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Something Appears to Be Giving

Remarks by

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Last month, I gave a speech entitled "Something's Got to Give."[1] That message was prompted by the fact that we were observing strong economic growth and employment data in the third quarter, while simultaneously seeing a clear moderation in core personal consumption expenditures (PCE) inflation. While this was good news for employment growth, the pace of real economic activity seemed inconsistent with continued progress toward the Federal Open Market Committee's (FOMC) goal of 2 percent inflation. It seemed clear to me then that something had to give— for inflation to continue falling to our 2 percent target, the economy needed to slow from its torrid third-quarter pace. If it did not cool off, then it was likely that progress on inflation would stop or even reverse. So, what remained to be seen was whether the economy would cool or inflation would heat up.

I am encouraged by what we have learned in the past few weeks—something appears to be giving, and it's the pace of the economy. Data for October indicated an easing in economic activity, and forecasts for the fourth quarter show the kind of moderation that is more in keeping with progress on lowering inflation. In addition, after watching core PCE inflation increase in September from its summer lows, the latest data showed inflation moving in the right direction in October, albeit gradually.

While I am encouraged by the early signs of moderating economic activity in the fourth quarter based on the data in hand, inflation is still too high, and it is too early to say whether the slowing we are seeing will be sustained. But I am increasingly confident

[1] See Christopher J. Waller (2023), "Something's Got to Give," speech delivered at the Distinguished Speaker Seminar, European Economics and Financial Center, London, October 18, https://www.federalreserve.gov/newsevents/speech/waller20231018a.htm.
The views expressed here are my own and not necessarily those of my colleagues on the Federal Open Market Committee.

that policy is currently well positioned to slow the economy and get inflation back to 2 percent. That said, there is still significant uncertainty about the pace of future activity, and so I cannot say for sure whether the FOMC has done enough to achieve price stability. Hopefully, the data we receive over the next couple of months will help answer that question.

Let's start by updating the picture on economic activity. The initial estimate was that real gross domestic product (GDP) grew at a vigorous 4.9 percent pace in the third quarter. We'll find out tomorrow if that estimate holds up, but growth in the quarter clearly picked up from the first half of 2023, when real GDP grew at a little more than a 2 percent pace. Growth in consumer spending, which accounts for most of GDP, was strong in the third quarter.

Data on economic activity in October indicate that consumer spending is cooling from its pace in the third quarter. Retail sales fell 0.1 percent, the first drop since March. Spending was down on motor vehicles, an interest-sensitive sector, which may be evidence that that the FOMC's tightening of monetary policy is having some effect. Spending was also down at gasoline stations, mostly because of a sizable decline in gas prices, often a larger factor for this segment of retail than shifts in demand. But even without motor vehicles and sales at gas stations, retail sales barely increased in October, which may reflect a broad-based moderation in demand.

Beyond consumer spending, there are indications that manufacturing and non-manufacturing activity by businesses slowed in October. If we factor out a big drop in motor vehicle and parts production due to the United Auto Workers strike which ended

October 30, manufacturing output edged up only 0.1 percent last month.[2] Surveys of purchasing managers by the Institute for Supply Management indicated that both manufacturing and non-manufacturing activity slowed in October.

Nowcasting models that forecast GDP based on available data are predicting a significant moderation in economic activity in the fourth quarter. After the retail sales report for October, the Atlanta Fed's GDPNow model is forecasting a 2.1 percent pace of increase for these three months, nearly identical with the actual growth rate for the first half of the year. Something that significantly boosted GDP in the third quarter was a buildup in inventories, which are quite volatile from quarter to quarter. This volatility reflects how businesses manage their inventories by building them up and drawing them down at other times to manage cash flow and anticipate swings in demand. Private inventory investment contributed 1.3 percentage points to GDP in the third quarter and that likely won't be sustained. Inventory swings could even subtract from GDP in future quarters.

One thing to bear in mind is that the GDPNow estimate does not include the effects of the auto workers strike. A range of estimates suggest the strike will cut roughly half of a percentage point off the GDP growth rate in the fourth quarter and then boost GDP in the next quarter around the same amount, so I will tend to look through the strike impact in considering the strength of economic activity. All in all, it seems like output growth is moderating as I had hoped it would, supporting continued progress on inflation.

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[2] See Board of Governors of the Federal Reserve System (2023), Statistical Release G.17, "Industrial Production and Capacity Utilization" (November 16).

The labor market is also cooling off. Job creation is down this year from the high rates of 2022, and the unemployment rate has risen from a more than 50-year low of 3.4 percent in April to 3.9 percent in October. The ratio of job vacancies to people seeking work has fallen, and so has the rate of people voluntarily quitting their jobs. Average hourly earnings, which grew at an annual rate of more than 5 percent last year, have decelerated more or less steadily in 2023 to 4.1 percent in October.

These are all signs of a loosening labor market. But for all of the measures I have mentioned, they are still at levels that, historically, would be associated with a fairly tight labor market. We have 10 months of data on job creation in 2023, and for the 5 months through May, the monthly average was 287,000. Even with the strong month in September, the average for the past five months has been 190,000, which is close to the 10-year average from 2010 through 2019.[3] That's a significant slowing, but job creation is still happening at a rate that is higher than what would be required to absorb new entrants to the labor force, factoring out changes in labor force participation. And while 3.9 percent unemployment is higher than the April low, it is still basically as low as unemployment got during the booming job market of the late 1990s. Members of the National Federation of Independent Businesses (NFIB) report job vacancies are down significantly from 2022, but still at a level that is higher than the late 1990s or any time in the 36 years of the NFIB survey.[4] The bottom line here is that the labor market is still fairly tight and I will be watching closely to see whether it continues to moderate in ways that keeps inflation moving toward 2 percent.

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[3] After job creation in September was initially reported as 336,000, it was later revised down to 297,000.
[4] The survey is available on the NFIB's website at https://www.nfib.com/surveys/small-business-economic-trends/

So, let's talk about that progress on inflation. Consumer price index (CPI) inflation for October was what I want to see. For the month, there was no inflation, prices were virtually flat, and unlike earlier moments where improvements were concentrated in some goods and services, the moderation in inflation was broadly distributed. Over the previous 12 months, CPI inflation was 3.2 percent, a dramatic improvement from 2022, when CPI inflation was above 8 percent for most of the year. For October alone, a drop in energy prices offset increases in other categories, but the increase that month in core inflation excluding food and energy was still a modest 0.2 percent. Core CPI inflation was 4 percent over the past 12 months, but a better sense of the recent trend comes from the annualized rate of 3-month inflation, which for core was 3.4 percent in October.

As you may know, the FOMC uses another measure of inflation for its 2 percent target, based on personal consumption expenditures, and this consistently runs a bit below CPI inflation. We'll get October PCE inflation on November 30, but a rough estimate based on differences with CPI and the producer price index indicates that headline PCE inflation was 3 percent over three months and 2.5 percent over six months.

The question is whether inflation can continue to make progress toward 2 percent. There are some factors favoring this outcome, so let me walk through them.

First, housing services inflation, based heavily on rents, has slowed from its peak last year, and the lagged effect of moderation in rental prices in the past year should keep this sizable component of inflation at a moderate level.[5] Goods prices have contributed a

[5] The pace of increase in asking rents and rents on new lease contracts—which do reflect contemporaneous rental market conditions—slowed since early 2022. This moderation has put downward pressure on shelter inflation this year, which should continue going forward.

lot to the decline in inflation recently and have moderated so much that they probably won't be contributing much more. But services excluding housing, which accounts for about half of PCE inflation, has not moderated as much as other categories, and there will have to be some improvement there for overall inflation to reach 2 percent.

Labor costs are a significant share of these service price increases, and the moderation in wage growth I mentioned earlier should help lower this segment of inflation. The increase in average hourly earnings has slowed to an annualized rate of 3.2 percent over the past three months, below the 4.1 percent 12- month rate, a sign of continuing improvement. That is also the indication from the Atlanta Fed's Wage Growth Tracker, which uses household survey data to estimate annual wage increases. It was as high as 6.4 percent in March and was down to 5.2 percent in October. A broader measure of compensation, the quarterly employment cost index, has improved less dramatically this year. A services-oriented measure of wage increases constructed by the St. Louis Fed also showed slowing. This research, based on data from the payroll company Homebase, shows wage pressure continuing to moderate in a way that is similar to broader measures of wage growth.[6]

This is encouraging, but it is not enough evidence to be sure it will continue. Just a couple of months ago, inflation and economic activity bounced back up, and the future was looking less certain. And while it is encouraging to see inflation by the FOMC's preferred measure dipping below a 3 percent rate over the last three or six months, our target is 2 percent, and policy needs to be set a level that moves inflation to 2 percent in

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[6] See Maximiliano A. Dvorkin and Maggie Isaacson (2022), "Recent Trends in Individual Wage Growth," *On the Economy Blog,* December 22, https://www.stlouisfed.org/on-the-economy/2022/dec/recent-trends-individual-wage-growth

the medium term. I will be closely monitoring the pressure on various categories of goods and services prices in the coming weeks to help me decide if inflation is continuing on its downward path.

Let me turn now to the implications of all this for monetary policy. I would start with the point I made at the outset—monetary policy is restrictive, and it is clearly contributing to the rapid improvement in inflation in the last year. The FOMC raised the federal funds rate from near zero to more than 5 percent, the sharpest increase in more than 40 years, and, as some people have noted, we have seen the most rapid decline in inflation on record. Elevated inflation was partly the result of supply-side problems related to the pandemic, and some of the improvement in inflation that we have seen has been due to the easing of those problems. But most data indicators and anecdotal evidence suggests that supply side problems are largely behind us so they will provide little support in the future in returning inflation to our 2 percent goal. Monetary policy will have to do the work from here on out to get inflation back down to 2 percent.

There has been chatter that robust economic growth and falling inflation may be the result of higher labor productivity growth. In fact, productivity growth over the last two quarters has averaged over 4 percent, more than double the long-term rate. However, measures of labor productivity are very noisy, and for the 15 quarters since the advent of the pandemic, productivity has increased at an annual rate of 1.4 percent, close to the 1.5 average over the past 15 years. So, relying on the productivity growth story to guide the current stance of monetary policy appears to be premature.

There has also been a lot of discussion about the overall easing of financial conditions this month, as reflected in market interest rates and the prices of other assets.

To put this easing into perspective, from July to the end of October, the yield on the ten-year Treasury increased about 1 percentage point. Since the FOMC's last meeting, which ended November 1, the ten-year rate has fallen six tenths of a percentage point. Long-term interest rates are still higher than they were before the middle of the year, and overall financial conditions are tighter, which should be putting downward pressure on household and business spending. But the recent loosening of financial conditions is a reminder that many factors can affect these conditions and that policymakers must be careful about relying on such tightening to do our job.

The October data I have cited on economic activity and inflation are consistent with the kind of moderating demand and easing price pressure that will help move inflation back to 2 percent, and I will be looking to see that confirmed in upcoming data releases. Before the next FOMC meeting we will get data on PCE inflation and job openings, and a job report and supply manager's survey for November. CPI inflation will come out on December 12, the first day of the FOMC meeting. All of that data will tell us whether inflation and aggregate demand are continuing to move in the right direction and inflation is on a path to our 2 percent goal.