FEDERAL RESERVE BANK *of* ST. LOUIS

Removing Monetary Policy Accommodation

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CENTRAL TO AMERICA'S ECONOMY®

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Introduction

Key themes

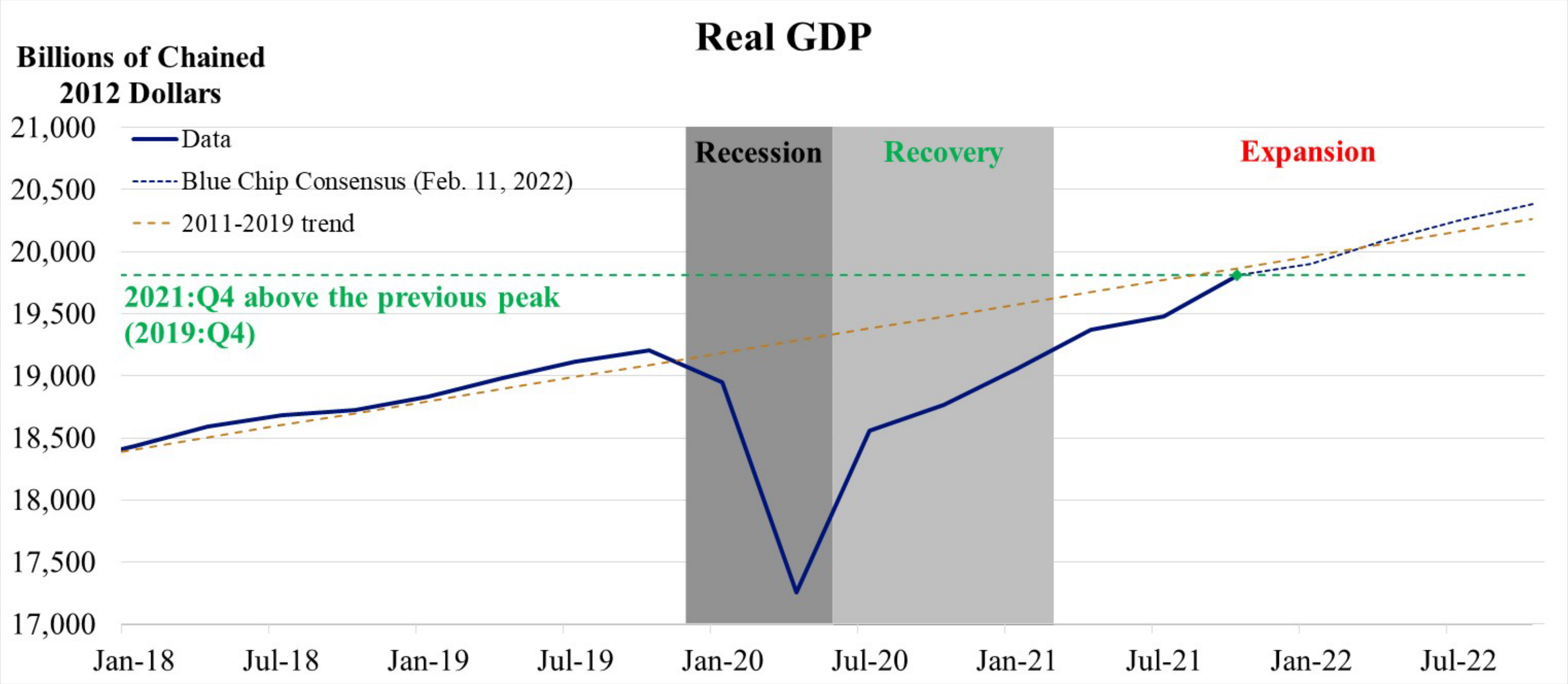
- The U.S. real economy has more than fully recovered from the pandemic recession, which ended nearly two years ago.
- The U.S. economy is expected to grow faster than its longer-run potential growth rate in 2022. There are risks to the upside and downside.
- U.S. inflation is running well above target by any measure.
- Current U.S. monetary policy is set at peak accommodation: The policy rate is near zero and the Fed's balance sheet has increased to nearly $9 trillion. This is putting upward pressure on inflation.
- This situation calls for rapid withdrawal of policy accommodation in order to preserve the best chance for a long and durable expansion.

U.S. Economy
More Than Fully Recovered

The U.S. economy has more than fully recovered

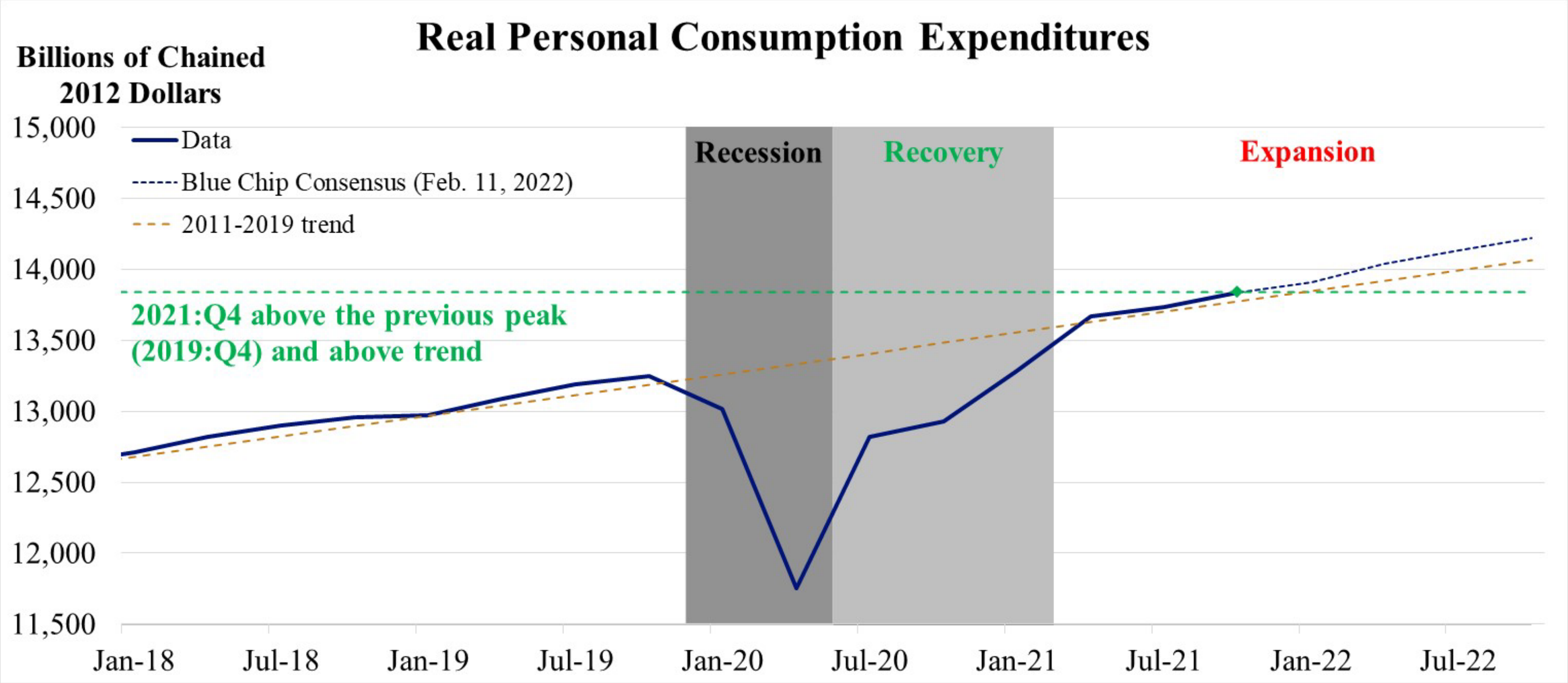
- The U.S. is currently in the expansion phase of the business cycle, with national income higher than it was at the previous peak.
- With respect to the level of real personal consumption expenditures, the economy has even surpassed the trend line drawn from 2011, indicating that the U.S. economy is doing better in terms of real consumption than it would have had there been no pandemic at all.

Output in the expansion phase



Sources: Bureau of Economic Analysis, Blue Chip Economic Indicators and author's calculations. The dark gray shaded area indicates U.S. recession, and the light gray shaded area indicates recovery. Last observation: 2021:Q4.

Consumption in the expansion phase



Sources: Bureau of Economic Analysis, Blue Chip Economic Indicators and author's calculations. The dark gray shaded area indicates U.S. recession, and the light gray shaded area indicates recovery. Last observation: 2021:Q4.

Continued above-trend growth

- Not only is the U.S. currently in the expansion phase of the business cycle, but real GDP is poised to continue to grow at an above-trend rate in 2022.
- Accordingly, as measured by key metrics, labor markets are very robust and are likely to improve still further in 2022.

Above-trend growth expected

Source	Date	2022 real GDP growth†
Summary of Economic Projections (SEP)‡	Dec. 15, 2021	4.0%
IHS Markit	Feb. 7, 2022	2.9%
Blue Chip Consensus	Feb. 11, 2022	2.9%

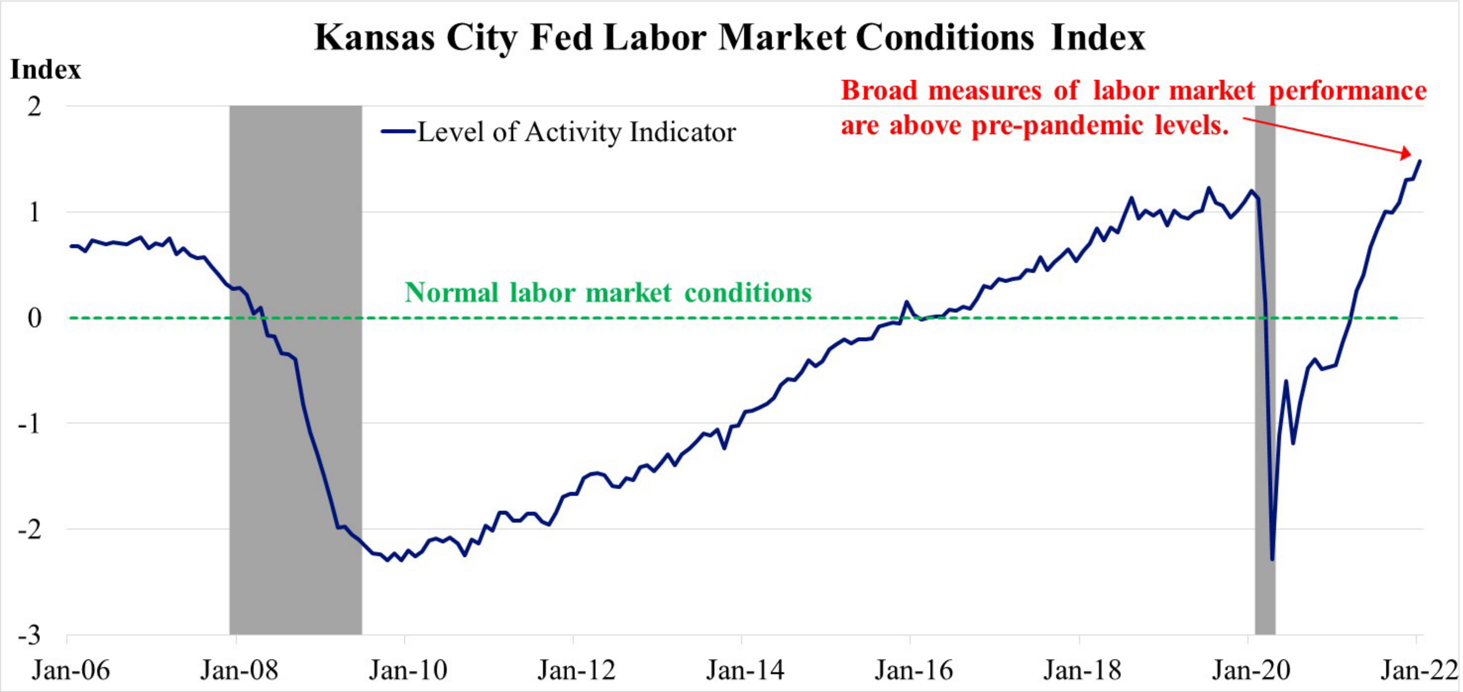
Source	Date	Longer-run/potential real GDP growth
Congressional Budget Office	July 1, 2021	2.1%
Summary of Economic Projections (SEP)‡	Dec. 15, 2021	1.8%

† *Q4-over-Q4 percent change.* ‡ *Median projection among Federal Open Market Committee (FOMC) participants.*

Risks to growth

- As always, there are risks to the growth forecast.
- Developments in the Russia-Ukraine war will have to be monitored closely but will likely impact Europe more directly than the U.S.
- Global energy markets will be impacted over the short-to-medium term, but this may lead to increased U.S. production.
- The omicron wave of the pandemic appears to be fading, suggesting further reopening of the U.S. economy in the second and third quarters of 2022.

Labor market conditions are the best in years



Source: Federal Reserve Bank of Kansas City. Shaded areas indicate U.S. recessions. Last observation: January 2022.

Many more job openings than unemployed

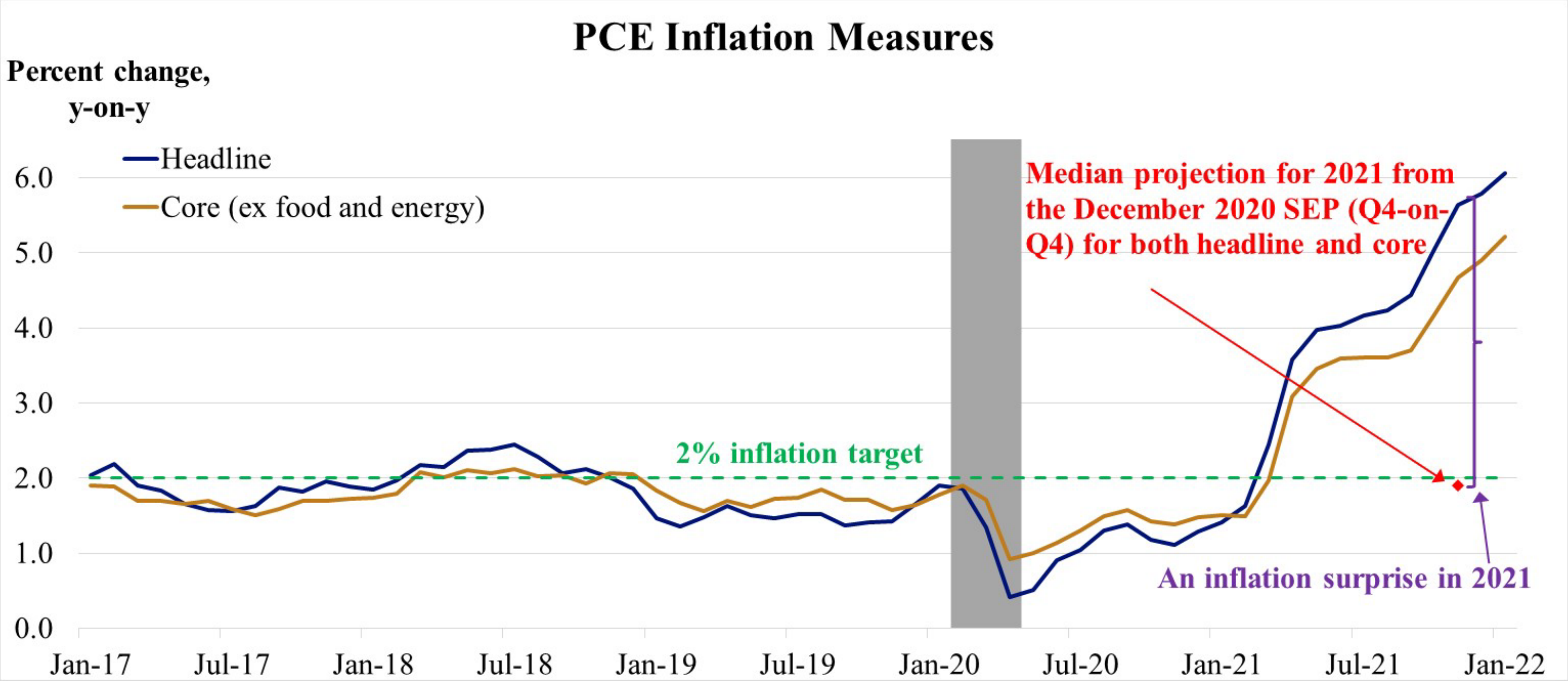
Sources: Bureau of Labor Statistics and author's calculations. Shaded areas indicate U.S. recessions. Last observation: December 2021.

An Inflation Shock

Inflation has surprised to the upside

- Measured from a year ago, headline PCE inflation is currently 6.1%, and core PCE inflation is 5.2%—well in excess of the FOMC's 2% target.
- This is the highest inflation in nearly 40 years for both measures.
- Inflation is especially hard on low- to moderate-income households, as wage gains have not kept up with inflation for many workers.

Core and headline inflation are well above target



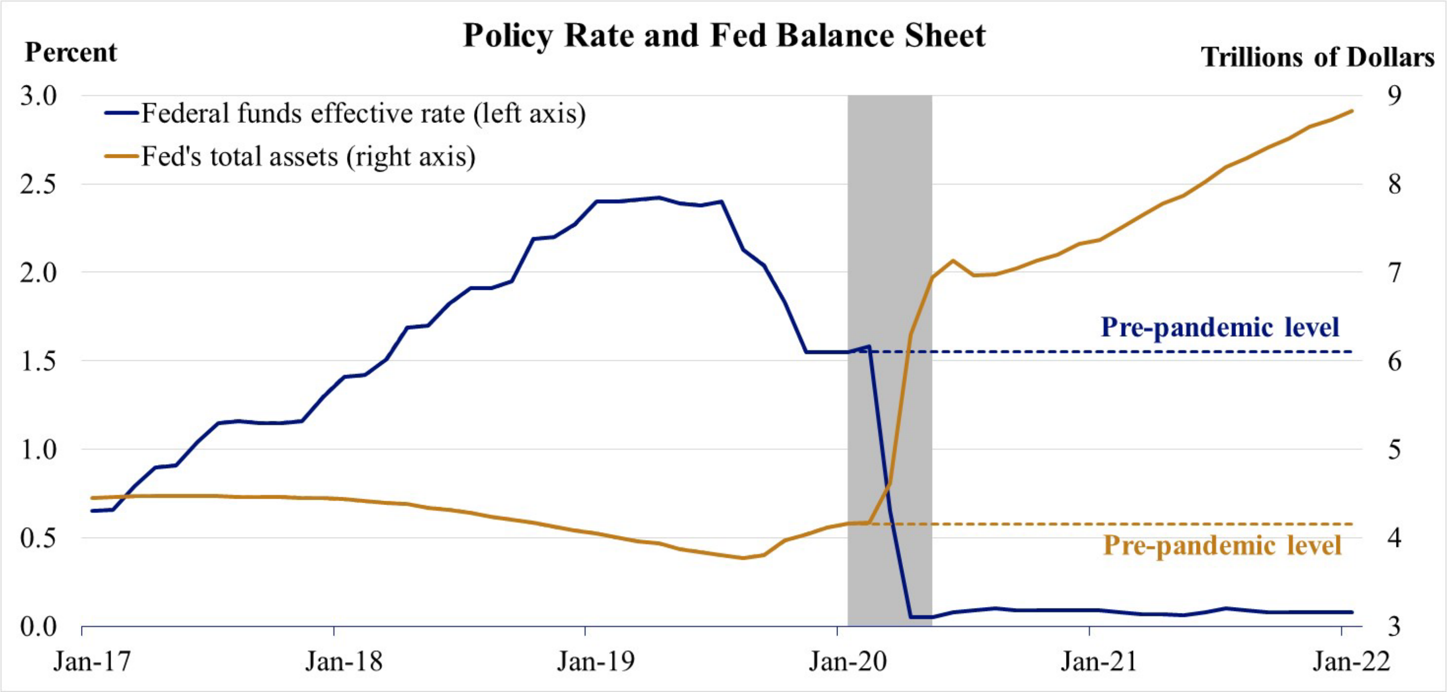
Sources: Bureau of Economic Analysis and Summary of Economic Projections (SEP). The gray shaded area indicates U.S. recession. Last observation: January 2022.

The Initial Response to the Inflation Shock

The monetary policy response

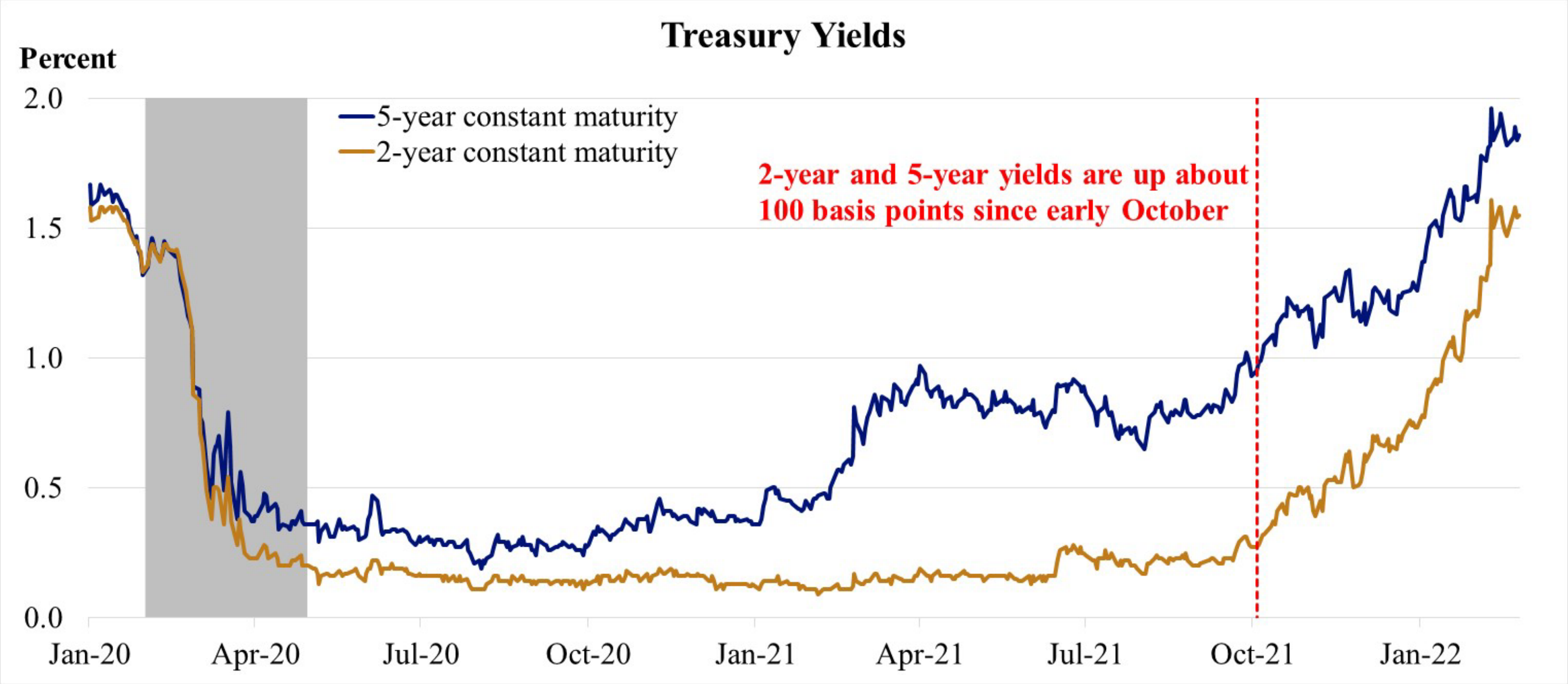
- At the time of the pandemic recession, the FOMC moved the policy rate to near zero and began large outright purchases of Treasury securities and agency mortgage-backed securities (MBS).
- These policy settings largely remain intact today, and this is putting upward pressure on inflation, exacerbating the inflation problem.
- However, the FOMC agreed to phase out asset purchases by mid-March, and public commentary has also suggested more policy rate increases for 2022 than previously anticipated.
- These steps have had an impact on financial market pricing, according to recent trading: 2-year and 5-year Treasury yields have increased about 100 basis points in the last five months or so.

The monetary policy stance



Source: Board of Governors of the Federal Reserve System. The gray shaded area indicates U.S. recession. Last observation: January 2022.

The monetary policy impact so far



Source: Board of Governors of the Federal Reserve System. Last observation: Feb. 25, 2022.

Next steps for monetary policy

- The FOMC has recently taken some steps to be in a better position to control inflation over the forecast horizon, and this has been reflected in market pricing. This has been helpful in tightening financial conditions.
- However, the FOMC must now follow through with policy rate increases and balance sheet runoff or risk squandering policy credibility.
- In addition, the FOMC may have to move more aggressively going forward if inflation increases or does not moderate as much as expected.

Conclusion

Removing monetary policy accommodation

- U.S. inflation has surprised substantially to the upside in an environment where measures of real economic activity and labor market performance are, despite geopolitical risks, expected to remain robust.
- There has been an initial, implicit U.S. monetary policy response to the ongoing inflation shock, and this response is already reflected in financial market pricing.
- The FOMC must now follow through with policy rate increases and balance sheet runoff or risk squandering policy credibility.
- Forthright and transparent actions designed to keep inflation under control will give the U.S. economy the best possible chance at a long and durable expansion.

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