Christopher J Waller: The economic outlook with a look at the housing market

Speech by Mr Christopher J Waller, Member of the Board of Governors of the Federal Reserve System, at the Mark C. Berger Workshop Series, University of Kentucky, Lexington, Kentucky, 6 October 2022.

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Thank you, Jim, and thank you to the University of Kentucky for the opportunity to speak to you today. It is nice to be back in the Bluegrass state and see old friends and colleagues. I taught at UK from 1998 to 2003 and one of my colleagues at that time was Mark Berger, who passed away at far too young an age. Mark was a good friend, and I am honored to speak in this seminar series that is named after him.

My subject is the outlook for the U.S. economy and inflation, and the Federal Reserve's efforts to get inflation under control. [1] I will start with the outlook for the economy, focusing on inflation, and then turn to a discussion of the housing market, where strong demand has outrun limited supply, causing substantial increases in prices for shelter, which is a large component of inflation. Because the housing market is sensitive to changes in interest rates and thus to monetary policy, I'll conclude by discussing how housing is being affected by the Federal Open Market Committee's (FOMC) efforts to achieve our dual mandate of maximum employment and stable prices.

Recent data on economic activity suggest that after a slight contraction in gross domestic product in the first half of this year, the economy is posed for modest but below-trend growth in the latter half. Meanwhile, the labor market remains strong and very tight. Employers added 315,000 jobs in August, well above the rate needed to keep up with population growth. While the unemployment rate rose, that was largely due to nearly 800,000 people who joined the civilian labor force, many of them drawn in by ample job openings and fast wage growth. At 3.7 percent, the unemployment rate was below the median projection for its long run rate among FOMC participants. Furthermore, initial unemployment claims are very low and stable. We will get another jobs report tomorrow. Expectations are for job gains of around 260,000, which would be lower than recent months but very healthy relative to past experience. A jobs number in this range along with the job openings rate reported on Tuesday would show that the labor market is slowing a bit but is still quite tight. As a result, I don't expect tomorrow's jobs report to alter my view that we should be focused 100 percent on reducing inflation.

Since I last spoke about the economic outlook on September 9, we have received two important pieces of data on inflation for August, consumer price index (CPI) and the price index for personal consumption expenditures (PCE). [2] Both reports confirmed that overall inflation remained much too high in August. Though gasoline prices fell, which was very welcome news for consumers, food prices increased notably. Core PCE inflation, which strips out the volatile categories of food and energy, moved up to 0.6 percent for the month, which implies an annualized rate of inflation of about 7 percent in core goods and services. Furthermore, core PCE inflation is not only high, but very

persistent, with monthly prints of core PCE inflation at an annualized rate averaging about 5 percent this year. These numbers indicate that inflation is far from the FOMC's goal and not likely to fall quickly.

This is not the inflation outcome I am looking for to support a slower pace of rate hikes or a lower terminal policy rate than projected in the September 2022 SEP. And, though there are additional data to come, in my view, we haven't yet made meaningful progress on inflation and until that progress is both meaningful and persistent, I support continued rate increases, along with ongoing reductions in the Fed's balance sheet, to help restrain aggregate demand. As far as achieving our dual mandate, this is a one-sided battle. We currently do not face a tradeoff between our employment objective and our inflation objective, so monetary policy can and must be used aggressively to bring down inflation.

Let me turn to the troubling persistence of inflation. In the past couple of inflation reports, housing services has been a major contributor to measured inflation. In the latest inflation reports, shelter prices rose 0.7 percent on a monthly basis. Housing has a large weight in price indexes, as households spend a sizable amount of their incomes on housing services. The combination of high monthly inflation and a large weight in measuring overall prices means that shelter inflation is a key driver of overall inflation. Moreover, shelter inflation is a particularly persistent component of inflation and why I am focused on closely watching shelter inflation in determining my outlook for U.S. inflation. Unfortunately, the message is that shelter inflation will likely remain high for several months, meaning overall core PCE inflation will continue to be persistently high.

There has been a considerable imbalance in the supply and demand for housing for some time. Housing is also sensitive to interest rates and thus quite responsive to monetary policy. So for the next few minutes, I would like to focus on how demand–supply imbalance in both owner-occupied and rental markets came about, how it is affecting prices for housing today and in future, and how housing is likely to affect the FOMC's efforts to return inflation to our 2 percent goal.

Housing demand increased strongly in the years leading up to the pandemic, sustained by relatively low interest rates, the formation of new households, and rising incomes. Demand for housing then surged during the pandemic as people spent more time at home, initially on the intensive margin-more housing square footage per household. Couples in apartments wanted more space to work from home and opted for bigger apartments or houses. Also, remote work enabled people to work from preferable locations so the demand for second homes surged. As the pandemic wore on, demand for housing also increased on the extensive margin-meaning more household formation-as roommates sharing apartments now wanted to live on their own as they continued to work from home. And adult children began moving out of their parent's homes. All of these factors led to higher rates of household formation and greater demand for housing. So, by the end of 2021, the pandemic was driving up the demand for housing on both margins.

Meanwhile, the pandemic's supply constraints caused shortages in construction materials and construction workers, limiting the supply of new housing. The

combination of soaring demand for housing and limited supply until earlier this year meant the housing market had substantial excess demand, which was reflected in substantial increases in housing costs.

But now imbalances in the owner-occupied market have started to shift. Due to the Fed's actual and anticipated tightening of monetary policy, mortgage rates have increased from less than 3 percent at the end of last year to nearly 7 percent recently. Higher borrowing costs have made it more expensive for households to buy homes, whether they are first-time buyers or trading their current home for a different one. And so, we have seen big drops in home sales over the course of this year. The monthly numbers of new and existing home sales are now back below the average levels seen in the few years before the pandemic. And the August decline in pending home sales released last week suggests that sales will fall further. Reflecting the slowdown in sales, builders have responded by pulling back on starting new single-family homes.

So far, the contraction in housing demand has been more pronounced than the changes in supply, and so inventories of homes for sale have increased. While inventories of existing homes are still low in historical terms, they have grown a lot for new homes. Based on the current pace of sales, estimates of the number of months of supply of new homes has shot up and is now nearing the peaks seen in 2008 during the previous housing cycle.

The easing in housing demand can also be seen in a slowdown in house price increases. Nationwide, prices of existing homes rose by about 20 percent over the 12 months ending in May, while they rose at an annual rate of less than 10 percent in recent months. Prices have even fallen in some areas of the country, especially those that saw the largest increases over the previous two years. And many builders are reportedly cutting their list prices and offering larger incentives.

The combination of price cuts and slowing of new single-family construction should help builders work off excess inventory, continuing to bring the market into better balance. In addition, after mortgage rates stabilize, their drag on housing demand should ebb. While this market correction could be fairly mild, I cannot dismiss the possibility of a much larger drop in demand and house prices before the market normalizes.

Despite the risk of a material correction in house prices, several factors help reduce my concern that such a correction would trigger a wave of mortgage defaults and potentially destabilize the financial system. One is that because of relatively tight mortgage underwriting in the 2010s, the credit scores of mortgage borrowers today are generally higher than they were prior to that last housing correction. Also, the experience of the last correction taught us that most borrowers only default when they experience a negative shock to their incomes in addition to being underwater on their mortgage.

Because people still need a place to live, demand for rental housing has remained quite strong. Rental vacancy rates are very low. Reflecting this fact, multifamily construction has been quite high this year, at a level not seen since the mid-1980s, when the tax treatment of investment in structures was much more favorable than it is today. But demand is still much greater than supply, so rents have continued to surge.

So what does all of this mean for inflation? The measures of inflation that receive the most attention in the United States attempt to measure the prices of goods and services consumed by households. For housing, this means measuring the price of consuming the shelter and other services provided by a home. The price of shelter is most easily measured by rents. Of course, rent cannot be observed for owner-occupied homes. For these homes, the price of shelter is estimated as the rent that owners would pay based on rents of nearby rental units. The purchase price of a home is not incorporated into these measures of inflation because it reflects the cost to invest in a real estate asset, not the price to consume the shelter that housing provides.

As I mentioned earlier, rent growth has been very high recently. The housing services component of the PCE price index rose a bit above 0.7 percent in August, which was slightly above the previous three-month average. And I expect a similar pace to continue for a while, well into next year. Why? Shelter inflation measures the rents actually paid by households. Only a fraction of households sign a new lease in a given month or renew their lease each month. So, when monthly shelter inflation is calculated, it includes a large share of homes under lease where rents did not change. As a result, changes in market conditions show up in the inflation statistics only over a period of several months. In addition, the inflation statistics use a six-month average when calculating rent growth. Asking rents and rents on new lease contracts-which do reflect contemporaneous rental market conditions-have been rising at a fast pace for more than a year. These increases have fueled shelter inflation so far this year, and they should continue to do so for at least the next six months. That said, there is a glimmer of hope in the most recent readings of asking rents, where the rate of increase has stepped down a bit. This slower pace should eventually contribute to a slowdown in shelter inflation, although that might not be seen until later next year.

So now let's consider the implications of this picture of the current and future housing market for overall inflation and monetary policy. If we assume that the recent rate of inflation in the cost of shelter continues, how much would prices of goods and other services need to moderate in order to lower overall inflation meaningfully-say, to 3 percent?

When talking about future inflation, it is most helpful to focus on measures of core inflation. So if the price index for housing services continues to increase at the recent monthly average rate of around 0.6 percent for the next several months, then other core price increases would need to moderate considerably, to a monthly average of a bit less than 0.2 percent. [3] This would be a big slowdown from inflation in August, which had core inflation of 0.6 percent, with non-housing services and core goods each increasing more than 0.5 percent.

Such a step-down in non-housing core inflation, if sustained over several months, would be a big improvement in inflation, and I think it is quite possible to get there because of the considerable tightening of monetary policy that has occurred so far and additional anticipated tightening. But this exercise shows why it is so important for the FOMC to maintain its focus on the appropriate path of monetary policy in order to moderate demand. While housing seems likely to continue contributing to high inflation in the near term, in the medium-term higher mortgage rates should slow the housing component of

inflation as housing demand cools. Meanwhile, increases in broader interest rates should help moderate demand and damp inflation in other sectors. So, across sectors, a moderation in demand should help bring inflation down toward our 2 percent target.

As we think about policy actions for the remainder of the year, one can look at the Summary of Economic Projections released by the FOMC at our meeting last month. These projections showed participants expected an additional 100 to 125 basis points of tightening by the end of the year, which means either a couple of 50 basis point hikes at our remaining two meetings, or 75 basis points in November and 50 basis points in December. Of course, the exact path for policy will depend on the data we receive between now and the end of the year.

Before the next meeting on November 1–2, there is not going to be a lot of new data to cause a big adjustment to how I see inflation, employment, and the rest of the economy holding up. We will get September payroll employment data tomorrow, and CPI and PCE inflation reports later this month. I don't think that this extent of data is likely to be sufficient to significantly alter my view of the economy, and I expect most policymakers will feel the same way. I imagine we will have a very thoughtful discussion about the pace of tightening at our next meeting.

So, as of today, I believe the stance of monetary policy is slightly restrictive, and we are starting to see some adjustment to excess demand in interest-sensitive sectors like housing. But more needs to be done to bring inflation down meaningfully and persistently. I anticipate additional rate hikes into early next year, and I will be watching the data carefully to decide the appropriate pace of tightening as we continue to move into more restrictive territory.

In considering what might happen to alter my expectations about the path of policy, I've read some speculation recently that financial stability concerns could possibly lead the FOMC to slow rate increases or halt them earlier than expected. Let me be clear that this is not something I'm considering or believe to be a very likely development.

I am a little confused about this speculation. While there has been some increased volatility and liquidity strains in financial markets lately, overall, I believe markets are operating effectively. Actions by banks and financial regulators in recent years have greatly strengthened the financial system. Banks are well capitalized. Functioning in the Treasury, equity, and commodity markets remains orderly.

One factor that is likely helping to stabilize the financial system is the existence of monetary policy tools which could serve as a backup source of liquidity in times of financial stress. For example, swap lines that the Fed maintains with other central banks have been used effectively in the past to relieve stress in the financial system, and I think the availability of these facilities tend to be a stabilizing force at other times. In addition, to help implement monetary policy, the Fed established new standing repurchase agreement (repo) facilities in July 2021, one for domestic counterparties and another for foreign and international monetary authorities. These facilities are capable of responding to strains that may put upward pressure on money market rates, but I think it is likely that their mere existence has been a stabilizing force. Along with

the improved regulatory framework, I believe we have tools in place to address any financial stability concerns and should not be looking to monetary policy for this purpose. The focus of monetary policy needs to be fighting inflation.

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

[2] See Christopher J. Waller (2022), "The Economic Outlook: Time to Let the Data Do the Talking," speech delivered at the 17th Annual Vienna Macroeconomics Workshop (2022), Vienna, Austria, September 9.

[3] This estimate is calculated for PCE price inflation, where housing services constitutes 17 percent of the PCE price indexes' measure of core inflation.