

Tightening Monetary Policy in a Tight Economy

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.

Thanks for the invitation to join you this morning to offer my perspective on the economy and monetary policy. I expect it will come as no surprise to you that my remarks will focus on inflation.

For decades, inflation has been an afterthought for most Americans. Individual prices of goods and services moved up and down, but overall inflation remained relatively stable. Over the period from 1991 to 2020, inflation, on average, ran near 2 percent, the Federal Reserve's longer-run target.

Today, inflation has climbed to 8.6 percent, the fastest pace in 40 years.¹ For many younger Americans, high inflation is a novel experience, while for others, the situation may seem uncomfortably reminiscent of the 1970s. Regardless, inflation is a source of considerable pain for households and businesses, and a central economic challenge for policymakers.

Congress has tasked the Federal Reserve with objectives for full employment and stable prices, often referred to as the Fed's dual mandate. To achieve those objectives, the Fed must act decisively to bring inflation down and reestablish price stability. While the goal is clear, the path to achieving that goal is a very challenging one. I'll talk about some of the considerations that are likely to influence the path ahead.

A Tight Economy

Strong demand for goods and services has been outpacing lagging supply for some time, resulting in a tight economy with prices rising as a consequence. To be sure, there have been a number of specific shocks, particularly to food and energy prices, that have contributed to the increase in inflation. Disruptions to the global market for crude oil arising from the war in

¹ This figure refers to the year-over-year percent change in the consumer price index (CPI) as of May 2022.

Ukraine, along with a reduction in global refining capacity after the pandemic, have contributed to an almost 50 percent increase in the price of gasoline since the beginning of the year.

Meanwhile, the war in Ukraine and poor growing conditions, including in the western portion of the Kansas City Fed's region, have pushed up global food prices.

However, as you know, today's high inflation story goes well beyond food and energy prices. Nearly every category tracked in the Fed's preferred price index for goods and services has recorded increases in recent months, a proportion not seen since the early 1980s.

When prices first started to move up in the spring of last year, the increases were most notable among goods. Pandemic spending patterns favored the purchase of home upgrades, including gym equipment and household appliances, over services such as restaurant meals and air travel. More recently, services prices have shown stronger growth, with airfares spiking and rents and housing costs also increasing robustly.

The broad-based nature of inflation suggests that a tight economy is driving price pressures rather than individual supply disruptions and shocks. Two main factors appear to be contributing to this tightness. First, as the economy reopened throughout 2021, demand for goods and services surged, supported by a tremendous amount of fiscal and monetary policy support. The federal government has provided about \$6 trillion of fiscal stimulus since the start of the pandemic. Monetary policy was also very accommodative, as the Federal Reserve cut interest rates to zero and added over \$4 trillion to its balance sheet.

A second factor that seems increasingly apparent is long-lasting damage to the supply side of the economy as a result of the pandemic. Even as inflation suggests that the economy is operating far above capacity, the level of real GDP remains 2 ½ percent below its pre-pandemic trend, a sizable gap equal to almost a full year's worth of growth. One explanation for this

dynamic is that the pandemic has affected the long-run productive capacity of the economy by more than anticipated. The pandemic recession was different from most recessions in that the services sector was hit particularly hard. Productive capacity in services appears to have been eliminated quickly during the pandemic, and it has been slow to come back even as demand has returned, pushing up prices.

A Tight Labor Market

Another factor holding back supply has been the continuing effect of the pandemic on the labor market. Workers have never experienced a disruption quite like the economic shut down that occurred in March 2020. Within a matter of weeks, 20 million workers lost their jobs and the unemployment rate skyrocketed from historic lows to a post-Depression high.

Now, two years later, although the unemployment rate is near its pre-pandemic level of 3½ percent, much has changed. For example, the labor market appears to be much tighter now than it was pre-pandemic. One way to see this is through the Kansas City Fed’s Labor Market Conditions Indicators (LMCI), which take into account a broader range of labor market measures than the unemployment rate alone. These indicators suggest that the labor market is considerably stronger and tighter than it was before the pandemic.² Both constrained labor supply and exceptionally strong labor demand are shaping this outcome.

The labor force participation rate is still more than 1 percentage point below its pre-pandemic level, primarily on account of lower participation among older workers, as most other

² The three-month moving average of the LMCI-implied unemployment rate currently stands at 3.29 percent. There has never been a lower reading for this measure since the LMCI began in 1992. For details on the LMCI-implied unemployment rate, see Glover, Andy; Jose Mustre-del-Rio; and Emily Pollard. 2021. “[KC Fed LMCI Implies the Labor Market is Closer to a Full Recovery than the Unemployment Rate Alone Suggests](#).” Federal Reserve Bank of Kansas City, *Economic Bulletin*, October 19.

demographic groups have largely returned to pre-pandemic norms. Some of this decline could be related to early retirement, or perhaps just more persistent retirement, as workers who have left the workforce now appear less likely to return.

On the other side, labor demand is historically strong. Currently, there are about two job openings per unemployed worker, the largest gap in over 20 years, and I hear regularly from my contacts on the difficulty of keeping positions filled.

Some observers have noted that many of these job openings may be irrelevant in measuring the tightness of the labor market since some companies appear to be testing the market rather than actively recruiting employees. If this is true, vacancies could decline to more normal levels without a rise in unemployment.

While low recruiting intensity may be part of the story shaping today's labor market, I am not convinced it is the only one. Sectors with a high number of reported vacancies, such as education and health, are also reporting very solid employment growth, suggesting robust hiring. At the same time, employment in these sectors is still below pre-pandemic levels, implying that many positions remain to be filled.

Professional and business services is another sector with a very high number of job openings and a very solid pace of employment growth. Interestingly, job gains in this sector have recently been fueled by growth in temporary help services, perhaps suggesting that employers are finding it difficult to hire in a tight labor market and are substituting toward temps. Another possibility is that businesses are increasingly turning to temp workers because they anticipate that the surge in demand that they are experiencing will be short-lived.

These different interpretations of the data underscore the high degree of uncertainty regarding where the labor market will ultimately settle. On the one hand, if labor demand eases

and job openings fall, we should expect at least some rise in the unemployment rate. On the other hand, labor supply could increase as pandemic effects wane and the participation rate of older workers rises. All else equal, with more labor supply, the tightness of the labor market could ease without a substantial fall in labor demand.

Monetary Policy Considerations

The Federal Reserve's monetary policy cannot, of course, reverse the supply shocks that have boosted inflation. It can, however, moderate the pace of demand growth to narrow imbalances in the economy and reduce price pressures. By doing so, its actions can also prevent high inflation from becoming embedded in price- and wage-setting behavior. For many workers, recent wage increases have not kept pace with price inflation. Declining real, or inflation-adjusted, wages are not sustainable and could lead workers and businesses to build high inflation into wage contracts, to the long-term detriment of the labor market. Instead, experience has shown that low and stable inflation is most conducive to maintaining a strong labor market that benefits households, workers, and businesses. To promote sustainable growth, monetary policy must therefore take decisive steps to tighten financial conditions and bring inflation down.

Since March, the policy rate has increased by 150 basis points, and the process of shrinking the Fed's large balance sheet began last month. In response to these actions, and with expectations of further rate hikes, broader financial conditions have tightened, with sharp increases across a spectrum of interest rates. With the policy rate still relatively low and a \$9 trillion dollar balance sheet in the early stages of shrinking, the case for continuing to remove policy accommodation is clear-cut. The speed at which interest rates should rise, however, is an open question.

I'm certainly sympathetic to the view that interest rates need to increase rapidly, recognizing that current rates are out of sync with today's economic landscape. However, I am also mindful of how the rate of change in tightening policy can affect households, businesses, and financial markets particularly during a time of heightened uncertainty. Policy changes transmit to the economy with a lag, and significant and abrupt changes can be unsettling to households and small businesses as they make necessary adjustments. It also has implications for the yield curve and traditional bank lending models, such as those prevalent among community banks. For these reasons, several considerations influence my own thinking about the appropriate path for policy.

First, communicating the path for interest rates is likely far more consequential than the speed with which we get there. Moving interest rates too fast raises the prospect of oversteering. It is notable that even before the March increase in the target range for the federal funds rate, Treasury yields had already moved up significantly and financial conditions were tightening, as expectations were building for significant adjustments in monetary policy. And indeed, the adjustment has been significant. This is already a historically swift pace of rate increases for households and businesses to adapt to, and more abrupt changes in interest rates could create strains, either in the economy or financial markets, that would undermine the Fed's ability to deliver on the higher path of rates communicated. Along these lines, I find it remarkable that just four months after beginning to raise rates, there is growing discussion of recession risk, and some forecasts are predicting interest rate cuts as soon as next year. Such projections suggest to me that a rapid pace of rate increases brings about the risk of tightening policy more quickly than the economy and markets can adjust.

Second, in addition to the oft-cited long and variable lags, the transmission of higher policy rates and the associated tightening in financial conditions to spending, employment, and inflation is subject to considerable uncertainty. For example, the shift in spending away from services to housing and durable goods during the pandemic may make the economy more sensitive to higher interest rates. Another possibility is that the significant accumulation of liquid savings during the pandemic will dampen the effects of higher interest rates on spending and ultimately inflation. Given this range of outcomes, it is unclear just how high rates will need to move in order to bring inflation down. These dynamics suggest it will be particularly important to observe how the economy is adapting to changes in monetary policy.

Finally, the pace of increases in the federal funds rate could have implications for balance sheet runoff. The economy is in unfamiliar territory, with a combination of high inflation and tight labor markets not witnessed in decades. Therefore, markets are understandably volatile as they grapple with the many unknowns surrounding the outlook for the economy and the path of policy. Limiting the extent to which uncertainty about the pace of interest rate adjustments contributes to this volatility could be important especially as balance sheet runoff gets underway. Certainly, relative to the last time balance sheet reduction was initiated in 2017, market conditions are considerably more unsettled. To the extent that the current strains in the Treasury market can be attributed in part to heightened uncertainty about the path of policy rates, a steady path of rate increases, and predictably adjusting this path to incoming data, could improve market functioning and facilitate balance sheet runoff, especially as the pace of runoff accelerates later this year.³

³ See Sengupta, Rajdeep, and A. Lee Smith. 2022. “Assessing Market Conditions ahead of Quantitative Tightening” Federal Reserve Bank of Kansas City, *Economic Bulletin*, forthcoming.

Making significant progress in reducing the balance sheet over the coming years will be important in my view. After amassing more than \$4.5 trillion in assets since early 2020, the Federal Reserve's outsized presence in financial markets can distort the price of duration and artificially flattens the yield curve. Unwinding the balance sheet should reduce this distortion and has the potential to steepen the yield curve, depending on the pace of increases in the funds rate. Raising short-term rates much faster than longer-term rates could further invert the yield curve and challenge traditional bank lending models as a consequence. To the extent an inverted yield curve has historically preceded recessions in the United States, such a scenario could pose yet another challenge to achieving a significant reduction in the balance sheet.

Conclusion

The Federal Reserve is committed to achieving its mandate for price stability, and I support ongoing rate increases accompanied by a significant reduction in the size of the balance sheet to bring inflation down and make progress towards longer-run price stability. The pace at which this path unfolds will need to be carefully balanced against the state of the economy and financial markets, particularly during a time of heightened uncertainty, to effectively achieve this objective.