Take Five with the St. Louis Fed
July 28, 2023

Transcript

Kathleen Navin: Welcome to this installment of *Take Five with the St. Louis Fed*. I'm Kathleen Navin, senior business economist, and today, I will be speaking with you about the FOMC meeting that took place on July 25 and 26.

At this latest meeting, the Federal Reserve raised the target for the federal funds rate by 25 basis points to 5¼% to 5½%. This was the 11^{th} rate increase in 12 meetings and brings the cumulative tightening to 525 basis points. At this point, that is viewed as restrictive and should be putting downward pressure on economic activity and inflation.

There were no changes to the Federal Reserve's balance sheet policy, where the reduction in holdings of treasuries, agency debt, and agency MBS continues as previously announced. The FOMC remains strongly committed to bringing inflation back to 2%.

While there were no updated economic projections at this meeting, Chair Powell did note that the incoming data between last FOMC meeting and this one in July was generally broadly consistent with expectations. He also emphasized that September will be a live meeting and that the FOMC will be evaluating data between now and September to determine what the future path of policy should look like—whether another rate increase will be appropriate or a pause will be appropriate in September.

Specifically, he noted, "We will continue to make our decisions meeting by meeting, based on the totality of incoming data and their implications for the outlook for economic activity and inflation as well as the balance of risks."

Given the importance of the incoming data between now and September, let's take a look at some major economic indicators. On the morning after the FOMC meeting concluded, we got real numbers for a GDP. What we saw is that real GDP rose at 2.4% in 2023 Q2. This was up from 2% in Q1.

Underlying the overall increase was a healthy increase in consumer spending, though the growth rate did moderate some from the first quarter. Still, it was the largest contributor to Q2 GDP growth. Another important contributor was from business fixed investment, which—despite higher borrowing costs related to higher interest rates—posted a very healthy number for 2023 Q2 and was another strong contributor to overall growth.

The strong figure, the rather healthy figure for 2023 Q2, is consistent with the FOMC's statement, which had a very nuanced upgrade to the assessment of economic activity in stating that it was expanding at a "moderate pace," which was an improvement from the previously used language of "modest pace." In addition, during the press briefing, Chair

Powell noted that staff forecasts, while they do still show a noticeable slowdown this year, had removed the recession from the forecast.

Moving now to inflation, here we have headline PCE inflation in blue and core PCE inflation in red. What we see is that headline PCE inflation has moderated quite a bit from highs reached last year. The most recent figure for May 2023 is 3.8%, measured year over year. Core PCE inflation, which removes the volatile components of food and energy, is currently at 4.6% as of May 2023.

Looking at core PCE inflation, underlying this figure, there's a large component related to services inflation that has yet to come down. This is very connected to labor markets, as the services industry—a large component of costs—is related to labor. So let's take a look at labor market conditions, as this is really where we're going to want to see a little bit more normalization to help bring those inflation pressures back into balance.

On this chart, we show labor market demand and labor market supply. Here, demand is measured by labor employment as well as openings, and supply is provided by the labor force. We see here that demand is still far exceeding supply, and this is really creating that upward pressure on inflation resulting from the labor market. So when we hear policymakers talk about bringing the labor market back into better balance, what we want to see here is these two measures being more closely in line.

So that can happen a couple of ways. One, we could see a slowing in employment, a slowing in job openings, or an increase in participation. So let's take a closer look at each of those indicators.

When we think of overall labor markets, one of the first indicators we think of is the unemployment rate. We know that this is included in the summary of economic projections, and it really gives a good sense of overall health in the labor market.

What we see here is that the unemployment rate for the U.S. was 3.6% as of June—so very low, back to pre-pandemic levels, which were very healthy. And when we look at the seven states across the 8th district, we also see that they have come down substantially since highs reached during the COVID pandemic and the recession that resulted. So we'll be watching this to see if there's some softening here—some slight increases in the unemployment rate going forward.

Now, while the unemployment rate still shows a very healthy picture of labor markets, indicating that they're very tight, if we look at payroll gains—so monthly job gains in the U.S. economy—we see that they have started to slow. So this chart we show monthly job gains since 2021. There was the very robust recovery from the COVID pandemic, where job gains averaged over 600,000 per month in 2021. They then slowed to about 400,000 last year. And in the first six months of 2023, they've slowed further to about 275,000. So looking for this to slow a little bit more toward more normal levels would be something that would help bring labor markets back better in balance.

And if we look at job openings, on the next chart, I show job postings by Indeed. Here we have postings not only for the U.S. but for the seven states in the district. And while they all have their own characteristics, we see the general trend that they peaked in early 2022, and they've come down since then but remain elevated relative to the pre-pandemic era. So this is another thing where with job postings returning more toward pre-pandemic levels, that will be taking some of the pressure off of inflation resulting from the labor market.

And when we look at labor supply, we can look at labor force participation. Here what we see is that as of June 2023, labor force participation was about two-thirds recovered of where it was prior to the COVID recession. And really, this is interesting, because when we look at subcomponents or rather, different age categories of labor force participation, we see that the age bracket from 16 to 24 as well as from 25 to 54—they have recovered beyond where they were pre-pandemic. And the shortfall is really emanating from the 55-year-and-older category, where we saw a sharp decline during the COVID recession, and participation simply has not picked back up in that category yet. And so that's really accounting for this shortfall.

But macro factors, while very important for assessing the economic outlook, are not the only thing that we're keeping an eye on. Banking conditions remain incredibly important right now, especially after the events in March. Chair Powell did note that since the turmoil in March, banking conditions had settled down quite a bit. He noted that deposit flows had stabilized, capital and liquidity remain strong, aggregate bank lending was stable quarter over quarter and remains up on the year, and that banking sector profits have been coming in strong.

Overall, he assessed that the banking system remains strong and resilient. The FOMC continues to watch the banking sector carefully in watching these conditions and how those effects may be on the economic outlook. Chair Powell also previewed the upcoming Senior Loan Officer Opinion Survey. He noted that overall, the picture is pretty tight when it comes to credit conditions in the economy, lending conditions are tight and getting a little tighter, and demand is showing to be weak. So these are things that we'll look at to evaluate how banking conditions are affected by the current monetary policy stance and how that will affect the economy going forward.

And in particular, Chair Powell noted during the press briefing, "The economy is facing headwinds from tighter credit conditions for households and businesses, which are likely to weigh on economic activity, hiring, and inflation." So this just emphasizes that key channel between the banking sector and the real economy.

This is just a small preview of the data that we'll be looking at between now and the September meeting to assess the current path of monetary policy and what the future path should look like.

Thank you so much for tuning in to this installment of *Take Five with the St. Louis Fed,* and I'll see you next time.

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