Christopher J Waller: A case for cautious optimism

Speech by Mr Christopher J Waller, Member of the Board of Governors of the Federal Reserve System, at the C Peter McColough Series on International Economics, Council on Foreign Relations, New York City, 20 January 2023.

* * *

Thank you, Ben, and thank you to the Council on Foreign Relations (CFR) for inviting me to be part of this discussion. It has been close to a year since the Federal Open Market Committee (FOMC) began tightening monetary policy. We began raising interest rates in March 2022 and shrinking our securities holdings in June in order to bring inflation down to our 2 percent target.[1] Today I thought I would spend a few minutes taking stock of the year behind us and talking about what's next.

A year ago, inflation was elevated and rapidly accelerating, and the Fed moved to quickly and dramatically tighten monetary policy. At the end of December, the federal funds rate target was set in a range of 4.25 percent to 4.5 percent, the highest in 15 years. Economic activity, meanwhile, has been holding up well. After shrinking slightly in the first half of 2022, real gross domestic product grew at an annual rate of 3.2 percent in the third quarter, and monthly data suggest it grew around 2 percent in the fourth quarter. I expect such slowing to continue in this quarter, which is both expected and desirable in our ongoing fight to lower inflation.

The FOMC's goal in raising interest rates is to dampen demand and economic activity to support further reductions in inflation. And there is ample evidence that this is exactly what is going on in the business sector. On the manufacturing side, industrial production declined for the second month in December. And the Institute for Supply Management's (ISM) forward-looking indicators of orders and customers' inventory suggested that further weakening is in train. Meanwhile, the ISM survey for nonmanufacturing businesses, which had reported expansion since April of last year, indicated a slight contraction in December. This slowdown in services activity was widespread, affecting 11 of 17 sectors in the survey, with significant slowdowns in construction and real estate, two industries heavily affected by higher interest rates. This slowing in business activity is consistent with the FOMC's goal of damping demand and reducing production so that it is in better alignment with the productive capacity of the economy. The goal is not, I would emphasize, to halt economic activity, and so we will be watching these sectors closely to see how this moderation continues.

Growth in consumer spending has also begun to slow. While that growth was surprisingly strong through most of the second half of 2022, nominal personal consumption expenditures growth slowed to 0.1 percent in November, and retail sales fell 1 percent. We don't have spending data on goods and services for December, but retail sales fell another 1.1 percent. While the latest readings of consumer sentiment from the University of Michigan moved up some from historic lows, I continue to expect that last year's decline in real incomes, along with higher borrowing costs, will moderate consumer spending this year and help return inflation more promptly to the FOMC's 2 percent target. Job one is maintaining the progress we are making in lowering inflation, and moderation in consumer spending will support that progress.

The slowing in output growth has occurred alongside the continuing strength of the labor market. Total nonfarm employment grew 223,000 in December, close to the average of 237,000 a month for the fourth quarter. That is down quite a bit from the monthly increase of 539,000 in the first quarter of 2022 but still a solid growth rate, far above the number of new jobs needed to keep pace with population growth. Employment grew robustly in the leisure and health-care sectors, where labor shortages are reportedly severe.

While the labor market is strong, it is also tight. The unemployment rate was 3.5 percent in December, matching the low reached before the pandemic, and the lowest in 53 years. But there are signs that demand for labor is moderating. Job openings reported in the November Job Openings and Labor Turnover Survey and job postings from December's Indeed data are down from their recent peaks. Temporary-help employment, which has sometimes been a leading indicator for overall employment, has declined in recent months, but that decrease may be due at least in part to employers opting to hire full-time workers in place of temps to help keep jobs filled.

A robust labor market, despite modest economic growth, is a plus for workers and allows the Fed to focus on lowering inflation. It shows that jobs and income can hold up to the effects of higher interest rates, helping the FOMC continue its efforts to lower inflation to our 2 percent goal by further tightening monetary policy.

A potential downside of a tight labor market is if labor costs, which heavily influence inflation, grow so fast that they slow progress toward the FOMC's 2 percent objective. Wages and other measures of compensation accelerated as inflation surged in the second half of 2021 and wage growth remained high in 2022. But as overall inflation has begun to moderate in recent months, so have some measures of growth in wages and other compensation. For example, the 12-month increase in average hourly earnings hit a recent peak of 5.6 percent in March (which is when the Fed began raising interest rates) and has been falling gradually and fairly steadily since then, reaching an annual rate of 4.6 percent in December. The 3-month annualized change in average hourly earnings-4.1 percent in December-is running below the 12-month rate and is thus a signal of ongoing moderation. These are encouraging signs, but we need to see continued improvement across various measures of labor costs, because additional moderation is needed to bring inflation down to our 2 percent goal and because a significant escalation in wage growth could drive up longer-range inflation expectations. Those longer-range expectations have been fairly stable through this period of very high inflation, and we want it to stay that way because escalating expectations could drive inflation higher.

Let me turn now to the outlook for inflation. Last week's report on the Consumer Price Index (CPI) showed that inflation continued to moderate in December, which was very welcome news. First, I am going to spell out why this was such good news, and then I am going to turn around and explain why I am still cautious about the inflation outlook and supportive of continued monetary policy tightening.

Overall headline inflation fell a tenth of a percent month over month in December, the first monthly drop since May 2020. The 12-month change in inflation peaked at 9 percent in June, and has fallen every month since, to 6.5 percent in December.

A big factor in the monthly decline in headline inflation in December was a significant drop in energy prices, which more than offset an increase in food prices. The FOMC targets headline inflation because food and energy are considerable expenses for most people, but they are more volatile than other components of the index, and by factoring them out, "core" inflation can provide a picture of where inflation is headed. Here also, we are seeing some progress. Yearly core inflation was down in December to 5.7 percent, from 6 percent in November and a peak of 6.6 percent in September. Over the past three months, core CPI inflation has run at an annualized rate of 3.1 percent, a noticeable drop from earlier in 2022.

Another encouraging sign is that higher inflation was less concentrated-the share of categories of different goods and services with inflation over 3 percent has declined in the past several months, from almost three fourths in early 2022 to less than one half in December. That's good news because it indicates that broader inflationary pressure across the economy is easing.

Now, here's why I am cautious about these latest results and why I am not ready yet to substantially alter my outlook for inflation. Month-over-month core CPI inflation actually ticked up in December from November and is pretty much where it was in October and where it was in March when we began raising interest rates. Although inflation measured over 12 months has been falling, December's reading is still close to where it was a year ago. Core inflation was 6 percent year over year (YOY) in January 2022 and was 5.7 percent YOY last month. Thus, it basically moved sideways all year. So, while it is possible to take a month or three months of data and paint a rosy picture, I caution against doing so. The shorter the trend, the larger the grain of salt when swallowing a story about the future. Back in 2021, we saw three consecutive months of relatively low readings of core inflation before it jumped back up. We do not want to be head-faked. I will be looking for the recent improvement in headline and core inflation to continue.

Wages, as I indicated earlier, are another stream of data that I will be watching for evidence of continued progress to help ease overall inflation. Though recent hourly earnings data are a positive development, I need to see more evidence of wage moderation to sustainable levels. The Federal Reserve Bank of Atlanta's Wage Growth Tracker has been running higher lately and has moderated less. The employment cost index for December won't be out until the end of this month. Over time, we need to see wages grow more in line with productivity growth plus 2 percentage points, consistent with the FOMC's inflation target.

Those are reasons that I am cautious about the recent good news, but it is good news. We have made progress. Six months ago, when inflation was escalating and economic output had flattened, I argued that a soft landing was still possible-that it was quite plausible to make progress on inflation without seriously damaging the labor market. So far, we have managed to do so, and I remain optimistic that this progress can continue.

I believe that monetary policy should continue to tighten, but using a comparison I employed in a speech a couple months ago, the view from the cockpit is very different at 30,000 feet than it is close to the ground. When the FOMC began raising the federal funds rate last spring from near zero, it made sense to move quickly. But after front-loading monetary policy tightening, with many unprecedented 75 basis point hikes in the federal funds rate target, by early December I believed the policy stance was slightly restrictive, and I supported a decision by the Committee to hike by a still considerable 50 basis points.[2] To return to the airplane image, after climbing steeply and using monetary policy to significantly raise interest rates throughout the economy, it was apparent to me that it was time to slow, but not halt, the rate of ascent.

And in keeping with this logic and based on the data in hand at this moment, there appears to be little turbulence ahead, so I currently favor a 25-basis point increase at the FOMC's next meeting at the end of this month. Beyond that, we still have a considerable way to go toward our 2 percent inflation goal, and I expect to support continued tightening of monetary policy.

I think that is probably enough from me, so that there will be more time for you to ask questions. Thank you again to the CFR for the opportunity to be here today.

---

[1] The FOMC communicated its intentions for some time before March, and this guidance effectively began monetary policy tightening before raising rates and beginning the tapering of asset purchases that month. The views expressed here are my own and to not necessarily reflect those of my colleagues on the FOMC.

[2] Each 75 basis point hike was the largest rate single increase since the FOMC began announcing its rate decisions in 1994. The Committee raised rates at individual meetings by larger amounts in the early 1980s, when it raised the federal funds rate to near 20 percent.