Michelle W Bowman: The view from here - the outlook for the U.S. economy and implications for monetary policy

Speech by Ms Michelle W Bowman, Member of the Board of Governors of the Federal Reserve System, at the Dykhouse Scholar Program Speakers Series in Money, Banking, and Regulation at South Dakota State University, Brookings, South Dakota, 13 October 2021.

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It has been a privilege to travel across and explore this beautiful state over the past several days and to be here in Brookings with you this evening. And I'm pleased to have the opportunity to share with you, the students of South Dakota State University (SDSU), my experience as a member of the Federal Reserve Board of Governors and my outlook for the U.S. economy.[1]

Today I will speak to you about my outlook for the U.S. economy and what the Federal Reserve has been doing to support economic activity during the COVID-19 pandemic recovery.

I will also touch on a few details about what I've learned of the economic conditions here in South Dakota. Over the past few days, I've had the opportunity to meet with a number of business and community leaders here in your state. Beginning on Monday in Rapid City, I made a quick pre-dawn visit to Mount Rushmore on Tuesday while en route to a Native American Indian reservation. Later in the day, I met with state, business, and tribal leaders in Pierre, and here in Brookings earlier today. Hearing directly about the successes and challenges from their perspective provides important context for understanding economic conditions that cannot be obtained from economic data. These conversations help us see through the data from the eyes of the people, businesses, and communities that make up the American economy. That information is very helpful to me and to us at the Federal Reserve as we make our policy decisions.

But before I turn to the outlook and its implications for Federal Reserve decisions, let me share some basics about the Fed's responsibilities and how we carry out those responsibilities.

As students of economics, you may already know that the Federal Reserve conducts monetary policy to support a strong and stable economy in the United States. Our official mandate from the Congress is to pursue two goals, maximum employment and stable prices. Together, we commonly refer to these objectives as our dual mandate, and pursuing both at the same time means that we seek the maximum level of employment that is consistent with price stability. Regarding the price-stability goal, our framework references an annual inflation rate of 2 percent as most consistent with our price-stability goal over the longer run.

The Fed pursues its monetary policy goals using a variety of tools, but the main policy tool is the federal funds rate, a key interest rate for overnight borrowing by commercial banks that influences other interest rates throughout the economy. Lower interest rates tend to stimulate demand—for housing, cars and other durable goods, and business investment, for example—which boosts economic activity and has the potential to push up inflation. Higher interest rates tend to slow the economy and tend to push inflation down.

In normal times, monetary policy decisions are made eight times each year through votes of members of the Federal Open Market Committee (FOMC).[2] In preparation for each meeting, the FOMC participants analyze the latest economic data and assess where the economy stands relative to our two mandated goals. And, because monetary policy decisions take some time to flow through to, or have their full effect on, the economy, FOMC participants must form a view about how they think the economy will evolve in the coming months and years. In addition to understanding where the economy is at any given point in time, making a judgment about where it is headed is also crucial to monetary policy.

As I have learned in my nearly three years and almost 20 meetings as an FOMC member, economic forecasting is challenging, to say the least. Despite all of the data and economic models at our disposal, the economy is exceedingly complex, the product of countless decisions made every day by human beings, who have varied goals and motives. Economic data, sometimes received with a considerable time lag, can give us only a rough, backward-looking picture of the economy, and judging where the economy is headed in the future is even more difficult. Even the most accurate forecasts about the economy are often wrong, simply because of the uncertainty that is inherent in the task of interpreting and predicting future economic conditions. Yet our responsibility is to do just that—make predictions about how economic activity will evolve, and act on those forecasts in real time, to ensure that monetary policy can help support a strong economy.

As part of this process, FOMC members also consider the different ways that our outlook may be wrong. We consider a number of alternative scenarios for the future and try to manage the relative risks of a policy decision if the future does not turn out as expected. I would compare that task with the judgments other professions might be required to make throughout the year. Since we are in South Dakota and farming is a familiar industry, let's use that as a comparison. Every farmer has an outlook for the costs of seed, fertilizer and other inputs, and the prices the crop might yield at the end of the growing season. Inherent in this outlook is considerable uncertainty, and a farmer has to be able to manage the risks and possible costs of being wrong in one way or another about prices. Decisions made before the growing or breeding season can have significant effects on profits after the crop is harvested or the livestock are sold. As with each member of the FOMC, this often involves careful decisions in the near term that can play out for months and years ahead.

These are some of the challenges faced by members of the FOMC. Now let me tell you a bit about how I approach our monetary policy decisions.

In preparation for each FOMC meeting, I regularly conduct extensive outreach to gather timely information from a broad range of industries and geographies. To me, it is important that economic discussion captures what is really going on in people's lives. With this in mind, I recently restarted the *Fed Listens* process at the Board, in which we focus not on monetary policy and hear from a range of different people about how the economy is affecting them. As the member of the Board of Governors with experience in community banking, I often speak to local bankers, who are excellent sources to understand the important effects of monetary policy decisions on Main Street. With this perspective, and relying on my rural Kansas background, I also pay special attention to developments in rural communities and in the agriculture sector, monitoring the effect of Fed policy in those areas.

For example, during my visit to South Dakota over the past few days, I have had the opportunity to tour parts of the Pine Ridge Reservation and discuss community development efforts and economic conditions with a number of tribal and community leaders. It is concerning to see that South Dakota's tribal communities, particularly those on rural reservations, are experiencing a slower employment recovery than in other parts of the country. I also heard firsthand about the challenges that some Native Americans, especially those living on reservations, face in accessing reliable financial services and finding affordable credit and housing.

Understanding the barriers to financial inclusion is particularly important to ensuring that our financial system works for everyone. For this reason, I am pleased that the Federal Reserve recently joined the Central Bank Network for Indigenous Inclusion, an international network of central banks committed to engaging with Indigenous peoples and understanding and addressing their unique economic and financial challenges. I will serve as the Board's representative to this group and look forward to continuing our outreach and work in this area.

As much as any other preparation for FOMC meetings, all of these conversations are vital inputs for my consideration of the data influencing my monetary policy decisions every six to eight weeks. To cite one example, in the early weeks of the pandemic, our outreach and communication with community bankers led the Fed to create a special lending program to help banks that were participating in the Paycheck Protection Program (PPP), which loaned and granted funding to small businesses. The Fed's PPP liquidity facility was crucial in ensuring that lenders had the liquidity they needed to get PPP funds out to businesses as quickly as possible, which resulted in the preservation of millions of jobs.

Now that I've given you an idea of what this process looks like for me as a member of the FOMC, let me describe my view of current economic conditions, my outlook for the economy, and how I believe monetary policy can continue to support the recovery. Along the way, I will also highlight a few factors that I believe could pose a risk to continued progress toward our maximum-employment and inflation goals.

First, looking at the job market, stringent economic and social distancing restrictions imposed in an effort to contain the spread of the virus resulted in enormous job losses in the early months of the pandemic, with the unemployment rate surging from 3.5 percent in February 2020 (a 50-year low) to 14.8 percent in April 2020. Since the middle of last year, however, as the economy started to reopen, we have seen steady progress toward maximum employment.

That progress continued in September, with the unemployment rate moving down to 4.8 percent. Although the September increase in payrolls was smaller than many had expected, over the past three months we've seen an average of 550,000 jobs created, just down from the remarkable average pace of 567,000 per month in the first half of the year. At least part of the recent slowing in payroll growth seems to reflect a limited supply of labor. That's certainly what I've heard in South Dakota. Employers are having a very tough time filling jobs. I was told one ethanol plant needed to fill 15 jobs and got four applicants. In contrast, indicators of labor demand, such as unfilled job openings, remain exceptionally strong. On balance, I anticipate that employment will continue to move up in the months ahead, although for several reasons that are unrelated to the stance of monetary policy, I don't expect that we will see employment fully return to pre-pandemic levels any time soon.

First, despite all of the economic progress, it is clear that switching off economic activity for such a long period has had lasting consequences, and expectations of a smooth resumption of production, transportation, and business operations may not be met for some time. Many workers that were initially laid off temporarily have left the workforce altogether, which is especially true for women, with nearly 2 million women leaving the workforce since the pandemic began. In addition, many older workers dislocated by the pandemic effectively retired and probably will not rejoin the workforce even in a much stronger job market.

While I would not want to place too much weight on one or two months of data, the most recent reports on employment and anecdotal reports from a wide range of businesses suggest that, even when offering higher wages and signing bonuses, many employers are finding it difficult to fill open positions. History tells us that the longer workers remain out of the workforce, the less likely it is that they will return to employment and the greater the likelihood that they will lose skills and connections with the job market, which could weigh on labor force participation for years to come. The Federal Reserve's policy tools are useful for promoting a strong job market, but they are not well suited to addressing these harmful effects on labor supply.

Another reason for my cautious outlook for employment growth is that, while large firms have adequate resources, funding options, and flexibility to withstand pandemic-related disruptions, many small businesses without those advantages have closed permanently. I continue to hear concern about the future from small business owners, which is also reflected in the latest readings from broader surveys of small business sentiment. While many factors lead to this perspective, I have heard specific reference to continued rising costs, supply chain issues, labor shortages, and uncertainty about other factors, like tax increases and vaccine mandates.

Let me turn now to our other monetary policy goal, price stability. Earlier this year, as the economy was reopening, we saw a pronounced pickup in inflation, as prices for motor vehicles, electronics, and other goods rose especially rapidly. Most of these increases could be traced to bottlenecks in global supply chains. The bottlenecks were often the direct result of shortages of labor and key materials used in production and distribution. Demand for semiconductors has surged because of a sharp increase of spending on high-tech equipment and consumer electronics, investment in new wireless networks, and increasing usage of semiconductors in motor vehicles, appliances, and other goods. But throughout the pandemic, the supply of semiconductors has been significantly restrained by pandemic-related production disruptions, most recently in Malaysia and Vietnam. We are seeing shipments at record levels, and more capacity is expected to come on line, but the combination of strong demand and intermittent disruptions to this complex supply chain poses a risk that it could be some time before semiconductor supply issues are resolved.

The motor vehicle industry is a prominent example of a downstream sector that has been adversely affected by the semiconductor supply crunch. Every new car and truck produced today has many semiconductors included in its electrical components. As a consequence, the shortage of automotive chips has considerably reduced the number of new cars completed in the manufacturing process, driving up prices for those that have been produced. The lack of new cars for sale on dealer lots has also boosted demand and prices this year for used cars and spilled over to the rental car market, leading to soaring car rental prices. Fortunately, these prices eased a bit in September, but they are still elevated, and this causes spillovers in the broader economy as well. When an auto assembly plant shuts down for several weeks and its workers are furloughed, a whole community and its businesses feel the ripple effects of that closure. For instance, when an auto assembly plant in Ohio was closed for several weeks last summer, we heard anecdotal reports of an outsized drop in bookings at a nearby hotel chain.

The semiconductor shortage highlights the global nature of many supply chains, where a disruption in one link can have wide and unexpected effects across the globe and in many industries. As another example, beyond the motor vehicle industry, supply chain disruptions have also limited the availability of major appliances, which impairs the completion and delivery timeline for homebuilders and puts further pressure on the limited housing inventory. Supply chain problems can have surprising spillovers. In the past couple of days, I've heard that the pheasant-hunting season in South Dakota may be disrupted by a shortage of shotgun shells. Nationally, these effects have led some firms to consider shifting their manufacturing from overseas or sourcing inputs from suppliers closer to home in an effort to reduce supply chain risks. In the longer run, these efforts may lead to more resilient supply chains, but the short-term transition could introduce different vulnerabilities. I will be watching these developments closely.

As the various supply bottlenecks we are currently seeing are gradually resolved, we should see monthly inflation readings step down further from the high rates we have observed this year. Nevertheless, I still see a material risk that supply-related pricing pressures could last longer than expected.

Another source of inflation risk comes from the lower labor force participation, which, as I mentioned earlier, has led some firms to offer inducements to bring potential workers back, including hiring bonuses and higher wages. Even with these incentives, however, many firms are struggling with staffing, and some are also offering training programs for new hires to develop required job skills. Wage increases and these additional employee investments are increasing firms' costs, potentially adding to inflationary pressures.

In the agricultural sector, prices for most major commodities remain above pre-pandemic levels, and farm income is expected to be higher than a year ago for the second consecutive year. But since farmers lock in prices for inputs before planting, the effects of substantial price increases for inputs like fuel and fertilizer have not yet been fully realized. In their planning for next season's planting, farmers are much more concerned about input cost inflation. Some estimates show that farmers could pay 30 to 70 percent more for fertilizer for the 2022 season. In addition, if they can even find equipment or land to buy, prices for these assets have continued to increase.

Another source of inflationary pressure is the rapid increase in house prices, something that also raises potential concerns about valuation pressures. The ongoing strength in housing demand is also notably driving up rental costs. Higher house prices also make it much more difficult for low- to moderate-income households to become homeowners, as larger down payments and other financing requirements, in effect, lock these households out of the housing market.

Amid the booming real estate market, some bankers I spoke with recently cited concerns about a possible house price bubble and growing concerns about potential risks to financial stability. These concerns are a notable change from our conversations a year ago, when most bankers were appreciating the frenzied activity in this market as a means to boost income in a very low-rate environment. Given the experience of the previous financial crisis, this development is something we should closely monitor. Now, unlike the conditions leading up to that crisis, homeowners have fewer financial obligations and debts, and many of the financial system vulnerabilities that existed have been addressed. But homes are a widely held asset, and even a modest shift in the housing market, especially a decline in home prices, could have significant ripple effects throughout the economy.

If elevated inflation readings continue into and through the next year, we may begin to see an imprint on longer-run inflation expectations. While short-term inflation expectations have moved up with the recent period of increased inflation, longer-term measures have remained relatively stable. As we know, after reaching uncomfortably high levels in the 1970s and early 1980s, in more recent decades, inflation has run close to our 2 percent goal, helping anchor the public's inflation expectations at levels that seem consistent with our goal. This is relevant because the Fed has long considered the anchoring of inflation expectations an important condition for meeting our monetary policy goals.

Finally, let's turn to the implications for monetary policy more broadly and the FOMC's most recent decision at our meeting in September. When actions taken to mitigate the spread of COVID-19 began to disrupt the U.S. economy and financial markets in the first half of last year, the FOMC cut short-term interest rates to near zero and began purchasing Treasury securities and agency mortgage-backed securities. These actions helped stabilize financial markets and sustain the flow of credit to U.S. households and businesses. By the middle of last year, we were seeing signs of resilience in economic activity, with labor market conditions beginning to recover from the economic effects of the pandemic.

In December, we indicated that we would start scaling back our asset purchases after the U.S. economy had made "substantial further progress" toward our maximum-employment and price-stability goals.[3] We have been closely monitoring that progress since then, and, at our most recent policy meeting, we noted that, if the economy continues to improve as expected, this scaling back, or tapering of our asset purchases, may soon be warranted. I fully supported that assessment. Provided the economy continues to improve as I expect, I am very comfortable at this point with a decision to start to taper our asset purchases before the end of the year and, preferably, as early as at our next meeting in November.

In my view, our asset purchases were an important part of our response to the economic effects of the pandemic, but they have essentially served their purpose. I am mindful that the remaining benefits to the economy from our asset purchases are now likely outweighed by the potential costs. In particular, I am concerned that our asset purchases could now be contributing to valuation pressures, especially in housing and equity markets, or that maintaining a highly accommodative monetary policy stance at this stage of the economic expansion may pose risks to the stability of longer-term inflation expectations. If the expansion continues as I expect, I will support a pace of tapering that would end our asset purchases by the middle of next year.

In closing, I would say that our economy has made great strides this year, which is a testament to the resilience of U.S. households and businesses and the many challenges faced throughout the pandemic experience. While many risks to the outlook remain, I expect that the recovery will continue in the coming months, and that steady progress will be made toward our maximum-employment and price-stability goals.

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1 The views expressed are my own and not necessarily those of other Federal Reserve Board members or Federal Open Market Committee participants. Return to text

2 Except in very unusual circumstances, monetary policy decisions are made during our regular FOMC meetings eight times each year. The 12 Reserve Bank presidents and the members of the Federal Reserve Board of Governors participate in these meetings, with 5 of the 12 presidents and all of the Governors voting as members of the FOMC. Return to text

3 See the December 2020 FOMC statement (paragraph 4), which is available, along with other FOMC statements, on the Board's website at www.federalreserve.gov/monetarypolicy/fomccalendars.htm. Return to text