

Christopher J Waller: Something's got to give

Speech by Mr Christopher J Waller, Member of the Board of Governors of the Federal Reserve System, at the Distinguished Speaker Seminar, European Economics and Financial Center, London, United Kingdom, 18 October 2023.

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Thank you, Professor Scobie. Thank you to the European Economics and Financial Centre for inviting me to speak and for the honor of referring to me as a "distinguished speaker." I have noticed that people started calling me "distinguished" only after my hair turned white. I suspect that "distinguished" is a polite way of saying you are old.

My subject today is one I trust is of interest in this center of global finance—namely, the outlook for the U.S. economy and the implications for monetary policy.¹ It has been one year and seven months since the Federal Reserve began raising interest rates to rein in inflation, and there has been considerable progress. But uncertainties remain, both about the forces that will shape the economic outlook in the coming months and about whether monetary policy has reached a level that is sufficiently restrictive to support continued progress toward the Federal Open Market Committee's (FOMC) target of 2 percent inflation. Let me share my thinking about what recent economic data can, and in some cases, cannot tell us about the outlook and the appropriate setting for monetary policy.

The data in the past few months has been overwhelmingly positive for both of the FOMC's goals of maximum employment and stable prices. Economic activity and the labor market have been strong, with what looks like growth well above trend and unemployment near a 50-year low. Meanwhile, there has been continued, gradual progress in lowering inflation, and moderation in wage growth. This is great news, and while I tend to be an optimist, things are looking a little too good to be true, so it makes me think that something's gotta give. Either growth moderates, fostering conditions that support continued progress toward our 2 percent inflation objective, or growth doesn't, possibly undermining that progress. But which is going to give—the real side of the economy or the nominal side?

I find myself thinking about two possible scenarios for the economy in the coming months. In the first, the real side of the economy slows. This is the scenario broadly reflected in the September Summary of Economic Projections (SEP) by FOMC participants, where an easing in demand helps bring the economy into better balance with supply and allows inflation to move closer to our 2 percent objective. In this scenario, I believe we can hold the policy rate steady and let the economy evolve in the desired manner.

But I also can't avoid thinking about the second scenario, where demand and economic activity continue at their recent pace, possibly putting persistent upward pressure on inflation and stalling or even reversing progress toward 2 percent. In such a scenario, failing to take action in a timely way carries the considerable risk of undermining what

have been fairly stable inflation expectations and possibly unwinding the work that we have done to date. Thus, more action would be needed on the policy rate to ensure that inflation moves back to target and expectations remain anchored.

Before getting into the economic data, let me address the increase in medium- and longer-term interest rates that has occurred since July. The 10-year Treasury yield is up about 90 basis points, while shorter-term maturities increased only a quarter of this amount and primarily early in the period. There are several factors that have been mentioned to explain this movement, including stronger-than-expected incoming data on third quarter economic activity, an increased focus on U.S. deficits and the associated increase in Treasury issuance, as well as geopolitical events and a flight to safety. Whatever the causes, I will be watching how these interest rates evolve in coming months to evaluate their impact on financial conditions and economic activity.

Let's now dig into the recent economic data, starting with those on economic activity that help us get a handle on the strength of demand. Real gross domestic product (GDP) grew at about a 2 percent annual rate in the latter part of 2022 and the first half of 2023. Recent data suggest that this pace stepped up in the third quarter. The latest consensus estimate from the Blue Chip survey of business forecasters was that third-quarter real GDP grew 3.5 percent, and the Atlanta Fed's GDPNow model is coming in even higher. We'll get a first look at the third quarter GDP number next week, but it seems clear that economic activity was substantially higher for July through September than earlier in the year.

The question is whether that acceleration of real activity will be sustained. Sometimes an uptick in activity is followed by some payback, or slowdown. For example, if firms pull construction forward because of good weather, then current structures investment will be high now but lower in the next period. Thus, we want to be careful and not pay too much attention to the specific month activity took place but instead average growth over a couple of quarters to get a clearer picture of the underlying strength of the economy.

To see this point more clearly, recall that at the start of this year, personal consumption expenditures increased dramatically in the first quarter but subsequently grew less rapidly in Q2 of 2023. A similar dynamic may be playing out now. On the other hand, if the third quarter data represents the beginning of persistently stronger demand, then we can expect that strength to show up in the fourth-quarter data, including by putting upward pressure on prices, which could have ramifications for upcoming decisions on monetary policy.

In thinking about these two possibilities, let me tell you how I view two key components of GDP growth this year.

Consumer spending, which represents nearly 70 percent of GDP, has been quite strong thus far in 2023. While household spending has been volatile, smoothing it out over the past several quarters indicates underlying momentum. Yesterday's September retail sales data indicated continued strong spending.

The solid spending in the face of tightened monetary policy suggests consumption is likely supported by households' strong balance sheets as well as confidence in future

labor income. I will be watching the spending data carefully, including those that hint at a slowdown. Though hard to measure, it seems that households are drawing down their liquid assets. Some other data supporting a slowing include more use of credit cards this year and a return of delinquency rates for consumer loans, which plunged over the course of the pandemic, to essentially their pre-pandemic levels.² Also, as I mentioned earlier, financial conditions have tightened considerably since July. Of course, I have been waiting a while for tightening financial conditions to cause a significant slowing of spending, and I have been consistently surprised at the resilience of consumer spending. So I will be patient in waiting for the data to document how spending evolves.

Another component of GDP that I'll be watching is investment in non-residential structures. Manufacturing investment boosted real GDP growth in the first half of the year, partly driven by a surge in the construction of semiconductor and electric battery factories that began before new government subsidies were enacted and driven higher by that legislation. Recent data suggests this spending is leveling off at a new, higher level: Construction spending growth has flattened out in recent months, and so have new project starts. In addition, the considerably higher interest rates over the past three months can dampen this growth. Only time will tell whether these factors slow investment activity or whether the subsidy programs and the enthusiasm for onshore chip and battery production continue to encourage higher investment spending.

Let me turn now to the labor market. Since the FOMC's September meeting, the labor market data indicate continued tight conditions. The economy created 336,000 jobs in September, a robust figure that was much higher than forecasters expected. While the previous two job reports had signaled softer job growth, revisions to those reports added another 100,000 jobs. While down from the elevated levels seen in the first part of last year, the latest three-month average for new jobs of 266,000 is not that much different from the three-month average at the end of 2022 of 284,000. The inference is that job growth is still exceptionally strong and hasn't slowed much this year.

Other data, however, are showing some continued loosening of conditions in the labor market. For example, looking through some monthly volatility, the number of job openings for every person counted as looking for a job was 1.2 in 2019 and shot up to a peak of 2 in March 2022. As we tightened policy and put downward pressure on labor demand, this ratio fell to 1.8 at this time last year and is currently 1.5. In addition, labor force participation has moved up notably this year, particularly among prime-age workers. Looking across various measures of labor compensation, the rate of wage growth has also moderated, despite an unemployment rate that is near a 50-year low. These metrics are not yet at their pre-pandemic levels but are moving closer to levels that would be consistent with 2 percent inflation.

In sum, although the labor market is showing signs of loosening by various metrics, it is still unusually tight. While I anticipate that it will continue to loosen, I will be watching closely to see that this remains true.

Now let's talk about inflation. As reported a week ago, headline inflation based on the consumer price index (CPI) was 3.7 percent in the 12 months through September, down significantly from 8.2 percent the year before. Core inflation, excluding energy and food prices, was 4.1 percent, down from 6.7 percent last September. We will get an update on personal consumption expenditures (PCE) inflation next week, but based on

data we received through August, the 12-month percent change in PCE inflation was 3.5 percent and core PCE inflation was 3.9 percent.

Focusing on the annualized three-month change in inflation gives a better, albeit noisy, indicator of inflation dynamics. With this measure, core CPI was 3.1 percent based on data from July through September. Core PCE, increased 2 percent based on June through August. Across the categories that make up these price indexes, one finds that more than half of them had annualized monthly price increases of less than 3 percent.

Clearly, this is progress. And there are some factors that would be expected to put downward pressure on inflation in the coming months. Monetary policy is restrictive. Households are spending the excess saving accumulated during the pandemic and have growing levels of debt, which are likely to moderate spending growth. The increase in medium and longer-term interest rates over the past several months should weigh on both household and business spending.

But, while core PCE inflation over the last three months has declined to our 2 percent target, there are a couple of reasons to be concerned that this progress might not continue. First, in the latest CPI report, despite expectations of continued deceleration, housing services prices jumped from a monthly change of 0.3 percent to 0.6 percent. I have been concerned since May about a resurgence of housing services inflation and this number heightens my concern that housing services inflation has not slowed, and may not slow, to the rate needed to sustain a return to our 2 percent target. Similarly, supercore inflation, which is core services excluding housing, has continued at a robust monthly rate of about 0.5 percent the past two months. Again, this reading is not at a level needed to make progress toward our goal and we need to watch and see if these numbers indicate that inflation is reaccelerating.

The second reason to be concerned is that, while there is some basis for expecting that inflation will continue to fall, let me remind you, as I have done repeatedly, that we have seen a string of good inflation reports evaporate multiple times in the recent past. So I will be watching the next several reports for clearer indications that inflation is on a trajectory to 2 percent.

What does that mean for monetary policy? I will be looking carefully at the data to see whether the real side of the economy begins to cool off or whether prices, the nominal side of the economy, heat up. As of today, it is too soon to tell. Consequently, I believe we can wait, watch and see how the economy evolves before making definitive moves on the path of the policy rate. Should the real side of the economy soften, we will have more room to wait on any further rate hikes and let the recent run-up on longer-term rates do some of our work. But if the real economy continues showing underlying strength and inflation appears to stabilize or reaccelerate, more policy tightening is likely needed despite the recent run up in longer term rates.

So I will be watching to see if core inflation comes in higher than expected, perhaps sustained by continued strength in spending and investment or, if demand and the real economy slow, moderating core inflation. My views on the appropriate path for policy will be based on a careful assessment of incoming data and financial market developments and a judgement about whether we are continuing on a path of sustained progress toward 2 percent inflation.

Thank you. I am happy to take some questions.

¹ The views expressed here are my own and not necessarily those of my colleagues on the Federal Open Market Committee.

² This fact holds for both auto and credit card delinquencies across all levels of the income distribution.