Economic Outlook

Economic Leadership Forum
New Jersey Bankers Association
Somerset, NJ

January 17, 2020

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The views expressed today are my own and not necessarily those of the Federal Reserve System or the Federal Open Market Committee (FOMC).

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One of the things I've noticed about this job is that people find me a lot more interesting when I'm a voting member of the FOMC. So I won't take it personally that the last time I spoke to this group was almost exactly three years ago …

Some things look very different in 2020 than they did in 2017. The makeup of the Fed's Board of Governors has changed. We are in a different part of the business cycle. My outlook for interest rates is markedly dissimilar. But some things have held firm. Specifically, while the outlook for rates may be starkly different, a lot of the phrases I used to describe the state of the economy back in 2017 still apply today.

That's positive news and pretty amazing when you consider how much the world has changed since 2017.

Today I will touch on three issues that are integral in today's banking world. The first is the economic outlook, a key driver for loan demand and investment opportunities. The second is an aspect of monetary policy that has been in the news over the past few months; namely, how the Fed is normalizing its balance sheet. Last, I will touch on the ongoing efforts around modernizing the Community Reinvestment Act (CRA).

Let me begin with the standard disclaimer — which I used three years ago — about my views being my own and not necessarily reflective of anyone else in the Federal Reserve System.

The Economic Outlook

Overall, the economy is looking pretty good. We are in the longest economic expansion on record, and I see growth returning to trend of about 2 percent this year, a view that is widely shared.

Just as I said last time I was here in 2017, I will note that the labor market continues to show considerable strength. In fact, it has outperformed most people's expectations, with continued job creation, continued low unemployment, and more people continuing to come off the sidelines.

At some point, we'll return to a trend of creating about 100,000 net new jobs per month. I've said that, too, in years past, and it hasn't yet come to fruition, which is great for the American workforce. And when we do return to trend — whenever that may be — it's important to note that, while 100,000 jobs a month may look disappointing in comparison with the strong numbers we've seen over the past several years, it will more than keep pace with growth in the labor force.

More good news in the labor market includes the fact that wages on the lower end of the pay scale have finally started to rise — as they have on the higher end — although midrange paychecks could still use a boost.

The continued strength of the labor market has contributed to booming consumer confidence. And with consumer spending making up some 70 percent of the U.S. economy, that makes it the hero in the growth story. Business investment, however, is lagging, and the uncertainty attached to fiscal and other policies, has continued to hold it back. So, too, have international developments, including the global slowdown, trade uncertainty, and geopolitical tensions.

Here's something else I said in 2017 — and in 2018 and in 2019 — while we haven't quite met our 2 percent inflation target, we're on track to get there. I still believe that inflation will rise to meet our goal, albeit slowly, and we're closing in on the target. But it has been a long time coming. To most people, this is a purely academic problem — who else but policymakers are going to complain that inflation is hovering below 2 percent? But because of our dual mandate, focusing on the inflation rate is more than an academic exercise.

New Jersey's Economy

As for the Garden State's economy, some numbers show New Jersey outperforming the nation, and others show some shortfall — but not by a lot. And as a lifelong South Jersey boy, I am happy to say our state's economy is in good shape. Job growth has hovered around 1 percent over the past three years, a little below the U.S. rate of about 1.5 percent. However, the unemployment rate is 3.4 percent, which is slightly better than the national average. That is despite the fact that New Jersey's jobless rate has ticked up in recent months. But even here, I view the news as positive. That's because the rise in the rate reflects more people coming back into the labor force. The state's labor force participation rate has

risen from about 62 percent last summer, to 63.6 percent at the end of 2019. That suggests more residents are feeling confident about the labor market and their ability to find work.

I should mention that the Philadelphia Fed's own state leading index for New Jersey recently turned negative. But that reflects the rise in the jobless rate. Since that rise is the result of more people coming into the labor market, I am not worried about New Jersey's economic future.

Monetary Policy

The main subject of this speech is monetary policy. While it is usual to discuss interest rates, today I want to touch on another key aspect of monetary policy going forward, and that is the Fed's efforts to normalize the balance sheet. This has received great attention lately, ever since the repo market problems of last September.

As you know, at the start of 2019, the FOMC decided that we would continue to conduct monetary policy in a regime of "ample reserves," in which control over the federal funds rate is exercised primarily through the setting of administered rates, and the supply of reserves does not need to be actively managed.

Shortly after that, we announced our plan to cease asset redemptions and hold the balance sheet to roughly a constant size come September. As currency and other non-reserve liabilities grew, aggregate reserves naturally declined. Our end game was for reserves to reach a level "consistent with efficient and effective implementation of monetary policy."

There were two primary objectives to this approach. First, to reduce uncertainty about asset purchases by announcing our plans well in advance. Second, to approach the necessary level of reserves, which is itself filled with uncertainty, with an abundance of caution.

We only have estimates of the demand for reserves, although we've conducted a great deal of research around the Federal Reserve System, including continued conversation with market participants. In fact, staff at the Philadelphia and New York Feds were among the first to identify that the need for reserves could be much larger than initially anticipated. To be on the safe side, it made sense to move slowly, buying time to carefully observe market developments and better assess their implications. That is, we gave ourselves time for the inevitable "unknown unknowns" of life.

Just such an unknown arose in September.

The episode was clearly triggered by the outsized flows of funds to the Treasury. But the dates for tax payments and bond settlements are not a surprise; they are fixed on the fiscal calendar and well known to both policymakers and markets. Everyone was expecting large liquidity flows.

The impact, however, was clearly much larger than anyone anticipated, markets included.

The repo market took the brunt of the impact, as the Secured Overnight Financing Rate (SOFR) rose above 5 percent on Tuesday, September 17, with some trades executed at rates as high as 10 percent.

While this was certainly not an average day, it's important to note that the repo market did not freeze. The volume of secured overnight finance remained steady, at the $1.2 trillion level it had maintained for the past several months.

The funding pressures in secured markets passed through to the federal funds market. The effective federal funds rate rose to the top of target range on Monday the 16th, and surpassed the top of the range by 5 basis points the next day.

We immediately took action to ensure that the effective fed funds rate returned to, and stayed within, the target range. The very next day, the Desk started repurchase operations to stem the pressures on money markets, and these actions have continued — including term operations — to date.

In October, the FOMC decided to restart asset purchases to keep reserves at or above the level reached in early September, at a little over $1.5 trillion. Additionally, the Desk has been conducting term and overnight repurchase agreement operations to offset money market pressures — for instance, the quarter-end dynamics that are inevitably more burdensome at the year's end. All in all, since September, we have supplied about $400 billion in additional reserves; about $250 billion via repo agreements, and the rest in asset purchases.

These measures clearly worked, with the effective fed funds rate maintaining a virtually constant level since October, and repo markets staying calm. Instead of wreaking havoc, the year's end was a non-event.

Going forward, the Committee remains committed to implementing monetary policy in a regime of ample reserves, which, again, does not require active management of the supply of reserves. The Treasury purchases announced in October will continue until at least the next quarter to ensure we meet that goal.

Central to this event is the question of why liquidity did not flow smoothly to where it was needed most. Are some of the market's pipes rusty? Clogged? Are more needed? Has regulation inadvertently contributed to some erosion or blockage?

Another question is whether the Fed ought to expand our toolkit — whether we could, or should, do more to ensure interest-rate control. One possibility under discussion is a standing repo facility. We are in the process of evaluating such a facility's potential costs and benefits, and exploring possible designs as well as alternatives, so it is still very much in the discourse, rather than the decision, phase.

While September's turmoil offered perhaps too much excitement, it also provided a good deal of information. It showed that we need a larger pool of reserves than most of our estimates had initially indicated. It showed that when reserves are scarce, even for as short a period as a week or so, it can generate large spikes in money market rates. And it showed, unfortunately, that banks remain extremely reluctant to borrow from the discount window, even when that reluctance results in outsized penalties far above the primary credit rate.

CRA Modernization

Finally, I know the banking community is awaiting final resolution to the discussion about modernizing the Community Reinvestment Act. Our meeting here today is taking place north of the jagged line that divides New Jersey between the New York Fed and the Philadelphia Fed. For those of you in the audience from South Jersey, you know that the discussion about the CRA takes on significant importance in the Fed's Third District, and we have hosted one-on-one meetings, roundtable discussions, and conferences with both banks and community members to better understand their concerns and gather their insights on updates to the regulation.

The CRA was passed in 1977, and the last significant update to the legislation was done back in 1995. As regulators, we have heard feedback over the years for the need to update and revise the CRA, and in 2018, we began an interagency process to make significant changes that reflect modern banking and community needs.

The Philadelphia Fed hosted a conference on CRA modernization in February 2019, and that event allowed us to listen as various community development experts and financial industry leaders weighed in on the best approach. We recognize there is value in modernizing the regulation to address the changing channels that serve customers beyond bank branches, to strengthen the law's focus on local communities, and to help bring greater consistency and predictability to CRA ratings.

As you probably know, the FDIC and OCC released their proposals in the fall of 2019. Last week, Governor Lael Brainard unveiled the Fed's own approach. The Fed's proposal is based not only on the feedback we heard from bankers and communities but also insights from the advanced notice of proposed rulemaking public comment process and a thorough review of a number of performance evaluations. In my view, modernizing the CRA will help banks better meet the credit needs in the low- and moderate-income communities they serve.

Because these updates to the CRA will impact your business models, I assume that you have read the ideas and the metrics of the Fed's plan, so I won't go into much detail. But let me make some points about the Fed's proposal.

The Fed is proposing the creation of two tests: a retail test to assess a bank's record of retail loans and services in its assessment area; and a community development test for large banks, and wholesale and limited-purpose banks to measure a bank's performance on community development loans, qualified investments, and other services. A separate retail test will align with the key focus of the CRA, which is to ensure that banks are meeting the credit needs of underserved markets. Separate tests also underscore the importance of the ability to tailor exams to each institution's asset size, business lines, and local conditions.

Our proposal also hones in on the importance of metrics and data dashboards, and distilling that data into helping banks better track and benchmark their CRA performance. We at the Fed like to say we are "data driven," and these dashboards will show that data matter not just in monetary policy but in the work the Fed does in ensuring the U.S. has a robust and equitable financial system.

To reiterate what Governor Brainard said last Wednesday, "it is more important to get reforms right than to do them quickly." I couldn't agree more with that sentiment when it comes to an important piece of legislation like the CRA. To achieve that goal, regulators at the Fed are having discussions with the other banking regulators. We are mindful of the business costs that two sets of rules would impose on banks. And I am hopeful that we can create a consensus going forward.

Conclusion

Congress gave the Federal Reserve a dual mandate to maximize employment and stabilize prices. The data show that the labor market is doing incredibly well, and I believe the economy is nearing our target inflation rate of 2 percent. All in all, my outlook for the economy is positive, but let me add that my outlook will continue to be driven by the data as each report is released throughout 2020.

The data will also determine my view on monetary policy. And policy entails more than interest rates. As the Fed oversees its balance sheet, we will be mindful of the unexpected, such as happened last September.

And with that, let me open the floor up to questions.