Money Talks May 2022

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The Federal Open Market Committee (FOMC) of the Federal Reserve has laid out a plan to fight inflation by raising interest rates and tightening the money supply. After dropping the benchmark federal funds rate to near zero in order to stimulate the economy at the onset of the pandemic, the FOMC raised the rate by 0.25% at its March 2022 meeting, and projected the equivalent of six more quarter-percent increases by the end of the year and three or four more in 2023. This would bring the rate to around 2.75%, just above what the FOMC considers a “neutral rate” that will neither stimulate or restrain the economy.

These moves were projected to bring the Fed’s preferred measure inflation, the Personal Consumption Expenditures (PCE) Index, down to 4.3% by the end of 2022, 2.7% by the end of 2023, and 2.3% by the end of 2024. PCE inflation, which was 6.6% in March, tends to run below CPI, so even if the Fed achieves these goals, CPI inflation will likely remain somewhat higher. The Fed has signaled a willingness to be more aggressive, if necessary, and the FOMC raised the funds rate by 0.5% at its May meeting, as opposed to the more common 0.25% increase. This was the first half-percent increase since May 2000, and there may be more to come. The FOMC also began reducing the Fed’s bond holdings to tighten the money supply. New projections to be released in June will provide an updated picture of the Fed’s intentions for the federal funds rate.

The FOMC also announced that they would begin to shrink their $9 trillion balance sheet. Starting in June, they will let securities roll off at a pace of $47.5 billion in June, July, and August ($30 billion in Treasuries and $17.5 billion in mortgage-backed securities). Then in September, the pace will accelerate to $95 billion monthly ($60 billion in Treasuries and $35 billion in mortgage-backed securities). At that pace, the plan is to reduce the balance sheet by a third over the next 3 years.

The question facing the FOMC is how fast it can raise interest rates and tighten the money supply while maintaining optimal employment and economic growth. The ideal is a “soft landing”, similar to what occurred in the 1990s, when inflation was tamed without harming the economy. At the other extreme is the “hard landing” of the early 1980s, when the Fed raised the funds rate to almost 20% in order to control runaway double-digit inflation, throwing the economy into a recession. Fed Chair Powell acknowledges that a soft landing will be difficult to achieve, but he believes the strong job market may help the economy withstand aggressive monetary policies. Supply chains are expected to improve over time, and workers who have not yet returned to the labor force might fill open jobs without increasing wage and price pressures. The next few months will be a key period to reveal the future direction of inflation and monetary policy. The hope is that March represented the peak and inflation will begin to trend downward. But even if that proves to be true, it could be a painfully slow descent.