St. Louis Fed

Reflections on Monetary Policy in 2022

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As we near the end of 2022, it is a good time to reflect on monetary policy during what has been a momentous year. When the year started, the target range for the federal funds rate (i.e., the policy rate) was near zero, and the Federal Open Market Committee (FOMC) was still increasing the size of the Fed's balance sheet by purchasing Treasury securities and agency mortgage-backed securities.

However, since March, the FOMC has been removing monetary policy accommodation at its fastest pace since the 1980s in an effort to bring inflation back down toward the Fed's 2% target, thereby fulfilling its dual mandate of stable prices and maximum employment.

Inflation Running Far above Target

Last year, the U.S. began to experience a sharp rise in inflation; at the time, it wasn't clear if this was a transitory or a persistent phenomenon. In November 2021, I wrote about the need for a risk management approach to monetary policy that entailed positioning monetary policy to account for scenarios in which inflation either moderated naturally or remained persistently above the Fed's 2% target. The latter scenario would have required additional policy action from the FOMC, which is precisely what has happened as inflation surprised to the upside for the second year in a row.[1]

According to the December 2021 Summary of Economic Projections (SEP), the FOMC was expecting inflation to decline toward 2% during 2022. In particular, the median FOMC participant last December projected that headline inflation would be 2.6% and core inflation would be 2.7% in the fourth quarter of 2022. (These measures are based on the year-over-year percent change in the headline and core price indexes for personal consumption expenditures, or PCE.) By September 2022, however, when the latest SEP was released, the median FOMC participant projected that headline inflation would be 5.4% and core inflation would be 4.5% at the end of this year—much higher than expectations last December. In fact, inflation in 2022 reached levels comparable to those in the 1970s. (The most recent readings for headline and core PCE inflation are for September and came in at 6.2% and 5.1%, respectively.)

Meantime, U.S. labor markets have remained strong all year, which has given the Fed some leeway to fight inflation. For instance, the Kansas City Fed's labor market conditions index, which aggregates many different measures of labor market performance into one metric, suggests that labor market conditions in 2022 have been near highs last seen in 1999-2000. Getting inflation under control is key to keeping the labor market strong and healthy in the long run.

Front-loading Rate Hikes

Early in the year, I began advocating that the FOMC front-load its planned removal of monetary policy accommodation.[2] The idea with front-loading is to withdraw policy accommodation more rapidly (e.g., by

raising the policy rate more quickly) to allow a better chance of containing inflation sooner and of preventing inflation expectations from becoming unmoored, like they did in the 1970s.[3]

Indeed, the FOMC has been removing monetary policy accommodation more aggressively than previously had been anticipated.[4]

In March, the FOMC raised the policy rate from its near-zero level. After the initial 25 basis point increase, the FOMC began making larger moves: 50 basis points at its May meeting and 75 basis points at each of its next four meetings (in June, July, September and November). The target range for the federal funds rate currently stands at 3.75% to 4%—up 375 basis points so far this year. Further increases are anticipated to raise the policy rate to a sufficiently restrictive level that puts meaningful downward pressure on inflation.

In addition to these policy rate hikes, so-called quantitative tightening (QT) has been occurring since June. At that time, the FOMC began allowing some maturing securities to run off the Fed's balance sheet, thereby reducing its size and putting some upward pressure on longer-term interest rates. The pace of the current runoff has been much quicker than the last time the FOMC implemented QT, which was prior to the pandemic.

A Policy Rate That Puts Downward Pressure on Inflation

What policy rate level is needed to exert downward pressure on inflation given the current macroeconomic situation in the U.S.? While there is plenty of debate on this question, a calculation I did in the spring suggested a policy rate of around 3.5% would be the minimum value needed to put downward pressure on inflation.[5] This particular calculation relied on assumptions that were favorable to a lower interest rate, such as using the Dallas Fed trimmed mean PCE inflation rate, which has been running lower than headline or core PCE inflation.

More recent calculations using the same generous assumptions have yielded a higher minimum value. Results based on the latest trimmed mean PCE inflation rate, which is for September, suggested that it would take a policy rate of at least 4.9% to exert downward pressure on inflation. Thus, even under generous assumptions, the policy rate has not yet reached a level that could be considered sufficiently restrictive, according to these calculations.[6]

Approaching More Normal Monetary Policy

With the moves the FOMC has made this year, we are approaching a point at which we will have removed monetary accommodation and can transition to what I would call ordinary monetary policy—that is, data-dependent policy that looks more like it did in the 1990s.[7]

The policy rate will eventually reach a level the FOMC judges sufficient to put meaningful downward pressure on inflation. From there, the FOMC can adjust the policy rate up or down depending on incoming data without first having to get it from near zero up to a level considered appropriate for the inflation environment.

Exactly what that point will be and when it will occur remain to be determined, but I look forward to continuing to work with my FOMC colleagues to fulfill our dual mandate and to return inflation to the Fed's 2% target.

Notes

1. I also discussed the potential need for the FOMC to move more aggressively if inflation increased or did not moderate as much as expected in a March 2, 2022, presentation on removing monetary policy accommodation.
2. For example, see my Feb. 14, 2022, CNBC interview.
3. I've also talked about lessons learned from the 1974 and 1983 experiences regarding the importance of getting ahead of inflation (for example, in my June 2022 *Regional Economist* article).
4. See my July 7, 2022, presentation on the FOMC's first steps toward disinflation in the U.S.
5. For details about the Taylor-type monetary policy rule and generous assumptions that I used, see, for example, the presentation I gave at Stanford University in May 2022 titled "Is the Fed 'Behind the Curve'? Two Interpretations." The calculation in this particular presentation yielded a minimum value of about 3.6%.
6. For details on what may be considered a sufficiently restrictive zone, see my Nov. 17, 2022, presentation.
7. I discussed a return to ordinary monetary policy during my Oct. 19, 2022, interview with Bloomberg, for instance.