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SPEECH

The U.S. Economy and Financial System in an International Context

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Alberto G. Musalem, Executive Vice President

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It is a pleasure to have been invited to speak to the Institute of International Bankers today about the U.S. economy and financial system in an international context. Developments in the U.S. have important implications for the rest of the world and vice-versa.

I have two main messages today.

First, the Federal Reserve has domestic objectives with respect to employment and inflation, the safety and soundness of supervised financial institutions, and the stability of the U.S. financial system. In the context of these domestic objectives, the Fed is mindful about the potential international implications of its policies. This comes from a sense of a special responsibility given the international reserve currency status of the dollar and also because the international effects of Fed policies can spill back onto the U.S. economy and financial conditions.

Second, policies that make the U.S. economy and financial system strong and stable are most likely to generate positive spillovers to the rest of the world. Federal Reserve transparency and clear communication about the evolution of the economic and financial landscape are critical for these positive spillovers to occur.

In my remarks I will review the U.S. economy; potential spillovers from U.S. monetary policy normalization; and U.S. financial system reforms in support of financial stability and economic growth.

As a reminder, my remarks reflect my own views and not necessarily those of the Federal Reserve Bank of New York or the Federal Reserve System.

As highlighted in the June FOMC statement and economic projections of FOMC members, the economy is expected to expand at roughly 2.0-2.5 percent per year over the next several years, in line with the average pace of the expansion experienced since the end of the Great Recession. The Committee's assessment was that the upside and downside risks to U.S. growth are nearly balanced.

Despite some softness in the first quarter, there are a number of reasons to expect a return to ongoing moderate growth going forward. Consumers are benefiting from improved balance sheets, low debt service burdens, the positive wealth effects of higher house and equity prices, and nearly a percentage point increase to real disposable incomes due to lower energy prices. The labor market has continued to strengthen. 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 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. Finally, business fixed investment outside of oil and gas seems likely to advance, reflecting high cash flows and a low cost of capital.

There are, however, also downside risks to the growth outlook. Households could behave cautiously given the experience of the Great Recession and thus far appear to be saving a high fraction of the windfall from lower oil prices and from positive wealth effects. Net exports have represented a notable headwind and are associated with weak domestic manufacturing activity. These effects may continue to be felt well into 2016. The fall in investment and employment in the oil producing sector have already been sharp and this could play out in activity over the next quarter or two, but the effects could also prove more extended. Finally, the U.S. economy's productivity performance has been poor in recent quarters, raising questions about whether there has been a step down in the underlying trend.

The FOMC also highlighted that it expects inflation to rise gradually over the medium term from its recent low level toward 2 percent, as the labor market improves further and the transitory effects of earlier declines in energy and import prices dissipate.

Some uncertainty also remains about the inflation outlook. On the upside, recent Federal Reserve Bank of New York research suggests the economy should be near a point at which further declines in labor market slack would put greater upside pressure on wages. Stronger wage growth could translate over time into upward pressure on inflation. This tendency could be amplified if productivity growth remains lackluster. However, there are also downside inflation risks. A range of indicators points to some remaining cyclical weakness in the labor market. Healthy profit margins give U.S. firms scope for absorbing stronger wage gains without raising prices. Also, the recent dip in productivity growth could prove temporary. More generally, core PCE inflation has been running measurably below the Committee's 2 percent objective for some time; and the experience of other advanced economies demonstrates how difficult it can be to raise low inflation.

It is in this context that the Committee is considering the appropriate timing and pace for beginning to remove extraordinary accommodation. The Committee stated in June that it will look at a wide range of indicators to make a data dependent evaluation, and that it will be appropriate to raise the federal funds rate "when it has seen further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term."[2] Given the Committee's communication about data dependence, market participants seem to expect that economic conditions will warrant a first rate increase in the latter part of this year.

Prospects of U.S. monetary policy normalization have raised concerns about international spillovers particularly for emerging market economies (EME). These concerns are understandable.

Looking back at previous periods of Fed tightening, average EME economic performance has actually been strong. For instance, industrial production growth has averaged between 7½ to 10 percent in the 12 months following individual Fed tightening cycles, while export volumes have risen 10 to 15 percent. These growth rates are comfortably above long-term averages. A likely explanation for this favorable record is that Fed tightening has recently occurred during periods of strong U.S. economic performance. The financial market performance of EMEs has been more varied, however. For instance, average financial market performance was strong in the tightening cycle that began in 2004, but very weak in the 1994 tightening cycle, and more mixed in the 1999 cycle. Of course, average performance hides considerable diversity across countries. In the 1994 tightening cycle, for example, the economic and financial performance of emerging Asia was strong while Mexico slumped and then fell into a crisis, with contagion to Latin America more broadly.

Concerns about EME economic and financial performance during Fed normalization also stem from the 2013 Taper Tantrum, when EMEs experienced sizeable weakening of their currencies, local currency and foreign currency bonds, and equity markets. Other factors also played an important role ahead of the Taper Tantrum, including record capital inflows into emerging markets, stretched asset valuations, and weaknesses in some countries' domestic fundamentals. Market stress was most severe for countries reliant on external financing and, in these countries, led to slower growth.

The impact of eventual Fed monetary policy normalization on EMEs will likely depend mostly on the underlying domestic economic fundamentals of individual countries and on the robustness of Fed communication.

The fundamental risk profile of EMEs has deteriorated modestly in recent years. This reflects a combination of slowing trend GDP growth, deteriorating fiscal positions, and a build-up of domestic and external debt. Commodity producers have experienced a more substantial deterioration in fundamentals. Compared to conditions prevailing ahead of the Taper Tantrum, more recently capital inflows to EMEs have been more muted, valuations of emerging market assets are lower, and market pricing appears to be differentiating countries to a greater extent based on fundamentals.

Still, many of the structural strengths that have enabled EMEs to weather recent periods of market strain remain largely in place; the most important of which is the presence of flexible and credible macroeconomic and monetary policy frameworks. A continued focus on implementing predictable policies, consistent with inflation and external sustainability objectives, will be important to help EMEs manage through potentially turbulent markets associated with the normalization of U.S. monetary policy.

What accounts for the difference in EME performance across tightening cycles? Research suggests that anticipated Fed tightening moves have historically been followed by a minor pullback in private capital inflows, while unanticipated tightening moves have typically been followed by a pullback in private capital flows some four times as large.[3] Research also suggests that the economic and financial performance of EMEs tends to be favorable when U.S. long-term yields rise because U.S. growth prospects are higher, as opposed to when U.S. yields rise because there is a monetary surprise not associated with higher U.S. growth prospects.[4] This highlights the importance of transparency and clear messaging by the Fed about how it is evaluating the evolving economic landscape, to reduce the risk that policy adjustments might be associated with undue market volatility.

Shifts in Fed monetary policy can also impact advanced economies and spill back to the U.S. For instance, President Draghi highlighted that financial conditions associated with Fed exit discussions contributed to the ECB's decision to bring euro area interest rates down to their effective lower bound and strengthen forward guidance in 2014.[5] Monetary policy actions by other central banks can also impact international markets, including U.S. bond and currency markets. There is growing evidence that unconventional monetary policy actions by the ECB have impacted U.S. and other markets.[6]

For all central banks, and the Fed in particular at this stage, it is important to clearly communicate assessments about the economy, the financial system and the stance of policy.

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 as well as 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, and may lead to some changes in bank business models and strategy in the U.S. and internationally.

In the U.S., regulatory reforms have made the banking system much stronger than before the crisis. In aggregate, Tier 1 risk-based capital ratios among U.S. bank holding companies have increased to 12.6 percent, an increase of almost 40 percent relative to pre-crisis levels, and the quality of capital has improved. This progress is also evident in firms' forward-looking, post-stress capital positions as assessed under the CCAR process. In the latest exercise, firms had a significantly higher *post-stress* Tier 1 common ratio of 7.1 percent, compared to their *starting* position of 5.3 percent in the 2009 SCAP exercise.

Bank holding company balance sheets are also significantly more liquid, with liquid assets increasing from 30 percent of total assets at end-2006 to just over 40 percent as of the first quarter of 2015. Core deposits now fund 47 percent of total assets, a more than 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.

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 be more relevant for emerging market economies and the former may be more relevant for advanced economies.

The adoption of Regulation YY, Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations (FBOs) is a key element of U.S. regulatory reforms, and a significant change in supervision of FBOs.[7] 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. Firms have submitted their IHC implementation plans for review. 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. The IIB has played a constructive role on this topic by offering comments on the original proposal and by providing assistance in organizing its members to discuss the implementation plan requirement with the Federal Reserve.

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 associated 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 counterparties and to legal flows, economic costs are 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.

Let me conclude. The U.S. economy and financial system have strengthened notably in recent years and in a mutually reinforcing way. Monetary, supervisory and regulatory policy need to be tailored to domestic U.S. conditions. In the context of its domestic objectives, 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 conditions. Policies that make the U.S. economy and financial system strong and stable are most likely to generate positive spillovers to the rest of the world. Fed communication about the evolution of the economic and financial landscape is critical for these positive spillovers to occur.

Thank you for the opportunity to speak to you today.

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[1] Idanna Appio, Gerard Dages, Matthew Higgins, David Hou, Siobhan Sanders and Kevin Stiroh assisted in preparing these remarks.

[2] See June 17, 2015 Federal Open Market Committee statement.

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

[4] 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.

[5] "The ECB's recent monetary policy measures: Effectiveness and challenges", Mario Draghi May 14, 2015.

[6] "Evaluating Asset-Market Effects of Unconventional Monetary Policy: A Cross-Country Comparison," Rogers, Scotti, and Wright, (March 2014); "ECB Unconventional Monetary Policy Actions: Market Impact, International Spillovers and Transmission

Channels," Fratzscher, Duca, and Straub (November 2014).

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