

Christopher J Waller: The time has come

Speech by Mr Christopher J Waller, Member of the Board of Governors of the Federal Reserve System, at the University of Notre Dame, Notre Dame, Indiana, 6 September 2024.

* * *

Thank you, Eric, and thank you for the opportunity to speak to you today.¹ My topic is the outlook for the U.S. economy and the implications for monetary policy, a set of judgements that have, of course, been influenced by this morning's jobs report. When I scheduled this speech several months ago, I knew it might be challenging to speak a few hours after the release of such an important piece of data. But we like to say that monetary policy must be nimble, so that means policymakers must be nimble also. Not *Simone Biles nimble*, but nimble. As you will hear, I believe the data we have received this week reinforces the view that there has been continued moderation in the labor market. In light of the considerable and ongoing progress toward the Federal Open Market Committee's 2 percent inflation goal, I believe that the balance of risks has shifted toward the employment side of our dual mandate, and that monetary policy needs to adjust accordingly.

Looking back at the economic data over the first six months of 2024, it portrayed an economy slowly cooling and not showing signs of significant weakening. The labor market had been gradually moderating for the past year or so, and although inflation rose in the first quarter, it then retreated in the second, and there was a widespread view heading into the second half of the year that the FOMC was on track to achieve a much desired but unusual "soft landing."

Then the July jobs report came in unexpectedly soft. Job creation slowed and the unemployment rate increased by two tenths of a percentage point to 4.3 percent, the highest since October 2021. There was speculation that weather-related issues might have distorted these results and, in fact, the unemployment rate ticked down in this morning's release. But, overall, the August report along with other recent labor data tend to confirm that there has been a continued moderation in the labor market.

The ups and downs in the data over time highlight what I consider the right approach to meeting the FOMC's dual mandate goals-I believe we should be data dependent, but not overreact to any data point, including the latest data. When we faced a period of banking instability in the spring of 2023, there were calls from some to stop rate hikes despite inflation still running over 5 percent. But there were other tools in hand to deal with that stress, monetary policy did not overreact, and the FOMC continued tightening policy. When inflation fell unexpectedly in the second half of last year, we did not overreact and immediately cut the policy rate. Then when inflation accelerated in the first quarter, we did not overreact and raise rates despite some calls to do so. I will be looking at these last two employment reports in combination with all other data as we head into the September FOMC meeting to decide the best stance of policy. I believe our patience over the past 18 months has served us well. But the current batch of data no longer requires patience, it requires action.

Today's jobs report continues the longer-term pattern of a softening of the labor market that is consistent with moderate growth in economic activity, the details of which I will get into in a moment. As I said at the outset, considering the progress we have made on getting inflation back to target, I believe that the balance of risks is now weighted more toward downside risks to the FOMC's maximum-employment mandate.

While the labor market has clearly cooled, based on the evidence I see, I do not believe the economy is in a recession or necessarily headed for one soon. The collective set of economic data indicates to me that the labor market and the economy are performing in a solid manner and the prospects for continued growth and job creation are good, with inflation near 2 percent. I continue to believe that this can occur without substantial harm to the labor market. But I also believe that maintaining the economy's forward momentum means that, as Chair Powell said recently, the time has come to begin reducing the target range for the federal funds rate.

In the rest of my remarks, I will lay out my reasons for believing that the economy and employment will likely keep growing as inflation moves toward 2 percent. The first of these is the large body of evidence that economic activity is continuing to grow at a solid pace. Real gross domestic product (GDP) grew at a 2.2 percent annual rate in the first half of this year and recent data indicates that growth is continuing at around this pace in the third quarter.

Retail sales were stronger than expected in July and showed that households continue to spend as their finances, in the aggregate, remain healthy. The increase was fairly broad based across goods categories. While many online retailers offered discounts last month, this was not a dominant factor in the solid results. Although manufacturing output fell in July and the August Institute for Supply Management manufacturing survey pointed to weak production and new orders, the similar survey for the larger, nonmanufacturing sector was consistent with a modest expansion of activity.

As for the labor market, on balance, the data that we have received in the past three days indicates to me that the labor market is continuing to soften but not deteriorate, and this judgement is important to our upcoming decision on monetary policy. As I said earlier, Wednesday's report on job openings in July was consistent with a moderating labor market. Meanwhile, the four-week moving average of initial claims for unemployment insurance has risen gradually since January but has changed little on net in the past two months, with initial claims remaining fairly low.

The jobs report for August, released this morning, supported the story of ongoing moderation in the labor market. After rising to 4.3 percent in July, the unemployment rate ticked down to 4.2 percent in August. Taking a longer perspective, the unemployment rate over the past 16 months has increased gradually but fairly steadily from 3.4 percent to 4.2 percent in today's release. Payrolls rose by 142,000 in August compared with 89,000 in July, leaving the three-month average payroll gain at 116,000, compared with the 267,000 average in the first quarter and 147,000 in the second. Accounting for revisions to the jobs numbers that we received in August, that level is a bit below what I see as the breakeven pace for job creation that absorbs new entrants to the workforce and keeps the unemployment rate constant.²

July marked the first time that the three-month average unemployment rate has increased by at least a half of a percentage point above its 12-month low, which was 3.6 percent in July 2023. This breached a threshold established by the Sahm rule, which observes that when this has occurred in the past, it has been a reliable indicator of the economy entering a recession.

While this is a correlation that certainly bears attention, I want to make a few cautionary points about relying on such rules in deciding that a recession has begun. As we have seen in the recent past with other supposedly reliable recession rules, such as an inverted yield curve, there is more to forecasting economic outcomes than the relationships between a couple of variables.

First, these rules are nothing more than a mechanical, statistical description of past economic outcomes—they do not seek to explain what economic forces drive the relationship between the data, nor are they based on the totality of economic data. All recessions rules do is pick up a correlation between movements in economic data and the dates of recessions or other outcomes. A second point is that, setting aside the unusual circumstances of the 1981–82 recession, recessions occur when a major shock hits the economy.³ In the absence of a big negative shock, an inversion of the yield curve or a triggering of the Sahm rule doesn't necessarily mean we are entering a recession.

Third, recession rules typically pick up demand-driven recessions. But this is not why unemployment is rising now. GDP forecasts for the current quarter all show solid growth, labor market data show lay off rates are stable, and consumer spending is growing at a healthy rate. These data suggest demand is fairly strong. Instead, most of the increase in the unemployment rate is from workers entering the labor force and not finding jobs right away. So, the recent rise in the unemployment rate appears to be more of a supply-side-driven phenomenon, not demand driven.

And lastly, it should be clear to everyone that many pre-pandemic economic relationships have not proven to be good policy guides post-pandemic. Reliance on old lessons from inverted yield curves to predict a recession, a Phillips curve to predict inflation, or a flat Beveridge curve to predict the movement in the unemployment rate have all led to mistaken economic forecasts.

While I don't see the recent data pointing to a recession, I do see some downside risk to employment that I will be watching closely. But at this point, I believe there is substantial evidence that the economy retains the strength and momentum to keep growing, supported by an appropriate loosening of monetary policy.

Let me now turn to the outlook for inflation. With the labor market cooling, it doesn't surprise me that wage growth has slowed to a pace consistent with the FOMC's price-stability goal, and this is supporting ongoing progress toward that objective. The employment cost index grew at an annualized rate of 3.5 percent from March to June, and the 12-month change was 3.9 percent for private sector workers, the lowest since late 2021.⁴ Average hourly earnings, reported in today's jobs report, rose at a three-month annualized pace of 3.8 percent in August, the same as the 12-month change.

Inflation in July continued to show progress toward the FOMC's goal. The price index for personal consumption expenditures (PCE), the Committee's preferred inflation measure, increased at a monthly pace of 0.2 percent in July for both total and core PCE inflation. Core PCE inflation, which excludes volatile food and energy prices, is a good guide to underlying inflation, and it increased 2.7 percent over the past 12 months. Given the downward trajectory of monthly readings, I also look at the 6- and 3-month annualized rate. These stand at 2.6 percent and 1.7 percent, respectively. These numbers are good news and suggest that our restrictive policy stance has put us on the right path to attain our 2 percent inflation target.

Looking across the components of inflation, one can see the breadth of the disinflation. Over 50 percent of categories in the total and core market baskets had annualized monthly inflation less than 2.5 percent in August. In fact, the index of core goods prices has reverted to its historical pattern of slight deflation, reflecting normalized supply after the disruptions of the pandemic as well as ongoing technological and productivity advances. Meanwhile, services price inflation has slowed as wage growth has slowed, since labor is a large input for much of the service sector. Overall, I see significant and ongoing progress toward the FOMC's inflation goal that I expect will continue over the remainder of this year.

Now let me discuss the implications of this outlook for monetary policy. As I said at the outset, considering the achieved and continuing progress on inflation and moderation in the labor market, I believe the time has come to lower the target range for the federal funds rate at our upcoming meeting. Reducing the policy rate now is consistent with many versions of the Taylor rule, which suggest reducing the policy rate is appropriate given the data in hand.

Furthermore, I do not expect this first cut to be the last. With inflation and employment near our longer-run goals and the labor market moderating, it is likely that a series of reductions will be appropriate. I believe there is sufficient room to cut the policy rate and still remain somewhat restrictive to ensure inflation continues on the path to our 2 percent target.

Determining the appropriate pace at which to reduce policy restrictiveness will be challenging. Choosing a slower pace of rate cuts gives time to gradually assess whether the neutral rate has in fact risen, but at the risk of moving too slowly and putting the labor market at risk. Cutting the policy rate at a faster pace means a greater likelihood of achieving a soft landing but at the risk of overshooting on rate cuts if the neutral rate has in fact risen above its pre-pandemic level. This would cause an undesired loosening of monetary policy.

Determining the pace of rate cuts and ultimately the total reduction in the policy rate are decisions that lie in the future. As of today, I believe it is important to start the rate cutting process at our next meeting. If subsequent data show a significant deterioration in the labor market, the FOMC can act quickly and forcefully to adjust monetary policy. I am open-minded about the size and pace of cuts, which will be based on what the data tell us about the evolution of the economy, and not on any pre-conceived notion of how and when the Committee should act. If the data supports cuts at consecutive meetings, then I believe it will be appropriate to cut at consecutive meetings. If the data suggests the need for larger cuts, then I will support that as well. I was a big advocate of front-

loading rate hikes when inflation accelerated in 2022, and I will be an advocate of front-loading rate cuts if that is appropriate. Those decisions will be determined by new data and how it adds to the totality of the data and shapes my understanding of economic conditions. While I expect that these cuts will be done carefully as the economy and employment continue to grow, in the context of stable inflation, I stand ready to act promptly to support the economy as needed.

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

² The preliminary estimate of the annual benchmark revision to the establishment survey data, which was announced on August 21, suggests that payroll growth between April 2023 and March 2024 will likely be revised down early next year by about 68,000 per month on average. The implications for payroll growth beyond March are less clear.

³ The 1981–82 recession was triggered by tight monetary policy in an effort to fight mounting inflation. For more information about this recession, see [Federal Reserve History](#).

⁴ The employment cost index is a valuable measure of compensation growth because it covers non-wage benefits and accounts for shifts in the shares of workers in different occupations and industries.