

For release on delivery
11:00 a.m. EDT (9:00 a.m. MDT)
July 14, 2022

Monetary Policy in a World of Conflicting Data

Remarks by

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at

Rocky Mountain Economic Summit
Global Interdependence Center

Victor, Idaho

July 14, 2022

Thank you, Mike, and thank you to the Global Interdependence Center for the invitation to speak to you today.¹ Let me start at the place that all remarks about U.S. monetary policy should start, which is with the Federal Reserve's dual mandate of maximum employment and price stability.²

As I discuss below, we have a very strong labor market, with an unemployment rate that is below the median of policymakers' expected longer-run level, and high inflation that is far above our target.³ We are achieving our mandate when it comes to maximum employment, but we are far from achieving our goal of stable prices. Consequently, while any monetary policy decision has implications for achieving maximum employment, and I will address those implications in a moment, the FOMC is now, and must be, utterly focused on moving inflation down toward our 2 percent target.

We must be focused on reducing inflation because, despite a lot of talk about recession lately, the evidence from the labor market indicates the economy is on track, while inflation continues to be far too high. It must be our focus because high inflation is the biggest challenge to sustaining our employment goal, and the greatest burden for individuals and families, especially lower- and moderate-income households that dedicate a larger share of their spending to necessities. Inflation has to be our focus, every meeting and every day, because the spending and pricing decisions people and businesses make every day depend on their expectations of future inflation, which in turn depend on whether they believe the Fed is sufficiently committed to its inflation target.

¹ This speech is dedicated to the memory of my dear friend Berthold Herrendorf, who passed away the day before I delivered this speech.

² These views are my own and do not represent any position of the Board of Governors or other Federal Reserve policymakers.

³ The June Summary of Economic Projections reports a median longer-run level of unemployment of 4.0 percent while the Bureau of Labor Statistics estimate is 3.6%.

So let me be clear: I am going to vote to set policy in a manner that will reduce inflation and achieve our price stability goal, and today I will explain why I don't see that progress conflicting with our maximum-employment goal. Let me start with my view of the labor market and inflation, then turn to the implications for monetary policy, and conclude with where I think the economy is headed.

A Puzzle: Very Tight Labor Market but Declining GDP

As many economists are discussing, recent economic data have created a puzzle. The labor market continues to be very strong, but the real economy appears to be faltering. How might gross domestic product (GDP) fall in the first half of 2022 while the economy created 2.7 million jobs in the same time period? Is the labor market not as strong as it appears or is the economy doing better than the data suggests?

To assess the strength of the labor market, there are numerous indicators of its health, and sometimes they point in different directions. Today isn't one of those times. Based on every major labor market indicator, the labor market is very strong and, in historical terms, very tight. The timeliest evidence for this strength was the jobs report that came out last Friday for the month of June, which found that the economy created 372,000 jobs. Now, I will admit my vision isn't what it used to be, but with revisions to May and April, it is hard to see any slowing in the pace of monthly job creation since February: 398,000 in March, then 368, 384, and 372. In the first half of 2022, the economy has created 2.7 million jobs. That isn't a picture of a weakening job market. The unemployment rate in June was steady at 3.6 percent. It is often said that this is "close to a half-century low" and that is true, but you really have to go back 69 years, to

1953, to find the unemployment rate more than a couple tenths of a point lower than it was in June. This is about as good a job market as any worker has ever seen.

The June job report is consistent with other labor market indicators. Job vacancies—an indicator I have highlighted in past speeches—are unprecedentedly high, with nearly two jobs for every person looking, and that hasn’t changed very much this year. Job postings, measured by the Labor Department for May and by Indeed for June, have fallen a bit in recent months but are still at historically high levels, consistent with a very tight labor market. As a share of the labor force, weekly initial claims for unemployment insurance are near record lows and have been fairly steady all year. Businesses continue to report that jobs are plentiful and small business owners say that jobs are very hard to fill.⁴ Looking more broadly across 24 labor market metrics summarized by the Federal Reserve Bank of Kansas City, we see that activity is above its pre-pandemic level, and the Atlanta Fed’s labor market distributions spider chart shows that the vast majority of labor market indicators are about as tight or tighter than just before the pandemic.⁵ The broad range of data showing a very strong labor market indicate that this isn’t a mismeasurement issue.

Turning to GDP, there are signs of slowing in economic activity. The Commerce Department estimates that there was a modest contraction in real GDP for the first quarter of the year, and “nowcasting” projections of economic activity, such as the Atlanta Fed’s

⁴ The measure of job availability is reported by the Conference Board, which calculates the difference between the share of survey respondents who report that jobs are plentiful and the share who report that jobs are hard to get. The measure of job-filling difficulties is reported by the National Federation of Independent Business, based on the share of small businesses reporting that they have at least one job opening that they are having difficulty filling.

⁵ The Kansas City Fed’s measure of labor market conditions and the Atlanta Fed’s spider chart can be found on the Reserve Banks’ respective websites at <https://www.kansascityfed.org/data-and-trends/labor-market-conditions-indicators> and <https://www.atlantafed.org/chcs/labor-market-distributions>.

GDPNow tracker, foresee a similar contraction in the second quarter.⁶ There is also softness in recent spending data, which has been widespread across consumer spending, business investment, housing, and government purchases, as well as some weaker indicators for the manufacturing sector and a deterioration in consumer sentiment, which by some measures are at historically low levels. Some argue that a recession has already started.

But I don't see how that squares with the job creation data, the low unemployment rate, and overall strong labor market that I described earlier. In addition to the contrasting evidence in the labor market, there are several other reasons why I am very cautious about acting on the GDP estimates and on projections of an output slowdown. One is that while first quarter real GDP is now estimated to have shrunk by 1.6 percent, according to another estimate, real gross domestic income (GDI) *increased* by 1.8 percent. GDP and GDI are basically measuring the same activity in different ways, and in the past when such wide gaps in the two numbers have appeared initially, they tend to move toward each other when the data are finalized. We know that there were some unusual trade-related reasons for the low GDP number in the first quarter that are unlikely to be repeated, and revisions in both GDP and GDI could largely erase that contraction in output.

And, the data that point to some slowing don't convince me that it will damage the labor market. Measures of manufacturing activity and indicators of future activity, such as the purchasing manager's index, have moderated but are still in expansionary territory. Rather than a recession, the softening data seem consistent with the pandemic-

⁶ The GDPNow forecast is available on the Federal Reserve Bank of Atlanta's website at <https://www.frbatlanta.org/cqer/research/gdpnow>.

related transition underway since last year among consumers from spending on goods to spending on services. And we should expect that as policy tightening feeds through the economy it will dampen household and business spending decisions—that is the objective of our policy tightening.

Past experience has shown that job creation and the unemployment rate are timely indicators of a recession, more timely than quarterly GDP. I will watch all the data carefully, but the factors I just cited, along with the evident strength across different measures of the labor market, leave me feeling fairly confident that the U.S. economy did not enter a recession in the first half of 2022 and that the economic expansion will continue.

Persistently High Inflation

Now let's talk about inflation. Yesterday's report on the consumer price index (CPI) for June was a major league disappointment. On a twelve-month basis, total inflation stood at 9.1 percent, the highest in 40 years. Core, which came down slightly in the last couple months, has averaged over 6 percent this year, and is too high as well. No matter how you look at the data, inflation is far too high and my job is to move it down toward our 2 percent target.

We know that supply shortages and bottlenecks, including the tight labor market, have contributed to the high inflation readings we are observing. We also know that the surge in demand during the pandemic that was driven by excess saving, significant fiscal stimulus, and accommodative monetary policy also has contributed to the high inflation we are now experiencing. There is some research estimating how much of this inflation

came from supply problems and how much from high demand.⁷ The main point is that both played a large part in driving the inflation that we have seen over the past year.

But the causes of inflation don't affect my approach to policy because in writing the FOMC's mandate, Congress did not say "Your goal is price stability unless inflation is caused by supply shocks, in which case you are off the hook." We want to reduce excessive inflation, whatever the source, in part because whether it comes from supply or demand, high inflation can push up longer-run inflation expectations and thus affect spending and pricing decisions in the near term. These decisions can then push up prices even more and make inflation harder to get under control.

I pay attention to both surveys of the public's inflation expectations and measures of inflation expectations derived from trading of inflation-indexed securities. I prefer the latter market-based measures, which are down from recent peaks but still elevated. The Board staff combines various surveys and market-based measures in our Index of Common Inflation Expectations, which has moved up slightly in recent months after being flat for a long time. We need to avoid expectations rising so much that they become a factor that drives inflation higher.

The Path of Monetary Policy

So, based on persistently high inflation and the very tight labor market that I have described, let's talk about the implications for monetary policy. Since March, the FOMC

⁷ A recent paper estimates that two-thirds of U.S. inflation is demand driven, while one-third is due to supply disturbances; see Julian di Giovanni, Sebnem Kalemli-Ozcan, Alvaro Silva, and Muhammed Yildirim (2022), "Global Supply Chain Pressures, International Trade, and Inflation," paper presented at the ECB Forum on Central Banking 2022, Sintra, Portugal, June 27–29, https://www.ecb.europa.eu/pub/conferences/ecbforum/shared/pdf/2022/Kalemli-Oezcan_paper.pdf. Also see Adam Hale Shapiro (2022), "How Much Do Supply and Demand Drive Inflation?" FRBSF Economic Letter 2022-15 (San Francisco: Federal Reserve Bank of San Francisco, June), <https://www.frbsf.org/economic-research/publications/economic-letter/2022/june/how-much-do-supply-and-demand-drive-inflation>.

has raised the federal funds rate three times for a cumulative 150 basis points. This is the fastest pace of tightening in close to 30 years. At our last meeting, we raised the policy rate by 75 basis points, which is a large move by historical standards. That size increase was not an over-reaction to one data point on inflation—it was primarily the response to a sequence of excessively high inflation readings since the beginning of the year. It was appropriate given the lack of progress on inflation and clearly signals the FOMC’s commitment to get inflation under control as soon as possible.

The response of financial markets to the FOMC’s policy actions and communications indicate to me that the Committee retains the credibility and the public confidence that is needed to make monetary policy effective. Longer-term interest rates have moved up to levels not far from those reflected in Committee members’ estimates of the final destination for the federal funds rate in this tightening cycle, effectively implementing policy ahead of time. The average rate for a 30-year conforming fixed rate home mortgage has increased by more than two percentage points since the end of 2021. While there is some slowdown in home sales, lenders and borrowers are still doing business at these rates, which indicates that they believe the FOMC’s policy intentions are credible, as broadly reflected in the interest rate paths in the Summary of Economic Projections (SEP).

As I have said before, with inflation so high, there is a virtue in front-loading tightening so that policy moves as soon as is practical to a setting that restricts demand. Getting there sooner will bolster the public’s confidence that we can get inflation down and it will preserve options for adjusting the pace of tightening later if needed.

With this view, it should not be surprising that looking toward the FOMC's next meeting July 26-27, and with the CPI data in hand, I support another 75-basis point increase, bringing the target range for the federal funds rate to 2-1/4 to 2-1/2 percent before August. I judge that level is close to neutral, by which I mean a level that neither stimulates nor restricts demand, assuming that the economy is growing moderately (at its potential) and unemployment is roughly where it is now.

However, my base case for July depends on incoming data. We have important data releases on retail sales and housing coming in before the July meeting. If that data come in materially stronger than expected it would make me lean towards a larger hike at the July meeting to the extent it shows demand is not slowing down fast enough to get inflation down.

Based on what we know about inflation today, I expect that further increases in the target range will be needed to make monetary policy restrictive, but that will depend on economic data in the coming weeks and months. Between the end of July and the FOMC's September meeting, we will get two employment and CPI reports with data for July and August. I will be looking for signs that inflation has started its move down toward our 2 percent target on a sustained basis.

I anticipate a decline in inflation will come as actual and anticipated hikes by the FOMC cool demand for products and labor, which will help demand and supply come into a better balance. The decline in the rate of inflation will also be assisted by continued improvement in goods supply bottlenecks, which is occurring in some sectors, and an increase in labor force participation, which is still significantly lower than it was before the pandemic. I hope these supply recoveries happen, but my expectations for

policy don't rely on it. I expect rate increases will continue after July at a pace that is dependent on the incoming data.

After the July meeting, further increases will be restricting demand. Looking further in the future, I will need to see how the tightening this year is affecting the economy and bringing inflation down toward our 2 percent target. Based on my forecast for the economy, I expect monetary policy to be restrictive until there has been a sustained reduction in core personal consumption expenditure (PCE) inflation, which excludes food and energy. Food and energy prices tend to be volatile, so focusing on core PCE inflation is a good guide to inflation pressures in the near and medium term. Importantly, as futures prices for commodities—food, energy, raw materials—have declined recently, I am expecting total PCE inflation to decline in coming months. But until I see a significant moderation in core prices, I support further rate hikes.

In talking about where monetary policy is headed, it is helpful to get a fix on where it is right now. I mentioned the concept of a “neutral” interest rate, and the belief that the federal funds rate will be close to neutral after another 75-basis point increase at the end of this month. But some would argue that monetary policy is actually further away from neutral, based on the fact that current inflation is so much higher than the federal funds rate.

In my view, that rests on a flawed idea of how monetary policy affects spending decisions. That's because spending decisions that require borrowing are based on an outlook that extends several years. This means taking into consideration longer-term real rates, which are tied to the expected path of policy and inflation over the next several years.

As a result, I think that estimates of the real federal funds rate should be based on the expected policy rate one to one and a half years in the future. Based on trading in inflation-indexed Treasury securities of different maturities (compared to nominal Treasury securities), investors see federal funds rates above expected inflation starting about six months from now and steepening thereafter. Primary securities dealers surveyed by the New York Fed likewise estimate the real federal funds rate will be a positive 0.7 percent in mid-2023 and 1 percent by mid-2024. This gives me some confidence that tightening now anticipated by markets and expected by FOMC participants will be sufficient to reduce demand and inflation.

Evolution of the Economy

The FOMC's plan for getting inflation under control depends on a view of the economic outlook. As I have noted in past speeches, accurate economic forecasting is very hard, especially when unusual factors, like a war, and unprecedented factors, like a pandemic, buffet the global economy.⁸ FOMC participants record their individual outlooks that are presented every three months in the SEP. At our June meeting, the latest SEP shows that there is some expectation among participants for what is often referred to as a soft landing. With a policy path like what I described for this year and a bit more tightening next year, the median SEP respondent projected that total PCE inflation is expected to fall from its current elevated level today to 2.2 percent in the fourth quarter of 2024. At the same time, the unemployment rate is projected to rise to

⁸ See Christopher J. Waller (2021), "A Hopeless and Imperative Endeavor: Lessons from the Pandemic for Economic Forecasters," speech delivered at the Forecasters Club of New York, New York, December 17, <https://www.federalreserve.gov/newsevents/speech/waller20211217a.htm>.

3.7 percent at the end of this year and to 4.1 percent by the end of 2024, while GDP would grow below its long-run trend for the next two years.

Of course, we can't be very certain about the path of the economy more than a few months in the future, but this medium-term view of a soft landing is very plausible. I say this based on the optimistic view I expressed earlier about the strength of the labor market and on my analysis of the relationship between job vacancies and the unemployment rate. In a recent speech, I noted that we have an historically high number of job vacancies compared to the number of unemployed people.⁹ Some people have argued that past experience indicates we cannot reduce this large number of vacancies without a big increase in the unemployment rate. But I have showed that past experience actually indicates that a reduction in vacancies can take place without a big loss of employment, and this is the kind of soft landing anticipated by FOMC participants. So, while some data measures suggest the chances of recession have increased, I believe it can be avoided.

Uncertainty over how the pandemic could afflict the economy in the future, and global economic risks related to the war in Ukraine are considerable. These factors could make future policy decisions more difficult than they are today. However, for the reasons I have laid out, and considering the evidence on the state of the economy and the outlook, I don't find it difficult to reaffirm my strong conviction that continued policy tightening will be appropriate to move inflation down toward our 2 percent target. I think we need

⁹ For a discussion of the Beveridge curve and how the data on vacancies show a soft landing is possible, see Christopher J. Waller (2022), "Responding to High Inflation, with Some Thoughts on a Soft Landing," speech delivered at the Institute for Monetary and Financial Stability (IMFS) Distinguished Lecture, Goethe University, Frankfurt, May 30, <https://www.federalreserve.gov/newsevents/speech/waller20220530a.htm>.

to move swiftly and decisively to get inflation falling in a sustained way, and then consider what further tightening will be needed to achieve our dual mandate.