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Looking for greater confidence in a sustained return to 2% inflation

Transcript

Kathleen Navin: Welcome to this edition of *Take 5 with the St. Louis Fed*. I'm Kathleen Navin, Senior Business Economist in Supervision. And today, I'll be discussing the latest meeting that took place on January 30 and 31.

At this meeting, the Federal Open Market Committee maintained the target range for the federal funds rate at 5¼ to 5½%, where it has been since the July 2023 FOMC meeting. Additionally, there were no changes to the Federal Reserve balance sheet policy, with the reduction in securities continuing as previously announced in 2022. Overall, the Federal Reserve's balance sheet has declined by roughly $1.3 trillion since its peak of roughly $9 trillion in 2022.

Now, during the Q&A, there were questions about balance sheet policy. And Chair Powell noted that while the Committee had discussed the balance sheet at this meeting, that there would be a more in-depth discussion at the March meeting. So we'll be looking toward the March meeting to get more details on how balance sheet policy may evolve over the next year. And in addition, turning back to the federal funds rate, Chair Powell noted in his opening remarks, "We believe that our policy rate is likely at its peak for this tightening cycle and that, if the economy evolves broadly as expected, it will likely be appropriate to begin dialing back policy restraint at some point this year."

And consistent with this in the FOMC meeting, there was a removal of the previous phrasing of "additional firming" to this new statement which stated, "In considering any adjustments to the target range for the federal funds rate, the Committee will carefully assess incoming data, the evolving outlook, and the balance of risks. The Committee does not expect it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2%."

And this idea that, in order to be comfortable beginning to remove policy restraint, the Committee will need to be more confident that inflation is indeed sustainably on its way to 2%, was reiterated throughout the press briefing. But Chair Powell did also note that the economic outlook remains uncertain, and that inflation risks are still very top of mind to the Committee. And essentially noted that the Committee would be comfortable keeping the federal funds rate at its current target range for longer if warranted by the data.

And really, the Committee now, as Chair Powell noted, is moving into a risk management mode, looking at how on the one hand, the risk of removing policy restraint too soon or too fast could create a reacceleration in inflation. But on the other hand, if policy restraint comes off either too late or too little, then you could see, kind of, unwarranted stress put on economic activity and employment. So the Committee will be looking at this evolving balance of risks, as well as the incoming data and the economic outlook.

And while new economic projections will not be released until the March meeting, we do have a lot of incoming data to look at. One of the most surprising figures recently has been the unexpected strength in real GDP for 2023. We saw in the fourth quarter, real GDP grew at a 3.3% annualized rate for the fourth quarter. And when we look at 2023 as a whole, real GDP grew at 3.1%, which was materially better than the expectation of 2.6%, as of the December summary of economic projections.

And in addition, labor markets remain tight. We see that the unemployment rate of 3.7% is still low. And overall, labor market conditions are coming back into better balance. We're seeing payroll gains, job openings still strong but moderating, and a pickup in labor force participation. And that's helping ease some of those inflation pressures that were coming from the labor market.

And when we look at inflation, what we've seen is progress toward that 2% objective. Here I show headline PCE inflation and core PCE inflation, which removes the volatile components of food and energy. We see that headline PCE inflation on a year-over-year basis reached 2.6% as of December. And core PCE inflation reached 2.9% as of December, moving back toward that 2% objective. But still, we know that we need to see more progress, and the Committee will need more confidence that inflation is sustainably moving to 2% before they feel comfortable beginning to remove policy constraint.

So we'll be watching this data closely over the coming months. So what are markets thinking about the January FOMC meeting? Leading into this latest meeting, markets had already moved their expectation for the first rate cut from March to May. And essentially, that was maintained following the meeting. And Chair Powell noted that his current base forecast essentially is that a March cut does seem unlikely at this time.

We will continue to watch incoming data and the evolving outlook and the balance of risks from now to the March meeting, and we will brief you on that next time. So until then, that concludes this edition of *Take 5 with the St. Louis Fed*. Thanks so much for joining us.

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