The Monetary Policy Response and Outlook

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Fed’s Efforts Helped Cushion Economic Impact of the Pandemic

- Easy monetary policy supported interest-rate sensitive sectors such as housing and motor vehicles
- Liquidity backstops restored market function
- Balance sheet expansion helped make financial conditions extraordinarily accommodative
- But benefits accrued unevenly, with higher income households disproportionately aided

But Fed Stayed Too Easy, Too Long

Four major errors

1. Operationalization of average inflation targeting regime
    - No lift off until three conditions are satisfied
        - Inflation at 2 percent
        - Expected to be above 2 percent for some time in the future
        - Have achieved maximum sustainable employment level consistent with price stability
    - Means that policy will be very easy when the economy has reached full employment
2. Worries about generating a taper tantrum slows down tapering of asset purchases
    - Concerned about generating bond market sell-off like 2013
    - So taper ruled out until substantial progress to 3 goals

But Fed Stayed Too Easy, Too Long

3. Inflation shock not entirely transitory
   - Inflation higher for longer than anticipated—supply side disruptions persistent
   - More persistent inflation leads to higher wages and risks unanchoring inflation expectations
4. Labor market has tightened much faster than expected
   - Fed officials focused on employment shortfall relative to February 2020—still large at 3 million
   - But unemployment rate already below level consistent with FOMC estimates of full employment
     - Labor force participation rate recovering only very slowly
       - Retirements, health risks and outcomes
   - Ratio of unfilled jobs to unemployed at all time record
   - Wage trend already above what's consistent with 2% inflation and a further rise is very likely

The Implications for Monetary Policy

- Fed is late, trying to catch up
  - Fed still buying assets today even as unemployment rate has fallen to 3.9% and inflation > 5%
  - Fed official recognize this: Taper is accelerated to finish by mid-March rather than mid-June
  - Setting the stage for a March rate lift-off
- Omicron not a major factor
  - Offsetting impacts on demand versus supply
  - Less virulent, especially for those triple-vaxed
  - Degree of social distancing/economic disruption less for any degree of risk

The Implications for Monetary Policy

- Stages of tightening process likely to unfold like last time
  - Asset purchase taper first (completed in mid-March)
  - Then lift-off in March
  - Once get federal funds rate up a bit, start to balance sheet run-off
    - But federal funds rate remains primary monetary policy tool
    - Balance sheet run-off on autopilot in the background
- Differences
  - Transition from stage to stage much faster
    - Last cycle, 3 years from end of tapering to beginning of balance sheet reduction
    - This time likely to occur in less than one year
  - Short-term rates will have to go higher than last time

What's expected

- By the Fed
  - 3 rate hikes in both 2022 and 2023, with median federal funds rate reaching 2.1% end of 2024
- By market participants
  - About the same this year and next
  - Anticipated peak a bit lower—around 1 ¾%-2%
- These are extraordinary forecasts
  - Even with the economy operating beyond full employment for 3 years, Inflation melts away
  - Without the Fed having to move to a tight monetary policy setting

My Outlook

- More rate hikes this year, starting in March
- Considerably higher peak—around 3%-4%
  - Neutral is higher because inflation is higher
  - And the Fed will need to make monetary policy tighter
- Two contrasting episodes: 2004-06 versus 2015-19
  - 2004-06: 17 consecutive ¼% rate hikes taking federal funds rate to 5 ¼% from 1%
  - 2015-19: Much more drawn out, federal funds rate peak only 2 ¼%-2 ½%
- Two drivers
  - Where is inflation
  - How sensitive are financial conditions to what the Fed does
  - If inflation above target and stocks and bonds insensitive to the Fed, more like 2004-06
  - If inflation near target and stocks and bonds sensitive to the Fed, more like 2015-19