Take 5 Five
WITH THE ST. LOUIS FED

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Fed Stays the Course on Rate Increases, Monitors Credit Conditions

Transcript

Kathleen Navin: Welcome to this installment of the *Take Five with the St. Louis Fed*. I'm Kathleen Navin, senior business economist here at the St. Louis Fed. Today I will be discussing the latest FOMC meeting that took place on March 21 and 22. Let's start with a brief overview of the latest FOMC meeting.

The Federal Reserve remains strongly committed to bringing inflation down to 2%. Some of the key policy changes from this meeting included the FOMC raising the target range for the federal funds rate by 25 basis points to 4.75% to 5%. In addition, the Federal Reserve announced it would continue its balance sheet policy as previously announced with a reduction in Treasuries, agency debt, and agency MBS of up to $95 billion per month.

In both the FOMC statement and the chair's press briefing after the statement was released, it was reassured that the banking system is "sound and resilient, with strong capital and liquidity." In addition, during the press briefing Chair Powell emphasized that lending remains available, and liquidity is ample, with lending available through the Discount Window and the newly created Bank Term Funding Program. In addition, Chair Powell emphasized that policymakers will be closely monitoring banking conditions.

At the latest meeting on March 21 and 22, we also received updated projections known as the Summary of Economic Projections, or SEP. On balance, these were little changed, and this really weighed two offsetting factors. One, we had incoming data that came in stronger than expected since the February meeting. This would have suggested stronger employment, stronger inflation, and therefore required higher policy rates going forward. On the other hand, events in recent weeks in the banking sector imply that tighter credit conditions could have a offsetting effect with activity. And so, balancing these effects is what led to little revision on the updated SEP.

Turning now to economic growth, we see that in the March set of projections, the FOMC median projection is for growth to continue slowing this year from 0.9% in 2022 to 0.4% in 2023. After that, growth is expected to firm to 1.2% in 2024 and 1.9% in 2025. Projections for 2023 and 2024 were revised down relative to the December set of projections, while 2025 was revised up a touch higher. During the press briefing Chair Powell noted that there was generally viewed as downside risks to these forecasts among participants.

Turning now to labor markets, currently labor market conditions remain very tight. However, with the recent slowing and expected continued slowing and growth, this is expected to raise the unemployment rate from 3.6% as of February of this year to 4.5% by the fourth quarter of this year, and then further to 4.6% by next year, where it remains through 2025. These are as of the March projections, and these would all be above the long-run estimate of 4%.

Now, turning to inflation. The focus really continues to remain on inflation, which is much too high relative to the Fed's objective. Headline PCE inflation was 5.4% in the 12 months ending in January, which is well above the 2% objective. The latest projections show PCE inflation moderating from 5.7% in 2022 to 3.3% in 2023, 2.5% in 2024, and further to 2.1% in 2025. During the press briefing Chair Powell noted there's really three stages of disinflation that policymakers continue to look for within core inflation. The first is core goods inflation, which, as we discussed last time, has been moving down and continues to do so as supply chain issues become resolved and those prices can move lower. The second is housing services inflation, which has yet to move down this year but is expected to do so as home prices and real estate prices move through to lower lease prices. And thirdly, core services inflation excluding housing. This is still the largest component of these three when it comes to core PCE inflation, and we have yet to see a clear sign of disinflation in this category, so this is really where policymakers will stay focused in seeing if disinflation begins.

Given those projections, policymakers also offered their forecasts for monetary policy, which essentially is the most appropriate path of policy going forward given those forecasts. As we see, they were very little changed relative to December. In 2023, we have a peak of 5.1%, which is implied a range of 5 to 5.25%, and then it moves down toward the long run, which was unchanged of 2.5%.

Now, also important to note is in the FOMC statement there was a change in language that gave us some indication about intentions and policy going forward. The current sentence now reads, "The Committee anticipates that some additional policy firming may be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time." This compares to the same sentence in February, which read, "The Committee anticipates that ongoing increases in the target range will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time." Here I have underlined the key differences in those sentences, with the current sentence saying, "Some additional policy firming may be appropriate," compared to last time, "Ongoing increases in the target range will be appropriate." So these changes highlight that policymakers will be looking very closely at how tightening credit conditions will be affecting the economy, and so it really shows increased caution and also uncertainty around that path going forward.

Now, looking at how market expectations compare to those latest set of projections from policymakers, we see that market expectations have moved a lot in recent weeks. So this chart shows the market expectations from the FedWatch tool from the Chicago Mercantile Exchange, and here I have selected the midpoint of the range implied by those probabilities of the most likely outcome at each meeting. In the gray solid line, we see the path as of the February meeting, February 1. Then we see that as of March 8, assumptions really jumped expectations really jumped considering what the Fed would do at the upcoming meeting, and this was in response to Chair Powell's testimony before Congress, in which it was indicated that more rate hikes into a higher level for longer would be required. Now, that more than reversed course following recent events in the banking sector, with rate cuts expected as soon as the June meeting as of March 15.

Now, again moving since the last FOMC meeting that concluded on March 22, those expectations as of that date following the meeting move back closer in line to the February expectation, but still remain below the FOMC projection as of the end of the year by about 75 basis points. So that disconnect, that discrepancy between the FOMC projection as the most appropriate path given the forecast, is still existing, but it is smaller relative to where it was a few weeks ago.

The key takeaways from this meeting, both the statement and the chair emphasized that the banking system is strong and resilient, with ample liquidity and strong capital. The baseline forecast continues to show a slowdown in growth this year, with an expected increase in the unemployment rate to 4.6% next year, and inflation moving down to the 2% objective over the next few years. Given this baseline forecast, FOMC projections signal one more rate hike this year, and no rate cuts until 2024 given the current outlook. Importantly, heightened uncertainty surrounding how much credit conditions will tighten means that policymakers will be watching banking conditions closely and will adjust expectations and policy as needed.

This concludes our latest installment of *Take Five with the St. Louis Fed*. Thank you for joining us.

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