- **November 30, 2021**. Article. "A Risk Management Approach to Monetary Policy," Federal Reserve Bank of St. Louis *Regional Economist*, Fourth Quarter 2021. This article also appeared in the *St. Louis Fed On the Economy* blog, December 2, 2021.

A Risk Management Approach to Monetary Policy

The U.S. has experienced an inflation shock this year. [Headline PCE inflation](https://fred.stlouisfed.org/graph/?g=JeAl), measured as the percentage change from a year ago in the price index for personal consumption expenditures, rose to 5.0% in October. [Core PCE inflation](https://fred.stlouisfed.org/graph/?g=JeAg), which is a smoothed measure that excludes food and energy prices, rose to 4.1%—its highest reading since early 1991. These inflation readings have turned out to be substantially higher than Federal Open Market Committee (FOMC or Committee) participants were predicting last December. In the December 2020 Summary of Economic Projections (SEP), the median projection among FOMC participants was that headline PCE inflation and core PCE inflation both would be just 1.8% in 2021.These projections are based on the percentage change in the relevant price index from the fourth quarter of 2020 to the fourth quarter of 2021.

An important consideration is what will happen with inflation going forward. While the latest SEP projections have inflation coming down closer to the FOMC's 2% target next year, there are reasons to be concerned that inflation might be more persistent than expected. That is why a risk management approach to monetary policy is prudent.

Monetary Policy during the Pandemic
The FOMC reacted swiftly to the initial shock of the COVID-19 pandemic in March-April 2020 with a very accommodative monetary policy to help alleviate financial market stress and moderate the pandemic's impact on the economy. The monetary policy response included moving to a near-zero target range for the federal funds rate (i.e., the policy rate) and beginning substantial asset purchases, split between U.S. Treasury securities and agency mortgage-backed securities (MBS).

The economic situation is substantially improved today compared to the pandemic-induced free fall of March-April 2020. Accordingly, the FOMC has begun the process of removing some of the monetary policy accommodation put in place at the beginning of the pandemic.

At its November meeting, [the FOMC decided to begin reducing the pace of asset
purchases](https://www.federalreserve.gov/newsevents/pressreleases/monetary20211103a.htm)(also known as "tapering") by $10 billion per month for Treasury securities and $5 billion per month for agency MBS. The Fed had been purchasing $80 billion per month of Treasuries and $40 billion per month of MBS. Therefore, if the reduction in purchases continues at the pace announced in November, the taper would be completed by mid-2022. In the past, the FOMC has phased out asset purchases before beginning to raise the policy rate. Furthermore, reducing the pace of purchases in a way that is well communicated to minimize any disruptions in financial markets is considered best practice.

Where Will the Economy Be When Tapering Ends?
In terms of national income, the U.S. economy has already recovered from the pandemic-induced recession, as real gross domestic product (GDP) surpassed its pre-pandemic peak level in the second quarter of this year. Although the real GDP growth rate was slower in the third quarter due to the COVID-19 delta variant's impact on the economy, I expect rapid growth to return in the fourth quarter and to continue through 2022.

In addition, the labor market seems to be exceptionally strong. The unemployment rate, which was 4.6% in October, has been declining at a rate of about two-tenths per jobs report this year. If that kind of improvement continues, the unemployment rate will fall below 4% sometime in the first quarter of 2022 and could hit the pre-pandemic rate of 3.5% in the second quarter.

When it comes to inflation in 2022, views differ. Important variables that might influence inflation, including the state of public health, the degree of supply chain disruption and the strength of consumer demand, are hard to forecast with any degree of confidence. Accordingly, the FOMC cannot be

certain whether inflation will dissipate naturally or, alternatively, remain persistently above the Committee's 2% target. However, by the time the tapering process is complete, the FOMC will have more information and be in a better position to assess which of these two scenarios is more nearly correct.

A Risk Management Approach

A risk management approach to monetary policy in the current situation entails putting some probability on each of the two inflation scenarios above and positioning monetary policy accordingly. In my own assessment, I am currently putting half the weight on the first scenario in which inflation naturally declines closer to 2% next year, and the other half on the second scenario in which inflation does not dissipate as much as expected or perhaps not at all in the absence of additional policy action from the FOMC.

For most of 2021, U.S. monetary policy has been almost entirely positioned for the first scenario, where inflation moderates naturally. In that scenario, inflation returns to the 2% target without further policy action by the FOMC. The FOMC could begin to taper asset purchases later and at a more gradual pace, and the Committee would not need to contemplate taking additional action by increasing the policy rate until some point further in the future.

Only recently has monetary policy become better positioned for the second scenario, in which inflation does not naturally moderate. In that scenario, inflation does ultimately return to the 2% target but only because of additional monetary policy action. To prepare for this possibility, the FOMC would have to begin to taper asset purchases sooner and at a faster pace, and the Committee would need to begin to contemplate increasing the policy rate sooner.

The FOMC's recent decision to begin tapering asset purchases and, by current estimates, to end the taper by mid-2022, embeds the risk management approach. As new data arrived during 2021, the probability of the second scenario began to rise and the probability of the first scenario began to fall. Accordingly, the tapering process began sooner and is scheduled for a faster pace than many anticipated six months ago, and market probabilities of an earlier date for raising the policy rate from near

zero (i.e., liftoff) have increased. This is good news because it means that monetary policy will be better positioned to respond smoothly to either of the two inflation scenarios in the year ahead.

Endnote

1. These projections are based on the percentage change in the relevant price index from the fourth quarter of 2020 to the fourth quarter of 2021.

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The text below, written by Federal Reserve Bank of St. Louis PresidentJames Bullard, first appeared as thePresident's Messagein the[Regional Economist](https://www.stlouisfed.org/publications/regional-economist).

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Notes and References
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- **November 18, 2021**. Remarks. [Bullard Discusses U.S. Economy with District Business Leaders].

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