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Hike, Skip, or Pause?

Remarks by

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Thank you, Peter, and thank you for the opportunity to speak to you today. I confess I am not an expert on Santa Barbara County's diverse economy, beyond my abiding interest in the excellent wines you produce. But you will hear more about the regional outlook from the other two speakers and so I'll focus my remarks on a broader perspective of the U.S. economy and how the data is shaping my policy views.[1] Let me cut to the chase—in my view, data since the last meeting of the Federal Open Market Committee (FOMC) has not provided sufficient clarity as to what we should do with our policy rate at the next meeting. We still have some major data releases coming up in the next three weeks and I'll also be learning more about evolving credit conditions, both factors which will inform me on the best course of action. Between now and then, we need to maintain flexibility on the best decision to take in June.

Starting with the economy, activity has slowed from its pace in the latter half of last year. Real gross domestic product (GDP) is estimated to have grown at a modest rate last quarter, and different data available for the current quarter could be interpreted as suggesting growth is slowing or even accelerating a bit. Real GDP grew at an annual rate of 1.1 percent in the first three months of the year. The consensus of private sector forecasts tracked by the Blue Chip survey is for annualized growth of only a tenth of a percent or two above zero this quarter. By contrast, the Atlanta Fed's GDPNow projection, based on a range of data, is for a 2.9 percent growth rate. Retail sales and industrial production rose in April, though those gains followed two months of declining or flat readings. At the same time, April was the second month non-manufacturing

[1] The views expressed here are my own and are not necessarily those of my colleagues on the Federal Open Market Committee.

businesses expanded modestly, according to respondents of the Institute for Supply Management survey.

Despite this slowing in activity from last year, we have a very tight labor market and high inflation. We also are at a period of higher-than-usual uncertainty about how credit conditions are evolving in response to the recent bank failures and stress among some other mid-size banks. Let me talk about each of these three key issues and then conclude with how I see these factors playing into my June policy decision.

A Very Tight Labor Market

The employment report for April showed solid job growth, but previous months were revised downward by a significant amount. The unemployment rate fell slightly to 3.4 percent, reaching its low in recent years, which is the lowest since 1969. The labor force participation rate held steady in April after several months of increases. Average hourly earnings rose at their fastest pace this year, and, over the past 12 months, were up 4.4 percent, slightly higher than the yearly pace in March. These data suggest the labor market is still powering forward.

However, there are some other signs that the labor market may be cooling. Temporary-help employment fell for the third straight month and is considerably down from last year. Some see this category as a leading indicator for overall employment, meaning we may see some softening in labor demand going forward. Furthermore, job vacancies declined by 384,000 in March, and the number of job vacancies for every person counted as looking for a job has declined to 1.6, down from the peak of 2 for every job seeker. This reduction is consistent with a softening in labor demand, but it is still far above the 1-to 1 ratio that was typical before the pandemic. Finally, the rate at which people are quitting jobs, a sign of confidence in the job market, has fallen and is in hailing distance of the level that persisted for the couple of years before the pandemic recession.

As I have argued in other speeches, a loosening labor market, to help our fight against inflation, doesn't have to mean a recession or big job losses.[2] But we do need to see more loosening than we have seen to help take the heat off the inflation rate.

Inflation Is Stubbornly High

Let's talk about where we are on inflation. The latest consumer price index (CPI) report showed that headline inflation fell from 5 percent year over year in March to 4.9 percent in April. But that decline was only due to rounding—the actual decrease was just five one-hundreds of a percentage point, from 4.98 percent to 4.93 percent. Almost no progress.

The news on core inflation was similar. Core CPI inflation excludes food and energy and is usually a better guide to the underlying trend for prices. Core was up 5.5 percent in April from a year before and has been more or less steady in 2023. It is only a bit down from around 6 percent a year ago. Whether measured on a three month, six-month or 12-month basis, it is running too high. Likewise, narrower definitions of inflation intended to filter out fluctuations in some prices show little progress in the past year. Six of seven of these alternative measures created by different parts of the Federal

[2] 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 Distinguished Lecture, Goethe University, Frankfurt, Germany, May 30, https://www.federalreserve.gov/newsevents/speech/waller20220530a.htm

Reserve System show inflation running between 4 and more than 5 percent over the past year or so.[3]

Bottom line, I am concerned about the lack of progress in any and all of these measures, and I have a couple specific concerns about some important components of inflation. First, core goods prices, which were among the biggest factors that drove the escalation in inflation the past two years, aren't slowing or retreating as much as we need to get inflation down closer to our 2 percent target. We're hoping there will be a continued slowdown in goods price increases, but we aren't seeing deflation in this category like we had pre-pandemic. A second concern is rent increases, which accounts for most of a category called housing services and is a sizable component of inflation. Lower rent increases from lease renewals last year are slowly making their way into the inflation data, but most recently, a rebound in the housing market is raising questions about how sustained those lower rent increases will be. While housing prices actually have less of a short-term effect on rents than one might think, this upturn in the housing market, which comes even with significantly higher mortgage rates, has raised questions about whether the benefit from the slowing in rent increases will last as long as we have been expecting. Lastly, as I think of the service category of inflation, I look to how wages are growing, since labor is a large input into production. Though some measures of wage increases have begun to slow, I am concerned that inflation won't be coming

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[3] See Kevin L. Kliesen (2023), "Measures of 'Trend' Inflation," Federal Reserve Bank of St. Louis, *Economic Synopses,* April 18, https://doi.org/10.20955/es.2023.7.

down very much unless average hourly earnings decelerate from the most recent level of 4.4 percent to a pace a lot closer to 3 percent.[4]

On Friday, we will be getting April inflation data based on personal consumption expenditures and then May CPI data on the first day of the FOMC meeting. These are two critical pieces of data I will be looking at between now and the June FOMC meeting to learn more about inflation dynamics and if we are seeing some easing in inflation pressures.

Uncertainty about Credit Conditions

Turning to banking conditions, I want to emphasize that overall, the banking system is sound and resilient, with strong capital and liquidity. In response to the recent stress, the Federal Reserve, working with the Treasury Department and the Federal Deposit Insurance Corporation, took decisive action to strengthen confidence in the banking system. Employing financial stability tools in response to liquidity pressures allows us to continue to focus on setting monetary policy to achieve our dual mandate of maximum employment and price stability.

Monetary policy works in large part by setting the target range for the federal funds rate, and this rate transmits to market interest rates and affects household and business saving, spending, and investment decisions. So, the FOMC has been raising the target range for the federal funds rate over the past year with the goal to slow demand for goods, services and labor to bring them into better alignment with supply and put downward pressure on inflation. Financial conditions can also tighten from non-

[4] Of course, I want to see wages grow. But wage growth needs to be at levels that are consistent with our two percent inflation goal. Otherwise, wage gains will be outstripped by inflation and families effectively will have less take home pay.

monetary policy developments. And there has been a lot of discussion about how the recent banking stresses may tighten credit conditions. If lending does slow, this can obviate the need for at least some monetary policy tightening. It is important to account for this other form of tightening in setting the stance of monetary policy. If not considered appropriately, the Fed could tighten too much and needlessly raise the risk of a recession.

I am monitoring how credit conditions may be changing, both interest rates and non-rate conditions, such as the number of new loans, the size of loans, and the lending terms. Since the bank failures in mid-March, the Fed's survey of bank loan officers in April showed some moderate tightening of lending conditions to firms over the previous three months, with somewhat more tightening for lending to smaller firms. Officers for many of the banks in the survey said they expected lending conditions to continue to tighten further in 2023. Lending conditions had tightened significantly already since 2021, and it is hard to tell whether the actual and expected incremental tightening in standards in this survey was more of the same or related to the banking stress.

In addition to the Fed survey, a variety of financial market participants over the past few weeks have also reported that credit tightening is expected to continue. They are not suggesting a credit crunch but are concerned that it could happen, and they say it isn't yet clear how banking terms and conditions will evolve. There are a wide range of estimates trying to map this expected credit tightening into policy rate hikes. As of today, it isn't clear to me what the effect on the economy will be.

Implications for Monetary Policy

Let me turn to the implications for monetary policy. There is a lot of discussion about the next step for policy. There are three options: hike, skip, or pause. Let me outline reasons why each of these options may be appropriate.

One might lean toward hiking by focusing on the economic data and interpreting it to suggest that inflation and economic activity are not consistent with significant and ongoing progress toward the FOMC's 2 percent inflation goal. Based solely on the data we have in hand as of today, we are not making much progress on inflation. If one doesn't believe the incoming data will be much better, one could advocate for another 25-basis-point hike as the appropriate action in June.

Alternatively, one might view the current and incoming data as supporting a hike in June but believe that caution is warranted because there is a high level of uncertainty about how credit conditions are evolving. Another hike combined with an abrupt and unexpected tightening of credit conditions may push the economy down in a rapid and undesirable manner. This possibility is the downside risk of an additional rate hike in the current environment. If one is sufficiently worried about this downside risk, then prudent risk management would suggest skipping a hike at the June meeting but leaning toward hiking in July based on the incoming inflation data. There is a little over a month between the June and July FOMC meetings, and during that time we will learn more about how credit conditions are evolving. Over four months will have passed between the Silicon Valley Bank failure and the July meeting. By then we will have a much clearer idea about credit conditions. If banking conditions do not appear to have tightened excessively, then hiking in July could well be the appropriate policy.

Lastly, one might want to pause hikes at the June meeting, meaning that the target range is at its terminal rate, if the current stance of policy is thought to be enough to bring inflation down over time. Between policy lags and possible tightening credit conditions, the current stance of monetary policy may be seen, at that point, as sufficiently restrictive to move us toward the dual mandate. From this viewpoint, the policy rate is high enough and we simply need to hold it there to bring inflation down toward our 2 percent target.

I do not expect the data coming in over the next couple of months will make it clear that we have reached the terminal rate. And I do not support stopping rate hikes unless we get clear evidence that inflation is moving down towards our 2 percent objective. But whether we should hike or skip at the June meeting will depend on how the data come in over the next three weeks. We will get additional labor market data, with some information about wages, and additional inflation numbers in the next few weeks that will continue to shape my view on where we stand relative to the FOMC's dual mandate. During this time, I'll also be reviewing data on credit conditions to evaluate how much potential tightening is coming from the banking sector.

Fighting inflation continues to be my priority. We worked very hard over the past year to quickly raise the target range for the federal funds rate from near zero to about 5 percent. While we are seeing some tentative signs of cooling in the labor market, I am determined to continue to use our policy tools as needed to appropriately bring inflation down to 2 percent.

Thank you.