Christopher Waller:

Thank you, Kathy. I'm happy to take your questions.

Kathy:

All right. So I have some prepared questions for you, Chris. Now, you spoke about how you will be watching financial conditions. [inaudible 00:00:16] is a normal thing for you to do, of course. What types of things do you look for, and what do you look at when you're evaluating financial conditions?

Christopher Waller:

Right. So the main point of our policy over the last year has been to try to tighten credit conditions, make lending tougher, reduce total demand to put downward pressure on prices. That's what we're trying to do, plain and simple.

So we're trying to tighten credit conditions. You can do that one of two ways. You can raise the price of credit, which is the interest rate, or the terms of the credit, maturity, your loan to value, other types of underwriting criteria.

We've been focusing on the price of credit. What we're now seeing is the financial sector is starting to adjust the terms of credit, which you all may face at some point. So that's what we're really going to look for.

We're going to look about changes in risk tolerance for banks through the senior loan officer survey, terms of credit, loan to value. These are all things that we can see whether they're starting to tighten credit conditions or not, whether you're raising your tolerance for who's going to get cut off, your prime borrowers, maybe less prime borrowers.

Those are the things we're going to be looking at to see, particularly if we see a sudden spike or a very abrupt adjustment in these, because we already saw a trend tightening as you go up, tightening, getting more severe. But if it suddenly accelerates, then it will have a much stronger effect on the economy.

Kathy:

And directly impact us, as we all know in our industry. Right. Our customers are really subject to this tightening.

Another question, can you talk a bit about how tighter financial conditions are related to your views of appropriate monetary policy?

Christopher Waller:

Right. So up until March 10th when SVB failed, the data that was coming in January and February was just extremely hot. The economy was not showing any signs of slowing down. So at that time, I thought that our terminal interest rate, where we might think about stopping, was going to have to be much higher than what we projected in December, which was five and an eighth in terms of the interest rate.

So I started thinking we were going to have to go up to five and a half or five and a quarter or higher to deal with it. Once the SVP situation happened and credit conditions started to tighten, that takes some of the work off of me, because if the financial market tightens the non-price credit, I don't have to do as much on the price side to tighten credit. So what that did is it kept me from pushing up my terminal rate and kept it where it was in December.

So we're going to let some of this... This is a silver lining in a bad cloud, but we're going to let some of this tightening do the work for us so that we don't potentially have to raise rates quite as much as I thought we would have to back in February.

Kathy:

It's encouraging that you continue to reevaluate everything after economic data comes in, because some people don't get to see that part of your decisions.

Christopher Waller:

Yeah.

Kathy:

Yeah.

Christopher Waller:

Yeah. We live and die by the data.

Kathy:

Yep. Super data. Yes, yes. All right. You mentioned that inflation is still too high. And so why is it taking so long to get to the 2% target that you've said?

Christopher Waller:

Yeah. So inflation's been kind of funny over the last 15 years. During the 2010s to 2020, we had a 2% target and inflation was running consistently below. And it's always a funny thing in economics. If there's one thing a central banker should know how to do, it's cause inflation. But we couldn't seem to get inflation to go from one and a half to two. It just stayed there for 10 years. We couldn't move it.

So now, so that stickiness in inflation was a puzzle to all the economics profession. Given everything we were trying to do to stimulate demand, get the economy going, it still just didn't seem to have any impact on inflation. And then we got a big surprise. Inflation went up. For a while, all the economics, all the theory, everything suggested that this would be, I'm going to say the dreaded word, transitory,

And then unfortunately, it didn't turn out that way. So inflation exploded on us really at the end of 2021. We had to do an abrupt adjustment in our policy to tighten at a much faster rate, because inflation was just screaming, as you saw last year in 2022. And it's my job to try to get it down, and that's what they put me in there for.

So we went on a very rapid rate hike to try to bring inflation down. Now, we have seen headline go from about 9% down to about five. So that is progress. But like I said, core, when you strip out food and energy, a lot of that run up and run down is just food and energy, particularly energy. So it's not really telling you what's going on underneath for all the other goods and services. That's why we look at core. That's why we strip those two categories out. That's everything else in the economy, and that just has not come down. It has stayed right around... In December 2021, I believe it was 6%. And right now, it's 5.6. So core inflation has just literally gone like this, sideways, and we need to get that down to get closer to our 2% target.

So one of the things we do know that's driving this persistent is housing cost, shelter cost. Rents move with a lag because people sign 12-month leases, say for rents, and then they only adjust once a year. But when they adjust, they go up a lot. So you get this lag that a lot of what we saw in housing pressures last spring are just now going to start showing up in prices, new rents, new leases that get signed. So shelter has this persistent component. We all know that. Everybody's fully aware of it. And a good sign we got in the CPI report is that we finally saw, instead of housing shelter costs going up at eight tenths of a percent per month, they only went up at 0.5, half a percent per month. And we expect that to keep coming down.

So that should pull some of the persistence. That's why most of us have inflation coming down to the three to three and a half range by the end of the year. Some of that persistence from housing will start fading away, and then we'll get inflation a lot closer to our target by the end of the year.

Kathy:

Probably the best explanation I've heard of why it's so stubborn, because it just isn't moving all... It's just sitting there.

Christopher Waller:

Yeah.

Kathy:

All right. So after months of inflation, and I mentioned this the other day in a casual conversation, our industry is starting to see some kind of price deflation, especially around commodities. Non-commodity products are still holding, but the commodity prices are starting to drop. Is this consistent with what you're seeing at the macro level? And would you share a broader view on this and what that could mean to us and the general economy?

Christopher Waller:

Yeah. So the pandemic caused a huge shift in spending by households from services to goods. Goods, you got to make stuff, you got to ship stuff, it's got to go on a truck, it's got to go on a plane. So we saw a huge demand for this in the pandemic. Prices exploded for manufactured goods, any durable kind of goods. A.

And then as the pandemic resided, we all anticipated rotation out of goods back into services. That took a lot longer to happen than we imagined. So we were always expecting goods prices, manufacturing good prices, they ran up and that they were going to come somewhat back down now, not maybe all the way back, but come down somewhat. We didn't see that till the end of last year. We were thinking this would happen by the end of 2021, early 2022, but it didn't happen till the end.

And in the last couple of months, good prices have started to go back up, not stay flat or continue to come down. So some of the decline in manufacturing and prices or some of that is we fully expected this rotation back into services. When you use terms like revenge travel, that should tell you something, that there's a rotation back to services.

And the other big disruption was just supply chains weren't prepared for this kind of massive increase in demand and shipping of all this stuff. So there was a lot of talk about supply chain problems. And we thought in 2021 that these things would unravel quicker than they did. It just took a lot longer to unravel these supply chains or reorient supply chains to help get goods prices back down.

The thing I learned in the pandemic is I thought all the economies would just power down and then just power back up. But they didn't happen at the same time. Some would power down, some were still going, this would come up, this one would go down. So every time you reestablished one link in the supply chain, another one would break. And unless they're all connected, it doesn't work. So that's why I think there was a lot of persistence in the supply chain, just because this asynchronous shutting down and opening up of economies around the world.

But we are starting to see a lot of the supply chain things unravel. I'd be curious to hear if that's your world. Love to hear comments on what you're seeing. But what we're seeing in the data is, for the most part, we're not hearing a lot of problems on supply chain. So what we're seeing right now is pure demand. People have income, their jobs are good, there's a tight labor market, and that supports demand for goods and services by households. So that's how I see it, but I'd love to hear later your thoughts on it.

Kathy:

Well, since we're at that point and my next question was around supply chain, would anybody in the audience to comment on what you're seeing around Chris's question about what you're seeing in supply chain? Because you all live it. We know because my organization's on that receiving end, but you all have lived the supply chain challenges and whatever you're dealing with today. What are you all seeing if anybody wants to comment? Yeah.

Christopher Waller:

Sure.

Speaker 3:

[inaudible 00:11:33].

Christopher Waller:

Yeah. So on the first point, the question was supply chains have gotten better, but there's still spot shortages of products. That's a great point. I heard that a year ago that if you need a hundred parts to put something together and you get 99, you still can't ship the product. So during the shortage of vehicles when they were short chips, at some point the automakers just said, "Okay. What things in the car do we not need a chip for and just sell it without some functionality in the car that we normally would've sold it?" Those are the kind of trade-offs you start making when you have the problem you just described.

This is the tricky part about pricing, right? You negotiate a contract to supply some goods. It takes a while to get there. Prices change dramatically. Somebody either has to bear the cost if the price isn't right, if it's too high. The buyer's saying, "Well, I could have got it lower," or they walk away, or you have to renegotiate the contract.

So I'm not sure exactly how much renegotiation there is in terms of your all contracts or orders, depending on how much it is, whether you have to eat it or the customer has to eat it. That's not my world. That's what I want to talk to you all about. But that's what I said. That's a similar kind of common problem with leases of any kind, that they're set last year, there's a lot of inflation pressure that builds up over the year, they reset higher. And then last year, we saw rents were skyrocketing last summer. But rents have come down. I have to reset my own rent here pretty quick. So yeah, it went up to like 15% and it's come down to eight. But I was at zero, so I got to go up to eight. So it's still going to be a shock for me when I get my rent increase. And so that's the issue with all the repricing, is, with a lag, you're still going to have to face these higher costs.

Kathy:

Well, I think we have two minutes left. Two minutes left. Are there any final comments? And if you don't, I have one quick question. It actually probably won't be quick, though.

Christopher Waller:

Fire away.

Kathy:

Okay. What are your views briefly on the recent chatter about de-emphasizing the US dollar as a world's reserve currency? We're hearing a lot of noise out there on that.

Christopher Waller:

Yeah. The thing I always try to stress with the US, the reserve currency of the dollar is this is a voluntary arrangement by trading partners in the world. If you're a German firm trading with a Japanese firm, you price your contract in US dollars. Nobody's forcing you to do that. You're doing that because you want the dollar to be the basis for that trade.

So it's always a question of why do people want our currency to be basis of a voluntary trade between two other countries? And the reason is we have good rule of law with good property rights, deep and liquid financial markets compared to everybody else on the planet, relatively stable political and policy institutions. And that's why these countries want to use our currency. So I always ask people if you think the dollar should go down, one of those things has to break and somebody else has to step up and do it better.

My whole 40 years, I've been told, "Oh, the dollar, the dollar's going to lose." It's still there. So it's going to be very hard for some country to step in and get... Remember, you can always put a gun to somebody's head and say, "Look, you got to use our currency to do something in our country." Okay. But that doesn't mean people outside your country who are voluntarily going to use your currency to do anything.

So that's why I personally don't think there's really a serious threat. When the euro came into existence 20 years ago, that's all I heard, "The euro's going to take over. The euro's going to knock..." Not even close. Didn't even come close. So the dollar's still the preeminent currency because people in the world want to use it. And that's why it is.

Kathy:

Well, join me in thanking Dr. Waller for joining us this morning. And thank you, Chris.

We're good? All right.

Christopher Waller:

All right. You all can get back to work.

Kathy:

Writing orders with margin, of course. Okay. Thanks, Chris. And again, if you guys have-