The Outlook for the Economy and Bank Regulation

Loretta J. Mester
President and Chief Executive Officer
Federal Reserve Bank of Cleveland

Ohio Bankers League 2015 Economic Summit
Columbus, Ohio

February 4, 2015

Introduction

Good afternoon. I thank the Ohio Bankers League for inviting me to participate in this year's economic summit. It is a pleasure to have the opportunity to speak with so many leaders from the state's banking community. I'm glad to be here with my colleague Steve Jenkins, whom many of you know well and who will be speaking later today. It is also great to be in Columbus, where it seems as if the euphoria from The Ohio State University's national championship isn't going to wear off any time soon.

Today, I will share my views on the outlook for the U.S. economy and monetary policy in 2015. Given the important role financial institutions play in the economy, I also want to offer some perspectives on banking supervision and regulation. Of course, the views I'll present today are my own and not necessarily those of the Federal Reserve System or my colleagues on the Federal Open Market Committee.

The Economic Outlook

The U.S. economy begins 2015 in its sixth year of expansion. The trip out of the Great Recession hasn't broken any speed limits. For most of the journey, the economy has been traveling at a relatively slow to moderate pace, and it's taken several rest stops along the way. But the recent data on the real side of the economy have been encouraging. There are accumulating signs that the economy is building momentum and that, this time, a pickup in speed will be sustained because the underlying fundamentals have improved.

Last year's severe winter helped spur an annualized decline of about 2 percent in real output in the first quarter. Growth rebounded to about 4 percent over the remainder of last year, quite a bit higher than the average growth rate of around 2 percent over the prior three years. Many of the so-called headwinds that held back the pace of growth earlier in the expansion and dampened the effect of very accommodative monetary policy on the economy have abated, suggesting that the economic momentum at the start of this year is likely to be sustained.

One of those headwinds has been the deleveraging that households and businesses had to do after the Great Recession. Consumer balance sheets have improved significantly over the expansion. Household debt relative to disposable personal income peaked at 130 percent prior to the recession but is now closer to 100 percent and has leveled out over the past couple of years. Very low interest rates mean that households are spending less to service their debt. And thanks to higher prices of equities and houses, households have more than made up the $10 trillion in net worth destroyed in 2008. The rise in home prices means that fewer households are underwater on their mortgages and mortgage delinquencies are down. Businesses also had to deleverage. But now business balance sheets are quite healthy. Business sentiment is positive and supportive of higher levels of investment and stronger hiring.

Another headwind came from the government sector. Government spending has been a drag on growth during much of the expansion. Unlike in most earlier recoveries, government payrolls actually fell during much of this expansion. Last year, buoyed by stronger tax revenues, state and local governments added to their payrolls after a meager increase in 2013 and declines in the prior four years. State and local government spending made a net positive contribution to real output growth last year, and the drag from federal government spending is waning.

Of course, this audience doesn't need to be reminded of the repairs that had to be made to bring the banking sector back to health in the wake of the Great Recession. Now that banks are recapitalized they are in a better position to take appropriate risks. Loans to consumers and businesses are rising and delinquencies and write-offs are at low levels.

At the same time the headwinds have diminished, we now have a tailwind in the form of lower oil prices. Last July, oil was selling at around $110 a barrel. Now the price is near $50. While the drop in oil prices will lead to some reduced investment and dislocation in parts of the domestic energy sector, lower oil prices will be a net positive for the U.S. economy. The lower costs of fuel to consumers, businesses, and local governments will support higher spending elsewhere. The U.S. Energy Information Administration is projecting that the average U.S. household will spend about $550 less on gasoline this year than it did last year. This will put money into people's pockets that can be spent on other goods and services.

Based on the improvement in fundamentals, as well as the fall in energy prices, and with the usual caveats that there are risks around any forecast, I expect the economy to grow at a 3 percent pace in 2015 and 2016, somewhat above my estimate of 2.5 percent longer-run growth. I don't expect the housing sector to come back strongly this year, although continued moderate improvement is likely. The improvement will be supported by some relaxation of mortgage credit conditions, which remain fairly tight except for the highest quality borrowers. Net exports are also unlikely to contribute much to U.S. growth. As you are well aware, the U.S. economy is in better shape than the economies of many of our trading partners. Weak demand from abroad will dampen U.S. exports but will be more than offset by healthy domestic consumer and business spending that will support above-trend economic growth this year.

The increased momentum in the economy reflects a significant improvement in labor market conditions, which is seen across a broad number of indicators. On average, firms added 246,000 jobs per month last year, up from an average of 194,000 in 2013 and 186,000 in 2012. Nonfarm payrolls are now 2 million above their pre-recession level.

The unemployment rate is now 5.6 percent. This is down from a peak of 10 percent in 2009 and a full percentage point lower than it was last January. For several years now, the decline in the unemployment rate has been faster than many economists and policymakers thought it would be. For example, in

December 2013, participants on the Federal Open Market Committee projected that the unemployment rate would be between 6.2 and 6.7 percent by the end of 2014. We are now well below that range.

Broader measures of the unemployment rate are also down considerably since the start of the expansion, and their rate of decline is increasing. These measures include those that track people who are working part time but would prefer a full-time job or people marginally attached to the labor force who say they want to work but aren't actively looking. Improvements are also evident in measures that track the long-term unemployed – people who have been out of work for more than six months. While these broader measures are not yet down to their pre-recession levels, they have all fallen considerably. For example, the Bureau of Labor Statistics' so-called U6 measure of the unemployment rate, which includes marginally attached workers and people working part-time who want full-time work, fell almost 2 percentage points last year.

I continue to view the unemployment rate as a useful indicator of labor market conditions. However, for those who put less stock in it because of the confounding effect of cyclical declines in labor force participation, I point to the ratio of employment to population. As our population ages, this ratio will naturally decline. Yet last year the acceleration in hiring was enough to overcome the effect of demographics, and we saw a nice increase in the employment-to-population ratio.

Labor market conditions in Ohio have also improved over time, although at a somewhat slower pace than in the rest of the nation. During the recession, Ohio saw a sharper rate of job loss compared to the U.S. Between the start of the recession in December 2007 and the start of the expansion in June 2009, Ohio lost nearly 7 percent of its payroll jobs, while the U.S. lost almost 5-1/2 percent of its jobs. Since the start of the expansion, job growth in Ohio has averaged 1 percent per year. While this is somewhat lower than the 1-1/4 percent per year job growth seen in the nation, it is pretty good performance for Ohio, which usually sees slower job growth compared to the nation because of its industry mix and slower population growth.

Despite the gains we've seen in labor markets, wage growth has remained subdued. However, as employment continues to grow, I anticipate that wages will accelerate and help support stronger consumer spending.

Consumer price inflation also remains subdued and is running below the Fed's 2 percent objective. The sharp drop in oil prices is showing up in much lower headline inflation numbers, and I expect inflation to decline further in the near term. So far, there has been only modest pass-through of those oil price declines to core measures of inflation that remove the volatile food and energy components. The Cleveland Fed's median CPI measure has remained near 2-1/4 percent since last April, and as shown in Cleveland Fed staff research, this measure has some predictive power for headline inflation over the medium term.[1] My expectation is that inflation will gradually move back up to 2 percent by the end of next year as economic activity continues to strengthen, oil prices stabilize, and inflation expectations remain anchored.

I recognize that continued low readings on headline inflation have the potential to unsettle estimates of inflation expectations, so it is important that we carefully monitor developments on this front. Economists look at several different measures to help gauge inflation expectations. Market-based estimates of inflation compensation based on the spread between the yields on 10-year Treasury securities and 10-year Treasury inflation-protected securities, so-called TIPS, have fallen in recent weeks. However, in periods of highly volatile financial markets and flight-to-quality flows into U.S. securities, like those we've been experiencing, it is difficult to parse how much of the decline reflects a change in

---

[1] Brent Meyer, Guhan Venkatu, and Saeed Zaman, "Forecasting Inflation? Target the Middle," Federal Reserve Bank of Cleveland *Economic Commentary*, April 2013.

inflation expectations and how much reflects liquidity effects and changes in inflation risk premiums. In such times, I put more stock in the survey-based measures of inflation expectations, and these have been stable. In addition, while the Cleveland Fed's own estimate of the 10-year expected inflation rate slipped from 1.85 percent in December to 1.66 percent in January, this reading is essentially in the middle of the range of readings we have seen since the financial crisis. Altogether, based on the various measures, my read is that inflation expectations remain anchored. And so long as that continues and growth doesn't falter, I am comfortable with the forecast that inflation will move gradually toward the Fed's 2 percent goal over the medium term, while lower oil prices drive down measures of headline inflation in the near term. Of course, this projection is dependent on appropriate monetary policy. So let me turn to that now.

Monetary Policy

In response to the financial crisis and deep recession, the Federal Reserve has run an extraordinarily accommodative monetary policy to promote its goals of price stability and maximum employment. The FOMC has kept its policy rate – the federal funds rate – at essentially zero since the end of 2008. This has lent important support to the economy, leading to the substantial progress we've seen in labor markets and the pickup in the pace of growth that underlie the projection that inflation will gradually return to our goal.

The economy is moving back to more normal territory, and as it does, monetary policy should begin to do so too. Because monetary policy affects the economy with a lag, policymakers need to be forward looking. We need to base our policy on both realized and expected progress toward our goals. Based on my forecast and the risks I see around that forecast, I believe it will soon be appropriate to begin moving rates up from zero. Because policy must be forward looking, in my view liftoff should occur before our goals are fully met. But even after liftoff, policy will remain very accommodative for some time, promoting attainment of both goals. Indeed, if incoming economic information supports my forecast, I would be comfortable with liftoff in the first half of this year, but as the FOMC has emphasized, policy isn't on a pre-set path. Both liftoff and the path of policy thereafter will be based on incoming information to the extent that it affects the economic outlook and progress toward our goals of maximum employment and price stability.

A Tiered Approach to Banking Supervision and Regulation

As I mentioned earlier, one of the headwinds that held back the pace of economic recovery was the considerable work that had to be done to improve the health of the financial system after the financial crisis. I wouldn't want to conclude my talk to this group without acknowledging the key role that banks play in providing valuable credit, risk-management, and liquidity services to businesses and households.

While banks are designed to take risks, operate with leverage, and are subject to oversight, we saw during the financial crisis that our system was not without flaws. The Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law in 2010, includes a number of provisions to strengthen the supervisory and regulatory framework, with the goal of promoting a more resilient financial system. Consistent with the act, the Federal Reserve and other federal banking agencies are taking a tiered approach to banking supervision and regulation. This approach recognizes that the risk a banking organization poses to the financial system is likely to vary according to its size, range of activities, and complexity, and so supervision and regulation should vary as well. For example, individual community banks are subject to regulatory oversight to help ensure they remain sound and able to extend credit and other services to their communities. But the actions community banks take do not typically impose costs on the rest of the financial system or create the kinds of contagion that can put the entire financial system at risk. So community banks shouldn't be subject to the same types of macroprudential rules and supervision aimed at the systemically important institutions.

The tiered approach categorizes institutions based on their complexity and the level of risk they pose to the overall financial system, and then tailors oversight appropriately. Doing so will help to reduce the potential costs bankers might face if made to comply with rules that don't further the goal of a healthy and resilient financial system. It will also free up the bandwidth of examiners and supervisors so they can focus more of their attention on where the risks actually lie. The Federal Reserve has organized its supervision of institutions around four groups of banks: community banks, which are institutions with $10 billion or less in assets; regional banking organizations, with assets between $10 billion and $50 billion; large banking organizations; and systemically important institutions. By appropriately deploying our supervisory resources, we feel we can better promote a healthier, more resilient financial system.

Several examples illustrate the tiered approach. Many of the new requirements under Dodd-Frank apply only to the 100 or so banks with more than $10 billion in assets. For example, the nation's 5,700 or so community banks are not subject to requirements for annual stress testing or resolution planning, but for those banks to which they do apply, the requirements become more extensive for the largest and most systemically important firms. Community banks and smaller regional banks with $50 billion or less in assets are not subject to the quantitative minimum liquidity requirement the Fed approved last year, nor do they fall under the extensive enhanced prudential standards required under Dodd-Frank for bank holding companies with more than $50 billion in assets.

Stronger capital requirements are an essential part of the new regulatory system. But the capital positions needed for systemically important banks are higher than those needed for community banks, and after consultations with community bankers, the rules adopted by the federal regulatory agencies reflect this.

Another more recent example of the tiered approach involves the Federal Reserve Board's policy statement that allows certain small, noncomplex bank holding companies to operate with higher levels of debt than normal so long as doing so doesn't compromise safety and soundness. In a recent speech, Federal Reserve Governor Tarullo explained that while the Federal Reserve Board generally discourages the use of debt to finance acquisitions, it recognizes that debt is often needed to finance transfers of ownership of small banks because they have limited access to equity financing.[2] Last December, Congress raised the asset-size threshold for bank holding companies qualifying to operate with higher debt from $500 million to $1 billion. Last week, the Fed invited public comment on its proposed rule to implement this law. When final, this rule will raise the percentage of banks qualifying for the policy to nearly 90 percent from 75 percent.

What I hope you will take from these examples is that the Federal Reserve recognizes the new regulatory environment poses challenges for bankers. We are committed to ensuring that our implementation of the Dodd-Frank Act does not put undue burden on community banks, but works to foster a healthier and more resilient financial system, which will benefit banks of all sizes and the overall economy.

Conclusion

In summary, I see the economy on firmer footing than it has been for some time. Although there are risks around my forecast, I see growth averaging about 3 percent over the next two years. While the drop in oil prices will lower inflation in the near term, as oil prices stabilize, output and employment growth continue, and inflation expectations remain anchored, I expect inflation to gradually move back to the Fed's goal of 2 percent. Based on realized and expected progress toward our goals, I believe it will soon be appropriate to begin moving interest rates up from zero. The Committee will base its decision about the timing and path of interest rates on incoming economic information to the extent that it affects the economic outlook and progress toward our goals of maximum employment and price stability.

As I noted earlier, it takes time for monetary policy to affect the economy. So the public won't be able to immediately see whether a policy action taken by the Fed was a good one. That is one reason that I

[2] Daniel Tarullo, "A Tiered Approach to Regulation and Supervision of Community Banks," Board of Governors of the Federal Reserve System, remarks at the Community Bankers Symposium, Chicago, November 7, 2014.

believe clear communication about monetary policy is so important. It is incumbent upon policymakers to explain the rationale for their decisions, including their evaluation of economic conditions as well as their outlook for the economy. This is what I tried to do today.

I would like to leave you with one final thought. Congress has set the Fed's goals but it has also given the Fed independence in making monetary policy decisions in pursuit of those goals. That is, monetary policy decisions do not have to be approved by the president or Congress. This is consistent with a large body of research, both here and abroad, which shows that when central banks formulate monetary policy free from government interference and are held accountable for their decisions, better economic outcomes result. I believe that calls to audit the Fed are misnamed and misguided. Misnamed because they really aren't about auditing the Fed – the Fed is already subject to many audits of its financial statements and activities, and Chair Yellen regularly testifies before Congress on monetary policy. Misguided because they really are about allowing political considerations to influence monetary policy decisions. This would be a tremendous mistake because it would ultimately lead to poorer economic performance. I strongly believe that the Federal Reserve's independence in setting monetary policy is worth preserving.