What (More) Should the Fed Do to Restore the US Economy?

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Today’s talk will be on US monetary policy

What is the state of policy right now?

What challenges have been created by the recent “supply shocks”?

What questions are monetary policymakers wrestling with?

What is the Fed likely to do and what are the risks associated with future policy actions?
Background
As the pandemic recession set in, the Fed acted swiftly to ease financial conditions

The Fed lowered its “policy rate” to zero

The Fed did quantitative easing, buying large amounts of long-term assets
Why these steps tend to help the economy in a recession

Lowering the policy rate and purchasing long-term assets **lower interest rates generally** => Stimulates purchases by consumers, spending by firms

Lower interest rates lead to **higher stock prices** (stocks are more attractive when bonds returns are lower) => Creates “wealth effects” that boost consumer spending

Lower US interest rates lead **investors to seek returns abroad** => Lowers the value of the US dollar, which supports exports

All of which should raise firms’ demand for workers and create jobs
Vigorous monetary and fiscal policy steps have contributed to an ongoing economic recovery in the United States.

Real GDP has now surpassed its pre-pandemic level.

The United States has seen a faster recovery than other countries hit hard by the pandemic.

Data from Bureau of Economic Analysis via FRED.
Even so, the Fed is now facing twin challenges—an incomplete labor market recovery and a jump in inflation.

**US Nonfarm Payrolls**

- Thousands

- Employment remains well below its earlier trend.

**Core PCE Inflation**

- Percent change from 12 months earlier

- Inflation is at its highest level since the early 1990s.

Data from Bureau of Labor Statistics via [FRED](https://fred.stlouisfed.org)

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It’s been a long time but remember there are costs to inflation being too high

People may have **less purchasing power if wages don’t keep up** with higher inflation

Unexpectedly high inflation **messes with arrangements involving future flows of money** (workers with contracts but also lenders counting on a certain real rate of return)

High inflation means businesses have to **change prices more often** and it generally distracting for them and for households

High inflation can make **financial planning harder**, particularly for those with limited financial sophistication
Many recessions do not present these twin challenges

In many recessions, **the main problem is weak aggregate demand**

When aggregate demand is weak, employment tends to be low and there are disinflationary pressures

By boosting aggregate demand, expansionary monetary policy tends to raise employment and raise inflation

In other words, **in a weak-demand recession, easier monetary policy addresses both problems**
But supply shocks (as we have now) potentially leave the Fed with a harder trade-off

Keep financial conditions easy because labor market conditions are still weak

OR

Tighten monetary policy because inflation has increased sharply and may stay at levels that are undesirably high
Key questions about inflation
Questions on the minds of monetary policymakers

What is the source of the higher inflation?

Where is inflation likely to go from here?

If inflation is going to recede by itself, monetary policymakers may not be facing the harder trade-off I just described

???
What is the source of the higher inflation?

Fundamentally, we have imbalances of supply and demand

Imbalances in the market for goods and services

tends to put upward pressure on prices (indirect effect on wages)

Imbalances in some parts of the labor market

tends to put upward pressure on wages (indirect effect on prices)
Pent-up demand for goods and services is strong and consumers have ample financial capacity to fund it.

The government provided substantial support to incomes last year and consumption was constrained by the pandemic

=> a lot of saving

Not shown, but many households also benefited from higher home prices and higher stock prices.
On the supply side of the goods and services market, bottlenecks and supply chain issues are a constraint.

We had a general sense that it would take time to restart an enormous economic machine, but people didn’t anticipate how large and persistent the problems would be, from semiconductor shortages to delays at ports.

(with general frictions being exacerbated by the Delta variant shutting down ports and factories)
Even after the acute problems ease, we will have a lot of ground to make up with inventories. For example, inventories of autos are now at half their usual levels.

Inventory-to-Sales Ratio for Domestic Autos

Data from Bureau of Economic Analysis via FRED
The imbalance between demand and supply for certain items is driving consumer inflation higher.

**Consumer Inflation for Select Categories**

Percent change from 12 months earlier

- **used car** prices are up 24 percent over the last 12 months
- **durable goods** prices have risen 12 percent
- **services prices** have risen 3 percent

Data from Bureau of Labor Statistics via FRED (here, here, and here)
Looking ahead

Consumer demand will probably remain strong given the high spending power of households.

Supply constraints are likely to dissipate as bottlenecks ease, pent-up demand is met, and people shift toward services.

But the process will be gradual, implying a gradual ebbing of inflation of goods and services.

(And we may see pressures in new categories, like rents and medical care services)
In the labor market, hesitation of would-be workers is holding down the supply of labor

Why the hesitation?

Fear of the virus
Unpleasant working conditions related to the pandemic
Accumulated savings from fiscal support and strong asset price growth

3 million fewer people are working or seeking work than prior to the pandemic

Labor Force Participation Rate
Percent of adult population

Data from Bureau of Labor Statistics via FRED
Workers of all types have dropped out, but older workers seem particularly reluctant to come back.

Greater fear of the virus, more sensitive to unpleasant conditions? Probably factors for some older workers.

I also suspect there is a “good news” story—some older workers experienced 401(k) windfalls or were bought out by their employers, allowing for an earlier retirement.

Data from Bureau of Labor Statistics.
Meanwhile demand for labor is strong in some sectors (particularly high-contact services like restaurants)

Job Postings for Workers with Minimal Education
Percent change since January 2020

Data from Burning Glass Technologies via Tracktherecovery.org

Photo by Tim Mossholder on Unsplash
Not surprisingly, the worker shortages have led to an increase in wage growth

Will these higher wages put further upward pressure on prices?

Probably in some instances, but note that the increase is not so large

Also, the level of profits for many companies is high right now which would (in principle) allow them to absorb wage increases without raising prices

Data from Atlanta Fed
Looking ahead

Early retirees may remain out of the labor force, but younger would-be workers seem likely to return after they have a break and their savings dwindle, particularly if virus caseloads continue to decline.

And businesses may not need as many workers post-pandemic given restructuring, sectoral shifts, and an acceleration of automation.

So, the labor demand/supply imbalance may be very different by the time we get to next spring or summer.

In other words, higher wage growth may not persist.
A final force bearing on inflation is expected inflation

Economists think inflation expectations matter for future inflation

Higher inflation expectations can be self-fulfilling and even lead to upward spirals (as was the case in the 1970s)
Some measures of inflation expectations are showing increases

This is not too surprising given that expectations tend to be shaped by what is actually happening.

As to whether inflation will shoot up further in response to recent events, bear in mind that we saw two decades of inflation at or below 2 percent prior to the pandemic.

Data from New York Fed, Philadelphia Fed, St. Louis Fed via FRED
Given that bottlenecks, supply chain problems, and worker shortages are likely to ebb, it is reasonable to expect inflation to subside.

The median Fed leader believed in September that core inflation would most likely drop back to 2.3 percent by the end of 2022.

The direction inflation is likely headed seems right, but this forecast may be optimistic.
What this all implies for monetary policy
Although the higher recent inflation is probably largely transitory, it’s not an easy time to be a monetary policymaker there’s a lot of uncertainty around any forecast the trade-offs are indeed more complicated
The Fed has already indicated that it is likely to begin “tapering” QE soon

Excerpt from the September 2021 FOMC statement
As of September, the median Fed leader expected that rate hikes would begin in late 2022.

If inflation continues to surprise on the upside, the Fed raise rates sooner than they currently expect.
Risks associated with this “wait and see” approach

Fed leaders understand they may have to raise rates sooner than currently expected but are counting on the ability to “pivot” quickly without surprising markets.

A good communications plan will be needed.

If investors are surprised, it could be disruptive to financial markets—interest rates could rise more sharply than expected, asset prices could decline.
Especially worrisome potential outcomes

The popping of an “everything bubble” … we don’t know that there is one, but some people are concerned about the sharp rise in stock prices, home prices, Bitcoin prices, NFT prices, and so on since the beginning of the pandemic.

A wave of sovereign debt crises for low-income countries who borrowed a lot during the pandemic and would face much higher interest payments with a sharp rise in rates.
Wrapping up

Unfortunately for monetary policymakers, supply shocks create hard trade-offs and the lack of similar episodes in recent history makes it difficult to forecast what’s coming with confidence.

Inflation *may* surprise on the upside.

The Fed *does* have tools to deal with higher-than-expected inflation, although deploying them may slow the labor market recovery.

Good Fed communications will be essential to avoid a “hard landing” where financial markets are disruptive.
Thank you!