Constraints on the Economy and Policy

Remarks by

Esther L. George
President and CEO
Federal Reserve Bank of Kansas City

September 9, 2022
Peterson Institute for International Economics
Remarks delivered virtually

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.

Two weeks ago, the Kansas City Fed hosted its annual Jackson Hole Economic Policy Symposium. The theme of this year's program focused on, "Reassessing Constraints on the Economy and Policy."

An elaboration of constraints has been a valuable contribution of the field of economics. Opportunity costs, comparative advantage, and the Phillips Curve are all defined around the existence of constraints and limits.

However, over the past quarter-century the economic conversation has been dominated by concerns over insufficient demand, and supply constraints faded into the background. Supporting this shift, recent recessions—up until the pandemic—have largely been attributed to financial disruptions related to demand being supported by unsustainable asset allocations. This is different from the supply shocks and inflationary dynamics that had driven earlier post-war recessions.

The economic recovery following the pandemic shock has brought supply considerations back to center stage. Bottlenecks and shortages related to pandemic disruptions have limited supply and driven up prices. More generally, strong demand, supported by a historic level of fiscal and monetary accommodation, has pushed on the capacity limits of the economy. With demand no longer insufficient, supply constraints have become a key factor in the outlook for economic activity.

The policy response to the pandemic raises additional questions about constraints. The extraordinary fiscal and monetary response to the pandemic appeared to redraw the boundaries of policy. Innovative and expansive fiscal programs pushed debt-to-GDP ratios to new highs as central bank balance sheets expanded rapidly with little discussion of constraints.

Against this backdrop, I'll spend a few minutes on the current outlook for the economy and for policy. On the economy, I will argue that the constraints revealed by the pandemic are likely to be with us for some time, perpetuating imbalances, contributing to inflation, and requiring a sustained policy response. I will also argue that constraints continue to bind policy, with a focus on the balance sheet and efforts to significantly reduce it from its current elevated level.

The Economic Outlook

High inflation is certainly a sign that constraints are binding the economy. Prices, measured on personal consumption expenditures (PCE), increased 6.3 percent in the 12 months ending in July, down from June's 40-year high, but still far above the FOMC's 2 percent objective. Energy prices have played an outsized role in inflation over the past year. Oil prices rose with the war in Ukraine but fell back over the summer as recession fears grew. Food prices have also contributed to the rise in inflation. In part, this is related to the run up in agricultural commodity prices connected to the war in Ukraine, but it is also a result of stressed growing conditions in many regions around the world, including in the western portion of the Kansas City Fed's region.

However, it is not just food and energy prices driving inflation. Excluding food and energy, core PCE prices have risen 4.6 percent over the past 12 months, also near a 40-year high. The rise in inflation has been very broad-based, with almost every category of consumption recording an increase in prices and about one-third of categories showing increases far above trend.

The widespread nature of inflation suggests that a tight economy is driving price pressures rather than solely individual supply disruptions and shocks. Two main factors appear to be contributing to this tightness. First, as the economy reopened throughout 2021, demand surged, underpinned by a tremendous amount of fiscal and monetary policy support. The federal government has provided roughly $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. While consumption growth has moderated this year, the level of demand remains strong, particularly for goods. For example, the consumption of durable goods continues to run about 20 percent above its pre-pandemic trend.

A second factor boosting inflation has been the inability of the supply side of the economy to keep up with the strength of demand. At first, the lack of supply seemed to largely reflect temporary disruptions related to the closing and reopening the economy. However, now it seems increasingly apparent that there has been persistent damage to the supply side of the economy as a result of the pandemic.

Constraints on the Economy

Three factors coming out of the pandemic seem likely to present a continued drag on economic supply: continuing damage to global supply chains, the quick destruction of capacity in the service sector, and long-lasting damage to workforce engagement and labor force participation. I will quickly review these issues.

The shock of the pandemic shutdowns and the sudden shift to goods consumption continues to reverberate through the global economy, with shortages and logistical snarls still plaguing many industries. The war in Ukraine, disruptions to European energy supply, and drought conditions across the globe that have disrupted both agriculture and inland transportation as rivers run dry have only contributed further to these supply disruptions. There has been some discussion that recent shocks could elicit permanent changes in production processes. As the efficiency of just-in-time production and global networks gives way to the accumulation of unproductive inventories and a preference for resiliency over efficiency, the damage to global productivity could prove permanent.

A second supply factor contributing to the tightness of the economy, particularly in the service sector, has been the quick destruction of capacity in a number of industries. Services inflation has picked up to 4.6 percent, the fastest pace in decades, even as services consumption remains 4 percent below its pre-pandemic trend. Elevated inflation suggests the sector is at capacity, although relative to pre-pandemic levels there would still appear to be considerable slack. One concrete example of a relatively persistent reduction in capacity appears to be playing out in the airline industry. Airfares have climbed 15 percent above pre-pandemic levels as strong demand has run up on a system that has yet to fully recover.

Labor markets are a third factor shaping the outlook for the supply side of the economy. While employment growth has been robust, and the unemployment rate has fallen to near record lows, workforce engagement continues to lag. The labor force participation rate remains one percentage point below pre-pandemic levels, representing roughly 2 million missing workers. The decline in participation is now concentrated among those older than 55 and likely reflects early retirements and health concerns, decisions which can be sticky and difficult to reverse. In contrast, the pandemic-induced decline in participation among prime age women, likely reflecting disruptions to dependent care, has now completely reversed, with participation by prime age women near an all-time high in July.

An additional factor holding back the ability of supply to ease inflation pressures has been the abysmal recent performance of productivity. Labor productivity, as measured by output per hour, declined almost 6 percent at an annual rate in the first half of the year. It was the largest two-quarter decline on record.[1] The sharp falloff in measured productivity is not surprising when we consider that the economy added 3 million new workers in the first half of the year even as the level of output (as defined by GDP) declined 1 percent at an annual rate. Looking back over history, GDP has almost never declined for two quarters even as the recorded number of hours worked has increased.[2]

Monetary Policy Considerations

To repeat a phrase that has become common through the pandemic, we are in unprecedented times. The Federal Reserve's monetary policy cannot, of course, reverse the supply shocks or loosen the constraints that have boosted inflation. It can, however, moderate the pace of demand growth to narrow imbalances in the economy and reduce price pressures. By raising interest rates, the Federal Reserve can help manage demand growth, in part by incentivizing saving over consumption and also through the effect on asset prices and financial market conditions.

By taking deliberate policy actions, the Federal Reserve 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 promoting sustainable growth and to maintaining a strong labor market that benefits households, workers, and businesses.

Since March, the Federal Open Market Committee (FOMC) has increased the policy rate by 225 basis points, and, beginning this month, has accelerated the process of shrinking the Fed's balance sheet. In response to these actions, and with expectations of further rate hikes, broader financial conditions have tightened, including mortgage and other borrowing rates. However,

---

[1] In a paper presented at this year's Jackson Hole Symposium (Fernald and Li, 2022), the authors argue that the recent decline in productivity reflects a return to the lackluster pre-pandemic trend.
[2] Of course, it is possible that the data has been mismeasured, and a number of commentators have noted that alternative measures of economic output, such as Gross Domestic Income, paint a more upbeat picture than GDP.

with the policy rate still relatively low, the balance sheet still near $9 trillion, and imbalances in the economy still holding up inflation, the case for continuing to remove policy accommodation remains clear-cut. The key questions are by how much and how quickly.

On the question of how much further tightening is required, I believe only careful observation of the economy will provide the answer. As unsatisfying as it might be, weighing in on the peak policy rate is likely just speculation at this point. The often-discussed neutral rate of interest, or the tipping point between accommodative and restrictive policy, is an unobserved and potentially unstable benchmark, potentially undermining its value as either a guide for policy or public communication. Whether any level of the interest rate is accommodative or restrictive will depend on the interest sensitivity of the economy, which could vary for any number of reasons. For example, as spending shifted away from services toward relatively interest-sensitive housing and durable goods during the pandemic, the economy may have become more susceptible to higher interest rates. However, the significant accumulation of liquid savings during the pandemic could work in the opposite direction, dampening the effects of higher interest rates on spending and ultimately inflation.

We will have to determine the course of our policy through observation rather than reference to theoretical models or pre-pandemic trends. Given the likely lags in the passthrough of tighter monetary policy to real economic conditions, this argues for steadiness and purposefulness over speed.

The path of policy is also likely to influence plans to shrink the Federal Reserve's elevated balance sheet. The economy is in unfamiliar territory, with a combination of high inflation and tight labor markets not seen in decades. Markets are understandably volatile as they grapple with the many unknowns surrounding the outlook for the economy. Limiting the extent to which uncertainty about the pace of interest rate adjustments contributes to this volatility could be important as balance sheet runoff hits its stride. Certainly, relative to the last time balance sheet reduction was initiated in 2017, market conditions are considerably more unsettled. To the extent that the 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.

Successfully shrinking the balance sheet will lessen the Federal Reserve's footprint in financial markets. In particular, the large balance sheet is distorting the price of duration and artificially flattening the yield curve in a way that could promote a reach for yield by investors with potential implications for financial stability.

Despite plans announced last May to significantly reduce the size of the balance sheet, the potential exists that there is an asymmetry that allows for relatively easy increases in the balance sheet but makes subsequent decreases more difficult. In a paper presented at this year's Jackson Hole Symposium, the authors argue that financial markets can become dependent on the increased liquidity added to the system as the balance sheet expands.[3] After markets have adapted and allocated the massive increase in liquidity from asset purchases, subsequently reducing the balance sheet can be difficult. As a result, large reductions in liquidity, especially absent a signal on longer-run objectives for the balance sheet, can result in volatility, like we witnessed in September 2019. One implication is that a clear signal to financial markets that an expanded balance sheet is temporary and not meant to be permanent could dampen volatility and ease the drawdown in liquidity in the longer run.

This is an important argument as the Federal Reserve considers the ultimate size of its balance sheet. Having committed to operating in an ample reserves regime, what constitutes "ample" can evolve over time and will be dependent on the decisions of financial market participants. A persistently large balance sheet can lead banks to adjust their business models around a high level of central bank liquidity, which then raises the amount of reserves required to maintain the ample regime.

Avoiding this threat will require clear signaling of resolve to shrink the balance sheet and remove liquidity. Given a clear signal, markets are less likely to become "liquidity dependent" and adjust their behavior in anticipation of declining reserve balances. There may be benefits to announcing the desired reserve levels as the balance sheet shrinks, giving banks time to prepare to operate with significantly fewer reserves.

[3] Acharya, Chauhan, Rajan, and Steffen (2022). "Liquidity Dependence: Why Shrinking Central Bank Balance Sheets is an Uphill Task."