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The Economic Outlook: Time to Let the Data Do the Talking

Remarks by

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Thank you, Klaus, and thank you for the invitation to speak at this workshop, which I have been attending since its very beginning in 2004. Something that I love about this conference that has kept me coming back almost every year is its tradition of open inquiry and even some fun, on the one hand, combined with rigorous, critical analysis, on the other. I am a supporter, and I guess a practitioner, of rigorous criticism, because, as you may have heard, the conference award given each year for “outstanding critic” was named for me. Based on the standard I set, the person who wins the award is also known as the “most annoying participant.” I suppose it was only karma that a guy like me who likes to dish out the criticism would end up in a job that receives plenty of it. Kidding aside, I do consider being the namesake for this award a great honor, and just to make sure I don’t get too much of a swelled head, by tradition the conference organizers purposefully misspell my name.

My subject today is the outlook for the U.S. economy and the Federal Reserve’s ongoing campaign to bring down inflation and achieve our 2 percent objective.¹ There are three takeaways from my speech today. First, inflation is far too high, and it is too soon to say whether inflation is moving meaningfully and persistently downward. The Federal Open Market Committee (FOMC) is committed to undertake actions to bring inflation back down to our 2 percent target. This is a fight we cannot, and will not, walk away from. The second takeaway is that the fears of a recession starting in the first half of this year have faded away and the robust U.S. labor market is giving us the flexibility to be aggressive in our fight against inflation. For that reason, I support continued increases in the FOMC’s policy rate and, based on what I know today, I support a

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

significant increase at our next meeting on September 20 and 21 to get the policy rate to a setting that is clearly restricting demand. The final takeaway is that I believe forward guidance is becoming less useful at this stage of the tightening cycle. Future decisions on the size of additional rate increases and the destination for the policy rate in this cycle should be solely determined by the incoming data and their implications for economic activity, employment, and inflation.

Based on all of the data that we have received since the FOMC's last meeting, I believe the policy decision at our next meeting will be straightforward. Because of the strong labor market, right now there is no tradeoff between the Fed's employment and inflation objectives, so we will continue to aggressively fight inflation. Inflation is widespread, driven by strong demand that has only begun to moderate, by an ongoing lag in labor force participation, and by supply chain problems that may be improving in some areas but are still considerable. For these reasons, I expect it will take some time before inflation moves back to our 2 percent goal, and that the FOMC will be tightening policy into 2023. But the answers to questions of "how high?" and "for how long?" will depend solely on incoming data.

Since I last spoke in July, I think the argument that we entered a recession in the first half of 2022 has pretty much ended—we didn't. With each passing week, the absence of any indication of a recession in spending or employment data buries that recession argument a little deeper. We understand some of the factors that lowered the gross domestic product (GDP) numbers in the first half, and a debate continues about other possible factors, such as mismeasurement, potentially underreporting GDP. What we can say is that after the Fed telegraphed its policy pivot to tightening in the latter

months of 2021 and began raising rates in the first quarter of this year, demand and economic activity slowed in the first half of 2022 from the strong pace of 2021. Data suggest an uptick in consumption growth in the third quarter. Meanwhile, the Atlanta Fed's GDPNow model forecasts real GDP will grow 2.6 percent this quarter, though other estimates are a touch below this prediction.

Spending data are supportive of continued expansion. Nominal retail sales overall were flat in July, but that is mainly because falling gasoline and auto prices—which is good news—held back sales in those sectors. Excluding that, retail sales rose 0.7 percent, suggesting that discretionary spending grew solidly. Businesses also continued to expand production and spending. Total industrial production increased 0.6 percent in July, standing 3.9 percent above its level a year ago. Forward-looking indicators of manufacturing activity, such as new orders indexes in various manufacturing surveys, are softer than earlier in the year, but most (and in particular the positive August reading from the ISM) are not suggestive of a material pullback in manufacturing activity. Meanwhile, the non-manufacturing ISM report suggests continuing growth, with its new orders index rising to a solid level last month.

But there are signs of moderation in economic activity, which is what the FOMC is trying to achieve by tightening monetary policy. Not surprisingly, higher interest rates this year are slowing activity in the housing market. There have been declines in construction of single-family homes for a number of months, with permits and home starts both decreasing in July. Sales of existing and new single-family homes have also slowed. Existing home sales fell by 5.9 percent to a seasonally adjusted annual rate of 4.8 million homes in July. While the imbalance between housing supply and demand

remains significant, it has meaningfully improved. The inventory of unsold new and existing homes has more than doubled since January. While the three months supply of existing home is still below levels before the pandemic, the eleven months of new home inventory is the highest since the spring of 2009. This latter statistic has raised concerns by some about a significant downturn looming in the housing market, but an important caveat is that much of the current elevated inventory reflects the recent low rate of housing completion due to continued supply constraints. Many of these new homes for sale are still under construction, and as supply constraints ease, builders will be able deliver more completed homes to a market where the supply of existing homes remains tight. All that said, the housing market is a significant channel for monetary policy, and I will be watching this sector carefully.

The FOMC's goal is that the tightening in monetary policy slows aggregate demand so that it is in better alignment with supply across all sectors of the economy. My expectation is that strong household savings, the tight labor market, and additional availability of manufactured goods as supply chains constraints continue to resolve will allow households to make long-awaited purchases, which will provide a partial offset to tighter policy. That will support a slowing, rather than a contraction, in demand.

Turning to the very strong labor market, private payroll employment has been increasing at an average of nearly 400,000 a month over the last several months. Unemployment rose two tenths of a percent in August to 3.7 percent, in part reflecting an increase in the labor force participation rate, but still stands at a very low level. The increase in participation was welcome news, but this rate is still far below that achieved before the pandemic, when unemployment was roughly as low as today. We are facing

worker shortages in many sectors of the economy. Job openings have started to decline a bit but remain very elevated. These data confirm that the Fed is hitting its full employment mandate, so all my attention is on bringing inflation down.

Inflation slowed in July, which was a very encouraging development. Headline inflation for both the consumer price index and the index derived from personal consumption expenditures (PCE)—the Fed’s preferred measure—slowed, largely due to continuing declines in prices for gasoline and other petroleum products. Excluding volatile energy and food prices, core inflation for these two indexes also stepped down from the rapid increases of earlier this year, but it is still too early to say that inflation is moving meaningfully and persistently downward.

Inflation is still widespread. For both headline and core inflation, at least 60 percent of the underlying categories of different goods and services increased by 3 percent or more. Prices for housing services are elevated and still rising. Core goods inflation continues to run well above its pre-pandemic level. Inflation for services excluding housing has moved up this past year in part due to consumers shifting back to more normal activities outside the household as social distancing has eased.

Looking ahead, I will be focusing on a number of factors that will influence inflation. On housing services—rent and the so-called owners’ equivalent rent—I expect to see sizable increases in this component of inflation for a while as the recent rise in new rentals makes its way into aggregate price measures.² In a speech in March, I noted that, based on various measures of asking rents, some analysts were predicting that the rate of

² Recent increases in asking rents and new rental contracts are incorporated in aggregate price measures with a lag because many of the properties surveyed for the Consumer Price Index Housing Survey do not have new rental contracts each month. In addition, the housing component of the official statistics is based on the average change over the previous six months.

rent inflation in the consumer price index could double in 2022, and so far it is on pace to more than double.³ Owners-equivalent rent is similarly on pace to nearly double this year.⁴ Sometime early next year, though, I expect to see the upward pressure on inflation from these forces to ease as future increases in new or renewed leases moderate and the full effects of monetary policy tightening make their way to housing services prices. Beyond housing, I expect goods price inflation to continue to moderate as monetary policy now and going forward slows the pace of increase in aggregate demand, supply problems ease, and supply and demand come into better balance. There is some evidence that goods supply production and delivery problems tied to the pandemic are improving, with supplier delivery times and reports of items in short supply continuing to drop. In terms of service price inflation, we saw a step-down in airfares and other travel-related services last month, but I am uncertain about how these services, as well as food services, and nonmarket services prices will evolve going forward.

Nominal wages have been growing quickly, and I'll be watching closely to see how wage growth evolves and feeds into inflation. The Atlanta Fed's Wage Growth Tracker hit another record in July for its 24 years of data, a 12-month rate of 6.7 percent wage growth. I don't expect wage increases to ease up much unless and until there is a significant softening in the labor market. One way to anticipate future wage growth is through quit rates. Most people who quit their jobs are moving to others that pay significantly better, so I take quits as one signal about where wages are headed in the near

³ See Christopher J. Waller (2022), "The Red Hot Housing Market: The Role of Policy and Implications for Housing Affordability," speech delivered at the "Recent Fiscal and Monetary Policy: Implications for U.S. and Israeli Real Estate Markets" conference, March 24, <https://www.federalreserve.gov/newsevents/speech/waller20220324a.htm>.

⁴ Tenants' rent, which rose 3.3 percent in 2021 and has already increased another 4.3 percent through the first seven months of 2022, is on pace to more than double this year. Similarly, owner's equivalent rent rose by 3.8 percent in 2021 and has risen another 3.8 percent in the first seven months of this year.

term. Quits are near their highest level over the 22 years that the government has tracked them, but they have come down from the start of this year, and further decreases would bring them closer to the level they were at immediately before the pandemic, when wages were growing much more slowly than today.

Another factor that I will be watching closely is longer-term inflation expectations, which I believe significantly influence inflation. As inflation moved higher over the past year and a half, measures of short-term inflation expectations moved up notably, but measures of longer-term expectations rose only a little and generally stand near levels seen in the years before the pandemic, when inflation was low. In fact, several measures of longer-term expectations have edged lower over the past couple of months. To me, this means that the public retains confidence that the Fed will be able to rein in inflation in the medium term.

To sum up, while I welcome promising news about inflation, I don't yet see convincing evidence that it is moving meaningfully and persistently down along a trajectory to reach our 2 percent target. I keep in mind that a year ago we saw similarly promising evidence of inflation moderating for several months before it jumped up to a high and then very high level. Those earlier inflation readings probably delayed our pivot to tightening monetary policy by a few months. The consequences of being fooled by a temporary softening in inflation could be even greater now if another misjudgment damages the Fed's credibility. So, until I see a meaningful and persistent moderation of the rise in core prices, I will support taking significant further steps to tighten monetary policy.

Now let me lay out the implications of this outlook for monetary policy. Since March, the FOMC has raised our policy target range from near zero to between 2¼ and 2½ percent. That puts the upper bound of the current target range at the median of FOMC participants' longer-run projection for the policy rate, as recorded in the June Summary of Economic Projections (SEP). This long-run rate is effectively where participants think the policy rate would settle when the economy is growing at its potential and inflation is at our 2 percent target. This is a good definition of success when employment and inflation are near our goals and no help is needed from monetary policy. But that isn't the case now; inflation is far from our goal, so more action is needed. The policy rate will have to move meaningfully above this neutral level to further restrain aggregate demand and put more downward pressure on prices.

Looking ahead to our next meeting, I support another significant increase in the policy rate. But, looking further out, I can't tell you about the appropriate path of policy. The peak range and how fast we will move there will depend on data we will receive about the economy. Earlier this year, when we were ending asset purchases, inflation was quite elevated, and we were lifting the target range off the effective lower bound, so it made sense to provide forward guidance to help convey the urgency the FOMC felt about tightening monetary policy. Forward guidance was useful in helping the public understand how quickly we expected to tighten, and we saw longer-term interest rates move up quite rapidly as a result of these communications. And additional hikes should lead to further restraint in aggregate demand. As we continue to raise rates, we need to see, month by month, how households and businesses are adjusting to the tighter financial conditions, and how that adjustment is affecting inflation. We shouldn't be

estimating what the peak level of the target range will be and how quickly we will get there, because those details are much more dependent on what new economic data tell us than was the case when the only direction for the federal funds rate to go was up—and up by a lot.

This is not to suggest that I anticipate rate increases stopping very soon. I expect that getting inflation to fall meaningfully and persistently toward our 2 percent target will require increases in the target range for the federal funds rate until at least early next year. But don't ask me about the policy path because I truly don't know—it will depend on the data. Six months ago, I would not have thought that we would be where we are today, with inflation so far from our target, after significantly tightening policy with a series of large rate increases and by shrinking the balance sheet.

There are a range of possibilities for how the economy will perform, however, and we can talk about the implications of that range. Say, for example, that inflation follows the path laid out in the June SEP, which has core PCE inflation falling to 4.3 percent in the fourth quarter of 2022 and then moving toward 2 percent over 2023 and 2024. In that case, I would support our policy rate peaking near 4 percent. But based on the experience of the past year and half, it would be foolish to express great confidence that this plausible path will come to pass. Instead, it is important to consider the range of possibilities and the appropriate policy responses. For example, if inflation does not moderate or rises further this year, then, in my view, the policy rate will probably need to move well above 4 percent. Alternatively, if inflation suddenly decelerates, then, in my view, the policy rate might peak at less than 4 percent.

One thing that is more predictable and has a significant effect on tightening policy over time is the shrinking of the Fed's holdings of assets as maturing securities run off our balance sheet. Starting this month, the Fed is shedding \$60 billion a month in Treasury securities and up to \$35 billion a month in agency mortgage-backed securities. This action effectively increases the supply of securities in the hands of private investors and will thus put upward pressure on interest rates, as private investors must now be enticed to hold these assets.

All told, the FOMC has taken unprecedented and decisive policy actions this year to quickly increase the policy rate in response to high inflation. But where we stand now is not good enough. Though the labor market is strong, inflation is too elevated. So I support another significant hike in two weeks. After that, the tightening path will continue until we see clear and convincing evidence that inflation is moving meaningfully and persistently down to our 2 percent target. The pace of tightening is uncertain; it will depend on the data. No matter what, I am ready and willing to do what it takes to bring inflation down.