Alberto G Musalem: US macroeconomic and regulatory developments and emerging market economies

Remarks by Mr Alberto G Musalem, Executive Vice President of the Integrated Policy Analysis Group of the Federal Reserve Bank of New York, at the International Financial Conference Annual Meeting, Cartagena, Colombia, 9 March 2015.

*   *   *

Thank you for the invitation to speak here today. It has been a pleasure to attend this conference, and to have the opportunity to exchange views with many of you.

My remarks today will focus on the potential effects of the U.S. outlook and policy for emerging market economies. I will make three main points.

- The U.S. economy appears likely to make further progress toward the Federal Open Market Committee's (FOMC) objectives of maximum sustainable employment and price stability. This actual and prospective improvement underlies market expectations that the FOMC will begin raising the Federal Funds rate sometime later this year.
- Emerging market economies (EMEs) have generally performed well during U.S. tightening cycles, especially when such policy shifts are supported by effective communication in the context of U.S. growth.
- There has been notable progress in improving the safety and soundness of the international and U.S. financial systems, to better support financial stability and economic growth.

Before I turn to the specifics, let me remind you that what I say today reflects my own views, and not necessarily those of the Federal Reserve Bank of New York or the Federal Reserve System.

Since the end of the Great Recession almost six years ago, U.S. growth has averaged a somewhat disappointing 2.3 percent. But growth has picked up recently, and the latest Blue Chip forecast is for growth to average slightly below 3 percent over the next year.

There are good reasons to think that a period of stronger growth can be sustained.

- Household balance sheets are in much improved condition, with total household liabilities well below their 2008 peak, and debt service burdens at the lowest share of disposable income in more than 30 years. Moreover, consumers are benefitting from the positive wealth effect of higher house and equity prices.
- Labor market improvement has picked up pace, with payrolls gains over the last several months the strongest since the mid-1990s. Workers are finally beginning to see at least modest real wage gains. And the U.S. unemployment rate has fallen to the lowest level since mid-2008.
- The recent drop in oil prices is providing a significant boost to household spending power with nearly a percentage point increase to real disposable incomes.
- The housing sector is now in much better balance. The inventory-sales ratio for homes is near, or even slightly below, levels typically considered "normal," and there has been a significant drop in the fraction of households carrying mortgage balances in excess of the value of their homes.
- The fiscal restraint that has held back growth in recent years has given way to a more neutral posture.

- The non-financial corporate sector remains in generally healthy condition, with high profit margins and a high ratio of liquid assets to current liabilities.

Of course, there are important risks to the growth outlook including: whether households behave cautiously relative to fundamentals given the experience of the Great Recession; the extent of the impact to the oil producing sector from lower oil prices, and the direction of the business cycle abroad. The FOMC's view in its January statement was that the risks to U.S. growth are nearly balanced.

There are also risks in both directions to the inflation outlook. Headline inflation has fallen quite low due to the drop in oil prices. These effects are likely to be transitory. Measures of underlying inflation such as the core PCE deflator have been running somewhat short of the FOMC's 2 percent objective for some time. Moreover, market-based measures of medium-term inflation compensation have fallen somewhat below the objective in recent months, even if survey measures of expectations have held essentially steady.

There are also upside risks to inflation. The unemployment rate has declined and wage growth should firm as remaining slack diminishes. Moreover, the U.S. economy's productivity performance has been relatively unimpressive in recent quarters. If continued, this could also begin to push inflation higher.

It is in this context that the Committee has begun to consider the appropriate timing and pace for removing extraordinary accommodation. The Committee stated in January that "it can be patient in beginning to normalize the stance of monetary policy," and that the timing of any policy shift will be data dependent, based on an ongoing careful evaluation of progress towards the Committee's goals of maximum employment and 2 percent inflation.[1]

Emerging market officials and market participants have expressed concerns that Fed liftoff might spark an undue tightening in global financial conditions, creating a new growth headwind for emerging market economies. These concerns are understandable. The Federal Funds rate has been near the zero lower bound for more than six years. The Taper Tantrum in the spring and summer of 2013 provides a ready reminder of the potential for volatility around actual or perceived news concerning Fed policy.

Like other central banks, the Fed's monetary policy mandate is defined in domestic terms. Yet the Fed takes the potential international implications of its policies quite seriously. In part, this comes from a sense of a special responsibility given the international reserve currency status of the dollar. An outward-looking perspective is also warranted because the international effects of Fed policies can spill back onto the U.S. economy and financial conditions.

It is of note that emerging market economic performance during previous Fed tightening cycles has generally been good. During the last three U.S. tightening cycles, EME industrial production growth has come to between 7½ and 10 percent over the 12 months from the start of Fed tightening, while EME export volumes have risen 10 to 15 percent. A likely explanation for this favorable record is that Fed tightening generally occurs during periods of strong U.S. economic performance. Recent research from the IMF bears out this hypothesis, finding that higher U.S. interest rates associated with stronger U.S. growth represent a net positive for EMEs.[2]

Financial performance of EMEs has been more diverse across Fed policy cycles. The strongest contrast is between the tightening cycle that began in 2004, and the one beginning

---

[1] See January 27–28, 2015 Federal Open Market Committee statement.

[2] See "Spillovers from Unwinding Monetary Support in Advanced Economies," 2014 Spillover Report, Chapter 2. See also, "On the Receiving End: External Financial Conditions and Emerging Market Growth Before, During and After the Global Financial Crisis," World Economic Outlook, April 2013, Chapter 4.

a decade earlier, in 1994. EME asset prices strengthened considerably during the 2004 cycle, but weakened considerably during the earlier cycle. Notably, the 1994 cycle was associated with a large increase in U.S. long-term bond yields, and appears to represent a case in which there was some distance between Fed policy and market expectations. Other IMF research suggests that anticipated Fed tightening moves have historically been followed by only a minor pullback in private capital inflows, while unanticipated tightening has typically been followed by a pullback in private flows some four times as large.[3] This evidence highlights the importance of transparency and clear messaging in how the Fed is evaluating the evolving economic landscape.

The FOMC has taken a number of steps in recent years to increase transparency and improve communications. This includes press conferences by the Fed chair following FOMC meetings; the publishing of growth and inflation forecasts of FOMC participants; participants' projections of the Federal Funds rate at various horizons; and a concerted attempt to lay out the guideposts that the FOMC will look at to assess progress toward its mandate. These steps are aimed at reducing the risk that Fed policy adjustment might be associated with undue market volatility.

The stance of Fed policy will be far from the only thing affecting the global landscape facing EMEs. As the FOMC considers the appropriate timing and pace of moving to a less accommodative policy stance, central banks in the Euro area and Japan are in the process of implementing additional easing measures. Other important factors affecting the global terrain include China's slowing of credit growth without derailing economic growth, the behavior of oil and other commodity prices, and EMEs' own domestic fundamentals and growth dynamics. Fed policy will be only one factor.

EME fundamentals are likely to be an important determinant of how EME financial conditions respond to Fed policy normalization. This was one of the key lessons from the Taper Tantrum. At first, market pressure was somewhat indiscriminant and then later became more discerning with respect to EME fundamentals. Financial conditions tightened, especially for countries with fundamental vulnerabilities including: large current account deficits, a heavy reliance on portfolio inflows, and high and above-target inflation rates. Markets then responded favorably as EME authorities shifted toward clear, more consistent policies focused on inflation objectives and external sustainability, and away from policies with multiple and sometimes competing objectives.

Let me now add a few thoughts about ongoing financial reform efforts. The complexity, severity and speed of the global financial crisis required a forceful and wide-ranging international regulatory response. This has included higher capital and liquidity standards, stronger recovery and resolution regimes for supervised institutions, and greater transparency and standardization in derivatives markets. These efforts will have a number of positive effects, although they may lead to some changes in bank business models and strategy in the U.S. and internationally.

In the U.S., these efforts have made the banking system much stronger today than before the crisis. In aggregate, Tier 1 risk-based capital ratios among U.S. bank holding companies have increased to just under 13 percent, an increase of almost 45 percent relative to pre-crisis levels, and the quality of capital has improved. Bank holding company balance sheets are also significantly more liquid, with liquid assets increasing from 26 percent of total assets at end-2006 to 38 percent at end-2014. Core deposits now fund 44 percent of total assets, a 10 percentage point increase from pre-crisis levels. A stronger U.S. banking system better protects against future shocks, provides a more solid foundation for growth, and therefore also enhances prospects for growth and financial stability abroad.

3 "International Capital Flows: Reliable or Fickle?" World Economic Outlook, April 2011, Chapter 4.

Basel III implementation has been proceeding on a comparable basis in advanced and emerging market countries. The Financial Stability Board has been monitoring the unintended effects of reforms on EME banks and EMEs report no significant adverse effects.[4] However, potential differences in reform implementation across jurisdictions could create challenges, particularly in countries where foreign banks are active. This underscores the importance of continued home and host coordination.

I would like to briefly touch on two U.S.-specific financial regulatory issues with international implications, namely enhanced prudential standards for foreign banks, including intermediate holding company requirements for the largest institutions, and issues surrounding correspondent banking, U.S. anti-money laundering rules, and "de-risking". Of these, the latter may have the most relevance for the EMEs broadly.

The adoption of enhanced prudential standards for foreign banking organizations (FBOs) is a key element of U.S. regulatory reforms, and a significant change in supervision of FBOs.[5] The largest FBOs (with U.S. non-branch assets greater than $50 billion) must hold their U.S. subsidiaries under an intermediate holding company (IHC), and meet various capital, leverage, liquidity, stress testing, risk management and corporate governance requirements. These requirements respond to a mandate in the Dodd-Frank Act for enhanced standards for the largest domestic and foreign banks. The most significant requirements are expected to fall on the largest FBOs from advanced economies – some of which have also adopted tighter local requirements for foreign banks – and should contribute importantly to a safer and sounder U.S. and international financial system.

Correspondent banking relationships have also received heightened attention in the context of serious violations of anti-money laundering and know-your-customer standards by some banks, and substantial fines. It is imperative to firmly deal with illegal, unsafe and unsound banking practices, including money laundering and transactions with U.S.-sanctioned countries.

It is also important to be on the look-out for potential unintended consequences and externalities, such as widespread de-risking where correspondent bank access is shut off to compliant counter parties and to legal flows, economic costs are excessively increased, or flows migrate to avenues subject to less oversight or transparency. The scope, scale, and impact of de-risking need to be better understood. Dialogue between market participants and the official sector is ongoing, both multilaterally and bilaterally.

Let me conclude. The U.S. economy and financial system have strengthened notably in recent years and in a mutually reinforcing way. U.S. monetary and regulatory policy both need to be tailored to domestic conditions. The Fed is also mindful of the international effects of its policies, given the central place of the U.S. in the global financial system, and the potential for spillbacks to the U.S. economy and financial system. Effective communication with market participants and policymakers is important. The opportunity for dialogue is what makes conferences such as this one valuable.

Thank you very much.

---

4 "Monitoring the effects of agreed regulatory reforms on emerging market and developing economies", Financial Stability Board, November 12, 2014.

5 Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, Federal Register, Vol. 79 No. 59, March 27, 2014.