

The Balance of Demand and Supply and the Outlook for Monetary Policy

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.

Thank you, Ann. It's a pleasure to begin this New Year with the Central Exchange. This is an important organization for women in Kansas City who contribute actively to our community in so many different ways, and it provides an important forum to share ideas, experiences and opportunities. The Kansas City Fed supports these goals, and I'm pleased that women play an important role on the Boards of Directors of our four offices, on our executive management team, and across all aspects of our public mission. In fact, several members of our leadership team are members of the Central Exchange, and I know their involvement has benefited them personally and professionally.

It's also an honor to begin the New Year by continuing the tradition of sharing my outlook for the economy here at the Central Exchange, something I first did in January 2012 shortly after I became president of the Kansas City Fed. It was a time of recovery in the U.S. economy after a terrible financial crisis and Federal Reserve policymakers were deliberating on how and when to unwind an extraordinary monetary policy response.

A decade later, the U.S. economy again finds itself recovering from an unprecedented shock with Federal Reserve policymakers contemplating how and when to unwind an unprecedented monetary policy response. To be clear, the challenges we face today are quite different in many respects even as the uncertainty that accompanies policymaking choices has familiar refrains.

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.

In my remarks this morning, 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 going into the holiday season, with November retail sales edging up following a large jump in October. Recent indicators point to continued strong demand even as the sharp rise in Covid cases linked to the Omicron variant threatens to muddle the picture somewhat. With newly reported cases now at all-time highs, many forecasters are revising down their projections for the beginning of the year, 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 surge in 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 Omicron variant threatens 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 during the pandemic. 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. Reports of supplier delivery delays declined in December even as they remain at historically elevated levels.

A lack of labor also has been an important constraint on supply. Speaking to contacts in my region, I hear consistent reports of 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 3.9 percent in December and wage growth picking up solidly. The strength of the labor market

is even more apparent within some parts of our region, with the unemployment rate in Nebraska dropping to 1.8 percent, a record low for any state.

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, 1.1 million persons reported not being in the labor force because of Covid, mostly prime-age workers and disproportionately women. Throughout the pandemic, issues in childcare availability have stood out 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 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. 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 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 are likely to return 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 disruption to business activity and production. This dynamic surfaced in the airline industry over the holidays, as a lack of employees led to the cancellation of flights and disrupted travel. The surge in the virus will also likely weigh on labor force participation as potential workers remain on the sidelines waiting for the situation to improve. While this new variant has added uncertainty to the outlook, I don't believe 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.

By many metrics 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 over \$8.5 trillion. By removing securities from the market, these purchases apply notable downward pressure on longer-term interest rates while pushing investors to look for 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. Even after accounting for the FOMC's decision at its December meeting to accelerate the timeline for ending asset purchases, the balance sheet will grow further until March.

Removing accommodation will unavoidably be complicated by the use of multiple policy instruments – short term rates and large-scale asset purchases – as it was during the last normalization cycle a decade ago. As policymakers chart a course for withdrawing this accommodation, it will be important in my view to consider the interaction between the ultimate size of the balance sheet and the longer-run normal funds rate. All else equal, maintaining a large balance sheet could imply a higher short-term interest rate to offset the stimulative effect of the balance sheet's continued downward pressure on longer-term interest rates. An approach of

raising rates while maintaining an outsized 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. For that reason, my own preference would be to opt for running down the balance sheet earlier rather than later as we plot a path for removing monetary accommodation.

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, I believe that it will be appropriate to move earlier on the balance sheet relative to the last tightening cycle.

Even as the pandemic continues to influence economic activity, the time has come to transition monetary policy away from its current crisis stance towards a more normal posture in the interest of long-run stability. With robust demand, high inflation, and a tight labor market, policymakers will need to grapple with the appropriate speed and magnitude of adjustments across multiple policy tools as they work to achieve their long-run objectives for employment and price stability. 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.