

Christopher J Waller: February's hot data releases

Speech (via webcast) by Mr Christopher J Waller, Member of the Board of Governors of the Federal Reserve System, at the Mid-Size Bank Coalition of America, Los Angeles, California, 2 March 2023.

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Thank you, Raj, and thank you to the coalition for the invitation to be with you-virtually, at least. I don't want to take up too much of the time for our discussion but let me frame a few of the issues around inflation and the economic outlook.¹

Last month we received a barrage of data that has challenged my view in January that the Federal Open Market Committee (FOMC) was making significant progress in moderating economic activity and reducing inflation. I'm not the only one whose outlook has shifted. Since the end of January, financial market participants have revised their outlooks in a way that has led them to mark up their expectations for the federal funds rate at the end of 2023 by about a half percentage point.

The shift in the data started with a bang on February 1, with a big increase in the number of job openings in December that reversed the gradual easing over several months in what is a key indicator of tightness in the labor market. Part of the FOMC's plan to lower inflation is reducing this excess tightness, which has been driving elevated wage growth and contributing to high inflation. The Job Openings and Labor Turnover Survey data can be noisy so, at times, there is a tendency to downplay large moves. But then on February 3, the job report for January showed a stunning 517,000 increase in employment and the unemployment rate moved down to a level not seen in over 50 years.² These data indicated that, instead of loosening, the labor market was tightening.³ A little over a week later, on Valentine's Day, instead of a box of chocolates, we got the consumer price index (CPI) inflation report for January and revisions to 2022. By this measure, not only had inflation stopped declining in January, it also slowed a lot less in the second half of last year than previously reported.⁴ Later that week, data on producer prices and last week's report on personal consumption expenditures (PCE) prices reinforced these two points. Retail sales for January also came in much stronger than expected, suggesting the economy was slowing less than it had appeared just a month earlier, a picture that was confirmed by data on personal spending, which represents almost 70 percent of gross domestic product. Continuing progress on inflation depends on lowering demand and moderating economic activity, and the retail sales and spending data suggest that progress on reducing aggregate demand may have stalled.

Whether or not subsequent data confirm the setback in progress last month, the FOMC will do what is needed to reduce inflation to the Committee's 2 percent objective over time. It is possible there may be some bumps on that path, but I assure you, the FOMC's dual mandate objectives will be achieved. Inflation has been elevated for nearly two years due to an excess of aggregate demand relative to supply. Even though the fiscal stimulus and goods supply constraints that contributed to that imbalance have mostly unwound and the FOMC has rapidly raised the target range for the federal funds rate, the labor market remains very tight and aggregate demand has proved resilient to

considerable increases in interest rates. One implication of the strong labor market is that the FOMC's maximum employment goal has been achieved and monetary policy can be utterly focused on fighting inflation. Any fear that we might face two-sided risk in achieving our dual mandate was blown away by the January employment numbers. But an excessively tight labor market complicates the path toward achieving price stability, because wages are growing faster than they have in decades, at a pace that may contribute to keeping inflation elevated. We see this excess pressure in the fast growth of services prices, where labor costs are a higher share of overall input costs and shortages of workers are reportedly most acute.

Although inflation has been coming down since the middle of last year, the recent data indicate that we haven't made as much progress as we thought. That assessment goes for both overall inflation, and "core" inflation, which strips out volatile energy and food prices and is a good guide to future price increases. And this holds for both CPI and PCE measures of inflation. Core CPI inflation over the last three months of 2022 was revised up from 3.1 percent (at an annual rate) to now be 4.3 percent. Similarly, the 2022 fourth quarter PCE inflation data was revised from 2.9 percent to 3.6 percent. And the three-month rates increased in January; even measures that trim out the largest and smallest price changes saw increases. These data underscore the view, as laid out in the FOMC's December Summary of Economic Projections, that the fight to bring inflation down to our 2 percent target will be slower and longer than many had expected just a month or two ago.

I don't want to brush aside the fact that we have made progress in reducing inflation, and there are indications that further improvement is coming. The three-month inflation rate is running below the 12-month rate, which highlights the progress. And there are reasons to be optimistic about continued improvement, including a sharp deceleration in rent increases since the middle of last year, which will start to get captured in inflation statistics only in the coming months.

But recent data suggest that consumer spending isn't slowing that much, that the labor market continues to run unsustainably hot, and that inflation is not coming down as fast as I had thought. It could be that progress has stalled, or it is possible that the numbers released last month were a blip, perhaps associated with unusually favorable weather, and that forthcoming data will show that economic activity and inflation resumed their decline.

Fortunately, we will get the next employment report and CPI release ahead of the March 21–22 FOMC meeting, information that will affect my assessment of the appropriate next step for monetary policy. If job creation drops back down to a level consistent with the downward trajectory seen late last year and CPI inflation pulls back significantly from the January numbers and resumes its downward path, then I would endorse raising the target range for the federal funds rate a couple more times, to a projected terminal rate between 5.1 and 5.4 percent.⁵ On the other hand, if those data reports continue to come in too hot, the policy target range will have to be raised this year even more to ensure that we do not lose the momentum that was in place before the data for January were released.

I would be very pleased if the data we receive on inflation and the labor market this month show signs of moderation, which would suggest that the February data releases

were just a bump in the road and that progress is continuing. But wishful thinking is not a substitute for hard evidence, in the form of economic data. After seeing promising signs of progress, we cannot risk a revival of inflation. Policymakers must remain data dependent, so my view will depend on what the data say.

¹ These remarks represent my own views, which do not necessarily represent those of the Federal Reserve Board or the Federal Open Market Committee.

² Some have argued that the large change in payroll employment should be discounted because of unusually warm weather; however, estimates of weather-adjusted employment are also quite large. See Federal Reserve Bank of San Francisco (2023), "[Weather-Adjusted Employment Change](#)," webpage.

³ Of course, more people finding jobs is good. But in the context of ongoing labor market tightness, this above trend number can complicate efforts to move the economy toward price stability, on which my remarks go into more detail.

⁴ Each year, with the release of the January CPI, the Bureau of Labor Statistics recalculates seasonal adjustment factors. This adjustment resulted in noticeable revisions to 2022 seasonally adjusted CPI prices.

⁵ This estimate of the terminal rate would align with the central tendency of FOMC participants' projections of the federal funds rate at the end of 2023.