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Data Insights: FOMC Minutes

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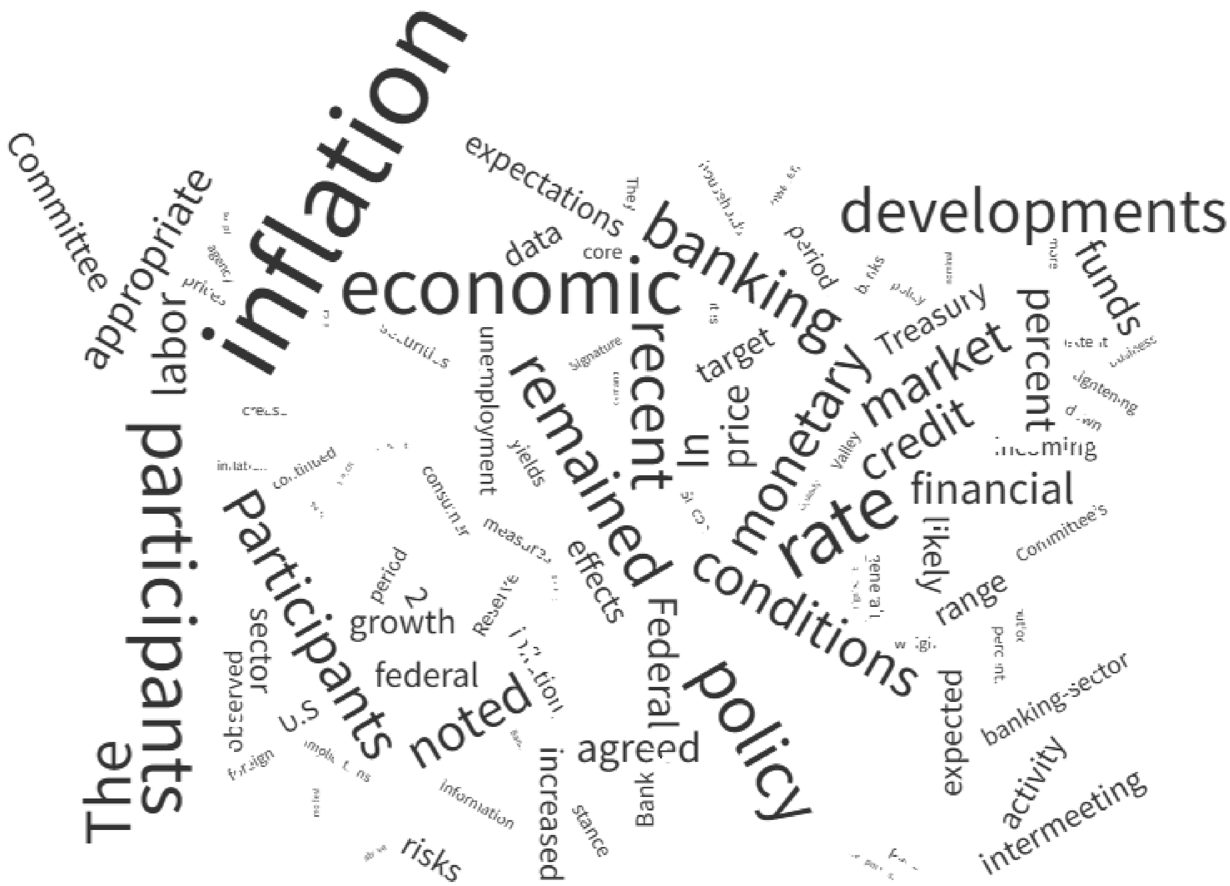
March minutes   Key signaling language: Featured   Important   Very important



Recent Developments in the Banking Sector

Before turning to other agenda items, the Chair asked the Vice Chair for Supervision to provide an update on recent developments in the banking sector. The Vice Chair for Supervision described the developments, including those at Silicon Valley Bank, Signature Bank, and Credit Suisse. He also described actions taken by the Federal Reserve and other regulatory agencies in response. He noted that the U.S. banking system is sound and resilient. He also noted that he will be leading a review of the supervision and regulation of Silicon Valley Bank, and that the Federal Reserve System will apply what is learned from the review to strengthen its supervisory and regulatory practices as appropriate.

Developments in Financial Markets and Open Market Operations

The manager turned first to a review of U.S. financial market developments over the intermeeting period. Early in the period, firmer-than-expected data and policy communications pushed interest rates higher and equity prices lower. Developments in the banking sector later in the period were met with sharp reductions in Treasury yields, particularly at shorter tenors. Treasury market liquidity was poor and implied volatility was high, but the market remained functional amid substantial trading activity. Higher Treasury market volatility contributed to wider spreads for household and business borrowing.

Financial conditions tightened considerably over the intermeeting period as a whole. Market contacts observed that the recent developments in the banking system will likely result in a pullback in bank lending, which would not be reflected in most common financial conditions indexes. Following the banking-sector developments, equity prices for large U.S. banks underperformed the broad market; equity prices for U.S. regional banks generally underperformed by relatively more…

Borrowing from the new Bank Term Funding Program had been small relative to discount window borrowing, which had increased to record levels. Use of the overnight reverse repurchase agreement (ON RRP) facility fell, especially for money market mutual funds (MMFs), as the supply of short-term securities at attractive rates increased...

Staff Economic Outlook

For some time, the forecast for the U.S. economy prepared by the staff had featured subdued real GDP growth for this year and some softening in the labor market. Given their assessment of the potential economic effects of the recent banking-sector developments, the staff's projection at the time of the March meeting included a mild recession starting later this year, with a recovery over the subsequent two years. Real

GDP growth in 2024 was projected to remain below the staff's estimate of potential output growth, and then GDP growth in 2025 was expected to be above that of potential. Resource utilization in both product and labor markets was forecast to be much less tight than in the January projection. The level of real output was projected to move below the staff's estimate of potential output in early 2024, more than a year sooner than in the previous projection. Likewise, the unemployment rate was projected to rise above the staff's estimate of its natural rate early next year...

Participants' Views on Current Conditions and the Economic Outlook

…In their discussion of current economic conditions, participants noted that recent indicators pointed to modest growth in spending and production. At the same time, though, participants noted that job gains had picked up in recent months and were running at a robust pace; the unemployment rate had remained low. Inflation remained elevated. Participants agreed that the U.S. banking system remained sound and resilient. They commented that recent developments in the banking sector were likely to result in tighter credit conditions for households and businesses and to weigh on economic activity, hiring, and inflation. Participants agreed that the extent of these effects was uncertain. Against this background, participants continued to be highly attentive to inflation risks.

In assessing the economic outlook, participants noted that since they met in February, data on inflation, employment, and economic activity generally came in stronger than expected. They also noted, however, that the developments in the banking sector that had occurred late in the intermeeting period affected their views of the economic and policy outlook and the uncertainty surrounding that outlook. Based on incoming economic data, participants' assessments of the effects of cumulative policy firming, and their initial views on the likely economic effect of the recent banking-sector developments, participants generally expected real GDP to grow this year at a pace well below its long-run trend rate. With inflation remaining unacceptably high, participants expected that a period of below-trend growth in real GDP would be needed to bring aggregate demand into better balance with aggregate supply and thereby reduce inflationary pressures. Many participants remarked that the incoming data before the onset of the banking-sector stresses had led them to see the appropriate path for the federal funds rate as somewhat higher than their assessment at the time of the December meeting. After incorporating the banking-sector developments, participants indicated that their policy rate projections were now about unchanged from December.

Participants agreed that the actions taken so far by the Federal Reserve in coordination with other government agencies, as well as actions taken by foreign authorities to address banking and financial stresses outside the U.S., had helped calm conditions in the banking sector. Even with the actions, participants recognized that there was significant uncertainty as to how those conditions would evolve. Participants assessed that the developments so far would likely lead to some weakening of credit conditions, as some banks were likely to tighten lending standards amid rising funding costs and increased concerns about liquidity. Participants noted that it was too early to assess with confidence the magnitude of the effect of a credit tightening on economic activity and inflation, and that it was important to continue to closely monitor developments and update assessments of the actual and expected effects of credit tightening. Several participants noted that regional and community banks, a small number of which had come under significant stress, were important in small business and middle-market lending and were providing critical and unique financial services to many communities and industries.

…Participants agreed that the labor market remained very tight. Job gains had picked up to a robust pace in January and February, and the unemployment rate remained low. Participants noted some signs of improvement in the imbalances between demand and supply in the labor market, including further declines in the quits rate as well as an increase in the overall labor force participation rate and the return of the prime-age participation rate to pre-pandemic levels. Furthermore, participants observed that wage growth appeared to be slowing gradually amid this apparent easing in labor demand and increase in labor supply. However, participants assessed that labor demand continued to substantially exceed labor supply, and several participants pointed out that wage growth was still well above the rates that would be consistent over the longer run with the 2 percent inflation objective, given current estimates of trend productivity growth. Participants expected that, under appropriate monetary policy, supply and demand conditions in the labor market will come into better balance over time, easing upward pressures on wages and prices.

With inflation still well above the Committee's longer-run goal of 2 percent, participants agreed that inflation was unacceptably high. Participants commented that recent inflation data indicated slower-than-expected progress on disinflation. In particular, they noted that revisions to the price data had indicated less disinflation at the end of last year than had been previously reported and that inflation was still quite elevated. Participants noted that, on a 12-month basis, core goods price inflation declined as supply chains continued to improve, but the pace of the decline had slowed, highlighting the still uncertain nature of the disinflationary process. Participants expected that housing services inflation would likely begin to slow in coming months, reflecting continued smaller increases, or potentially declines, in rents on new leases. Regarding prices for core services excluding housing, participants agreed that there was little evidence pointing to disinflation in this component. Participants generally judged that some more easing in labor market tightness and slowing in nominal wage growth would be necessary for sustained disinflation. Additionally, participants observed that indicators of short-term inflation expectations from surveys of households and businesses had come down further, while longer-term inflation expectations remained well anchored. Participants also discussed the potential effect on inflation of the developments in the banking sector. They noted that a tightening of credit conditions was likely to weigh on aggregate demand, which in turn could help reduce inflationary pressures. However, participants observed that the size of such an effect was highly uncertain.

Participants generally observed that the recent developments in the banking sector had further increased the already-high level of uncertainty associated with their outlooks for economic activity, the labor market, and inflation. Participants saw risks to economic activity as weighted to the downside. As a source of downside risk to activity, they noted the possibility that banks would reduce the supply of credit by more than expected, which could restrain economic activity significantly. Participants mentioned potential intensification of Russia's war against Ukraine as an additional source of downside risk to the economic outlook. Participants generally saw risks to inflation as weighted to the upside, though they also recognized some downside risks to inflation. As a source of upside risk to inflation, participants cited the possibility of more-persistent-than-anticipated price pressures, due to, for example, surprisingly resilient labor demand. As a source of downside risk to inflation, participants noted that if banks reduce the supply of credit by more than expected, the likely restraint on economic activity and hiring could put additional downward pressure on inflation.

In their consideration of appropriate monetary policy actions at this meeting, participants concurred that inflation remained well above the Committee's longer-run goal of 2 percent and that the recent data on inflation provided few signs that inflation pressures were abating at a pace sufficient to return inflation to 2 percent over time. Participants also noted that recent developments in the banking sector would likely result in tighter credit conditions for households and businesses and weigh on economic activity, hiring, and inflation, though the extent of these effects was highly uncertain. Against this backdrop, all participants agreed that it was appropriate to raise the target range for the federal funds rate 25 basis points to 4-3/4 to 5 percent. All participants also agreed that it was appropriate to continue the process of reducing the Federal Reserve's securities holdings, as described in its previously announced Plans for Reducing the Size of the Federal Reserve's Balance Sheet.

Several participants noted that, in their policy deliberations, they considered whether it would be appropriate to hold the target range steady at this meeting. They noted that doing so would allow more time to assess the financial and economic effects of recent banking-sector developments and of the cumulative tightening of monetary policy. However, these participants also observed that the actions taken by the Federal Reserve in coordination with other government agencies helped calm conditions in the banking sector and lessen the near-term risks to economic activity and inflation. Consequently, these participants judged it appropriate to increase the target range 25 basis points because of elevated inflation, the strength of the recent economic data, and their commitment to bring inflation down to the Committee's 2 percent longer-run goal.

Some participants noted that given persistently high inflation and the strength of the recent economic data, they would have considered a 50 basis point increase in the target range to have been appropriate at this meeting in the absence of the recent developments in the banking sector. However, due to the potential for banking-sector developments to tighten financial conditions and to weigh on economic activity and inflation, they judged it prudent to increase the target range by a smaller increment at this meeting. These participants noted that doing so would also allow the Committee time to better assess the effects of banking-sector developments on credit conditions and the economy as the Committee moved toward a sufficiently restrictive stance of monetary policy.

Participants observed that the actions taken by the Federal Reserve in coordination with other government agencies in the days preceding the meeting had served to calm conditions in the banking sector. Participants noted that the most significant issues appeared to have been limited to a small number of banks with poor risk-management practices and that the banking system remained sound and resilient. Participants emphasized that the Federal Reserve should use its liquidity and lender-of-last-resort tools, as well as its microprudential and macroprudential regulatory and supervisory tools, to address stress in the banking sector and to mitigate future financial stability risks. Participants agreed that recent banking developments would factor into the Committee's monetary policy decisions to the extent that these developments affect the outlook for employment and inflation and the risks surrounding the outlook. Participants reaffirmed their strong commitment to returning inflation to the Committee's 2 percent objective.

In discussing the policy outlook, participants observed that inflation remained much too high and that the labor market remained tight; as a result, they anticipated that some additional policy firming may be appropriate to attain a sufficiently restrictive policy stance to return inflation to 2 percent over time. Many participants noted that the likely effects of recent banking-sector developments on economic activity and inflation had led them to lower their assessments of the federal funds rate target range that would be sufficiently restrictive compared with assessments based solely on the recent economic data. In determining the extent of future increases in the target range, participants judged that it would be appropriate to take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments.

In light of the highly uncertain economic outlook, participants underscored the importance of closely monitoring incoming information and assessing the implications for future monetary policy decisions. Participants noted that it would be particularly important to review incoming information regarding changes in credit conditions and credit flows as well as broader changes in financial conditions and to assess the implications for economic activity, labor markets, and inflation. Several participants emphasized the need to retain flexibility and optionality in determining the appropriate stance of monetary policy given the highly uncertain economic outlook.

Participants emphasized a number of risk-management considerations related to the conduct of monetary policy. Some participants observed that downside risks to growth and upside risks to unemployment had increased because of the risk that banking-sector developments could lead to further tightening of credit conditions and weigh on economic activity. Some participants also noted that, with inflation still well above the Committee's longer-run goal and the recent economic data remaining strong, upside risks to the inflation outlook remained a key factor shaping the policy outlook, and that maintaining a restrictive policy stance until inflation is clearly on a downward path toward 2 percent would be appropriate from a risk-management perspective. Several participants noted the importance of longer-term inflation expectations remaining anchored and remarked that the longer inflation remained elevated, the greater the risk of inflation expectations becoming unanchored. Participants generally agreed on the importance of closely monitoring incoming information and its implications for the economic outlook, and that they were prepared to adjust their views on the appropriate stance of monetary policy in response to the incoming data and emerging risks to the economic outlook.

Source: Federal Reserve Board