Fed Unfiltered, Transcript

10/6/22 – Charles Evans, Interview: Illinois Chamber of Commerce Annual Luncheon

Todd:

Okay. So, we're going to talk about the unemployment rate, which is very low. And I will tell you that I will go ahead and inject this, is that the single biggest issue I talk about, whether it be Sheriff's Association, whether it be Caterpillar, whatever else, the labor market is really, really problematic. You've got very, very difficult decisions to make. The unemployment rate is really low, but at the same time, we all are very aware of inflation and such. So I just want to make sure, how do you view the US economy? And this is going to be... It's kind of a weird dichotomy right now. So how do you view the US economy, and where do you see the economy headed for the rest of '22 and beyond?

Charles Evans:

Okay, great. Thanks Todd. And it's really an honor to be here. It's a great opportunity to talk to you about where I see the economy going. It's hard to start any conversation about the US economy without acknowledging that inflation is very high right now. And that's really the issue that's top of mind for the Federal Reserve, and I think everybody, around the economy. Part of what is driving that is the challenging situation in the labor market that you're alluding to. There is a good amount of strength in the US economy. Even though the first half of this year was flat, or even negative measured by GDP, we're optimistic that the second half of this year is going to be closer to, well, one and a half percent growth. Trend growth is about one in three quarters percent. So it's sort of getting back up to at least where it ought to be, and then we'd like to it to be a lot more than that.

Charles Evans:

The challenge has been that the supply constraints on the economy have really taken their toll, that's part of the slowing, and that's part of what's driven up prices. So in terms of the unemployment rate, we've been at 3.7% now, and we're tightening monetary policy. I suspect that the unemployment rate is going to begin to creep up as the effect of higher interest rates work their way into the mortgage market and other credit activities.

Charles Evans:

But I would say that the message is, the fundamentals of the economy, there are places of strength, the labor market is still good, but I think everybody's extremely wary that it's going to be much more challenging with the higher interest rate environment. After all, that's part of what we're looking for to curb the high inflation, is to get the state of demand in line with the restricted supply at the moment. And then we're hoping that supply will expand, and then the economy will take off after that.

Todd:

Very good. We've got some questions here, and one in particular I want to jump down to, and not to be too wonkish, but you've got the 2% inflation target.

Charles Evans:

Right.

Todd:

We're at 5.8%, seven...

Charles Evans:

It's a big number. That's right. It's way above two.

Todd:

So, tell us how you get from a big number down the 2%, without really creating some real problems with the labor market.

Charles Evans:

So the current situation is really unusual, and it changed very quickly. I mean, if you go back a ways, we spent 10 years in a relatively low inflation environment where we were trying to get inflation up to 2%, but it was really a challenge. There were so many restrictions on... I mean growth, it was the slow recovery from the great financial crisis, unemployment was high, it was coming down, and inflation, there just wasn't any inflationary pressures. The inflationary pressures really became evident, I mean in a big crystallized way, I would say, in the February 2022 CPI report, where all of a sudden, inflation year over year leaped up to 7.9%. I say all of a sudden, because the previous February, 2021, that CPI rate was 1.7%. 1.7%. And the core, when you stripped out food and energy, was 1.3%. So after the covid pandemic, the business shut down, the recovery, but very uneven, inflation was beginning to percolate up, and then we had a lot of special factors.

Charles Evans:

So all of a sudden we have these special supply factors, which are leading to very high inflation, and we're kind of expecting that those are going to unwind or be reduced a bit, as the supply channel improves. So we had semiconductor chips that were not available, so cars couldn't be produced, used car prices went up 40% in one year. 40%. Can't get cars, or it was very difficult, and you had to pay quite a lot to get there.

Charles Evans:

So a very small part of the consumer basket, 15%, went up by 20%, as of February of this year. The others were more contained, although high, they were still at 4%. So we've got a variety of factors. Your question is, how are you going to get inflation down? We're going to do it through making policy more restrictive. That's the part that would normally work on that momentum, middle part of inflation, that's driven by demand, if we reduce demand a little bit. But those supply chain factors, supply chain's got to get better. So we can't really address that, but we think in time, as we get right size with monetary policy, it's going to continue to improve.

Todd:

So, just stay on that line of thought here, and tell us whatever you can, we know you're restricted here, but when you're with Jay and the rest of the Federal Reserve Open Market Committees, how much do you talk about headline inflation versus the underlying inflation? And just tell us what you can tell about, "Okay, yes. I know that now gas costs $4.50, but maybe a gallon of milk is not going up as quick." So can you just tell me how you view headline versus core inflation?

Charles Evans:

So we look at all the categories that you just talked about. We have a very large committee, we've just recently gotten up to full strength. We have seven governors on the committee, we've got 12 reserve bank presidents, so we've got 19 principles who are sitting around a table eight times a year, and we're dissecting the inflation reports that you're talking about. Staff have prepared memos that are trying to peel apart, how much of this is because of these supply factors that I talked about? And as we see improvements ahead, that seem reasonable to expect, that would suggest those relative prices are coming down. After all, take container ships. Containers for shipping. I mean, those were extraordinarily expensive not long ago. Now they're much more reasonable. They're probably still above what they are normally, but they're not the 18,000, they're the 3,000, and that kind of thing.

Charles Evans:

So as those things come down, that's helpful, but it's that core function, the food is very concerning, shelter prices are going up, housing has been high, car prices continue to surprise me in terms of holding up, demand is really very strong there. And so all of those things, we have to look at the momentum in that central component of inflation. And that's really the part that I believe has most of my colleagues and myself nervous about. I'm nervous about the supply side too, but I think that that's, as I talk to more and more people, I keep hearing stories. It's improving here, it's improving there. It'll take a while to make it all hang together, but I think that's kind of improving.

Todd:

All right. This wasn't on your list, but I'm going to ask it anyway.

Charles Evans:

Sure.

Todd:

Do you have somebody on your staff that goes out and counts how many shipping folks are parked off of Long Beach or LA's shipping ports?

Charles Evans:

Not on my staff. There are people who put together indices like that. And as you looked at the backlog of ships coming into the West Coast ports, there was tremendous backlog. If you look at it long enough, and then you start making a big deal about it, then all of a sudden people start behaving a little bit differently. And so some of those ships, they were in line so long, they were further offshore and they weren't counted. So it's kind of like, what's an accurate measure of that? So for anybody who's putting an index like that together, there are a lot of details that they have to pay attention to. For consumers of things like that, we do have certain activities, data that we contribute. Usually about our seventh district here, it's a five state district, the larger parts of Illinois, Indiana, Michigan, Wisconsin, and Iowa.

Charles Evans:

So we're paying attention to our businesses, how things are going, providing that commentary to the committee, not because it's a Midwestern stance on monetary policy, monetary policy's national. But as we all talk about our own parts of the country, a different take on the national trends comes into play. And sometimes it aligns very well with the national data, and sometimes it's like, "Oh, things seem to be a little bit different, aren't they?" For instance, labor shortages. It's really unusual. Well, I mean unemployment's 3.7%, but when it was a little bit higher, we would hear a lot about labor shortages. And it seems focused in so many manufacturing areas, outside of large metropolitan areas, sort of exurb, small market, rural areas, manufacturing facilities are located, and workers have different attitudes these days. Some of labor force is workers who are aging but haven't decided to retire.

Charles Evans:

They may well work well into their sixties, and then all of a sudden in a covid environment, having put up with a lot of stuff, they're kind of like, "I'm not interested in overtime." Overtime's important. "I'm not interested in working the weekend shift." Well, the weekend shift's important, especially when demand is so high, goods demand is high productions at capacity. And so those are the shortages that then you talk to the OEMs, the larger producers, and they're kind of going, "I can't get the parts." That's the shortage. Well, that part is because some other worker didn't show up to finish something. So Labor is running throughout this story.

Todd:

And I'll just tell you, Suzanne Clark was here just earlier from the US Chamber of Commerce, and she had dinner and it was somebody who can't produce their product, because they can't get it at a reasonable price, and that just happens. But I will tell you that if you need somebody to go to LA and count ships, I might send you my resume. That's okay.

Todd:

But anyway, I did want to go ahead and also get a little wonkish. Everybody concentrates on what the interest rate is, but you've also got a huge balance sheet that blew up that we know about that. And that's another lever that I don't think gets enough attention, in my opinion, but I'm just a want to be economist. So what would you say about the other mechanisms that the Fed has, to go ahead and generate monetary policy or anti inflationary issues?

Charles Evans:

So inflation's high right now, we need a more restrictive setting, a monetary policy. And as of last March, we were basically still at zero. The federal funds rate was at the zero to a quarter percent target range. And so we had quite a ways to go, and we have increased interest rates by three percentage points, 300 basis points. That is an enormous increase as of our last FOMC meeting. To put it in perspective, back in 1994 to 95, I remember being in exactly this ballroom when I think Governor Angel gave an economic outlook speech at about that time, and said that there were problems.

Charles Evans:

The Fed, in 12 months, increased the interest rate by 300 basis points, and it was referred to as the biggest blood bath in the bond market of all time. That was in 1994, 95. We have just done 300 basis points in seven months. So we have very quickly expeditiously adjusted the stance of monetary policy. If you are of the opinion that we got off to a late start, and looking back, I can see we should have started earlier, at the time it seemed okay, but we have very quickly turned things around. And we've indicated through our communications, our projections of where the funds rate's supposed to end up this year and next year, that we have further to go. We look, to me, according to our reports, headed for four and a half to four and three quarters percent, by sometime next year, which given how fast we've been raising interest rates is likely to be the springtime. That is a lot.

Charles Evans:

On interest rates, we can tighten things easily. It's on the easing side that we ran into problems, and that's why our balance sheet got to be so large. When you get down to zero, the economy's not doing well, inflation's low, and it's kind of like, we need to do more. You go back to 2011, Congress wasn't going to provide more fiscal support, they were going in the other direction. So we had to do more. So we ended up buying assets, we bought treasuries, we bought mortgage back securities. That reduced the premium on long term interest rates, and made borrowing a bit easier. It's not our first choice, it's not as powerful as interest rates, but it does contribute. Our balance sheet went up very strongly. Now, once things got better, we wound down our balance sheet. So one thing that you need to keep in mind, when it comes to central banking, we are of the opinion, it's our strategy that when we expand the balance sheet for these reasons, we intend to unwind it, so that it's back at the spot that it's supposed to be relative to the size of the economy.

Charles Evans:

Our balance sheet will always grow with the economy, so we're never going back to $800 billion of treasuries, where we were in August 2007, about the time I became president. But it's going to be well north of that. But we will be winding it down. At the moment, we are letting assets roll off, and there's a question as to what will be the pace, how long it'll take, I believe that this will be completed within a couple, three years, and then we'll be back to a pace that you kind of go, "Okay, that's where they should be." So that sounds fiscally responsible, doesn't it? I mean, if you're thinking about balance sheets and how it can get out of hand, if you've got a plan where you needed it for that type of support, but then you're going to get back to where you should have been, then that's a pretty good plan, I think. Yeah.

Todd:

Yeah, Suzanne will consult with you on that.

Todd:

So your staff told me I could ask this question, although I think I know what the answer's going to be. The next meeting's going to be 75 basis, points or 50 basis points?

Charles Evans:

Well, we're going to have a discussion about that. As I alluded to earlier, we started in March raising rates, and we had a long ways to go. We all of a sudden in June, decided we would increase interest rates by three quarters of a, 75 basis points, which is a lot. That's a big number. In the old days, 50 was a big number, and all of a sudden we're at 75.

Charles Evans:

We did two 75's June and the late July meeting, and then we go into September, and I probably went... I had been previously of the opinion that the 75's were sort of... We have to front load, we have to get to the right spot where then we can start increasing at a pace that's not so fast, that we'll overshoot the data as it begins to improve, and then we over tighten. But inflation has been disappointing beyond what I thought, so we did another 75. If you look at the median participant who submitted projections for where our federal funds rate will end at the end of this year, there are only two meetings, they're looking for 125 basis points of increase. So in two meetings, how do you do 125 basis points of increase? Well, you can sort make that choice yourself.

Todd:

So you're saying hold off on your CD purchases for a little while here?

Charles Evans:

Oh, no. Now wait a minute, I mean... Oh, CD purchases. Well, I mean, for one thing, in my opinion, we have offered quite a lot of information about what our plan is. We've described what our strategy is, we've executed on it, and we have these projections. And so I'm here talking about we are expecting and will need further interest rate increases. If you're pricing something in a market, you're going to take this into account. I mean, you're not going to go, "Oh, okay, I'll wait till December and then I'll increase interest rates." I mean, you would think that the market would get ahead of that. Now, banks are always a little later to do these things. So if you're talking CD rates....

Todd:

Okay, so I've got to ask this question as well, and tell me, again, whatever you can tell us. I'm a little wonkish, so what's it like to walk in with the other members of the Open Market Committee, and what can you tell us about what the dynamic is? I mean, literally going through huge binders of information, are you just kind of arguing with each other? Or, tell me what it's like to be in the room with the other members of the Open Market Committee?

Charles Evans:

Well, the setting for the meeting is in traditionally a very formal, large board room. And so it's impressive, it's intimidating, you must feel this all the time when you go to the state legislature or courthouses and things like that. I mean, there's just a lot of esteem, prestige, and it's very formal in that regard. We walk in, we've got a job to do, and we've all studied the data ourselves. We've studied briefing papers, we've got a variety of briefing papers, some that are shared among everybody, and some that just my staff has done on my behalf. And then we go and talk about what the situation is. Some cases, some meetings are more interesting, more challenging, subject to more divergent views than others, and then there are others where it's like everybody's very much inclined.

Charles Evans:

Most recently, there's been a tremendous amount of cohesiveness to everybody's views, just because we realized we were behind, we had a long ways to go, you know we have to be expeditious, and we want to get to a certain place either by the end of this year or next spring. It's pretty clear, and everybody's on board. When you get to the point where the data are a little unclear, are you at a turning point? Has inflation really in increased?

Charles Evans:

That last report was good, but do you remember when that happened in the summer and we had a good inflation report, and then it was really bad for two times in a row? So how much does it take to be convinced? How much are you going to wait your forward looking projection, or how much do you have to see your own eyes into data, that type of thing. These are honest discussions, disagreements, and what I love about what's referred to as the Federal Funds Rate Dot Plot, because you've got now 19 participants, and everybody's supposed to say, "At the end of this year, I think the interest rate's going to be here."

Charles Evans:

Well, you put that on a scatter plot, and when everybody agrees, it's like everybody's in the same place. It's a very tight cluster. When there's a big discussion taking place, it gets spread out. Some people want a lot of increases, other people are saying, "Oh, I'm not sure we need to do anything. Or maybe it's in the other direction." And some people kind of go, "That's not helpful when I see that dispersion. You guys can't agree on anything. It just sounds like you haven't thought things through." My reaction is, that's an indication that a very interesting meeting took place. People felt very strongly about their forecasts, they talked about it at great length, and you can see the dispersion of viewpoints. There's a tremendous amount of information in the fact that they're dispersed. And when they're all sort of clustered in the same place, there's information and it's kind of like, "Boy, they're really certain about this, aren't they?"

Todd:

I find that fascinating. That's really great.

Charles Evans:

I need to bring you along for all of my presentations. Cause there aren't that many fans of these.

Todd:

I'll sign up for everything.

Charles Evans:

Yeah, we'll see.

Todd:

All right, so I'm going to make your staff really mad at me one more time because it's not on this question sheet, but I'm going to ask it anyway, because the Illinois Chamber has always had a pretty good interaction with international community because of trade. We want foreign direct investment here, we want to go ahead and export, we're the six largest just exporter in the nation, but can you talk to me about how much you talk to the Bank of England, and the whole notion of whether what the Fed does here in America is influencing what happens in Germany and the UK and their decisions that they're making? So again, tell me whatever you can tell me.

Charles Evans:

So trade's very important, all the activities that you mentioned that you and the chamber and business folks are involved in are extremely important, more trade in each direction is going to lead to a better living standard for everyone here in Illinois and support the national economy as well, especially with our transportation logistics contributions and all that. So that's really tremendous, and everything that we're doing is geared towards supporting the economy and the best possible way, so that we can reach our potential growth, and that we don't somehow disadvantage or even destroy physical infrastructure that we have in place, because it can't be maintained at certain things. And so that's all part of the longer term perspective. The global economy is large, but it's small. The US economy has a big influence. And so when we are leading the way in terms of monetary policy tightening, other economies and central banks feel that.

Charles Evans:

The Bank of England started raising rates before we did. But we've done it very quickly, they've had other factors, they're a small open economy, so when the pound changes, that effect on their pricing and everybody's ability to buy and sell. Is really much larger. We're a little bit more insulated here in the US and so we, in the Federal Reserve, we have conversations with other central bank entities, Bank of England, ECB, there are regular discussions that take place at the Bank for International Settlements in Basel, Switzerland, where a lot of central bankers come together to work on common problems.

Charles Evans:

When the US takes a strong action and a direction that other central banks aren't heading to, and if it's not a unique US situation, I mean, inflation is high in the US, fiscal support was strong, demand has been very strong, but it would be wrong for anybody to think that only the US has an inflation problem. Inflation is high in the UK, in Europe, there's a whole bunch of energy related issues, other structural challenges, the supply chains and that. So everybody's struggling with that. If we're out ahead, everybody else is sort of feeling that, their currency rates and all of that. So we have lots of conversations. At the end of the day, everybody's got to make their own decisions, but knowing better what everybody is facing and calibrating what that means for our own projections in a more informed way, is very helpful.

Todd:

Well, I will say thank you very much. I found this very fast saving, hopefully you did as well. Thank you for all the work you do for Chicago and the Midwest.