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Financial Stress and the Current Macroeconomic Outlook

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Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee.

Introduction

This talk

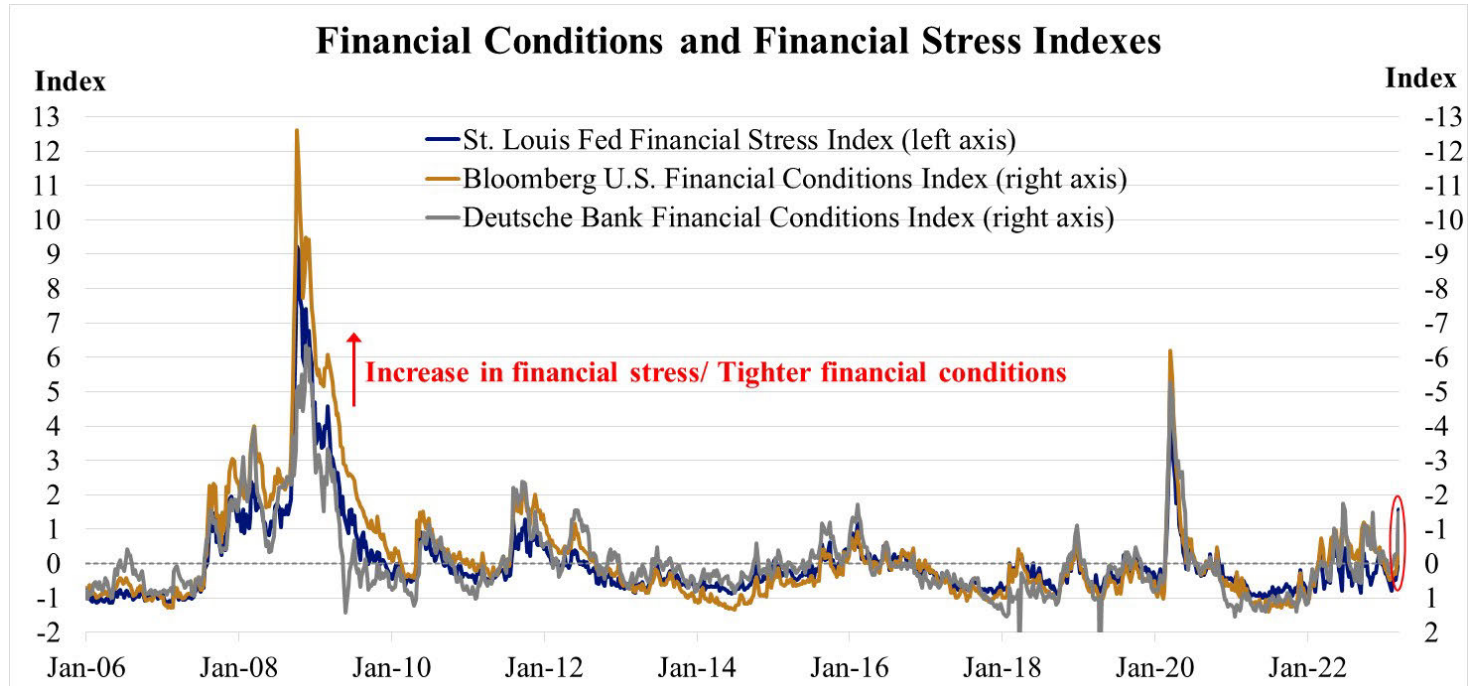
- Financial stress has been on the rise in recent days, but the macroprudential policy response has been swift and appropriate.
- Meanwhile, the data on the real economy have been stronger than expected during the first quarter of 2023, and inflation remains too high.
- Front-loaded Fed policy has helped keep market-based measures of inflation expectations relatively low, helping disinflationary prospects during 2023.
- Continued appropriate macroprudential policy can contain financial stress, while appropriate monetary policy can continue to put downward pressure on inflation.

Financial Stress Returns

Financial stress returns

- Financial stress has been on the rise in recent days.
- Two U.S. banks with crypto-related strategies, Signature Bank and Silvergate Capital Corp., have closed after the failure of cryptocurrency exchange FTX last November.
- California-based Silicon Valley Bank (SVB) suffered a rapid run on deposits and has been closed by the FDIC.
- In Europe, Credit Suisse (CS), a large but troubled Swiss bank, has been sold with Swiss government assistance to UBS.
- These developments have led to volatile trading in banking equities and increases in measures of financial stress.

Financial stress readings are higher



Sources: Federal Reserve Bank of St. Louis, Bloomberg and Deutsche Bank. Last observation: Week of March 17, 2023.

Note: For the St. Louis Fed Financial Stress Index, positive values suggest above-average financial market stress. For the Bloomberg and Deutsche Bank indexes, negative values suggest tighter financial conditions.

A strong macroprudential response

- After the Global Financial Crisis (GFC) from 2007-2009, macroprudential policy was significantly enhanced around the globe.
- In recent weeks, authorities deployed some of the tools developed, or first utilized, at that time to limit macroeconomic damage that might have otherwise occurred.
- In the U.S., the Fed worked with the U.S. Treasury to use the 13(3) provisions in the Dodd-Frank Act to create the Bank Term Funding Program (BTFP). This program seems likely to be very effective.
- Swiss regulatory authorities acted quickly to ask UBS to purchase CS as a method of preventing additional fallout from CS decline.
- Regulatory authorities stand ready to take additional action as necessary.

Adjustment to rising interest rates

- The Fed has been raising the policy rate over the last year to combat the highest inflation in the U.S. since the early 1980s.
- Even with considerable forward guidance, it is relatively common that not all financial entities adjust their businesses appropriately to the changing environment.
- Examples: Continental Illinois (1984), the Mexican “Tequila Crisis” (1994), Orange County (1994), Long-Term Capital Management (1998).
- These events received considerable attention at the time, but were not ultimately harbingers of poor U.S. macroeconomic performance.

GDP Growth Improves

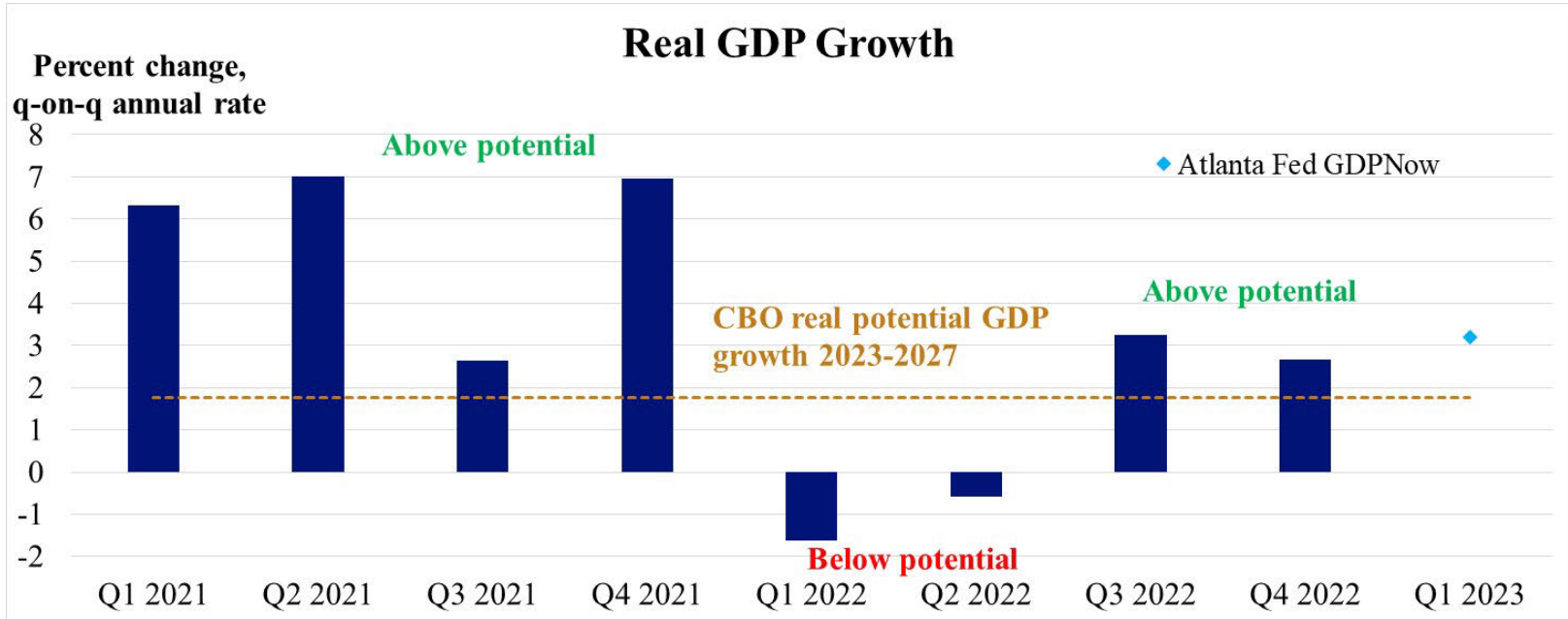
Improved real GDP growth

- Meanwhile, incoming data on the U.S. economy during the first quarter of 2023 have been stronger than expected.
- GDP growth improved in the second half of 2022.
 - Third-quarter 2022 real GDP growth was 3.2% and fourth-quarter 2022 growth is currently estimated at 2.7%.*
- The Atlanta Fed's GDPNow nowcast of first-quarter 2023 growth is currently 3.2%.**
- The associated real consumption expenditures have also been stronger than expected.

**These growth rates are from the previous quarter at an annual rate.*

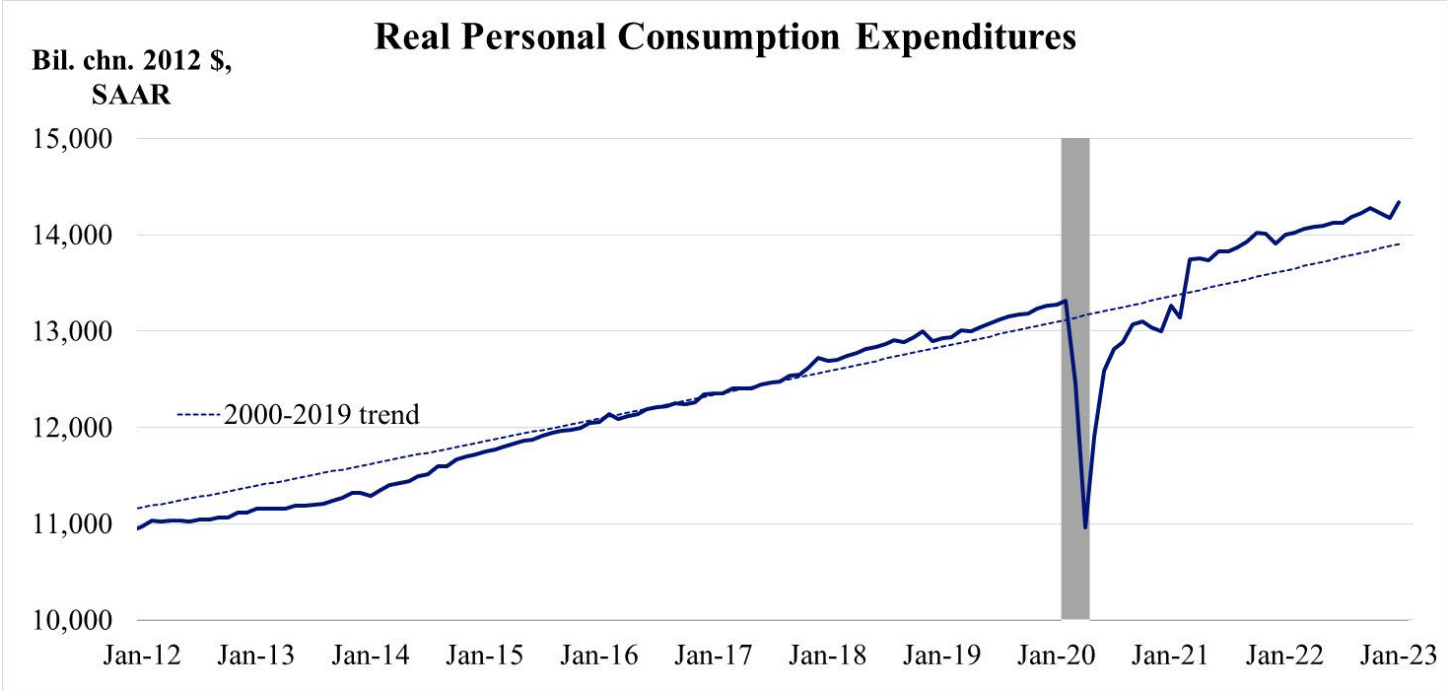
***As of March 16, 2023.*

Improved growth performance



Sources: Bureau of Economic Analysis, Congressional Budget Office and Federal Reserve Bank of Atlanta. Last observation: 2022:Q4. Projection for Q1 is as of March 16, 2023.

Real consumption is above trend



Sources: Bureau of Economic Analysis and author's calculations. The shaded area denotes U.S. recession. Figures are billions of chained 2012 dollars at a seasonally adjusted annual rate. Last observation: January 2023.

Labor Market Performance Remains Strong

Labor market performance

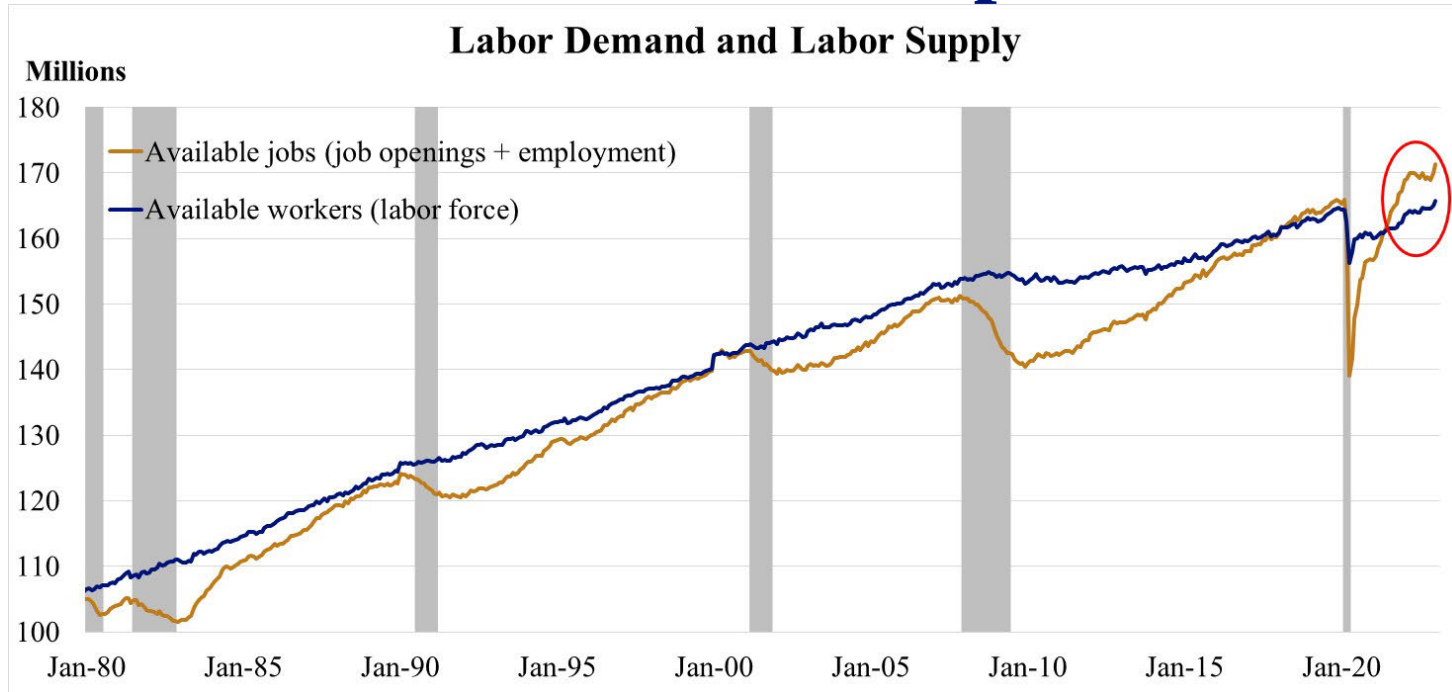
- Labor market performance remains strong.
- The number of job openings per unemployed worker remains high.
- Viewed in historical perspective since the 1980s, the current labor market situation is unprecedented, with measures of labor demand significantly exceeding measures of labor supply.
- Unemployment insurance claims remain low.
- The Kansas City Fed's labor market conditions index remains high.
- Normally, a strong labor market bodes well for consumption expenditures, the largest component of GDP.

Vacancies per unemployed person remain high



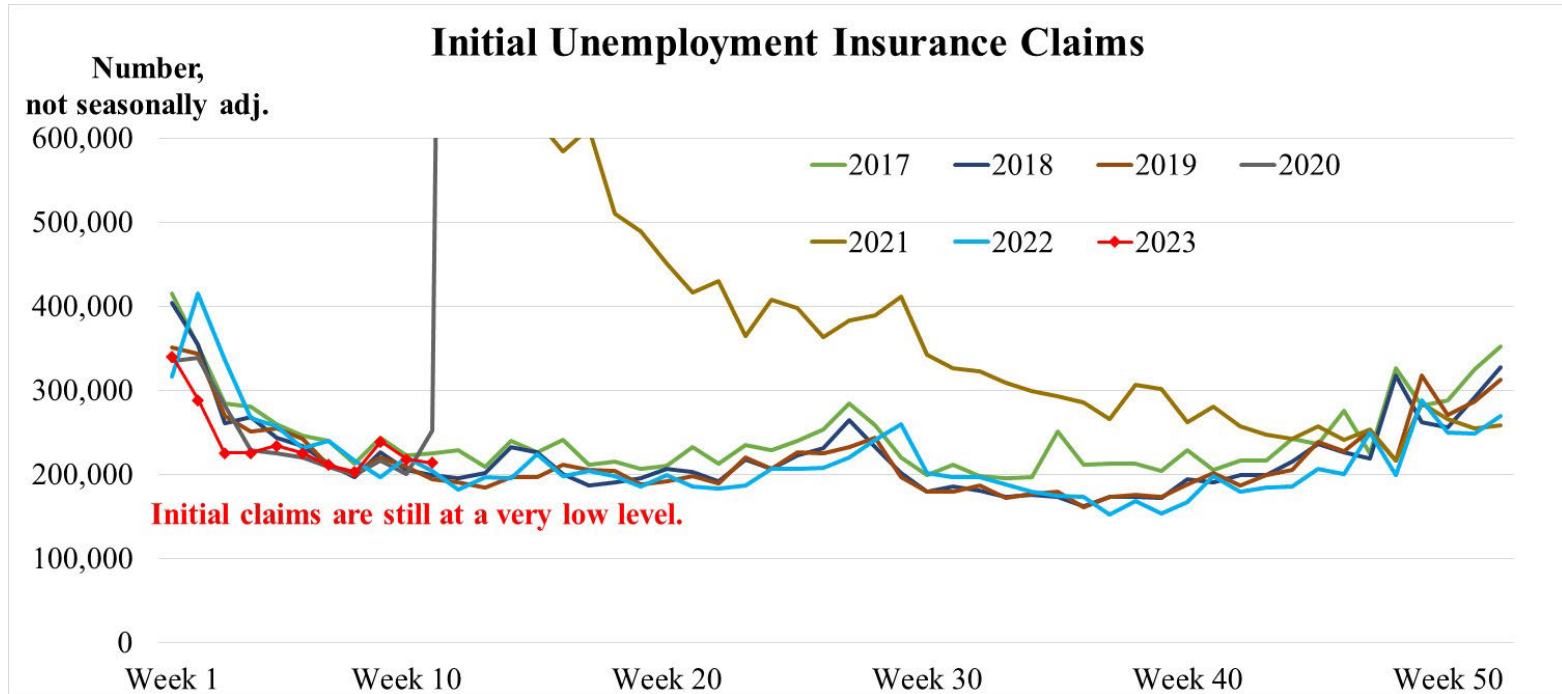
Sources: Bureau of Labor Statistics and author's calculations. Shaded areas denote U.S. recessions. Last observation: January 2023.

The labor market situation is unprecedented



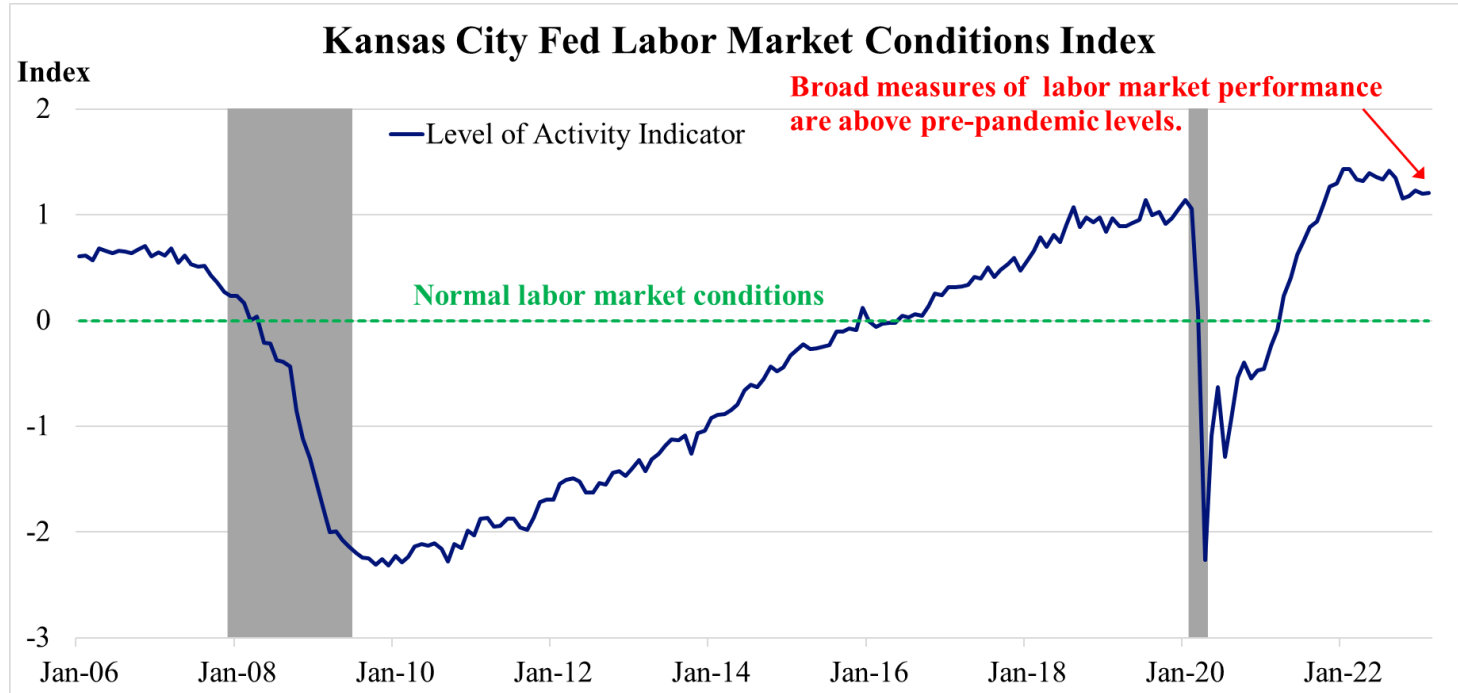
Sources: Bureau of Labor Statistics; R. Barnichon, “Building a composite Help-Wanted Index,” *Economics Letters*, December 2010, 109, pp. 175-178; and author’s calculations. Shaded areas denote U.S. recessions. Last observation: January 2023.

Unemployment insurance claims remain low



Source: U.S. Employment and Training Administration. Last observation: Week of March 18, 2023.

Overall labor market conditions are strong



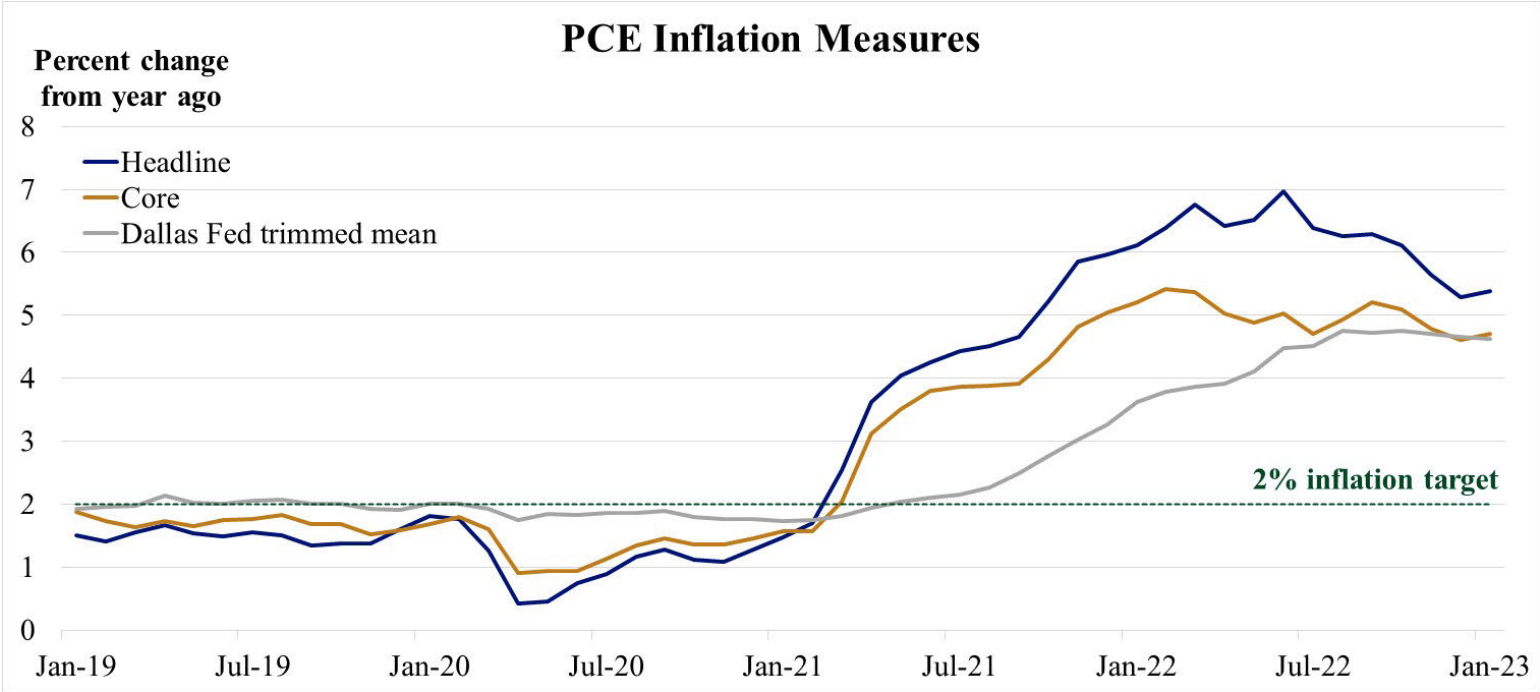
Source: Federal Reserve Bank of Kansas City. Shaded areas denote U.S. recessions. Last observation: February 2023.

Disinflation

Inflation

- Inflation remains too high, but it has declined recently.
- The FOMC has a 2% inflation target specified in terms of headline personal consumption expenditures (PCE) inflation.
- Headline inflation has declined, but it can be inordinately influenced by fluctuations in energy and food prices.
- Measures of inflation that strip out volatile price movements, such as core PCE inflation and the Dallas Fed's trimmed mean inflation measure, have also declined but by less than the headline measure.

Inflation remains well above target



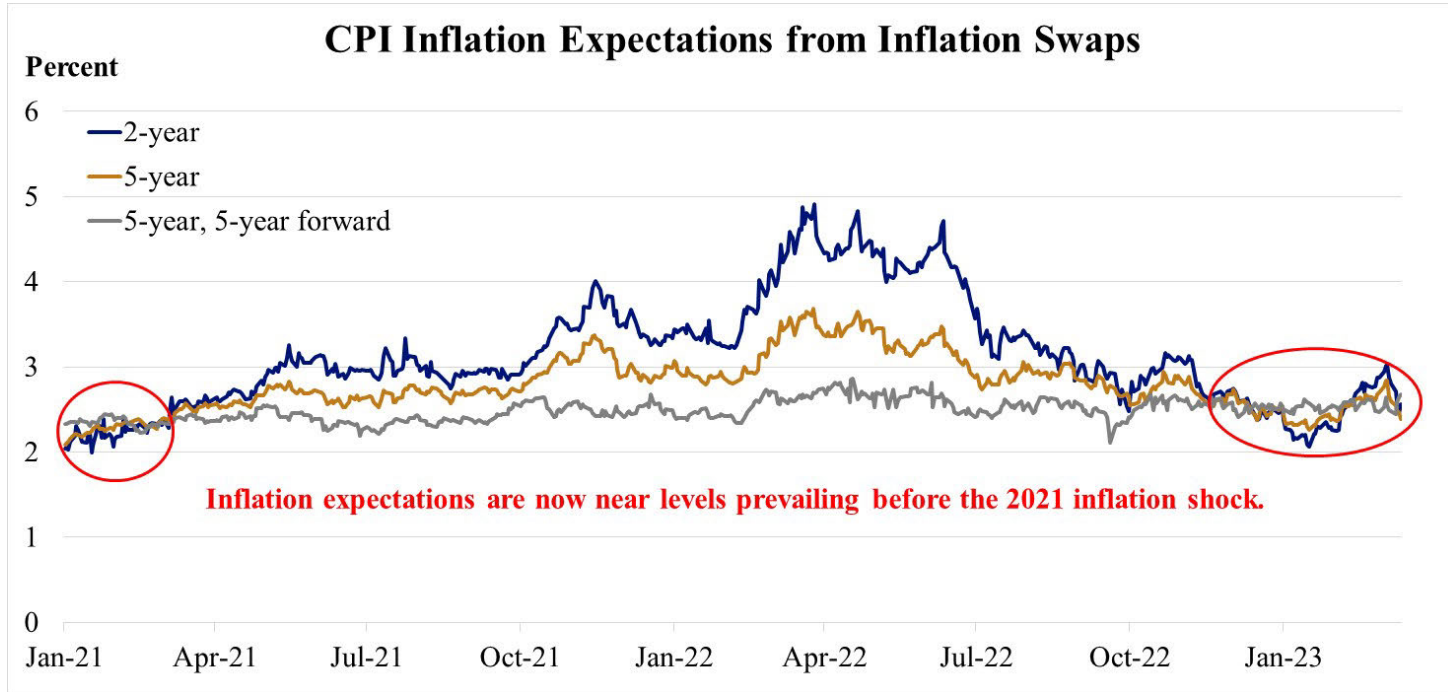
Sources: Bureau of Economic Analysis and Federal Reserve Bank of Dallas. Last observation: January 2023.

Inflation Expectations Are Relatively Low

Inflation expectations

- In part due to front-loaded Fed policy during 2022, market-based measures of inflation expectations are now relatively low.
- According to standard macroeconomic theories, inflation expectations are a key determinant of actual inflation.
- This bodes well for the disinflationary process in 2023.

Inflation expectations are back to low levels



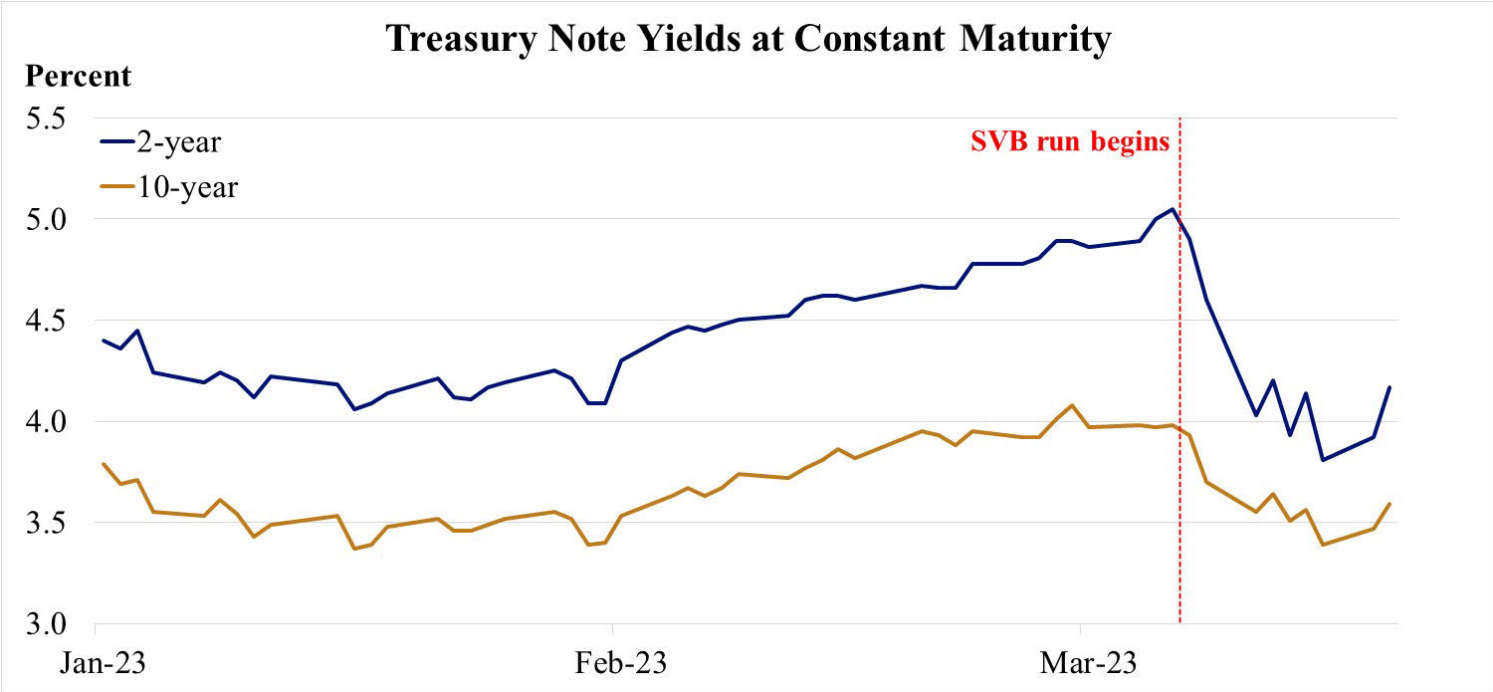
Sources: Bloomberg and author's calculations. Last observation: March 23, 2023.

Financial Stress and Macroeconomics

Financial stress and macroeconomics

- Financial stress can be harrowing but also tends to reduce the level of interest rates.
- Lower rates, in turn, tend to be a bullish factor for the macroeconomy.
- During the current stress, the benchmark U.S. 10-year Treasury yield has declined by about 50 basis points, and the 2-year Treasury yield has declined by about 100 basis points.
- This may help to mitigate some of the negative macroeconomic fallout that might otherwise occur in the aftermath of a period of financial stress.

Financial stress and macroeconomics



Source: Board of Governors of the Federal Reserve System. Last observation: March 21, 2023.

Conclusion

Conclusion

- Financial stress has increased in recent days.
- The macroprudential response has been swift and appropriate, and regulators stand ready to take additional action if necessary.
- Meanwhile, incoming U.S. macroeconomic data have been stronger than expected, and inflation remains too high.
- FOMC policy has kept market-based measures of inflation expectations relatively low, which bodes well for disinflation during 2023.
- Continued appropriate macroprudential policy can contain financial stress, while appropriate monetary policy can continue to put downward pressure on inflation.

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