Fed Unfiltered, Transcript
8/30/22 – John Williams, Interview: WSJ Live Q&A

Nick Timiraos:

Hello, and welcome back to Ask WSJ. I'm Nick Timiraos, chief economics correspondent for The Wall Street Journal. I'm pleased to be joined today by John Williams, President of the New York Fed. John, thanks for being here.

John Williams:

It's great to be here, Nick.

Nick Timiraos:

This is a special opportunity for our readers to ask questions and viewers can submit them right now, but John, let's get right to it. You haven't spoken publicly on the economic outlook since July. How has the economic outlook changed for you in the last month and a half?

John Williams:

Well, there's a lot of data we watch and there's some cross currents in that data. We've seen indicators of spending and GDP come in pretty weaker than maybe expected. But the labor market has remained very strong and the inflation data have been coming down a little bit, which is encouraging. Overall, I think that the picture is very similar to where it was in July. Inflation is kind of following what I was hoping to see, some following inflation rates and some good signs there. But again, I think the real news here has been the labor market's been very strong despite some slowing growth in the first half of the year. So we're coming into the second half of the year. I think still with some positive momentum, the economy's growing, labor market's very strong because inflation is far too high, and that's really where we're focused, is bringing inflation down.

Nick Timiraos:

So the two big data reports before your next meeting in September, we'll get the jobs report this Friday. We'll get another inflation report in the middle of September. Chair Powell last week said that your next interest rate decision would depend on the totality of the data. So what information are you looking at to determine whether to raise interest rates by half point or three quarters of a point at your next meeting?

John Williams:

Well, I always go back to our dual mandate, maximum employment and price stability. Again, our focus is on getting inflation back down to 2%, it is far too high. So we're watching the indicators from inflation, as you said, we'll get another CPI report, we'll get another employment report, and looking at all the other indicators like job openings and in indicators of consumer spending and inflation expectations. So it really, is looking at all of the information in total, but I'm of course, very focused on what's happening in terms of drivers of inflation. What are we seeing there given that, that's the number one problem that we're facing today.

Nick Timiraos:

If the labor market is as tight as you've suggested, would that argue for a more front loading of your rate increases?

John Williams:

Well, I do think if you look to our past two meetings, we made the decision to move 75 basis points then, and that I think made it complete sense. We had strong labor market inflation, far too high, and the need to get interest rates higher, to get slow demand and make it more in line with the available supply in the economy. We have clearly an imbalance where demand far exceeds supply in the economy that's creating inflationary or contributing to inflationary pressures. So looking back, it was really about getting monetary policy more to our position will slow demand enough to equal supply. Obviously, as we think about the next meeting, we'll be weighing all of the information we have and coming to a decision about what the rights setting of policy is. But again, it's really on the totality of all the data.

Nick Timiraos:

So I'm going to work in audience questions here. Tim asks, what is the cost of raising rates 75 basis points relative to 50, when the Fed projects that well more than another 75 basis point of rate hikes is needed to bring inflation under control?

John Williams:

Well, I think the question is framing the issue well, in the sense that we really do have to think not just about one meeting, but where do we want to see interest rates by the end of the year and into next year? And so that's how I think about it too. If based on the data, it's clear that we need to get interest rates significantly higher by the end of the year. Then obviously that informs the decision about at any given meeting. In terms of the costs and benefits, I think it's really about getting monetary policy in the right place, making sure that we're creating conditions, such the demand is more in line with supply. We always have the opportunity at the following meeting to adjust the policy actions as well. So it's not like you make one decision once and for all, but you really think about the path of policy. So I think that will really depend on how strong the labor market is, what we're seeing in inflation, making that decision and then thinking, well, obviously what do we do next time and the time after.

Nick Timiraos:

So that's, fair. A lot of these questions that you get are about tactics, monetary policy asking for a looking. So I am wondering about the destination, the terminal rate, as it sometimes said. In June, you said in an interview, "we are far from where we need to be." Do you still feel that way based on the outlook right now? How high do you think interest rates might have to rise here to get the job done on inflation?

John Williams:

Well, my first answer is going to be, it depends. It depends on the data, but here's how I think about it. I do think with demand far exceeding supply, we do need to get real interest rates. That's the interest rate adjusted for inflation above zero. We need to have a somewhat restrictive policy to slow demand and we're not there yet. So if you think about next year, if inflation is somewhere between two and a half and 3%, a lot lower than now, but that's kind of a forecast that I think is reasonable. You're thinking about having interest rates that are well above that, because it's the interest rate minus the inflation rate tells you what the real interest rate is. So we're so quite a ways from that. And I think that to me, that's one of the benchmarks. If we need to get the interest rate relative to where inflation's expected to be over the next year into a positive space and probably, even higher than the longer run neutral level, which I think is around a half a percent on real interest rates.

Nick Timiraos:

So before we get into that, can you explain why is it that the real rate is what matters for the setting of interest rate policy?

John Williams:

Well, I think actually nominal interest rates, the actual interest rates do matter if you're paying a mortgage or looking at your monthly payments, whether you can get approved for mortgage, depends on your ability to pay every month, a mortgage rate, which is affected by the interest rate. But I think economics and experience teaches us that you have to think about, well, what's the interest rate relative to inflation. So say, you're a business and you're the inflation rate means that you're able to sell your products at every year, but 3% or higher prices each year. Then that cost of in a sense of paying back the original loan or is lower because you have more and more revenue. Similarly, when you're working, if you have inflation of 2% or 3%, you see that your income goes up over time and your ability to pay, given interest rate become is easier. So we really want to think about is the interest rate adjusted in a way for the fact that the prices are going up over time.

Nick Timiraos:

So you've done a lot of work in an academic setting, estimating the real neutral rate that is likely over the long run. We often talk about a corresponding nominal neutral rate that assumes inflation is 2%. Assuming that the real rate is still positive, does that mean you want to see interest rates rise above the rate of inflation to provide restraint to the economy?

John Williams:

So when you look at the analysis we've done about what this long run neutral interest rate is, it's always in terms of a real interest rate for the reasons we just discussed. And again, a typical estimate of that is say something like a half a percent. And so if you add 2% inflation, that would be the two and half that you see discussed as a longer run neutral nominal interest rate because of Fed's target is them 2% inflation the longer run. So the way I think about it in our economic analysis tends to support this is basically where's the Federal funds rate, less the inflation rate they expected over the next year. So to me, a real interest rate has to be forward looking in that way. And if you look at market participants, I mean, that's how I think they think about holding a bond. What's what is going to happen to inflation over the time period that I hold that bond for example, or have a loan. So to me, it's basically the Fed funds rate. Let's say the inflation expected over the next year.

Nick Timiraos:

So you said earlier, you think inflation could get down to 2.5, 3% by the end of next year. That if there's a positive, real rate of a half percent, that suggests that a nominal neutral rate might be 3.5%. Are you saying that you would need to go above 3.5% to provide restraint to this economy?

John Williams:

Well, I'm going to give the same answer before. It depends what happens with the data, and I think you have to consider what's happening with inflation, what's happened with the economy. But I think that my baseline kind of view would be, yes, you do need to get a little bit or somewhat above that, because you're trying to get not just to neutral in a real interest rate sense, but you're actually trying to get demand in line with supply. Now, my hope is that the supply side of the economy over the next few years also improves as some of the bottlenecks and other constraints on in the US economy and the global economy ease over time. But it's really about getting supply and demand and balance, getting inflationary pressures down so we get back to our 2% inflation.

Nick Timiraos:

I hear Fed officials talk a lot about the desire to see financial conditions tighten. What are you looking to see progress there? Are you pleased with the progress that you've seen so far over the past few months and what is the primary metric you follow to see if market participants, after all, that is the transmission mechanism for monetary policy are getting the message?

John Williams:

But your point is absolutely right. I mean, no one actually buys or sell anything at the federal Funds rate, which is the target interest rate that we set, it's really about the broader financial conditions. So you look at in bond rates, you look at credit spreads, you look at equity markets, you look at all types of financial pricing and conditions when you're thinking about that. Because monetary policy works by affecting financial conditions in a wide set of markets. So I do tend to look at some of these financial conditions indexes. There's a number of them constructed in different ways, but they basically try to aggregate what's happening in the various markets to give you a summary statistic of how financial conditions have evolved.

John Williams:

And so again, to your original question, when I look at those, which can aggregate all the different aspects of it, not one or the other. They have tightened quite a bit since the beginning of the year in line with what I think what we're trying to achieve in terms of monetary policy of bringing financial conditions tighter, helping bring demand and supply and balance and bringing inflation down. So I'm not sure it's about being pleased or not. I do think that the tightening in financial conditions is consistent with the direction that I see us in and taking a monetary policy.

Nick Timiraos:

So to bring in a reader question here, Kia asks, does the 10 Year Treasury yield need to go up for financial conditions to tighten if most everything meaningful in the economy is priced on the 10 year yield? And if we keep getting a deeper yield carbon version, wouldn't that loosen the financial conditions since it lowers the 10 year yield relative to other tenures?

John Williams:

Right. And this question really gets to the fact that any asset price or bond yield or equity price or something like that, reflects a lot of different conditions. It reflects where people expect the economy to go, where they expect interest rates to go. And also, the amount of risk that they associate with those or uncertainty around those. So it is harder to just look at one asset price or another and say, well, this must mean that or must mean something else. So I do think from my perspective, I tend to go back to start from where monetary policy is, where our market expectations of the Fed funds rate.

John Williams:

How does that relate to the bond market? And then how does that spill over more broadly into financial conditions? Because there's so many reasons, bond yields move around in the short run and the long run. There's just a lot of factors that you have to take into account. But right now, I would say what I'm seeing is the financial conditions, or I think broadly consistent with what we're doing and where the economy is going and just keep watching that. But that's how I see it.

Nick Timiraos:

On Saturday, one of your counterparts from Europe, Isabel Schnabel outlined her views at the Jackson Hole Symposium in Wyoming that we both attended. She outlined two different approaches to an environment where supply shocks are hitting the economy and pushing up inflation. One, guided by caution because monetary policy can't easily remedy supply shocks and the other guided by determination where policy makers do respond more forcefully, even if this lowers growth and raises inflation. And she said, she preferred the latter approach that it's time for policy makers to stop aiming for the best possible outcome. And instead, to try to limit bad outcomes from happening. Is that what the Fed is doing or should be doing?

John Williams:

Well? I think the Fed, we're always doing risk management or thinking about it that way. I think that's been true throughout my career and I definitely think it's highly relevant now. And it's always a question of where are the most salient risks. If you ask me in 2020, where those were, it was really about the great uncertainty about how the economy would behave and eventually recover. Today, obviously the uncertainty to me, the prominent uncertainty is really around inflation how quickly, and we can get inflation down and making sure the inflation expectations remain well anchored. So that does argue for a policy that it's not a policy that's only focused on inflation. Clearly, we're thinking also about how to achieve both of our mandate goals. But really, is being very focused on getting inflation down, back to our 2% longer one goal. And managing those risks, the inflation could get stuck for too long, at a higher level than we want. So I do agree that risk management is important consideration, and I think that's exactly what we've kind of done throughout time, but it's particularly relevant.

Nick Timiraos:

But do you agree with her framing of cautious versus determined and airing on that side of maybe being more forceful than not?

John Williams:

Well, it's always an issue about what do you do with uncertainty. So sometimes uncertainty tells you, I want to collect more information, I want to get more certainty and then I can be more confident in my decision. So that's times where you might say, you want to be more gradual and things. And there are other times where you say, well, there's a lot of uncertainty, but how do those risks play out? So for example, if inflation comes down more quickly than we expect, well, that's a situation obviously we can adjust to. It's a manageable, good risk in a way, if that happens. If inflation gets stuck higher, or if we see signs of inflation expectations going higher, then that's a much more challenging thing to manage.

John Williams:

So I'm not sure if that's exactly the way she framed it, but I do think there's time to uncertainty tells you to maybe wait and see. And other times that uncertain tells you, "Hey, we need to make sure that say upside risk to inflation doesn't happen." And I think our actions at the Fed have been very much in the context that we need to take the strong actions to make sure that inflation does in fact, come back down and risks of higher inflation. We're really trying to mitigate those risks.

Nick Timiraos:

So it seems likely that after another few increases, I mean, you will have raised rates more this year than any point since in calendar year, since the 1980s. How are you thinking about the lags of policy? Does that create an argument for a skipping policy meeting? Not raising interest rates at a meeting or getting to a place where you're moving up the policy rate in the more traditional quarter point increments?

John Williams:

Well, I do think that there will be a time where the policy actions will change because the conditions, first of all, where we've got the policy rate in terms of a real interest rate, in terms of versus neutral will be different than it is today. Because interest rates are still way, much lower than I think where they're going to need to be. And the second is, we're going to be watching the data about what's happening with inflation, how is the labor market and the economy responding. And so of course, there's going to be a period in the future at some point, where you're adjusting probably in smaller steps or possibly just taking whatever is appropriate at that time. And so, I think what we're achieving now is, we're getting interest rates back to what I think are appropriate stance to deal with the high inflation. And then, obviously watching that data.

John Williams:

We're always data dependent at every meeting, we're watching that data. But there's a point at which where decisions I think will be really be driven exactly by how we see the inflation outlook, how quickly inflation's coming down and what do we need to do then. I do feel that next year, because of the lags of monetary policy, because some of the signs in inflation I think are somewhat persistent. We're going to need to have restricted policy for some time. This is not something that we're going to do for a very short period of time and then, change course. It's really more about getting policy to the right place, to get inflation down and keeping it in a position that helps make sure that in the next few years, not only are we moving to 2%, but we achieve our 2% inflation goal on a sustaining basis.

Nick Timiraos:

So people ask about the Fed's reaction function, which really means how the Fed reacts to different incoming data. And this year the focus has been on the speed of rate increases. You're talking about of a time dimension, getting to a place then holding there. The market has been pricing in rate cuts. Are you saying that you don't think that's a realistic scenario at this point? Rate cuts specifically happening next year.

John Williams:

Well, I think currently they price in about one rate cut next year right now. And that's going to depend on where things are. But honestly, from my perspective, right now, I see us needing to hold this a policy stance, pushing inflation down. Bringing demand and supply into alignment is going to take longer than we'll continue through next year. So that's my view right now. And I think it's based on what I'm seeing in the inflation data, where I'm seeing in the economy. It's going to take some time before I would expect it to see any adjustments of rates downward.

Nick Timiraos:

So the Fed has a framework, you call it flexible inflation targeting. And I want to ask about what flexible means. The question here really is, what is your timeframe for returning inflation to target? I'm reminded that the committee under Greenspan, when he became chair, inflation was at 4%, it took him almost a decade to get it down to 2%. And so, would the committee behave differently if it was able to get inflation down below, say 4%? Would you run the same risk of a recession to get inflation from 3 to 2?

John Williams:

Well, I think things are very different from that time. First of all, the FOMC didn't have a 2% inflation at target or explicit numerical target like we have now. I think that is a very powerful organizing kind of number, 2%. That's what we've all agreed, every member of the FOMC is agreed on what we're trying to achieve and committed to doing that. The second is, we've seen inflation expectations today because of the policy actions of going back to Chairman Volcker and Greenspan and throughout, since then, of keeping inflation low and stable. Sometimes it's been too high, sometimes it's been too low, but really trying to keep it anchored at 2%. And we're seeing that in the market and the household surveys of inflation expectations.

John Williams:

So I think relative to the period that you're talking about, I think we have some advantages. I think inflation expectations are well anchored. We've communicated over and over and over again, our commitment to achieve that 2% goal. I think it'll take a few years, but there's no confusion about, well, what is good look like? Back then, it was like, well, the Fed's aiming for 3, 4, 3, 2, 1, 0, whatever. Today, we're very clear on that and we're absolutely committed to doing it. The situation is very challenging, inflation is very high. The economy, like I said, has a lot of cross parents. I do think it'll take a few years, but we're going to get that done.

Nick Timiraos:

There are a lot of questions coming in about the Fed's balance sheet, which is really managed by the New York Fed. So let me ask about that. You began the process of shrinking it passively in June, that will step up next month so that, you'll have about 95. You will have 95 billion in holdings maximum in the rundown. Now, this process drains reserves from the banking sector that have been created when you purchase these assets. Reserves are also declining because of strong demand for another Fed liability. The overnight reverse repurchase agreements, which are created when money market funds park cash at the Fed. And reserves have declined from around 4.2 trillion at the end of last year to a little over 3.2 trillion now. So here's the question, sorry, that was a lot of numbers.

John Williams:

That was a lot of numbers there.

Nick Timiraos:

If preserves continue to decline because of strong demand for reverse repos, wouldn't that imply an earlier end to balance sheet runoff?

John Williams:

I agree with your statement of what's been happening. I don't agree with that concern. In fact, I see that what we call the ON RRP program.

Nick Timiraos:

To make it even more simple.

John Williams:

To make it simpler, because we speak in acronyms. But I do see the ON RRP has been a great buffer for us as we reduce the size of our balance sheet, like any entity, we have the assets and we have our liabilities. And because we're reducing the dollar value of our assets through the running down our balance sheet, nor in the past, we would say, well that has to come off the bank's holdings and reserves. But actually, that adjustment can come either through the ON RRP facility or through reserves. And what we're seeing is a natural adjustment of that. Market participants in the banking sector, where the reserves are held, or as you said, it's often money market mutual funds who are the counterparts of ON RRP. Those market segments are adjusting, they're adjusting their pricing, they're adjusting the quantities there.

John Williams:

So I actually see, this is not like that the ON RRP is making it a little harder. I actually think it makes it easier. It allows two different parts of our financial system to adjust the liabilities of our balance sheet, as we reduce the asset side of our balance sheet, that is running extremely well. Short term interest rates are right where the FOMC is directed, for us to have them in the target range. And we've seen very good stability in those markets. I do expect going forward, that we'll see over time reductions in the balances, both of reserves and ON RRP. And that will happen depending on how the adjustment process works, but it's working well. And I expect it to continue to.

Nick Timiraos:

So maybe to ask that differently, could a difference between bank and money market fund deposit rates wide enough to bring quantitative tightening to an earlier end?

John Williams:

Well, again, I don't expect that to happen. I think that the banks will obviously, as they see the demand for deposits and their demand for reserves, they'll see adjustments and pricing on that. We'll see adjustments and pricing in the repo markets. So there is a natural market process that prices will kind of bring that adjustment to happen. And similarly, these institutions are making their decisions about where to best put their money. So to me, it's a system that has a lot of flexibility, kind of buffer aspect and we're watching it carefully. But to me, it is working very well and I think will help smooth pave the market reactions over time.

Nick Timiraos:

So another question on the same subject from Maria, she asks, and I get this question a lot too. Why has the planned reduction of the Feds balance sheet through runoff not kept pace with the published plans? People look at the balance sheet that's reported every week and they see that, especially on the MBS side, it hasn't been going down by the stated $17.5billion plan reduction. So can you explain why that actually hasn't shown up yet on the income statement we put out every week?

John Williams:

So there's a couple reasons. I'll start with the treasury one, because that's a simple one. The FOMC has directed us explicitly to run down the balance sheet at a certain pace. With mortgage back securities, the way it works is, the FOMC has set a maximum. But what we are doing there is as the underlying mortgages are paid off or the payments that we get for those, that happens just over time. And so, that depends on kind of market conditions, it depends on what's happening in the mortgage market. And obviously with interest rates higher, people aren't refinancing their mortgages as much. So we allow the rundown to occur up to this maximum, this stipulate by the FOMC. The second thing I'll mention is very technical, that market takes a little time for things to happen.

Nick Timiraos:

Moving forward, selling purchases.

John Williams:

Yes. Well, we're not... There is a little bit of a time to delay between the weeks, but let me just be clear. We are carrying out the FOMCs directive, we are doing exactly what was indicated. And so, any week to week kind of discrepancies really are just more the technical factors, except for the point I made about the maximum there set by the FOMC. We may not always be at that maximum.

Nick Timiraos:

There are a number of questions here about whether some of the forces that benefited central banks over the past few decades, globalization, technology, demographics are reversing, was referred to as the great moderation. Is the great moderation reversing in your view?

John Williams:

Well, it is obviously a big question, we hear a lot about that. I think that there was an open question about whether productivity trends have changed, whether globalization maybe will reverse over time. Those are questions, I'm not sure quantitatively yet, how important they are. And we listen to the experts, including at the Jackson Hole Symposium about discussing this. So I think there's a lot of uncertainty about that. I do think that having watched what happened in the '90s, say in early 2000s, we did see a number of positive supply shocks. One was globalization and trade. One was higher productivity growth and other factors. Now, those do not determine what inflation will be over the medium or longer term. That's determined by the central bank, the Fed's job.

John Williams:

But it definitely creates conditions that we saw in the late '90s and early 2000s where the economy grew faster because the supply side was going faster. So we have to, as economists and as policy makers, we have to watch what's happening in terms of the supply side of the economy. And then obviously, make our policies appropriate for what's happening out there in order to achieve our objectives. Right now, I would describe this as mostly uncertainty about some of these more fundamental factors, but definitely things that we're studying regularly.

Nick Timiraos:

You're right. The central bank controls. If you're right that the central bank controls inflation over the longer run, it would still mean that you face tougher trade offs more often. How do you think about managing those trade offs between growth and inflation?

John Williams:

Well, they are tougher trade offs in the short run because there's no question. As we saw, say in the '70s where I gave my example of the '90s, when productivity slows down, it's a negative supply shock, it's in the short run, it makes it harder to achieve both your inflation and maximum employment mandates. In the late '90s, we had kind of the opposite example of that. But those are really about short run dynamics of adjusting monetary policy appropriately to the changing supply side dynamics, recognizing them early on and having a policy appropriate to that. Again, in the medium or longer term, I think it's really what we've seen from experiences in the last 30 something years, we've had a low productivity stage of the '80s. We had a strong productivity stage of the '90s. We've seen productivity both slower over the past 10 years. We've managed over that time to keep inflation low and stable. We can do that, it does mean a different mix of policy and really, being on top of what's changing around us.

Nick Timiraos:

Well, John, it looks like that is all the time that we have today. So thank you, John, for joining us. And to all the viewers out there, thank you so much for joining us today. You can email us at voices@wsj.com with any further questions or stories and keep up on our live coverage at wsj.com. We'll be back here next month with other interviews with Fed presidents. And if you missed part of this event, even the full Q&A, will be available to rewatch on this page. Thank you again for joining.