

Christopher J Waller: Economic outlook

Speech by Mr Christopher J Waller, Member of the Board of Governors of the Federal Reserve System, at the Center for Financial Stability, New York, 19 November 2021.

* * *

It is a pleasure to speak today at the Center for Financial Stability, and I look forward to our conversation. Let me take the next several minutes to speak about the continued improvement of the U.S. economy, recent inflation data, and their implications for monetary policy.¹ I will also discuss the Federal Open Market Committee's (FOMC) recent decision to begin reducing monthly purchases of securities and how incoming data may affect the pace of tapering. Finally, I will address issues concerning the size of our balance sheet.

Let me start with my views on the economy. Since I last spoke on the subject exactly a month ago, the basic shape of my outlook hasn't changed: The economy continues to grow and add jobs at a strong pace, making steady progress toward the Federal Reserve's goal of maximum employment. New data shows that employment gains were better than first reported in August and September and were back to a strong level in October. But we also have learned that supply constraints—both bottlenecks and labor shortages—are having a larger and more persistent effect on the economy. Due to a combining of those supply constraints with strong demand, inflation pressures are becoming more widespread and may last longer into 2022 than I thought they would. These factors haven't dented my optimism that the strong recovery will continue but they have raised the risks that supply constraints may limit job gains and output growth, and that inflation may complicate the FOMC's management of monetary policy in 2022.

These factors weighed on output growth in the third quarter, which was down considerably from the three months before but which I expect will rise again to a strong rate in the fourth quarter. The explanation for the downturn is the same story we have all been living through since March 2020: the ups and downs of the pandemic. The Delta variant and supply chain problems threw the economy off its very strong growth track in the third quarter, but I anticipate it will return to that path in the fourth quarter, as society continues to learn how to manage the disease and ever-improving treatments reduce the likelihood of death and hospitalization. Assuming another damaging COVID-19 variant does not arise this winter, I expect gross domestic product (GDP) to resume its robust growth not only in the fourth quarter of 2021 but also in the first half of 2022.

In terms of the job market, households and businesses perceive that conditions are as tight as or tighter than they were pre-COVID, even though the unemployment rate is more than a percentage point higher. There are certainly ample data showing labor demand is very strong. Job openings remain at a record level. New businesses are starting up at a much higher pace than they did from 2017 to 2019. People are quitting jobs, either to take new ones or because they are confident that they can find new ones, likewise at a record rate. The improvement I expect in managing COVID should drive demand higher but also provide a boost to labor supply as those who have been on the sidelines return to a job market that keeps improving.

With respect to employment data, revisions to the August and September job numbers indicated that the summer slowdown in job gains wasn't nearly as bad as initial reports suggested. Job creation averaged 442,000 a month from August to October, down from the 641,000 average for the other seven months of 2021. Nevertheless, this is a healthy pace for job creation and will speed the recovery of the labor market if it continues. Adjusting for early retirements, we are only 2 million jobs short of where we were in February 2020. Regarding the unemployment rate, in October the rate stood at 4.6 percent. Compared with one year ago, that rate has fallen 2.3 percentage points. If the decline continues at about that pace in coming months, the unemployment rate could be below 4 percent before too long. In light of these data, in my view, the labor market is rapidly approaching maximum employment. But I will be watching for factors,

from continued supply bottlenecks and a winter surge of COVID cases, that could slow this progress.

Turning to inflation, inflation has escalated substantially this year, along with a significant rise in inflation expectations. The October consumer price index report showed an unexpected surge in inflation. The monthly print corresponds to an annualized rate exceeding 10 percent, while the year-over-year increase was 6.2 percent—the highest since December 1990. Despite the highest wage gains in years, inflation this year has wiped out any real wage increase for the average worker. High inflation is painful to Americans who have little choice about the goods and services they buy for everyday living. Prices are up significantly at the grocery store, which is a major problem for many individuals and families. Unlike earlier this summer, price pressures are no longer concentrated in a few categories, they appear to have broadened.² There has been a notable increase in the prices of energy, food, goods, and services as well as the cost of owning a home. Even trimmed mean measures of inflation that exclude some big price increases, such as the Cleveland Fed and the Dallas Fed measures, report inflation rates above the Fed's 2 percent target. Diffusion indexes of price changes, which are often useful in detecting turning points in the data, show an increasing number of categories with 3 or 12-month inflation exceeding 3 percent, compared with earlier this year.

I expect that these pressures are related to both supply constraints, which may be beginning to improve, and strong demand, which shows no sign of abating. Wages continue to grow quickly on a more sustained basis than they have in more than 20 years, most recently reflected in a striking increase in the employment cost index, which considers both pay and benefits. Wages and employment costs seem to be widespread across industries and among businesses of different sizes. Crucial to the path of inflation will be whether we see input cost increases consistently reflected in final goods prices. Our business contacts report that companies are comfortable passing along these cost increases to their customers.

It has been argued that because price pressures connected to supply constraints are transitory, they will come to an end, so monetary policy does not need to respond to temporary price pressures. I find this argument puzzling for a few reasons. First, all shocks tend to be transitory and eventually fade away; by this logic, the Fed should never respond to any shocks, but it sometimes does, as it should. Second, the macroeconomic models we use to guide policy typically have cost shocks built in that cause inflation to move. In those models, appropriate monetary policy responds to these inflation movements; it doesn't ignore them, even though they are transitory. Finally, the choice to take a policy action depends on how large the shocks are and how long they are expected to persist. To make this point clearer, consider a snowfall, which we know will eventually melt. Snow is a transitory shock. If the snowfall is one inch and is expected to melt away the next day, it may be optimal to do nothing and wait for it to melt. But if the snowfall is 6 to 12 inches and expected to be on the ground for a week, you may want to act sooner and shovel the sidewalks and plow the streets. To me, the inflation data are starting to look a lot more like a big snowfall that will stay on the ground for a while, and that development is affecting my expectations of the level of monetary accommodation that is needed going forward.

Inflation expectations on the part of the public also play a role in the conduct of monetary policy. Two surveys of consumers—by the University of Michigan and the New York Fed—show medium inflation expectations running over 4 percent, and bond investors are requiring over 3 percent compensation for future inflation and inflation risks. It is very concerning to me that households and markets are no longer expecting us to keep inflation near our 2 percent target over the next three to five years. Now, it is true that there is some evidence that these consumer survey measures of future inflation tend to move around a lot based on changes in current inflation. So I hope these large movements in inflation expectations are—wait for it—transitory and will come back down as bottlenecks and labor shortages resolve themselves over the coming months. But if these measures were to continue moving upward, I would become concerned that expectations would lead households to demand higher wages to compensate for

expected inflation, which could raise inflation in the near term and keep it elevated for some time. This possibility is a risk to the inflation outlook that I'm watching carefully.

So, what are the implications of all these considerations for monetary policy? The economy made faster progress in 2021 than most of us expected back in December 2020. This substantial progress toward our dual mandate goals allowed us to begin reducing the \$120 billion a month in asset purchases that are aiding the recovery by steadily providing accommodation to financial conditions. When we started tapering a few days ago, it happened several months earlier than was expected by market participants in the early months of 2021. We cut both the amount of Treasury securities purchases to \$70 billion per month from \$80 billion per month, and the amount of agency mortgage-backed securities (MBS) to \$35 billion from \$40 billion. We will make another \$10 billion and \$5 billion cut to the monthly purchases in mid-December.

The next few months will be critical, however, in determining how the tapering process plays out. The Committee has been very clear, in the months leading up to our decision, and in making that decision, that the pace of reducing asset purchases would depend on progress toward our dual mandate goals. If COVID or some other factor substantially slows the recovery, hindering the progress toward maximum employment, the FOMC could slow the taper. But if the economy makes quick progress toward maximum employment or inflation data show no signs of retreating from their currently high readings, the Committee may choose to speed up the taper, which would position it to accelerate subsequent steps in tightening monetary policy if necessary. The timing of any policy action is a decision for the FOMC, but for my part the rapid improvement in the labor market and the deteriorating inflation data have pushed me towards favoring a faster pace of tapering and a more rapid removal of accommodation in 2022.

Another policy action already being discussed in public by market participants is the timing of the first increase, or liftoff, of the target range for the federal funds rate. The FOMC has described the conditions that must be met to consider liftoff. They are when the economy has reached maximum employment, and when inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time. Assuming inflation expectations are well-anchored, I judge that the timing of liftoff is any time after both of these conditions have been met.

I believe the condition for inflation has been met and we are making great strides towards achieving the employment leg of our mandate. I will be looking at the incoming data to determine when we have achieved both these criteria. After that point, whenever the Committee ultimately decides to raise the target range for the federal funds rate from zero, monetary policy will still be providing an extraordinary extent of support for the economy—short-term interest rates will still be very low, and the large amount of securities holdings on the Fed's balance sheet will continue to put significant downward pressure on longer-term interest rates.

This fact leads to another policy action that the FOMC needs to consider: when to begin reducing securities holdings. It is important to remember that the FOMC makes monetary policy decisions with the best interest of the American people in mind and not based on how these actions affect the balance sheet. Between March of 2020 and today, the Fed's securities holdings have increased by \$4.2 trillion to stand a bit over \$8 trillion. These holdings are about 35 percent of the level of annual real GDP. This percentage sounds quite large, but the Fed's share is not out of line with what is found on the balance sheets of other advanced foreign economies' central banks. For example, our share is larger than that of the Bank of Canada, but it is about the same as the Bank of England's, and much smaller than the shares of the European Central Bank and the Bank of Japan.

One must remember that there is no economic theory that tells us what the optimal size of a central bank balance sheet should be. So, just because our balance sheet is "large" does not mean there is anything wrong with it. However, arguments can be made that we should reduce the size of our balance sheet. First, we expanded it for emergency reasons due to the pandemic.

As the emergency passes, we can undo those actions and get the balance sheet down to something close to its pre-pandemic trend. Second, by doing so, we free up balance sheet space in the event we need to expand it in the future to deal with economic shocks. Third, the private sector appears to be inundated with liquidity, as evidenced by the large take-up at our overnight reverse repurchase agreement facility. Draining some of this liquidity would help maintain smooth market functioning.

Going forward, the Committee will need to decide what type of reinvestment policy to have in place. Currently, when securities on the Fed's balance sheet mature, the proceeds are reinvested in new securities, keeping the balance sheet growing in line with net purchases. Under this policy, when net asset purchases cease, reinvestment will keep the balance sheet constant at the size at that time. Based on past experience, an effective way to gradually reduce the balance sheet to a more efficient level is to change that reinvestment policy to limit, or cease, reinvestment. Allowing this "runoff" was the main way the FOMC shrank the balance sheet before the pandemic.

I expect the reinvestment strategy will be heavily influenced by the Fed's experience with this policy between 2017 and 2019. During that time, the FOMC recognized that the monthly maturity of securities was lumpy; some months there were many securities maturing, and others few. The FOMC ensured a gradual and predictable roll-off of securities that allowed market participants to plan for the Fed's gradual retreat from the Treasury and MBS markets, which was done by instituting monthly redemption caps that gradually increased over time. I would support a similar process when the time comes to alter reinvestment policy.

As securities holdings declined, so did reserves in the banking system. In mid-September 2019, upward pressures emerged in funding markets as reserves dropped to about \$1.4 trillion or 6.6 percent of GDP at that time. Most thought the Fed's balance sheet could be reduced further. In fact, the median of the respondents to the June 2019 primary dealer survey conducted by the Federal Reserve Bank of New York indicated reserves could fall to \$1.2 trillion.³ But, the underlying level of reserves wanted by financial markets seemed to be more than we anticipated. In response to the emerging pressures at that time, the Fed stopped redemptions and instituted a number of actions over a few days that boosted reserves to at least the level seen in early September of that year.⁴

With this experience in hand, we will need to proceed with caution with future securities redemptions. That said, clearly today's balance sheet is elevated, and we can decrease our holdings. Should we drain reserves too quickly, we have a new tool to help correct this action should our pace of runoff prove to be too fast again. The standing repurchase agreement facility provides a backstop in cases where demand for liquidity is more than the Fed otherwise thought. Counterparties can come to the facility and obtain financing for their Treasury securities. Of course, I do not anticipate reducing reserves to a level where this tool would be used, but it is nice to know that, as we move forward, we have an additional support available to us that we did not have in 2019.

To close, I have outlined how I see the economy evolving and mentioned several policy steps in the future that underly that outlook. The tapering of our asset purchases has started and should continue over coming months. Then the Fed will turn to normalizing other aspects of monetary policy as the economy continues to recover from the severe COVID shock we encountered last year. I believe that policy may need to pivot to a faster taper based on incoming data that I will be monitoring.

¹ These views are my own and do not represent any position of the Board of Governors or other Federal Reserve policymakers.

² See Fernando M. Martin (2021), "[How Widespread Are Price Increases in the U.S.?](#)" On the Economy Blog,

October 19

- ³ In June 2019, the median of the respondents to the Survey of Primary Dealers indicated a \$1.2 trillion level of reserve balances in 2025. Responses to the survey are available on the Federal Reserve Bank of New York's website at www.newyorkfed.org/medialibrary/media/markets/survey/2019/jun-2019-spd-results.pdf.
- ⁴ Against a backdrop of declining reserves and high levels of Treasury securities outstanding, in mid-September 2019, imbalances in the supply of and demand for short-term funding led to pressures in the repurchase agreement (repo) market. In response to elevated rates, the Federal Reserve began conducting repo operations to help stabilize money markets and provide reserves to keep the federal funds rate within its target range. These operations boosted reserves to levels averaging about \$1.6 trillion in early 2020. For a detailed discussion of the pressures in money markets and the Fed's response, see Sriya Anbil, Alyssa Anderson, and Zeynep Senyuz (2020), "[What Happened in Money Markets in September 2019?](#)" FEDS Notes (Washington: Board of Governors of the Federal Reserve System, February 27).