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February 6, 2023

Early Stages of Disinflation but More to Do

Transcript

Kathleen Navin: Welcome. My name is Kathleen Navin, and I am a senior business economist in Supervision here at the Federal Reserve Bank of St. Louis. Today, I have the opportunity to share with you my main takeaways from the latest FOMC meeting that occurred on January 31 and February 1. At this meeting, the Federal Reserve continued to raise the target range for the federal funds rate, this time by 25 basis points to 4½ to 4¾%. This was the second consecutive meeting at which the FOMC slowed the pace of rate increases. Slowing the pace of rate increases allows policymakers to take a step back and monitor the full effects of this tightening campaign, which is important for determining the steps going forward. Overall, this marked the eighth consecutive meeting of rate hikes, and that brings the total amount of increase to 4½ percentage points.

Turning now to balance sheet policy, the Fed continues quantitative tightening, allowing for $95 billion of runoff each month. While the latest set of economic projections will not be available until the March meeting, we did get some insights on the economic outlook…both through the FOMC statement, but also in the Chair's press briefing. Most notably, during that briefing, Chair Powell noted that we are finally seeing early stages of disinflation, and that brings me to my first chart.

Here, we are seeing those early stages of disinflation. Here, we have headline PCE inflation, as well as core PCE inflation, which removes the volatile components for energy and food, and we see that those measures have come down since last year. However, it's very important to note they remain quite elevated relative to the 2% objective. Therefore, it's simply too early to declare victory on the inflation front for this reason. And if we really dive down to what can be attributed to the disinflation that we've seen; when we're looking at headline inflation, we've had the reversal in energy prices. That has help bring down overall inflation. And for core inflation, we finally have seen improvement in the goods sector, which has been troubled by supply chain issues for quite some time.

So, the focus now is really turning to what's left and, in particular, of course, services inflation. Here, we have a chart that shows the disinflation and core PCE has really been led by the improvement in the goods sector. So, we see here on the chart that core PCE for goods has declined and quite sharply over the last few months, while core PCE services remains elevated and is really something to watch going forward. Without a clear picture on core services inflation, again, it's simply too early to know what the path for inflation will be going forward. As a result, the FOMC sees it is still going to be appropriate to continue to raise rates to continue to get inflation down to 2% over time.

Well, what are markets thinking? If we look at the latest fed funds futures, the market is actually expecting another rate increase of 25 basis points before the pause begins. While the Chair did not note what the expectations are among the committee, we will get updated projections for the fed funds rate in March. He did note that this year would not be appropriate to begin cutting rates. And that is something that markets do expect, so that was a clear response to those expectations. And the Chair said that, given the current outlook, which is one for slow growth, softening labor market conditions, and inflation moving down, but not quickly…that it simply would not be appropriate to cut rates this year.

So, attention is really going to be focused on, okay, well, we'll get to 5% on the federal funds rate. How much further will we go? When will we pause? And then, when will that reversal start? If the Fed does not tighten enough, inflation could become entrenched in business and household decisions and, then, it would become even more painful to try to unwind that going forward. On the flip side, if the Fed increases rates perhaps too much, they start to see inflation going down more quickly than expected, they can reverse course. And so, the risks are really tilted at this time to not tightening enough.

And what are the implications for the economic outlook? Well, with monetary policy continuing to tighten, I also expect growth to slow this year and for unemployment to rise, and this is really as the Fed just continues to battle inflation. And the question now actually is, is it possible that the Fed could avoid an outright recession in the U.S. economy, given the strong half to growth that we had last year? And while this debate is somewhat renewed, I continue to see a short, shallow recession this year as a very likely outcome, but it all goes back to how much will the Fed need to continue to tighten and what are the full effects of that tightening campaign on the economy? And these are the issues, really, to watch in determining the economic outlook going forward, and ones I will be paying attention to closely.

Thank you so much for your time today and for joining our *Take Five* with the St. Louis Fed.

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