OPINION

BY KARTIK ATHREYA

Unwinding Pandemic Monetary Policy

When COVID-19 hit, it put consumers and businesses in unprecedented difficulty. People could not work easily, and service-oriented businesses (think hotels and restaurants) lost demand for their services. At the same time, people spending increased time at home — including working from it if they could — demanded more goods (think furniture and remodeling). In a nutshell, the economy was reacting both sensibly and sharply to the new reality.

Given the magnitude of the unique shock hitting the economy, the Fed acted to ensure that broader financial conditions did not further hurt consumers and businesses. It cut short-term interest rates to near zero and facilitated emergency short-term loans to portions of the financial sector and to foreign central banks.

The overnight rates most directly controlled by the Fed, though, are less important for consumers and businesses — and hence the economy — than the longer-term rates applicable to the loans we take out (think mortgages and car loans). Normally, by lowering the expected path of short-term rates, the Fed can move those longer-term rates as well. At the onset of COVID-19, however, the Fed faced a barrier: Short-term rates were already around zero and could not directly be pushed lower. So, the Fed worked in other ways to lower longer-term rates. It did so by signaling that its support would remain until conditions improved, and then by purchasing about $5 trillion in Treasury bonds and mortgage-backed securities.

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The effects of the pandemic have receded to some extent now, especially in terms of macroeconomic activity. GDP is back to, and perhaps even exceeding, pre-pandemic levels. Unemployment sits at 3.6 percent as of April 2022, down from 6.1 percent in April 2021. Labor force participation is largely back to normal.

Inflation, though, has reached the highest level in a generation. A part of this can be directly connected to current spending patterns — for durable goods especially — and the real disruptions we have seen in supply chains. Another piece is the war in Europe that has increased commodity prices sharply.

Of course, such shorter-run inflationary pressures are beyond the Fed's control. Indeed, monetary policy can at best only partially address some short-term price fluctuations stemming from supply disruptions, and even here, doing so requires anticipating when the causes of those shocks will cease. This is difficult to do in the best of times, and especially so as the economy uncoils after a pandemic. It's therefore important to avoid overreacting to real changes in prices that reflect real circumstances such as pandemic-induced plant closures or supply chain disruptions, allowing price signals to guide supplies to where they are scarce.

Yet, another part of inflation now appears clearly broader and more durable, suggesting a need to lower monetary policy accommodation. So, to execute on its commitment to its 2 percent target, the Fed is acting now to bring inflation down. It started by first shrinking the pace of its asset purchases, then by lifting interest rates away from near zero, and then by indicating that it will begin to sell off assets outright.

Of these steps, rates are the key. Taking into account both inflation and the strong labor market, the Federal Open Market Committee voted in early May to raise them by 50 basis points to a range of 0.75 percent to 1 percent, and, importantly, has indicated openness to further hikes as needed to tackle inflation. Long-term inflation expectations remain near target, suggesting that these policy moves will keep current inflation from persisting.

Will these moves to lower inflation create a recession? While there is always a risk, a variety of indicators suggest that by themselves, they will not. Instead, the moves so far are best seen as simply taking us toward a more "neutral" stance. Of course, such a neutral interest rate is a moving target in a turbulent world. So, as President Barkin has said, we want to move at a pace that allows us to assess and respond to conditions as they evolve. **EF**

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Kartik Athreya is executive vice president and director of research at the Federal Reserve Bank of Richmond.