Christopher J Waller: The economic outlook and a word of caution on inflation

Speech by Mr Christopher J Waller, Member of the Board of Governors of the Federal Reserve System, at the 59th Annual Economic Forecast Luncheon, Phoenix, Arizona, 16 November 2022.

* * *

Thank you, Dean Kadan, and thank you for the opportunity to speak today about the outlook for the U.S. economy and the implications for the Federal Reserve's ongoing fight to reduce inflation.

I will begin with some comments on the overall outlook for economic growth and then try to explain how tighter monetary policy this year is intended to dampen demand and put downward pressure on inflation. One way is by influencing the labor market, so next I will give an update about labor market conditions and how I expect them to evolve. I'll then turn to the outlook for inflation, where we saw moderation in some measures in October, but to a level that remains unacceptably high. I'll finish up with how I expect monetary policy will evolve in the coming months to reduce inflation and return it to the Federal Open Market Committee's (FOMC) 2 percent goal.

Economic growth in the United States has slowed significantly in 2022, and I expect that slow growth to continue into next year. After shrinking slightly in the first half of this year, real gross domestic product rebounded in the third quarter to a 2.6 percent annual growth rate. But all indications are that this was a temporary boost, and that weak growth has returned in the last quarter of this year and will persist into 2023. Consumer and business spending has softened, amid deteriorating business sentiment in most sectors of the economy and near-record-low readings on surveys of consumer attitudes about the economy. There is no secret about why-inflation is very high, something people are reminded of every day when they see the prices of things they buy go up. On top of that, higher interest rates are raising borrowing costs for businesses and households.

At any other time, I would be pretty unhappy about slowing growth, but not now. If you believe, as I do, that supply bottlenecks in the economy have mostly abated and that elevated inflation is primarily a function of high demand, then slowing down economic growth is absolutely necessary to bring inflation down to our 2 percent target. This slowing in activity is a sign that actions taken by the Federal Reserve this year to reduce inflation are working. Let me take a few minutes to explain how.

The Federal Reserve tightens monetary policy to reduce inflation primarily by raising short-term interest rates, which has the effect of boosting interest rates throughout the economy. Higher borrowing costs curtail spending and investment by households and businesses. Since the FOMC pivoted in late 2021 in response to upwardly revised labor data and higher than anticipated inflation data, rates for 30-year fixed-rate home mortgages are up from around 3 percent to 7 percent today. Rates for triple-B corporate

bonds have roughly doubled in 2022, and rates on higher yield debt have increased even more. As a result, there is a slowdown in the volume of financing in most markets, with some effect on various prices.

The sector that has seen the most significant slowing is housing. New home construction and new and existing home sales, which grew strongly before and during the pandemic, have all fallen in 2022. As purchases of homes fall, so does demand for goods that typically accompany purchases-new carpeting, new furniture, new lawn mowers and so on. So slowing home sales will decrease demand for goods that complement the purchase of a new home and that will put downward pressure on the prices of those goods.

Furthermore, housing prices that were increasing at an annual rate of 20 percent as late as May slowed to about a 2 percent rate in October, according to data from Zillow. Housing may be the first but won't be the last sector of the economy where higher interest rates will have the effect of dampening demand and will ultimately help moderate price increases. Our goal is to rein in demand, bringing demand and supply into better balance, which will help reduce upward pressure on inflation.

One sector where improving this balance will be crucial is the labor market. Even as economic output has slowed, the labor market remains very tight. While there was roughly one job vacancy for every job seeker in what was a strong labor market before the pandemic, now there are almost two jobs for every person looking for work. Wages have been rising more quickly than they have in decades, much faster than productivity growth plus 2 percentage points that I think of as consistent with the FOMC's 2 percent inflation objective. But I do see tentative signs of some cooling in the labor market, which is vital to keep rising labor costs from putting upward pressure on inflation.

The employment report published November 4 showed that payrolls grew by 261,000 in October. This increase, while large, was a step down from the pace earlier this year, when payrolls grew an average of 539,000 per month in the first quarter, 340,000 per month in the second quarter and 381,000 per month in the third quarter. At the same time, we also saw the unemployment rate tick up to 3.7 percent, though still close to its more than 50-year low.

Other labor market data are also showing evidence of slight cooling. Various surveys of job vacancies are down from their peaks reached in March but are still historically very high. There have been some tech layoffs, which had been one of the fastest growing parts of the economy, but so far not in other sectors. And quits-which are mainly workers switching jobs for higher pay-are also down from their peak late last year.

These tentative signs of cooling are mixed with many stories of continued labor market tightness. Business contacts tell me of empty offices and idle production capacity because employers cannot find workers. Retailers who hire seasonal workers say they will try to hold onto these employees after the holidays to fill future vacancies from attrition. And that is even with some expectation of slower sales growth in the next couple quarters.

That said, we are starting to see some tentative signs of a moderation in wage growth. The 12-month increase in average hourly earnings continued to slow in October and the

3-month change continued to run lower than the 12-month rate, a promising signal of ongoing moderation. Wage growth has been a contributing factor to inflation, especially in the service sector, so it is important to get the labor market into better balance to bring future wage growth down to a more sustainable level that will assist in moving overall inflation lower.

Let me now turn to the outlook for inflation. Last week's consumer price index (CPI) report was a very welcome moderation in the pace of increasing prices. Headline inflation rose 0.4 percent from September to October, the same pace as the month before, and was up 7.7 percent over the previous 12 months, down from 8.2 percent in September and 9.1 percent as recently as June. Core CPI, which excludes food and energy prices, increased 0.3 percent in October from September, a marked step-down from the 0.6 percent readings in the previous two months and the average of 0.5 percent over the first nine months of 2022. On a twelve-month change, core inflation came in at about 6.3 percent, down from 6.6 percent the previous month. The step down in October was widespread, involving both a deceleration in services prices and the first decline in core goods prices since March.

Though welcome news, we must be cautious about reading too much into one inflation report. I don't know how sustained this deceleration in consumer prices will be. But, as a snapshot, the 0.3 percent increase in core CPI inflation in October from September, (actually 0.27 percent rounded up) works out to an annualized rate of about 3.25 percent. I focus on core over headline inflation because I believe it is a better indication of future inflation. This increase is much improved from the past several months but still very far from our 2 percent target. Looking at the categories that make up the CPI, we see that about half still have inflation over 3 percent. And, if you weight the categories by their contributions to the CPI, over 70 percent of the CPI basket continues to see inflation above 3 percent.

I cannot emphasize enough that one report does not make a trend. It is way too early to conclude that inflation is headed sustainably down. In 2021, monthly core CPI inflation fell during the summer-it fell from 0.9 percent in April 2021 to 0.2 percent in August 2021 before accelerating back to 0.6 percent and 0.5 percent in October and November of that year. More recently, monthly core CPI inflation fell from 0.7 percent in June 2022 to 0.3 percent in July, only to rebound to 0.6 percent the next two months. We've seen this movie before, so it is too early to know if it will have a different ending this time.

Inflation remains too high relative to the FOMC's target, and I thought it would be helpful to offer some detail of what I will be looking at to see continuing improvement in the inflation outlook. One area is goods inflation, where there was a widespread deceleration across durables and nondurables in October. With drops in core import prices and processed materials excluding food and energy over the past few months, I'm looking for continued downward pressure on core goods prices going forward.

Housing, which is a large share of expenses for households, is another sector I will be watching closely in the months ahead as an indicator of the direction of overall inflation. As I discussed in a recent speech, escalating rents have played a large role in driving up inflation this year, and because turnover of leases occurs only periodically, I expect

measures of rents and the equivalent for homeowners will continue to increase significantly for at least several more months.[1] But I will be watching for signs of moderation.

Finally, I will be looking for a slowing in price increases in non-housing services, which have been quite robust in recent months and running at about twice their pre-pandemic level. As I said a moment ago, the inflation outlook for this sector will partly depend on the growth of wages. I will be looking closely for continued slowing in wage growth back to a more sustainable rate. Given that medium- and longer-term inflation expectations remain stable, an indication that investors and consumers retain confidence in the Fed's commitment and ability to achieve its inflation goal, I believe we can expect wage growth to slow.

So, the recent CPI report is a positive development, but I'll need to see further progress. Like many others, I hope this report is the beginning of a meaningful and persistent decline in inflation. But policymakers cannot act based on hope. I will not be head-faked by one report and will continue to watch the data between now and the December FOMC meeting before deciding on the next step for policy.

Now let me turn to the implications of this outlook for monetary policy. Since my last outlook speech in October, we have gotten some additional data that reinforces my sense that the labor market may be loosening, and that inflation pressure may be easing. But as I said a moment ago, this hasn't been sufficient to significantly alter my outlook or my view of appropriate monetary policy. Achieving the FOMC's dual mandate of maximum employment and price stability is still a one-sided campaign. With the labor market still strong and extremely tight, the Committee does not face a trade-off between employment and inflation. Inflation has been running significantly above our objective for more than a year, so monetary policy can and must be used aggressively to reduce it.

To pursue that goal, the Federal Reserve has been aggressive. In nine months, we have raised the target range for the federal funds rate from near zero to 3-3/4 to 4 percent, a historically rapid pace of increases. In addition to that, the Fed is continuing to reduce its balance sheet each month by allowing the runoff of maturing securities, which supports the tightening of financial conditions.

Despite these actions, I believe that policy is barely in restrictive territory today, so more interest rate hikes are needed to get inflation down. In the FOMC's November statement, the Committee added two new sentences on its view of the future path of policy, elaborating on our "reaction function," which is the basis for those future decisions.[2] Let me explain how I view this new language.

The first new sentence is about "where we are going," which is the level of interest rates at which it will be appropriate to stop hiking. If asked what that sentence means, I would say that, with the current strength and outlook for the labor market, my decision for the "terminal rate" for policy will focus on progress toward our inflation goal. So, assuming the labor market and financial stability remain in check, the endpoint of the tightening path is highly dependent on the evolution of the inflation data.

The second new sentence in the statement is about "how" we will get to the terminal rate-that is, the pace of rate increases to arrive at that destination. The FOMC language notes the pace will depend on several factors. The first is "the cumulative tightening of monetary policy." I have noted how significant and aggressive this tightening has been. We have gone from a low interest rate economy to one with fairly significant interest rates (although in historical terms, rates are still not that high for a tightening cycle). There is a tendency for Fed watchers to view each meeting's policy decision as solely determined by what has happened in the preceding six weeks. For me, this new sentence is an important reminder that each decision we make in the coming months will be heavily influenced by the significant, cumulative effect of the decisions we made earlier this year.

Another factor listed by the Committee was "the lags with which monetary policy affects economic activity and inflation." In my view, the Committee will reach the terminal rate well before inflation reaches 2 percent because of the abundance of evidence that it takes months, and perhaps even longer, for the full effects of a rate increase to work through the economy.

Considering the cumulative effect of tightening and the likely lags for policy doesn't mean these factors are more important than new information about the economy. On the contrary, new data, especially on inflation, are much more important now, well into the tightening cycle, than when the only direction for the federal funds rate to go was up- and up by a lot.

I am going to take a considerable risk here and employ an airplane simile to illustrate how I think of our past policy actions and where we are going. When an airplane is taking off, the pilot fires the engines as much as possible to get off the ground. The goal is to get to cruising altitude quickly, so the initial ascent is steep. But as the plane gets closer to cruising altitude, the pilot slows the rate of ascent, while continuing to climb. The final cruising altitude will depend on many factors, most notably details about the weather. Turbulence may force you to a higher or lower altitude, but you adjust as you go to have a smooth ride.

This is similar to our policy actions this year. When the Fed was faced with rapidly escalating inflation and a strong labor market, it lifted rates aggressively off the effective lower bound including several 75-basis-point steps. But as the policy rate gets higher, the stronger is the case for slowing the rate of ascent while continuing to climb. This would correspond to slowing to 50-basis-point hikes. At a certain point, policy will reach an optimal cruising altitude, but we don't know exactly what that level will be because it depends on the data. Maybe new data will point to a shallower climb and a lower cruising altitude, which would suggest stepping down to 25-basis point hikes. Or maybe it could be necessary to continue climbing a little longer to a higher final attitude by implementing a sequence of 50 basis point hikes. In the end, the higher we raise the policy rate, the more pressing it is to think about the terminal rate and how policy should be adjusted to get there, but that will depend on the incoming data.

Looking toward the FOMC's December meeting, the data of the past few weeks have made me more comfortable considering stepping down to a 50-basis-point hike. But I won't be making a judgement about that until I see more data, including the next PCE inflation report and the next jobs report.

If the FOMC were to step down to a 50-basis-point increase, it is important to remember that this would still be a very significant tightening action-in other words, just pulling back on the rate of ascent a little bit. At this angle of ascent, with policy already in restrictive territory, the federal funds rate can still be increased quite rapidly with several 50-basis-point increases, a pretty aggressive path for policy.

So, although I believe we are seeing some progress in the economy to dampen demand that will help moderate inflation, we have not yet made enough progress. As I have said recently, I expect that getting inflation to fall meaningfully and persistently toward our 2 percent target will require increases in the federal funds rate into next year. We still have a ways to go. Until then, I support continued rate increases and ongoing reductions in the Fed's balance sheet to restrain aggregate demand. When we reach our terminal rate, how long we stay at that level will largely be driven by our progress in bringing down inflation.

---

[1] See Christopher J. Waller (2022), "The Economic Outlook with a Look at the Housing Market," speech delivered at the Mark C. Berger Workshop Series, University of Kentucky, Lexington, Kentucky, October 6.

[2] See Board of Governors of the Federal Reserve System (2022), " Federal Reserve Issues FOMC Statement (PDF)," press release, November 2.