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Data Insights: FOMC Minutes

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… Asset prices were less volatile and financial market conditions eased somewhat over the intermeeting period as investor sentiment around the banking system stabilized. …

Regarding developments late in the intermeeting period, the closure and acquisition of First Republic Bank were seen as orderly, though investors remained focused on

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stresses in the banking sector. In addition, the U.S. Treasury Department announced it may not be able to fully satisfy the federal government's obligations as early as June 1 if the debt limit is not raised or suspended, but that the actual date this event would occur might come a number of weeks later. Yields on Treasury bills and coupon securities maturing in the first half of June increased notably amid significant volatility.

Deposit outflows from small and mid-sized banks largely stopped in late March and April. Although equity prices for regional banks fell further over the period, for the vast majority of banks these declines appeared primarily to reflect expectations for lower profitability rather than solvency concerns. Market participants remained alert to the possibility of another intensification of banking stress…

The information available at the time of the May 2–3 meeting indicated that real gross domestic product (GDP) had expanded at a modest pace in the first quarter. Labor market conditions remained tight in March, as job gains were robust and the unemployment rate was low. Consumer price inflation—as measured by the 12-month percent change in the price index for personal consumption expenditures (PCE)—continued to be elevated in March. Limited data were available on economic activity during the period after the onset of banking-sector stress in mid-March, although several recent surveys—such as the Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS) in April, the National Federation of Independent Business's survey in March, and the Federal Reserve Bank of New York's Survey of Consumer Expectations in March—indicated that bank credit conditions were tightening further.

The pace of increases in total nonfarm payroll employment slowed in March but was still robust, and the unemployment rate ticked down to 3.5 percent. The unemployment rate for African Americans fell to 5.0 percent, and the jobless rate for Hispanics dropped to 4.6 percent. The aggregate measures of both the labor force participation rate and the employment-to-population ratio edged up. The private-sector job openings rate—as measured by the Job Openings and Labor Turnover Survey—moved down markedly during February and March but remained high.

Recent measures of nominal wage growth continued to ease from their peaks recorded last year but were still elevated. Over the 12 months ending in March, average hourly earnings for all employees rose 4.2 percent, well below its peak of 5.9 percent a year earlier. Over the year ending in March, the employment cost index (ECI) for private-sector workers increased 4.8 percent, down from its peak of 5.5 percent over the year ending in June of last year.

Consumer price inflation remained elevated in March but continued to slow. Total PCE price inflation was 4.2 percent over the 12 months ending in March, and core PCE price inflation—which excludes changes in consumer energy prices and many consumer food prices—was 4.6 percent; the total inflation measure was down markedly from its level in January, while the core measure was only slightly lower. The trimmed mean measure of 12-month PCE price inflation constructed by the Federal Reserve Bank of Dallas was 4.7 percent in March. The latest survey-based measures of longer-term inflation expectations from the University of Michigan Surveys of Consumers in April and the Federal Reserve Bank of New York's Survey of Consumer Expectations in March remained within the range of their values reported in recent months; near-term measures of inflation expectations from these surveys moved up but were still below their peaks seen last year…

Market sentiment improved over the intermeeting period, with concerns about a sharp near-term deceleration in economic activity appearing to recede as stress in the banking sector declined. The market-implied path for the federal funds rate in 2023 increased modestly over the period. Broad equity price indexes increased, although equity prices of some regional banks were lower, and equity market volatility declined. Financing conditions continued to be restrictive, and borrowing costs remained elevated…

In the April SLOOS, banks reported further tightening of standards for most loan categories over the past three months, following widespread tightening in previous quarters. Banks of all sizes expected their lending standards to tighten further for the rest of 2023. The most cited reason for tightening C&I standards and terms was a less favorable or more uncertain economic outlook. Mid-sized banks—those that have total consolidated assets in the range of $50 billion to $250 billion—tightened C&I standards more than other banks and additionally reported that a deterioration in

their current or expected liquidity position was an important reason for their tightening. Such banks account for a bit over one-fourth of C&I lending. Banks of all sizes expected to tighten C&I standards further over the remainder of the year, with small and mid-sized banks more widely reporting this expectation.

Although CRE loan growth on banks' balance sheets remained robust in the first quarter, the April SLOOS indicated that loan standards across all CRE loan categories tightened further in the first quarter. The reported tightening in standards over the first quarter was particularly widespread for mid-sized banks. Banks also reported that they expected to tighten CRE standards further over the remainder of the year, with mid-sized banks very broadly reporting this expectation. Meanwhile, commercial mortgage-backed securities (CMBS) issuance was very slow in February and March, amid higher spreads and volatility as well as tighter lending standards.

Credit remained broadly available in the residential mortgage market for high-credit-score borrowers who met standard conforming loan criteria, but credit availability for households with lower credit scores remained tight. In the April SLOOS, the net percentages of banks reporting tighter standards for all consumer loan categories during the first quarter were elevated relative to their historical range, and respondents expected that standards would continue to tighten over the remainder of 2023. Even so, consumer loans grew at a robust pace in the first quarter, with a continued strong expansion in revolving credit balances…

With regard to vulnerabilities associated with funding risks, the staff assessed that although funding strains had been notable for some banks, such strains remained low for the banking system as a whole, especially in light of official interventions by the Federal Reserve, the Federal Deposit Insurance Corporation, and the U.S. Department of Treasury to support bank depositors. Outflows of funds from bank deposits in mid-March, which were concentrated at a limited number of banks, had slowed.

…The economic forecast prepared by the staff for the May FOMC meeting continued to assume that the effects of the expected further tightening in bank credit conditions, amid already tight financial conditions, would lead to a mild recession starting later this year, followed by a moderately paced recovery. Real GDP was projected to decelerate over the next two quarters before declining modestly in both

the fourth quarter of this year and the first quarter of next year. Real GDP growth over 2024 and 2025 was projected to be below the staff's estimate of potential output growth. The unemployment rate was forecast to increase this year, to peak next year, and then to start declining gradually in 2025. Resource utilization in both product and labor markets was forecast to loosen, with the level of real output moving below the staff's estimate of potential output in early 2024 and the unemployment rate rising above the staff's estimate of its natural rate at that time.

The staff's core inflation forecast was revised up a little relative to the previous projection. Recent data for core PCE goods prices and the ECI measure of wage growth—the latter of which importantly influences the staff's projection of core nonhousing services inflation—came in above expectations, and the staff judged that supply–demand imbalances in both goods markets and labor markets were easing a bit more slowly than anticipated. On a four-quarter change basis, total PCE price inflation was projected to be 3.1 percent this year, with core inflation at 3.8 percent. Core goods inflation was projected to move down further this year and then remain subdued, housing services inflation was expected to have about peaked in the first quarter and to move down over the rest of the year, and core nonhousing services inflation was forecast to slow gradually as nominal wage growth eased further. Reflecting the projected effects of less tightness in resource utilization, core inflation was forecast to slow through next year but remain moderately above 2 percent. With expected declines in consumer energy prices and a substantial moderation in food price inflation, total inflation was projected to run below core inflation this year and next. In 2025, both total and core PCE price inflation were expected to be at about 2 percent.

The staff continued to judge that uncertainty around the baseline projection was considerable and still viewed risks as being determined importantly by the implications for macroeconomic conditions of developments in the banking sector. If banking-sector stress were to abate more quickly or have less of an effect on macroeconomic conditions than assumed in the baseline, then the risks would be tilted to the upside for economic activity and inflation, a scenario that the staff viewed as only a little less likely than the baseline. If banking and financial conditions and their effects on macroeconomic conditions were to deteriorate more than assumed in the baseline, then the risks around the baseline would be skewed to the

downside for economic activity and inflation. On balance, the staff saw the risks around the baseline inflation forecast as tilted to the upside, as an upside economic scenario with higher inflation appeared more likely than a downside scenario with lower inflation, and because inflation could continue to be more persistent than expected and inflation expectations could become unanchored after a long period of elevated inflation.

…In their discussion of current economic conditions, participants noted that economic activity had expanded at a modest pace in the first quarter. Nonetheless, job gains had been robust in recent months, and the unemployment rate had remained low. Inflation remained elevated. Participants agreed that the U.S. banking system was sound and resilient. They commented that tighter credit conditions for households and businesses were likely to weigh on economic activity, hiring, and inflation. However, participants agreed that the extent of these effects remained uncertain. Against this background, participants concurred that they remained highly attentive to inflation risks.

In assessing the economic outlook, participants noted that the growth rate of real GDP in the first quarter of this year was modest despite a pickup in consumer spending, as inventory investment—a volatile category—declined substantially. Participants generally expected real GDP to grow at a pace below its longer-run trend rate in 2023, reflecting the effects of restrictive financial conditions. Participants assessed that the cumulative tightening of monetary policy over the past year had contributed significantly to more restrictive financial conditions. They also judged that banking-sector stress would likely weigh further on economic activity, but the extent to which that would be the case remained highly uncertain. With inflation well above the Committee's longer-run 2 percent objective, and core inflation showing only some signs of moderation, participants expected that a period of below-trend growth in real GDP and some softening in labor market conditions would be needed to bring aggregate supply and aggregate demand into better balance and reduce inflationary pressures over time.

Participants generally noted that the actions taken by the Federal Reserve and other government agencies in response to developments in the banking sector had been effective in largely reducing stress. They noted that conditions in the banking sector

had broadly improved since early March, with the initial deposit outflows experienced by some regional and smaller banks moderating substantially over subsequent weeks. Many participants commented that the recent developments in the banking sector had contributed to some tightening of lending standards beyond that which had occurred during previous quarters, especially among small and mid-sized banks. Some participants noted that small businesses tend to rely on small and mid-sized banks as primary sources of credit and therefore may disproportionally bear the effects of tighter lending conditions. Some participants mentioned that access to credit had not yet appeared to have declined significantly since the recent onset of stress in the banking sector. Participants judged that stress in the banking sector would, in coming quarters, likely induce banks to tighten lending standards by more than they would have in response to higher interest rates alone. However, participants generally noted that it was too early to assess with confidence the magnitude and persistence of these effects on economic activity.

In their discussion of the household sector, participants noted that consumer spending showed strength in the first quarter, supported by gains in personal disposable income. They also remarked that the quarterly strength was driven mainly by very strong spending growth in January, while real spending fell modestly over February and March. Consistent with that slowing, participants anticipated that consumer spending would likely grow at a subdued rate over the remainder of 2023, reflecting in large part the effects of the tightening in financial conditions over the past year. Participants remarked that higher interest rates would continue to restrain interest-sensitive expenditures by households, such as those on housing and durable goods. Participants also noted that the rise in uncertainty associated with recent developments in the banking sector could weigh on consumer sentiment and spending. However, several participants observed that high-frequency measures of consumer sentiment had not yet shown significant changes following the banking-sector developments. A few participants remarked that there had been some ongoing reduction in consumers' discretionary expenditures in the face of elevated inflation and higher borrowing rates, especially among lower- and middle-income households; some of those declines were reportedly driven by shifts in purchases toward lower-cost options.

Regarding the business sector, participants observed that growth in business fixed investment was subdued in the first quarter, reflecting relatively high borrowing costs, weak growth of business-sector output, and businesses' increasing concerns about the general economic outlook. Participants expected the tightening of bank lending standards to weigh further on firms' capital expenditures. Several participants noted that, based on reports from their District contacts, concerns related to banking-sector stress could add more uncertainty to an already soft economic outlook, increasing firms' caution, especially at smaller and mid-sized firms that rely heavily on bank credit to finance their operations. However, some other participants mentioned that developments in the banking sector appeared to have had only a modest effect so far on credit availability for firms.

Participants noted that the labor market remained very tight, with robust payroll gains in March and an unemployment rate near historically low levels. Nevertheless, they noted some signs that the imbalance of supply and demand in the labor market was easing, with prime-age labor force participation returning to its pre-pandemic level and further reductions in the rates of job openings and quits. In addition, some participants noted that their District contacts reported less difficulty in hiring, lower turnover rates, and some layoffs. Participants anticipated that employment growth would likely slow further, reflecting a moderation in aggregate demand coming partly from tighter credit conditions. Participants remarked that al-though nominal wage growth appeared to be slowing gradually, it was still running at a pace that, given current estimates of trend productivity growth, was well above what would be consistent over the longer run with the Committee's 2 percent inflation objective. Participants generally anticipated that under appropriate monetary policy, imbalances in the labor market would gradually diminish, easing pressures on wages and prices.

Participants agreed that inflation was unacceptably high. They commented that data through March indicated that declines in inflation, particularly for measures of core inflation, had been slower than they had expected. Participants observed that although core goods inflation had moderated since the middle of last year, it had decelerated less rapidly than expected in recent months, despite reports from several business contacts of supply chain constraints continuing to ease. Additionally, participants emphasized that core nonhousing services inflation had shown few signs of slowing in the past few months. Some participants remarked that a further easing

in labor market conditions would be needed to help bring down inflation in this component. Regarding housing services inflation, participants observed that soft readings on rents for leases signed by new tenants were starting to feed into measured inflation. They expected that this process would continue and would help lead to a decline in housing services inflation over this year. In discussing the likely effects on inflation of recent banking-sector developments, several participants remarked that tighter credit conditions may not put much downward pressure on inflation in part because lower credit availability could restrain aggregate supply as well as aggregate demand. Several participants noted that longer-term measures of inflation expectations from surveys of households and businesses remained well anchored. Participants emphasized that with appropriate firming of monetary policy, well-anchored longer-term inflation expectations would support a return of inflation to the Committee's 2 percent longer-run goal.

Participants noted that risks associated with the recent banking stress had led them to raise their already high assessment of uncertainty around their economic outlooks. Participants judged that risks to the outlook for economic activity were weighted to the downside, although a few noted the risks were two sided. In discussing sources of downside risk to economic activity, participants referenced the possibility that the cumulative tightening of monetary policy could affect economic activity more than expected, and that further strains in the banking sector could prove more substantial than anticipated. Some participants also noted concerns that the statutory limit on federal debt might not be raised in a timely manner, threatening significant disruptions to the financial system and tighter financial conditions that weaken the economy. Regarding risks to inflation, participants cited the possibility that price pressures could prove more persistent than anticipated because of, for example, stronger-than-expected consumer spending and a tight labor market, especially if the effect of bank stress on economic activity proved modest. However, a few participants cited the possibility that further tightening of credit conditions could slow household spending and reduce business investment and hiring, all of which would support the ongoing rebalancing of supply and demand in product and labor markets and reduce inflation pressures.

In their discussion of financial stability, various participants commented on recent developments in the banking sector. These participants noted that the banking

system was sound and resilient, that actions taken by the Federal Reserve in coordination with other government agencies had served to calm conditions in that sector, but that stresses remained. A number of participants noted that the banking sector was well capitalized overall, and that the most significant issues in the banking system appeared to be limited to a small number of banks with poor risk-management practices or substantial exposure to specific vulnerabilities. These vulnerabilities included significant unrealized losses on assets resulting from rising interest rates, heavy reliance on uninsured deposits, or strained profitability amid higher funding costs. Some participants additionally noted that, because of weak fundamentals for CRE such as high vacancy rates in the office segment, high exposure to such assets was a vulnerability for some banks. Participants also commented on the susceptibility of some nonbank financial institutions to runs or instability. These included money market funds, which had recently experienced large cash inflows; hedge funds, which tend to use substantial leverage and may hold concentrated positions in some assets with low or zero margin; thinly capitalized nonbank mortgage servicers; and digital asset entities. Many participants mentioned that it is essential that the debt limit be raised in a timely manner to avoid the risk of severely adverse dislocations in the financial system and the broader economy. A few participants noted the importance of orderly functioning of the market for U.S. Treasury securities or stressed the importance of the appropriate authorities continuing to address issues related to the resilience of the market. A number of participants emphasized that the Federal Reserve should maintain readiness to use its liquidity tools, as well as its microprudential and macroprudential regulatory and supervisory tools, to mitigate future financial stability risks.

In their consideration of appropriate monetary policy actions at this meeting, participants concurred that inflation remained substantially elevated relative to the Committee's longer-run goal of 2 percent. Economic activity had expanded at a modest pace in the first quarter. The labor market continued to be tight, with robust job gains in recent months, and the unemployment rate remained low. Participants also noted that recent developments in the banking sector would likely result in tighter credit conditions for households and businesses, which would weigh on economic activity, hiring, and inflation. However, the extent of these effects remained 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 5 percent to 5-1/4 percent. All participants agreed that it was also 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.

In discussing the policy outlook, participants generally agreed that in light of the lagged effects of cumulative tightening in monetary policy and the potential effects on the economy of a further tightening in credit conditions, the extent to which additional increases in the target range may be appropriate after this meeting had become less certain. Participants agreed that it would be important to closely monitor incoming information and assess the implications for monetary policy. In determining the extent to which additional policy firming may be appropriate to return inflation to 2 percent over time, various participants noted specific factors that should bear on future decisions on policy actions. One such factor was the degree and timing with which cumulative policy tightening restrained economic activity and reduced inflation, with some participants commenting that they saw evidence that the past years' tightening was beginning to have its intended effect. Another factor was the degree to which tighter credit conditions for households and businesses resulting from events in the banking sector would weigh on activity and reduce inflation, which participants agreed was very uncertain. Additional factors included the progress toward returning inflation to the Committee's longer-run goal of 2 percent, and the pace at which labor market conditions softened and economic growth slowed.

Participants also discussed several risk-management considerations that could bear on future policy decisions. A few assessed that there were upside risks to economic growth. However, almost all participants commented that downside risks to growth and upside risks to unemployment had increased because of the possibility that banking-sector developments could lead to further tightening of credit conditions and weigh on economic activity. Almost all participants stated that, with inflation still well above the Committee's longer-run goal and the labor market remaining tight, upside risks to the inflation outlook remained a key factor shaping the policy outlook. A few participants noted that they also saw some downside risks to inflation.

Taking into account these various considerations, participants discussed their views on the extent to which further policy firming after the current meeting may be

appropriate. Participants generally expressed uncertainty about how much more policy tightening may be appropriate. Many participants focused on the need to retain optionality after this meeting. Some participants commented that, based on their expectations that progress in returning inflation to 2 percent could continue to be unacceptably slow, additional policy firming would likely be warranted at future meetings. Several participants noted that if the economy evolved along the lines of their current outlooks, then further policy firming after this meeting may not be necessary. In light of the prominent risks to the Committee's objectives with respect to both maximum employment and price stability, participants generally noted the importance of closely monitoring incoming information and its implications for the economic outlook.

Participants discussed the importance and various aspects of clearly explaining monetary policy actions and strategy. All participants reaffirmed their strong commitment to returning inflation to the Committee's 2 percent objective over time and remained highly attentive to inflation risks. A few participants commented that recent monetary policy actions and communications had helped keep inflation expectations well anchored, which they saw as important for the attainment of the Committee's goals. Participants emphasized the importance of communicating to the public the data-dependent approach of policymakers, and the vast majority of participants commented that the adjusted language in the postmeeting statement was helpful in that respect. Some participants stressed that it was crucial to communicate that the language in the postmeeting statement should not be interpreted as signaling either that decreases in the target range are likely this year or that further increases in the target range had been ruled out.

Source: Federal Reserve Board