Philip N Jefferson: Financial stability and the US economy

Remarks by Mr Philip N Jefferson, Member of the Board of Governors of the Federal Reserve System, at the 22nd Annual International Conference on Policy Challenges for the Financial Sector, Washington DC, 31 May 2023.

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Good afternoon, everyone. It is a pleasure to be here and share my perspective on some key challenges policymakers currently face. Before I begin, let me remind you that the views I will express today are my own and are not necessarily those of my colleagues in the Federal Reserve System.

This conference is timely and relevant. Among the topics covered are current financial stability risks and vulnerabilities, potential developments in banking supervision and regulation, and operational risk and resilience under evolving technologies. During the next three days, you will have an opportunity to engage in stimulating discussions with expert panelists on these and other critical issues.

Today, I would like to share with you, at a high level, some of the Federal Reserve's recent and ongoing initiatives on a few of these issues. I also want to share with you an overview of the Federal Reserve's approach toward financial stability and my thoughts on interactions between the economic outlook and financial stability. My remarks will be U.S. focused, fully understanding that other countries monitor financial stability similarly and that the health of the U.S. economy and financial system has an impact on other countries, and vice versa.

The Federal Reserve's Approach Toward Financial Stability

A stable financial system is resilient even in the face of sharp downturns or stress events. It provides households and businesses with the financing they need to participate and thrive in a well-functioning economy. It is difficult to anticipate or prevent shocks, but sound policies can mitigate their impact. At the Federal Reserve, we work hard to make sure that an initial shock in one area of the financial system does not spill over to other markets or institutions and cause severe or widespread strains. Such spillovers could disrupt the flow of credit and cause outsized declines in employment and economic activity. It is not our role, nor should it be our objective, to influence the allocation of credit within or across sectors of the U.S. economy.

Financial and nonfinancial institutions and households are linked through a web of relationships. The economic activities of households and businesses depend on the strength of financial institutions' balance sheets, as households and businesses obtain funding through the financial sector. Similarly, the health of the financial sector hinges on the strength of the balance sheets of households, businesses, and financial institutions, as financial institutions' assets are the liabilities of these sectors.

The Federal Reserve monitors and assesses potential vulnerabilities that may develop because of interactions among key participants. We do that by focusing on the safety and soundness of individual supervised institutions and by looking across the entire financial and nonfinancial system for potential risks and vulnerabilities. These risks and vulnerabilities can include elevated valuation pressures, excessive borrowing by households and businesses, excessive leverage in the financial system, and elevated funding risks. In other words, at the Federal Reserve, we use both microprudential and macroprudential approaches to monitor the health of financial institutions and the financial sector.

The recent banking stress events remind us that risks and vulnerabilities in financial markets are continuously changing. That is why the staff at the Federal Reserve is constantly monitoring domestic and foreign financial markets and institutions, as well as the financial condition of households and businesses, with the goal of identifying current and future vulnerabilities. Such forward-looking financial stability monitoring helps inform policymakers about ongoing vulnerabilities in the financial system that may amplify a range of potential adverse events or shocks.

The U.S. Financial System and Economic Outlook

U.S. financial markets and institutions remain resilient even though financial stability risks and vulnerabilities in the U.S. financial system have increased since the recent stress events. Conditions in the banking sector have stabilized thanks, in part, to decisive emergency actions taken in March by the Federal Reserve, the Federal Deposit Insurance Corporation, and the Treasury. The Federal Reserve, using existing regulatory and supervisory tools, is working to ensure that banks improve and update their liquidity, commercial real estate, and interest rate risk-management practices.

I expect spending and economic growth to remain quite slow over the rest of 2023, due to tight financial conditions, low consumer sentiment, heightened uncertainty, and a decline in household savings that had built up after the onset of the pandemic. Inflation has come down substantially since last summer, but it is still too high, and by some measures progress has been decelerating recently, particularly in the core services sector. While it is reasonable to expect that the recent banking stress events will lead banks to tighten credit standards further, the amount of tightening and the magnitude of the effect such tightening might have on the U.S. economy is not yet clear, and this uncertainty complicates economic forecasts.

Short-term interest rates are 5 percentage points higher than they were a little over a year ago. History shows that monetary policy works with long and variable lags, and that a year is not a long enough period for demand to feel the full effect of higher interest rates. While my base case forecast for the U.S. economy is not a recession, higher interest rates and lower earnings could test the ability of businesses to service debt. In addition, and perhaps more in focus given the recent events affecting certain areas of the banking sector, higher interest rates could further exacerbate stress at banking organizations, especially those that are highly exposed to longer-duration assets and have a relatively high ratio of uninsured deposits to total deposits. Since late last year, the Federal Open Market Committee has slowed the pace of rate hikes as we have approached a stance of monetary policy that will be sufficiently restrictive to return inflation to 2 percent over time. A decision to hold our policy rate constant at a coming meeting should not be interpreted to mean that we have reached the peak rate for this cycle. Indeed, skipping a rate hike at a coming meeting would allow the Committee to see more data before making decisions about the extent of additional policy firming. With that said, let me turn to the topics covered in our two sessions this afternoon.

Current Financial Stability Risks and Vulnerabilities

During the first session this afternoon, you will be discussing current financial stability risks and vulnerabilities as well as historical parallels. As we have seen in the past couple of months, the failure of a large banking organization, even if not deemed individually systemically important under our regulations, can cause markets to reassess the condition of other firms with roughly similar size and risk profiles, and the resulting spillovers can generate significant negative consequences for the broader economy. As I mentioned earlier, conditions in the banking sector have stabilized. Moreover, broader U.S. financial markets and the overwhelming majority of financial institutions have been resilient to the recent stress events.

The resilience of the financial system to current salient risks can be appreciated by contrasting it to the 2008 Global Financial Crisis. Leading up to the Global Financial Crisis, housing markets were substantially overvalued, mortgage underwriting standards were weak, and home mortgages were at substantial risk of falling underwater if house prices fell. Yet banks had limited loss-absorbing capacity and were heavily reliant on wholesale short-term funding, and interconnections across the financial system were opaque. When housing markets weakened, opacity contributed to investors' fears, short-term funding pulled away, and excessive leverage led to fire sales as financial institutions experienced losses and major firms failed or were rescued by the government. The economy experienced a deep recession, and unemployment ultimately reached 10 percent.

The current resilience of the financial sector points to substantially more limited spillovers from recent events. The failures of Silicon Valley Bank, Signature Bank, and First Republic Bank showed excessive reliance at those institutions on uninsured deposits and excessive exposure to interest rate risk. Even so, the overwhelming majority of banks have strong balance sheets with limited leverage, high levels of loss-absorbing capacity, and healthy liquidity. Moreover, household and business balance sheets are generally strong, and the credit quality of loans is generally much better than on the eve of the Global Financial Crisis. Leverage across key parts of the financial sector, including especially the largest banks and broker-dealers, is much lower than in the mid-2000s.

Even so, we remain vigilant to the potential for vulnerabilities to emerge. Three areas of potential concern have been the focus of our supervisory and regulatory work. First, recent stresses highlighted the importance of effective liquidity and interest rate risk management, including both reliance on uninsured deposits and exposure to duration risk in asset holdings. While the resilience of the financial sector will limit the spillovers from recent events, I expect those strains to lead to a further tightening in credit supply from banks that will weigh on economic activity. Second, it is also important to assess how changes in the financial sector, including expanded use of online banking and shifts in behavior that may be driven by access to social media, may alter the potential speed of deposit flows. Third, the weakness in some sectors of commercial real estate will affect the credit quality of those types of commercial real estate loans and thereby place strains on lenders with high concentrations of those loans. Changes in work preferences and the increase in remote work is leading to a reassessment of the outlook for office and associated retail properties, and it will take time for the extent of that weakness to become clearer.

Ongoing Regulatory Capital Initiatives

Later in the afternoon, during the second session of the conference, you will be discussing a few key ongoing regulatory capital initiatives, focusing on the completion of the Basel III reforms. As Vice Chair for Supervision Michael Barr has noted, finalizing the Basel III reforms is a high priority for the Federal Reserve. The revised framework should improve the resilience of the banking system by producing more robust and internationally consistent capital requirements for large firms, building on improvements made to the capital framework following the Global Financial Crisis. Importantly, the revised framework is expected to reduce unwarranted variability in capital requirements. By increasing standardization, these reforms aim to increase transparency and public confidence in risk-weighted assets while also reducing complexity.

As we speak, the staffs of the U.S. federal banking agencies are diligently working on a Basel III endgame proposal that should be issued for public comment soon. At the same time, the Federal Reserve staff is considering ways to enhance the ability of stress tests to capture a wider range of risks and identify vulnerabilities at the largest banking organizations.

Conclusion

Based on this brief overview of the issues, this afternoon promises to be invigorating and informative. I look forward to hearing how the panel discussions go. I hope that you enjoy the conference.

Thank you.