relative to the dynamics that have shaped economies over time, and what lessons can be drawn from past inflationary periods? Both aspects are relevant in my view to how the economy is likely to evolve, particularly as it relates to inflation.

In my remarks this afternoon, I will offer my views on the factors I see shaping the outlook for economic activity and inflation, and how those factors inform my thinking about the appropriate path for monetary policy.

The Outlook for Demand, Supply, and Inflation

Consumers continue to spend, and the underlying fundamentals for consumption are positive. Retail sales adjusted for inflation increased 9 percent over the 12 months ending in February, far above the average 2½ percent pace observed in the decade prior to the pandemic. This burst of consumption has been particularly apparent for long-lasting durable goods as the

pandemic scrambled typical spending patterns away from services, such as gyms, restaurants, and movie theaters, and towards goods, such as treadmills, kitchen appliances, and home entertainment systems. Although there is good reason to think spending patterns will eventually return to pre-pandemic trends, the demand for goods has shown only modest signs of abating so far, and spending on many services remains depressed.

Overall consumption has been supported by strong income growth. Since the beginning of 2020, personal income has increased at a faster rate than in any two-year period in the past 15 years, first as the result of stimulus checks and enhanced unemployment benefits and then with the rapid recovery in the labor market with employment increasing and wages rising. Households now hold over $2 trillion in additional savings relative to pre-pandemic trends, positioning them with the capacity to spend.

This robust demand has outpaced the available supply of goods and services, especially as pandemic-related disruptions continue to weigh on product and labor markets, and geopolitical conflict has further impeded the supply of many commodities.

Production bottlenecks and shortages originated in the rapid closing and subsequent slow reopening of the economy during the pandemic. The range of disruptions across factories and across countries has jumbled global supply chains, as have disruptions to transportation networks. Signs of improvement are slowly emerging. The New York Fed's index of global supply chain pressures fell notably in January and February, and inventories rose faster at the end of 2021 than any time since 2015, suggesting that companies are finding ways to work around these constraints.

A lack of labor also has been an important supply constraint. Contacts in my region continue to express concern about labor shortages. 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 to 3.8 percent in February while wage gains have been picking up in recent months.

Still, many workers remain on the sidelines. In February, the labor force participation rate remained 1 percentage point below its pre-pandemic level. Taking into account the trend decline in participation as the population ages, this amounts to a shortage of roughly 2 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.

Why have workers left the labor market? The pandemic likely remains a key consideration, and one that is likely to fade only slowly. In February, 1.2 million people reported not being in the labor force because of Covid. Throughout the pandemic, issues in childcare availability have stood out as a key constraint on labor force participation. And here things are not yet back to normal. Employment in daycare facilities, a proxy for capacity, has only slowly recovered and remains 11 percent below pre-pandemic levels. However, it is not only childcare. Employment in nursing and residential care facilities has declined some 12 percent since the beginning of 2020, and it has shown almost no recovery to date. This substantial shift in family care responsibilities towards households may take some time to resolve.

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 generally not attributing their lack of workforce participation to Covid, I would not underplay the role that the pandemic could have 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.[1] 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. During the pandemic it appears as though more retirees decided to stay retired, perhaps related to pandemic concerns or as buoyant equity and housing markets have boosted retirement nest eggs and financial security. A change associated with either reason could bring some fraction of these workers back over time.

These supply constraints in the face of strong demand are pushing up inflation to a 40-year high. CPI inflation was nearly 8 percent in February, with core inflation, stripping out food and energy prices, at 6.4 percent. Initially, the run-up in inflation was primarily associated with a few specific goods, particularly cars (new, used, and rented). This led to assumptions that such price pressures would dissipate. But rather than being short-lived, inflation has broadened its reach. Currently, inflation for almost half of a typical consumer's purchase bundle is far above a five-year average. Consumer sentiment has plummeted as a result.

[1] What Has Driven the Recent Increase in Retirements? - Federal Reserve Bank of Kansas City (kansascityfed.org)

The outlook for inflation will be affected in several ways. Supply constraints can be expected to ease as workers re-enter the labor force and transportation and production networks untangle, taking some pressure off inflation. The timeline for seeing this relief is highly uncertain. Demand growth is also expected to cool, as fiscal policy becomes less expansionary and monetary policy accommodation is removed to stabilize prices. That process is just getting underway.

At present, global dynamics pose upside risks to the inflation outlook. Although the pandemic has fortunately taken a backseat in the U.S., effects continue to be felt in other parts of the world with the capacity to disrupt. The U.K. and Europe are witnessing rising case counts as an even newer variant takes hold. A particularly salient risk is the continued threat of lockdowns in China as that country's zero-Covid strategy runs up against ever more transmissible variants. Shutdowns, of course, will aggravate already disrupted global supply chains, likely boosting prices, even as the lockdowns could weigh on China's demand and global growth.

Additionally, the conflict in Ukraine presents a variety of risks to the outlook, both on the supply and the demand side. Prices have moved up sharply for a number of commodities, both as Ukrainian production has been affected and as sanctions limit Russian exports. Given Russia's importance in global energy production, we have seen a sharp rise in oil and natural gas prices. The conflict has further boosted inflation, and it threatens to extend or worsen supply chain disruptions.

The Outlook for Monetary Policy

Against this backdrop of high inflation, last week, the FOMC began adjusting the stance of policy. The Committee raised the policy rate by 25 basis points and signaled that it will soon begin the process of running down the Fed's balance sheet.

Given the state of the economy, with inflation at a 40-year high and the unemployment rate near record lows, it is clear that removing accommodation is required. How much and how aggressively accommodation should be removed is far more uncertain.

Real interest rates—that is, the interest rate adjusted for the pace of inflation—remain highly negative, encouraging borrowing and consumption. In addition, the balance sheet now stands at a record $9 trillion. By holding a substantial share of U.S. Treasury debt as well as mortgage-backed securities (MBS), these asset holdings are putting significant downward

pressure on longer-run interest rates, by some estimates lowering the yield on the 10-year Treasury by 150 basis points.[2] All in all, monetary policy is likely as accommodative as it has ever been at a time when inflation is well above the Fed's target and labor markets are tight.

Considerations in the Removal of Accommodation

With the current stance of monetary policy out of sync with the state of the economy, policymakers face a challenging set of global and domestic dynamics as they begin the process of removing accommodation. My own thinking about the approach to removing accommodation is influenced by several considerations.

The first takes into account continued risks to the outlook associated with further pandemic-related disruptions in Europe and Asia as well as spillovers from the Russia-Ukraine conflict. While much of the economic fallout so far has been directed towards further disruptions to supply, both of these risks have implications for demand as well as supply. Assessing the balance in real time will be difficult. Recognizing these risks is not an argument for stalling the removal of accommodation, but it does suggest a steady, deliberate approach for the path of policy could provide space to monitor developments as they unfold.

Another consideration for policymakers is judging how responsive economic activity is to the level of the interest rate. This responsiveness is likely to change over time and with the state of the economy. For example, with consumption skewed towards durable goods, which tend to be more interest-sensitive than other components of spending, it is possible that higher rates will have a more pronounced impact on the economy than observed in the past. On the other hand, high levels of liquidity in the economy and healthy household balance sheets might make consumption more resilient to higher interest rates, requiring a steeper path of rate increases to slow demand growth and bring inflation down. A steady, deliberate approach to removing accommodation will allow policymakers to observe where this equilibrium might be.

Finally, the interaction of higher policy rates with a large balance sheet will need to be considered. Raising short-term rates while the balance sheet continues to depress longer-term yields will contribute to a flattening and inversion of the yield curve. Already, as markets have anticipated a rapid increase in short-term rates, the spread between the yield on the 2-year and

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[2] 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.

10-year Treasury bond turned negative yesterday. While many factors influence longer-term yields, including the growth outlook, foreign demand for Treasuries, and the quantity and maturity of Treasury debt issuance, the Fed's asset holdings also play a role. These purchases aimed to depress long-term rates, and the roll-off of these assets is likely to put some upward pressure on those rates, possibly steepening the yield curve.

My concern about an inverted yield curve does not reflect its intensely debated value as a predictor of recession. Rather, my view is that an inverted curve has implications for financial stability with incentives for reach-for-yield behavior. An inverted yield curve also pressures traditional bank lending models that rely on net interest margins, or the spread between borrowing short and lending long. Community banks in particular rely on net interest margins to maintain their profitability, with rural areas especially dependent on community banks.

As the FOMC begins the process of removing accommodation, not only will the policy rate need to rise, but the balance sheet will need to decline significantly. Negative real rates and a large balance sheet have distortive effects. For example, by owning roughly one-quarter of the MBS market along with a significant portfolio of longer-term Treasuries, our presence in financial markets muddies price signals, encourages excessive risk-taking, and can foster financial instability. Asset prices remain historically high and remain vulnerable to economic and policy uncertainty.

Given the state of the economy, with inflation at a 40-year high and the unemployment rate near record lows, moving expeditiously to a neutral stance of policy is appropriate. At the same time, the factors I noted earlier, including monitoring risks, the responsiveness of activity to interest rate changes, and yield curve developments will be important guides to that pace in my view.

The degree to which fading disruptions contribute to an easing of inflation and the lags of policy actions will be relevant for what happens after more-neutral policy settings are accomplished. If at that point inflation shows signs of remaining elevated, more restrictive policy may be required to meet our price stability objective and to reinforce an anchoring of inflation expectations.

Concluding Thoughts

The start of a tightening cycle is always fraught with challenges. The public's focus quickly pivots from asking "When will they start?" to "When will they stop?"

The previous tightening cycle initiated in December 2015 proved to be a difficult transition. Although the initial rate increase was almost fully expected, it soon became apparent that "expected" was not the same as "understood." And it proved challenging to articulate a compelling narrative for the path of policy throughout 2016.

Of course, today's policy landscape is quite different. The rationale for removing accommodation is not difficult when inflation is high, demand is strong, and the labor market is hot. Under those conditions, a soft landing is possible but not guaranteed. While an outlook of easing supply constraints and moderating demand growth is consistent with inflation stepping down even as the labor market remains strong, less favorable outcomes are certainly possible. In the event high inflation persists while demand turns down, and the labor market falters, policymaker resolve could be tested.

If the assumption of temporary pandemic effects on supply and demand proves to be overstated, and the imbalance between strong demand and lagging supply persists, the potential to dislodge inflation expectations and price-setting dynamics will further complicate policymakers' task. Here the comparison to the 1970s is apparent, when persistently high inflation over several years led to the unanchoring of inflation expectations that then became embedded in price and wage setting behavior. Unlike that period, however, Fed policymakers today have emphasized a commitment to act expeditiously to restore price stability.

Still, the landscape we face is murky. Uncertainty and risks seem likely to accompany each step on the path to policy normalization, demanding equal doses of flexibility and resolve.