Heterogeneity and Monetary Policy

Remarks by
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Thank you to Governor Costa and to the organizers for the invitation to participate in this conference about heterogeneity and macroeconomics. The consideration of differences across individuals, industries, and geographies within an economy is particularly relevant for policymakers today as central banks around the world confront high inflation and tighten policy.

As the depth of research at this conference suggests, the study of heterogeneity and macroeconomics is a rich and active field. Models incorporating heterogeneity are necessarily complex, but as this conference has highlighted, progress has been made in recent years. That said, and perhaps as a consequence of the complexity of the models, the importance of heterogeneity can often appear to be overlooked in macroeconomics. In my experience as a central banker, regardless of the state of the academic literature, it has long played an important role in policymaking and continues to do so today.

From the perspective of the United States, one could argue that the structure of the Federal Reserve System itself is recognition of the importance of heterogeneity. In establishing 12 distinct regional banks, the Federal Reserve Act recognized that it was important to monitor a diversity of conditions across the nation and to ensure that a range of communities were connected to the central bank. Monetary policy can affect industries and populations differently, and for a country like the United States, which has a history of skepticism surrounding centralized authority, it is critical for diverse regions of the country to have a voice in the making of policy.

The benefits of a central bank that is engaged with diverse stakeholders are also evident in the Federal Reserve's focus on local and targeted outreach and engagement with communities across the country. For example, at the Kansas City Fed we hold regular symposiums, roundtables, and advisory group meetings with representatives from diverse industries, geographies, and cultural and economic backgrounds. Perhaps most well-known have been our Fed Listens events where the Federal Reserve welcomes voices from a wide range of organizations — unions, small business owners, residents of low- and moderate-income communities, Native American leaders, and others — to hear how monetary policy affects them and their local communities. In addition, each Reserve Bank is governed by a Board of Directors that is representative of the range of community, business, and labor interests in their region. It is at this regional level where the central bank builds trust and enhances communication in ways that resonate across a range of audiences. In this regard, heterogeneity is central to the way the Federal Reserve operates.

I will focus today on two additional aspects of heterogeneity and monetary policy. First, how it affects the conduct of monetary policy, as distributional differences obscured by aggregate measures can be important for how we interpret the data and inform policy decisions. And second, how the conduct of monetary policy can affect heterogeneity, as monetary policy can have distributional consequences by affecting different segments of the population with varying intensity.

The Importance of Looking Within Aggregates

Starting with the importance of heterogeneity in the conduct of monetary policy, let me offer a very real and current example from the United States' experience. During the pandemic, the United States adopted an extraordinary fiscal stimulus, roughly $6 trillion, a large proportion of which consisted of direct transfers to households and businesses. Relative to previous programs, the pandemic stimulus was distributed widely across the economy and, consequently, led to a sharp improvement in household balance sheets, with households estimated to have accumulated roughly $2.3 trillion in excess savings relative to pre-pandemic levels.[1]

As the Fed tightens monetary policy with the aim of closing the imbalance between demand and supply that has pushed up inflation, the dynamics of these excess savings and the distribution of these savings will be key factors shaping the outlook for output, inflation, and interest rates. Higher savings provide an important buffer to households that can ease the adjustment to economic disruptions. However, high savings could also provide a further impetus to consumption as the central bank attempts to slow the pace of demand growth. Higher savings could lessen a precautionary pullback in consumption, and it could well take a higher interest rate for some time to convince households to hold onto their savings rather than spend them down and add to inflationary pressure.

How savings affects the outlook is going to be importantly affected by the distribution of these excess savings across households. Heterogeneity is going to matter. If these savings are concentrated in the upper brackets of the wealth distribution, a group that tends to spend a

[1] Aditya Aladangady, David Cho, Laura Feiveson and Eugenio Pinto. "Excess Savings during the COVID-19 Pandemic." *FEDS Notes*. Board of Governors of the Federal Reserve System. Oct. 21, 2022.

smaller share of their wealth and income, higher savings might provide little additional momentum to consumption. However, if savings are spread more evenly across the population, including households with a higher propensity to spend out of wealth, then the effect on the persistence of consumption is likely to be larger.

Currently, available data suggests that savings remain elevated across the wealth distribution. However, recent evidence also suggests that lower-income households are running down their buffers quickly. This is to say that monitoring the distribution of savings is likely to be important as we think about the course of the economy and the path of policy.

While high savings are likely to provide momentum to consumption and require higher interest rates, the fact that households are wealthier, less financially constrained, and better insured is a positive development. Even so, bringing down inflation will require incentivizing savings over consumption. The short-run pain from monetary contraction is lowest when demand moderation is progressive across the income distribution. Moderating demand growth by encouraging high-income households to save more with higher interest rates would certainly be preferable to crashing the consumption of lower-income households.

Acknowledging heterogeneity can also improve our understanding of the forces contributing to elevated inflation. Overall wage growth remains strong, reflecting what by many measures has been a historically tight labor market. With inflation recently rotating from goods to services prices, as supply chain disruptions ease and the labor market remains tight, understanding wage growth is likely to be important for understanding the overall path of inflation.

Nominal wage growth for the median worker is tracking at 6 percent according to the Atlanta Fed's Wage Tracker, but this aggregate number masks an important difference between job stayers and job movers. The median worker who switches jobs sees 7.3 percent wage growth, which is substantially higher than those who stay put at their current job. Furthermore, the rate at which people switch jobs has increased significantly, especially for prime-age workers, whose average tenure at their current job fell by about three months from 2020 to 2022. With labor markets historically tight, a calmer labor market with fewer quits and less churn could lower job switching and reduce inflationary pressures by lowering nominal wage growth.

Additionally, the first half of 2022 saw a substantial reduction in average labor productivity. If weaker labor markets force people to stay put longer, then they may become more proficient, and labor productivity growth may provide some inflationary relief in the near term. In addition, many of my District contacts report problems with low worker engagement, which is a drag on productivity. If workers who no longer see their current job as replaceable become more engaged, they may also become more productive.

The Distributional Effects of Monetary Policy

Turning to the differential effects of monetary policy on heterogeneous groups, we should understand that our policies affect different groups in different ways. Central bankers are largely constrained to using blunt tools, limiting the ability to fine-tune monetary policy. Still, there are potential distributional consequences of central bank policies.

For example, in the United States, even after some recent declines, house prices in the remain 25 percent above their pre-pandemic trend. This is partly, though certainly not wholly, due to the magnitude and duration of quantitative easing implemented by the Fed from 2020 through 2022, especially the purchase of $1.4 trillion in mortgage-backed securities. Though the goal of these purchases was not to explicitly support house prices, it likely had such an effect. How are the benefits of supporting house prices distributed? People who already own houses, who tend to be wealthier and older, certainly gain. However, their gain may be at the expense of others who cannot get their foot in the door when prices are extremely high, even if rates are also low. Loan-to-income and loan-to-value limits on mortgages are more likely to bind for people without large down payments, such as young people at the beginning of their careers, and others with relatively low incomes.

To close, heterogeneity matters for monetary policy, both in how we interpret the data and think about the outlook, as well as in the effect that our policy actions have on the economy. Acknowledging that policy can affect diverse groups differently is an important piece of building and maintaining central bank credibility. While it is tempting to simplify our analysis through aggregate measures, we should always be aware of the importance of individuals in setting the course for the economy and in bearing the consequences of policy decisions.