Take 5 Five
WITH THE ST. LOUIS FED

May 3, 2024

Fed remains on hold in May, announces changes to balance sheet policy to begin in June

Transcript

Kathleen Navin: Welcome to this edition of *Take Five with the St. Louis Fed*. I'm Kathleen Navin, senior business economist in Supervision, and today I'll be discussing the latest FOMC meeting that took place on April 30 and May 1. At this meeting, the Federal Open Mark Committee unanimously decided to maintain the current target for the federal funds rate at a range of 5.25 to 5.5%, where it has been since July of 2023.

During the press briefing, Chair Powell noted that the current stance of policy was viewed as restrictive. He cited a number of factors, including a cooling in labor market conditions since highs seen in recent years, in particular on labor demand. He also noted that higher borrowing costs were weighing on interest-sensitive sectors of the economy like housing and also on equipment investment. Now, there was a change to policy at this meeting, and that was in the balance sheet. What we saw is that the Committee is determining that it's going to slow the pace of balance sheet runoff beginning in June. So, in particular, for Treasury securities, the cap will be reduced from $60 billion to $25 billion per month, and on mortgage-backed securities and agency debt, what we see is that the current cap was maintained at $35 billion per month. And this is as we think about, in the longer run, the Committee looks to hold mostly Treasury securities. So, it will be leaving that cap for agency debt and agency MBS unchanged, and anything above that cap will be reinvested into Treasury securities.

Now, since quantitative tightening began in June of 2022, what we've seen is that the overall balance sheet has declined by nearly $1.6 trillion, and this pace of decline in the Federal Reserve's balance sheet, it will slow as part of this process going forward but still decline. And in explaining this policy move, the Chair noted, "In particular, slowing the pace of runoff will help ensure a smooth transition, reducing the possibility that money markets experience stress, and thereby facilitating the ongoing decline in our securities holdings that are consistent with reaching the appropriate level of ample reserves."

Let's turn now to economic activity. In late April, we received the most recent data on real GDP growth, and in this report, it showed that real GDP growth slowed from 3.4% in the fourth quarter of last year to 1.6% in the first quarter of this year. Now, this was somewhat below expectations, although it was expected to see a slowing moving into this year. Now, underlying the headline figure, it's important to remember we saw positive, healthy contributions from consumer spending, residential investment, and business investment. And

so really, the underlying strength of economic activity, it's still solid, and this was noted in the latest FOMC statement.

Where the surprises have been mostly in recent data are related to inflation, and this was addressed in the most recent press release and also in the press conference. What we saw in the statement was it was noted, "Inflation has eased over the past year but remains elevated. In recent months, there has been a lack of further progress toward the Committee's 2% inflation objective." And it's really this second part, this second sentence, that was new to the statement, and this is addressing those higher-than-expected inflation ratings we've had since the start of the year. And in particular, Chair Powell noted during the press briefing that the data we've had on inflation so far this year have not given the Committee the greater confidence they were looking at and that they've told us is a conditionality for lowering interest rates. So, as we know, they're looking for greater confidence that inflation is on a sustainable path back to 2%, and that's what they'll need to start removing policy restriction. In other words, lowering rates. And Chair Powell let us know that the data so far this year have not given them this confidence and that the Committee was prepared to maintain the current range of the federal funds rate as long as would be appropriate.

So, given the importance of the inflation data, let's take a look at recent readings on the Fed's preferred measure, PCE inflation. So here we have headline PCE inflation in the darker maroon color and core PCE inflation in gray. We see that core PCE inflation, which removes the volatile components of food and energy, it most recently was at 2.8%, and these are year-over-year changes. Headline PCE inflation, 2.7%. Now, these readings by themselves are down substantially from where they were in 2022, so we have had disinflation, especially over the second half of last year. But what we see is that in the most recent readings, these measures have moved more sideways than down, and in fact, headline PCE inflation moved up in the most recent report through March. So, we need to see these coming back down to the 2% objective, and so this part, this stalling over recent months, is what was focused on a lot during the press briefing and addressed in the FOMC statement in that press release.

Now, with core inflation being a good guide to, kind of, underlying senses of inflation, let's look at the composition of core PCE inflation. We can break this down into three large components. We have core goods inflation. We also have core services inflation, which here I break out into core services excluding housing and also housing services. What we see is that in the run-up in inflation that we had in 2021 and 2022, a big part of that was core goods inflation. So, as we were coming out of the pandemic, during that recovery, we saw a lot of supply chain issues, as well as heightened demand for goods, and supply couldn't keep up, and this put upward pressure on prices. We see that this component's contribution has really returned to something that would be more normal prior to the pandemic in that it's a small drag on this part of core PCE inflation.

So that kind of brings us back to what was a more traditional composition of it being mostly about core services, and we look at, we have housing services. That contribution reached its high in early 2023 and has been slowing, but is still above pre-pandemic. So it's still an area to watch. And core services excluding housing, which is the largest component here, we see that that is also still above pre-pandemic levels in terms of this contribution and has actually picked up a little bit over the last few months. So, these will be two areas to watch as we look to see if, you know, it gives us a better sense of inflation returning back to 2% and having that greater confidence.

But what we also keep in mind is that the Federal Reserve has a dual mandate. So while it is thinking about price stability, it is also thinking about maximum employment, and during the press briefing, Chair Powell noted that the Committee is also watching labor market conditions, and he said that if there was to be an unexpected weakening in labor market conditions, that could be another path that the Federal Reserve would decide it needed to be removing policy restraints. So we're looking at the totality of data and everything that can be going into those decisions and watching that data very closely between now and the next meeting.

That concludes this installment of *Take Five with the St. Louis Fed*. Thanks so much for joining us.

(END OF RECORDING)