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FOMC Raises Policy Rate by 25 Basis Points in May, Remains Data Dependent on Determining Path Ahead

Transcript

Kathleen Navin: Welcome to this installment of the *Take Five with the St. Louis Fed*. I'm Kathleen Navin, senior business economist in Supervision. Today I will be talking about the latest FOMC meeting that took place on May 2 and May 3.

At this meeting the Federal Reserve raised the target range for the federal funds rate by 25 basis points to 5% to 5.25%. The Federal Reserve has raised the federal funds rate by a cumulative 500 basis points in a little over one year. The Federal Reserve also continued its balance sheet policy, which it first announced last year. It will continue to allow a runoff of $95 billion per month in Treasury securities and agency debt and MBS. Through the last week of April, the balance sheet had declined by roughly $400 billion, or about 4.5% the total size of the balance sheet.

There continues to be focus on the banking system. As of the Wednesday FOMC press briefing, Chair Powell noted that banking conditions have broadly improved since early March and that the U.S. banking system is sound and resilient. Considering the importance of the banking system, policy makers continue to monitor conditions here and, in particular, are looking for whether tightening credit conditions could have an impact on lending, and that would then weigh on economic activity, so something that is being watched closely.

Moving now to economic conditions, while there were no new FOMC projections at this latest meeting—those will be released next in June—we do have some insights to current economic conditions and what the FOMC is thinking in this regard. In particular, released just the other week, real GDP growth for the first quarter rose a modest 1.1%, which is below trend. And, more broadly, real GDP growth has been slowing since the strong recovery in 2021.

Turning now to labor conditions, while overall real GDP growth has slowed, labor conditions remain very tight, though we have seen some signs of cooling. The FOMC statement noted that the unemployment rate has remained low, and we see that across all states in our Eighth District. So the U.S. unemployment rate has declined from highs reached during the COVID recession to 3.5% as of March 2023.

And, when we look across the District, we see the similar trend with unemployment declining across all seven states, although to varying degrees. At the lower end of the range, we see that Missouri has declined to 2.5% as of March, and Illinois is at 4.4%, which is still a little

elevated relative to where they were prior to the COVID recession. But, in general, we've seen this downward trend to healthy levels for the labor market.

But what we're also seeing is that some labor market conditions are beginning to look like they're cooling. For example, job openings, or job vacancies, have declined over recent months and at a faster pace over the last few months. This is allowing for what we're currently seeing with labor demand, which is in far excess to labor supply. It's allowing for that to somewhat move back more in balance. And so that's something that we'll look for going forward.

And, when we think about inflation, what we see here is that inflation remains very elevated. And the Federal Reserve, therefore, is very strongly committed to bringing inflation back down to 2%. But we see that we have a ways to go. When we look at headline PCE inflation, while it has declined since highs reached in 2022, it remains elevated at 4.2%. And, when we remove the very volatile components of energy and food from that metric, we're left with core PCE inflation, which can give us a better sense of the underlying trend in inflation. And here we see, while we have had some improvement, that it remains elevated and is somewhat trending sideways over the last few months, with a most recent reading of 4.6% measured year over year—still well above that 2% objective.

The focus here in most recent weeks is not just on economic conditions, however, but also on banking conditions given the stress that was experienced in early March. In the FOMC statement, they wrote, "The U.S. banking system is sound and resilient. Tighter credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation. The extent of these effects remains uncertain."

And, when we look at some anecdotal evidence, such as from the Beige Book released by the Board of Governors—and this is as of April—in the national summary, they wrote, "Lending volumes and loan demand generally declined across consumer and business loan types. Several Districts noted that banks tightened lending standards amid increased uncertainty and concerns about liquidity." And, for the Eighth District, "Banking contacts reported slowing loan growth and a decline in deposits but expressed confidence in their overall position." So the FOMC is really looking at how tighter credit conditions could have implications for lending and then the extent to which that could then weigh on economic activity and have implications for monetary policy, so something that is being looked at very closely.

And, when we look at weekly data on lending, which is provided in the Board of Governors' H.8 release every Friday, we see that there was a pullback in lending in the second half of March following the bank stress that occurred in mid-March. And, in particular, that pullback was at regional and community banks and in commercial and industrial loan types, and then commercial real estate. However, by the end of March, we also were seeing declines in

residential loans and consumer loans. Through mid-April, that decline had stabilized but is something that we're continuing to watch. And, again, those data are released weekly.

What does that mean for market expectations about policy going forward? Well, as of May 3, following the press briefing, markets were expecting rate cuts totaling 75 basis points by the end of 2023. This is a disconnect between what Chair Powell said during the press briefing and other FOMC communication prior to the most recent meeting. What Chair Powell had noted is that given the current outlook and, in particular, the expectation by the committee that inflation will come down more slowly and that it will take some time for inflation to come down to 2%, that rate cuts this year would not be appropriate. We did not receive new FOMC projections for monetary policy at this meeting. Those will be provided in June, and we'll be looking at whether those have changed since the March meeting.

During Chair Powell's press briefing, he noted, "Looking ahead, we will take a data-dependent approach in determining the extent to which additional policy firming may be appropriate." This will include economic data on inflation, labor market growth. It will look at banking data and the extent to which tighter credit conditions are having an effect on lending, which then could weigh on economic activity. It will also be looking at financial and international developments. And all of this will be taken into account in determining that future path for monetary policy. So we'll be watching the data and the anecdotes and the forecasts closely over the next few weeks.

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

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