Federal Reserve Bank of San Francisco

Unreserved Opportunity

Policymaking in a Time of Uncertainty

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These are unusual times.

The very worst of the pandemic looks to be behind us—a welcome relief. But the impact of COVID and its ongoing threat continue to disrupt and delay the full recovery of the economy.

Worse perhaps is that we don't know how long any of this will last. We are in flux—limbo—waiting for the pandemic to be done so we can move on to whatever the new future holds.

But waiting is hard, and it's tempting to want to act. To want to respond to what we see today as if it's a clear signal of what we will see tomorrow.

Action, after all, feels empowering.

But feeling empowered and empowering our future are two different things. Acting without clarity is risky. It can lead to decisions that have costly unintended consequences, box us into outcomes, and make the flux we feel today a more persistent feature of our economic future than it needs to be.

Today, I'm going to talk about how the recognition of ongoing uncertainty affects monetary policy and the Federal Reserve's dual mandate of price stability and full employment. And about why the Fed is taking a vigilant and measured approach as we navigate the long tail of the pandemic.

But before I get too far along, I want to remind you that the views I will express today are my own and do not necessarily reflect those of anyone else within the Federal Reserve System.

Taking Stock of the Economy We Have

Inflation

Let me start by taking stock of where we are today.

Here is the headline: Inflation is high. Both overall and core inflation have been running well above the Fed's two percent goal. In fact, overall inflation is at its highest level in 30 years, with price increases in some sectors hitting eye-popping rates.

The magnitude and persistence of these readings has come as a surprise, but it's actually not that mysterious. Standard theory tells us that inflation occurs when demand outstrips supply and prices rise to adjust.

So, the question is less about why it's happening and more about how long it will persist. Specifically, will it last beyond the pandemic? There are good reasons to think that it won't. And I will focus on three of these reasons in particular—two related to demand and one related to supply.

Let me start with demand. COVID has changed how and where we spend our money. Public health policies aimed at stopping the virus—lockdowns, social distancing, mask wearing—have kept us from going to the gym, seeing a movie, traveling, and using a host of other services. So we've taken to the internet and worked to recreate our normal lives at home. In economics parlance, we "rotated" spending, buying an outsized number of goods—things like home exercise equipment, video games, lawn furniture, and cars—while leaving behind spending on services.

These individual actions, which I am sure feel familiar, show through to the aggregate data. Over the past 18 months, consumer spending has been historically tilted towards goods—

something you might have noticed when the load of packages stacked up at your door.[1] The result is higher prices for a range of things that we want more of today than usual, as we manage our way through COVID.

Of course, another unusual characteristic of the pandemic is that people have money to spend. Some of this reflects the fact that the pandemic has been a highly focused sectoral shock, devastating certain parts of the economy that rely on in-person contact while boosting others that enable working from home and connecting through technology. For workers in these thriving sectors, incomes have stayed steady or grown, supporting spending even as the economy struggles.[2]

For other workers and households more negatively affected, financial challenges were met with unprecedented fiscal support. Cash grants and expanded unemployment insurance and child tax credits helped those who've been hardest hit maintain their financial well-being through the worst of the pandemic.[3] This has not only benefited workers and households, but it has also kept consumer spending high even as labor markets have lagged. In other words, during the worst economic shock in U.S. history, demand has remained resilient.

Unfortunately, the resilience of supply and supply chains been far less robust. COVID-related disruptions have episodically depressed production across the globe. City by city, plants have shut down or reduced shifts to curb infections. These disruptions have accumulated and snowballed, leaving many goods in short supply.

Even when goods are available, it's been hard to get them delivered. Shipping containers are in the wrong places. Trucking networks are lagging. And ports across the globe are struggling to clear backlogs of ships waiting to dock and unload.

And we're not out of the woods yet. With lagging vaccination rates in many countries, shutting down is often the best way to fight surging infections. These policies, while necessary, leave a long imprint. In fact, a port closure in Vietnam in August meant to curb surging Delta infections continues to be felt up and down the supply chain.

Putting all of this together, it's easy to see why prices are rising. Consumers with income to spend have demanded more goods than usual and suppliers have struggled to keep up. But what does it mean for future inflation?

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[1] Data on monthly personal consumption expenditures (PCE) from the U.S. Bureau of Economic Analysis (BEA) show that the goods share of nominal PCE was slightly under 31 percent just before the pandemic and has risen about 3.5 percentage points, to 34.3 percent (averaged over the past 18 months).

[2] BEA data show that monthly disposable personal income has been highly uneven over the past 18 months but is up on average since the pandemic started.

[3] Banerjee and Zipperer (2021).

Given the factors boosting prices that I've just described, I expect a moderation in price pressures as the pandemic recedes. Consumers will likely pivot back to their normal bundles of goods and services—spending some time with their new home entertainment centers, but also going to movies, concerts, dinners and, hopefully, holiday parties.

Similarly, as fiscal support rolls off and many households move their savings back to historically normal levels, demand will likely become more in sync with the overall strength of the economy. Production and supply chains should also catch up and repair, reducing bottlenecks and easing the pressure on prices.

As these things happen, we should return to the typical dynamics that drive the economy.

The Labor Market

But what about the labor market? What's its future?

On one hand, labor markets look tight. Unemployment is down, job openings are at all-time highs, and wages are up in many sectors. Help wanted signs are everywhere and workers are quitting at record levels. These are all things we typically see only when the economy is "hot" and we are nearing full employment.

On the other hand, we're still over four million jobs short of our pre-pandemic peak. And that doesn't count where we would have been if COVID had never occurred. That's a number closer to six million missing jobs.[4]

Now, some have speculated that this is the new normal—a great epiphany that work isn't all it's cracked up to be, so maybe we won't work at all. While it's hard to argue against epiphanies, I'll offer a few alternatives.

COVID continues to affect schooling and childcare, workplace safety, transportation, and even the ability of businesses to offer consistent hours and pay. Faced with these barriers, some individuals, especially women and older Americans, have opted to leave the labor force altogether.[5] Others have stayed but continued to search for jobs that feel safe, predictable, convenient, or simply better suited to their aspirations and interests.[6]

[4] Bidder, Mahedy, and Valletta (2016). Labor force participation trends prior to the pandemic suggest that the underlying trend was at or above the high end of their estimated range.
[5] Lofton, Petrosky-Nadeau, and Seitelman (2021), Montes, Smith, and Leigh (2021).
[6] De Smet et al. (2021).

These behaviors are understandable reactions to an unprecedented shock. As COVID recedes, I expect people to settle in, land a job they want, and return to the labor market to support their families and build a career.

And history supports this prediction. Although labor force participation tends to lag behind falling unemployment, workers do come back. We saw this in the last expansion and in most expansions before that.[7] In other words, it's too early to count out the millions of people sitting on the sidelines.

To summarize, although inflation is high and the labor market seems tight, when we dig into the data, it's easy to see that some of what we observe today reflects the ongoing effects of the pandemic. This makes it harder to conclude that we are facing a completely new world that will persist once the worst of COVID is behind us.

Getting to the Economy We Want

Of course, the truth is, none of us is completely certain how the economy will evolve. We can't say for sure that the eye-popping rates of inflation won't leave a more lasting imprint on overall price setting. And we don't know how long it will take for sidelined workers to come back.

And this is a hard place for policymakers. We have the tools to support the economy if it needs it, and we have the tools to beat back inflation and cool the labor market if necessary. The question is, which of these scenarios will turn out to be true?

In the face of this uncertainty, many have argued that we should act preemptively—get ahead of things, rather than fall behind the curve.

This logic has some appeal. If the high readings on inflation last long enough, they could seep into our psychology and change our expectations about future inflation. Households would then expect prices to keep rising and ask for higher wages to offset that. Businesses, of course, would pass those increases on to consumers in the form of higher prices, causing workers to ask for even higher wages. And on it would go, in a vicious wage-price spiral that would end well for no one.

Although this would be a deeply disturbing trend should it occur, so far, there is little evidence that this is happening now. Despite the large jumps in measured inflation, inflation expectations in the longer run remain relatively stable and well-anchored around the Fed's price stability

[7] Hobijn and Sahin (2021). See also Cajner, Coglianese, and Montes (2021).

goal.[8] This suggests that households and businesses expect inflation to moderate as the global economy emerges from the pandemic. And most importantly, these readings suggest that people understand that the Fed will act if inflation begins to look more persistent.

But why not take out some insurance—preemptively raise rates to make sure that a painful inflation spiral doesn't occur? The main answer is that preemptive action isn't free. Like all insurance, there are costs. And policymakers must balance these costs against the risk of waiting.

Monetary policy is a blunt tool that acts with a considerable lag. So, raising interest rates today would do little to increase production, fix supply chains, or stop consumers from spending more on goods than on services. But it would curb demand 12 to 18 months from now. Should current high inflation readings and worker shortages turn out to be COVID-related and transitory, higher interest rates would bridle growth, slow recovery in the labor market and unnecessarily sideline millions of workers.

With the zero lower bound on nominal interest rates, the Fed would have limited room to respond to this type of forecast mistake. On the other hand, if we hold rates steady and inflation persists, we can raise rates later on. This policy asymmetry makes the potential costs of acting prematurely disproportionately high.

Against this calculus, I come down on the side of waiting to gain greater clarity. The Fed is well positioned to act should inflation begin to look more persistent. It's much harder to unwind a preemptive action that turns out to be wrong.

But "not now" for interest rates does not mean "not ever" for policy. In fact, earlier this month, we announced that we will reduce the monthly pace of net asset purchases in response to substantial improvement in the economy from the depths of the recession. This will slow the amount of support we are adding to the economy, allowing it to function more on its own.

Over the next several quarters, as tapering occurs, we will watch how the economy does and see whether inflation eases and workers come back. As we get a clearer signal, we will be ready to act accordingly, continuing to provide or remove support as needed to ensure the economy settles at a sustainable place.

The Bravest Action We Can Take

Let me leave you with a few concluding thoughts. As a policymaker and a person, I'm biased toward action. I like to solve problems. So, I understand the desire to immediately confront the

[8] Inflation implied by yields on 10-year and 5-year nominal and inflation-adjusted U.S. Treasury securities has been running close to pre-pandemic values, consistent with the FOMC's 2 percent inflation goal (see https://fred.stlouisfed.org/series/T5YIFR).

challenges in front of us. Action gives us a sense of agency, especially at a time when it feels like we have none.

But not all motion is forward motion. Reacting in response to things that aren't likely to last will move us farther from—not closer to—our goals. And while it's easy to mistake motion for competence or action for attention, running headlong into a fog can be costly. So in the face of unprecedented uncertainty, the best policy is recognizing the need to wait. Although this can be hard, in the end, patience is the bravest action we can take.

Thank you.

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