The Outlook for the Economy and Banks

Remarks by
Esther L. George
President and Chief Executive Officer
Federal Reserve Bank of Kansas City

May 26, 2021
Oklahoma Bankers Association Annual Conference
Oklahoma City, Oklahoma

I appreciate the opportunity to attend your annual meeting in person and to extend my best wishes to Roger Beverage as he retires. It has been my pleasure to work with Roger over the years, and his leadership to the banking industry will be missed.

For more than one year now, our nation has been confronted by a pandemic that has taken a heavy toll. In addition to substantial loss of life and illness, our economy was also challenged in ways that were without comparison in recent history. Now, thanks to the efforts of science and healthcare, it appears we are on a path to return to normalcy.

In my remarks today, I will offer some thoughts on the economic outlook, as well as the outlook for banking.[1]

The outlook

Since the pandemic upended the global economy a little over a year ago, we have made considerable progress along the path to economic recovery. By many measures, the gaps that opened up in early 2020 have narrowed. Real gross domestic product (GDP), the broadest measure of the nation's economic output, increased at a robust 6½ percent annual rate in the first quarter, and will likely surpass its pre-pandemic level this quarter. The unemployment rate, at just over 6 percent in April, has improved considerably from its nearly 15 percent peak a year ago.

That progress alone is reason to be optimistic. Even so, we remain more than 8 million jobs shy relative to pre-pandemic levels. While this shortfall partly reflects the still-elevated unemployment rate, another factor has been a decline in labor force participation with many potential workers sitting on the sidelines.

As we look ahead, I anticipate strong employment growth in the coming months, particularly in contact-intensive industries such as hospitality and live entertainment, where the rebound in jobs has so far been incomplete. The outlook is also supported by an extraordinary amount of policy stimulus, both fiscal and monetary. Fiscal transfers have led to a considerable improvement in household balance sheets, with an accumulation of savings far in excess of normal levels. In fact, the outlook is so strong that the discussion has quickly shifted from demand shortfalls to supply constraints.

---

[1] I thank Nick Baker, Stefan Jacewitz, Blake Marsh, and Rajdeep Sengupta of the Federal Reserve Bank of Kansas City for their assistance in preparing these remarks.

Inflation over the 12 months ending in April, as measured by the consumer price index (CPI), increased to 4.2 percent, the fastest pace in over a decade and up considerably from the 1.4 percent pace recorded at the start of the year. What the current pace of inflation means for the inflation outlook for the medium term is less than clear. Many factors that have boosted current inflation seem likely to fade over time. All the same, I am not inclined to dismiss today's pricing signals or to be overly reliant on historical relationships and dynamics in judging the outlook for inflation. The past few decades saw inflation play a relatively minor role in the day-to-day decision-making of businesses and consumers. Maintaining this state of affairs as we seek to achieve our objectives for maximum employment and price stability will be important.

As the pace and strength of the recovery unfolds, monetary policy settings remain highly accommodative and will remain so for some time in line with the FOMC's forward guidance. The Committee has stated that it expects to keep the policy rate near zero until the labor market has reached levels consistent with maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time. The FOMC also expects to maintain its purchases of Treasuries and mortgage-backed securities until substantial further progress has been made towards these employment and inflation goals.

Judging the appropriate timing for policy adjustments is always challenging. The economy is an incredibly complex set of relationships, many of which have been disrupted by the pandemic with uncertain long-term consequences. This is true for how we consume, how we produce, and how we work. As the economy works its way towards a new equilibrium, policymakers will be well served to take a flexible approach to monetary policy decisions, in my view. In this regard, the Federal Reserve's revised framework for monetary policy, adopted last August, provides a "framework," rather than a "rule." The FOMC has in the past avoided strict adherence to monetary policy rules, so it is unsurprising that the revised framework is not a precise prescription for policy action even as it repositions the Federal Reserve's approach to achieving its congressional mandates for employment and inflation.

The structure of the economy changes over time, and it will be important to adapt to new circumstances rather than adhere to a rigid formulation of policy reactions. With a tremendous amount of fiscal stimulus flowing through the economy, the landscape could unfold quite differently than the one that shaped the thinking around the revised monetary policy framework. That suggests remaining nimble and attentive to these dynamics will be important as we seek to achieve our policy objectives in the context of sustainable economic growth and the well-being of the American public.

The role of banks in the recovery

The banking industry has of course also played a key role in the recovery to date. Banks were vital in keeping the economy going in the early days of the pandemic. As investors fled to the safety of cash and other liquid assets, financial markets witnessed a liquidity squeeze that was particularly acute in short-term funding markets. Banks were well situated to withstand this liquidity squeeze.[2] Crucially, their resilience reflected strong liquidity and capital positions and massive economic support from the government. As a result, banks were not only able to provision for anticipated losses from the pandemic, but also to continue lending during the early days of the pandemic. Banks provided around $270 billion in withdrawals on existing lines of credit to businesses in the first quarter of 2020 to cover anticipated revenue shortfalls.[3]

While the initial pandemic policy response of the Treasury and the Federal Reserve addressed the liquidity squeeze in March 2020, subsequent policy actions have pivoted from containing a potential financial crisis to addressing the challenges of supplying new credit to the businesses and households hardest hit by the pandemic. Banks have been a critical conduit for these policy measures. Most notably, banks disbursed funds to small businesses that were hard hit by the pandemic through the Paycheck Protection Program (PPP). As of May 2, 2021, over 5,000 lenders have approved close to 11 million loans under the PPP, totaling $780 billion in funds to eligible small and medium-sized businesses.[4] Regional and community banks have been particularly active participants in the program. PPP loans make up more than a quarter of outstanding C&I loans at regional banks and around 40 percent at community banks—significantly more than large banking organizations (LBOs). This is a massive program, and its ability to reach critical corners of the economy has depended on the strength of the relationships that community and regional banks built over years of work with small, local businesses in their communities.

[2] Rajdeep Sengupta and Fei Xue, 2020. "The Global Pandemic and Run on Shadow Banks," Economic Bulletin, Federal Reserve Bank of Kansas City, May 11, 2020.
[3] The data reported are end-of-quarter changes in unused commitments for banks between Q4:2019 and Q1:2020. Anecdotal evidence would suggest that most of the draws occurred late in the first quarter of 2020.
[4] https://www.sba.gov/funding-programs/loans/covid-19-relief-options/paycheck-protection-program/ppp-data

The sheer size of the economic policy response to the pandemic, however, has created certain challenges for banks. Bank deposits have increased dramatically. At the same time, fiscal transfers have weighed on loan demand. While small businesses have obtained much-needed funding through the PPP program, most large corporate firms have been able to take advantage of easing credit conditions in bond financing. Federal aid packages have helped households repay debt, boost savings and improve credit scores—complementing a decade-long cycle of deleveraging by households from the peak of the 2008 financial crisis. As a result of this rapid and broad turnaround in credit conditions, demand for more credit, especially for bank loans, has been reduced. Facing low loan demand, banks have used much of their increased deposit funding to acquire low-yielding, liquid securities, which has weighed on overall bank profitability.

As the recovery from the pandemic continues, loan demand is likely to increase, and banks will find new lending opportunities. Indeed, demand for auto lending, for example, has picked up recently. However, total loan growth—and particularly business lending growth outside the PPP program—remains tepid despite bank standards easing as economic uncertainty has abated. Pressure to raise profitability could increase.

Implications for risk-taking and bank capital

Even if loan volumes do pick up appreciably, profitability is likely to remain a concern. With interest rates expected to remain low for some time, profitability measures, such as net interest margins, will continue to be compressed. The pressure to boost profitability can result in turning to other, possibly riskier, alternatives to bolster returns.

The link between profitability and risk-taking is not always clear cut, but the search for higher returns can understandably have negative consequences for the banking system and the economy more broadly. Some research argues that when a bank's incentives are well aligned, preserving value can limit risk-taking.[5] Such incentives may come under pressure in today's environment where lower profitability might encourage risk-taking, whether by increasing

[5] Demsetz, Rebecca, Mark R. Saidenberg, and Philip E. Strahan, 1996, "Banks with Something to Lose: The Disciplinary Role of the Franchise Value," Federal Reserve Bank of New York Economic Policy Review, 2(2), 1-14; among others.

duration in asset portfolios, by loosening underwriting standards to compete for loans, or by expanding into new or riskier lines of business.

Despite loan demand uncertainties, bank earnings during the first quarter of this year have been positive, benefitting in large part from the release of loan loss reserves, particularly for larger banks. Banks also have become more reliant on non-interest income sources. However, recent events around Archegos Capital and Greensill Capital are reminders of the impact of idiosyncratic losses and the ongoing value of risk management and strong capital. Both opaque, complex transactions or those with seemingly well-understood risks can lead to unexpected losses.

Regulatory reforms enhanced capital rules in response to the 2008 financial crisis, in part to protect against risks that are not well understood. These rules strengthened requirements for the amount and quality of capital in systemically significant banks and undoubtedly contributed to stability in the banking industry as the global pandemic unfolded. Our largest banks, those labeled GSIBs (global systemically important banks) entered the pandemic with capital levels well above those leading into the last crisis. However, in terms of leverage ratios, community and regional banks continue to hold even more capital than GSIBs.[6]

The fundamentals of strong capital and robust risk management will remain important as the economic recovery advances and banks resume dividend payments and share repurchases. Resisting an excessive focus on short-term results at the expense of long-term interests will be key.[7] The full effect of the pandemic on bank portfolios is still unknown, and with so much uncertain, there are benefits to a longer-term view of capital.

A shifting financial sector landscape

Even as the banking industry manages through the aftermath of the pandemic, banks also are responding to strategic shifts in the broader financial sector landscape. The nation's banking system across all sizes—large, small, and regional—has historically been the driver of financial services for consumers and businesses. However, technology and innovation also have a long

[6] The Federal Reserve Bank of Kansas City's semi-annual updates on Bank Capital Analysis (BCA) judges capital strength across the banking industry. As of December 31, 2020, the aggregate Tier 1 leverage ratios for global systemically important banks (GSIBs) was 7.5 compared to 9.1 for RBOs and 10.0 for CBOs.

[7] For definitions of *short-termism*, see Sheila Bair, "Lessons of the Financial Crisis: The Dangers of Short-Termism," Harvard Law School Forum on Corporate Governance & Financial Regulation, Monday, July 4, 2011, or https://www.cfainstitute.org/en/advocacy/issues/short-termism.

history of joining forces to disrupt existing conventions. Similar to the proliferation of nonbank lenders, we now see this dynamic playing out in today's financial system as it relates to facilitating payments. In essence, the unbundling of traditional banking services poses new questions for a legal and regulatory framework that has positioned the banking system to support monetary policy transmission, financial stability and consumer protections.

The ability to send money with the speed and convenience of an email is appealing and understandably gaining rapid adoption. Indeed, we've witnessed over the past year an increased adoption of digital payments. Yet we can't overlook that despite efforts to make payments faster, less costly, and broadly accessible, nonbank entrants into financial services operate largely outside our existing institutional and regulatory frameworks. In some cases, novel charters at the state and federal level have emerged to conduct these activities with new forms of money and customized regulatory frameworks.

To what extent our existing legal and regulatory frameworks will need to evolve is unclear. The characteristics associated with commercial banks have generally assumed access to the public safety net of federal deposit insurance and the Federal Reserve's discount window with a state/federal regulatory framework and direct access to the Federal Reserve's payments rails.[8] State and federal regulators collectively should consider how these fintechs and payment platforms fit into the banking system.

Today's accelerating pace of technological change has implications for our financial system. But what hasn't changed are the Federal Reserve's priorities for the payment system: safety, accessibility and efficiency. It is through this lens that the Federal Reserve remains committed to its goal to deliver its first new payment service in over 40 years, the FedNow Service. The FedNow Service is a high priority for the Federal Reserve and will lay a foundation for the future of payments that can be used as a springboard for innovation and yield important economic benefits for the public. We are taking a phased approach in developing the FedNow Service so we can bring initial releases to market as quickly as possible, while providing flexibility to add key features in future releases. We continue to collaborate with the industry and have established a FedNow Community for those interested in helping evolve the development

[8] On May 5, 2021, the Federal Reserve Board invited comment on proposed guidelines to evaluate requests for accounts and payments services at Federal Reserve Banks: https://www.federalreserve.gov/newsevents/pressreleases/bcreg20210505a.htm.

of the FedNow Service. If you aren't already a member and would like to join, you can visit the FRBservices.org website[9] for more information.

New entrants and new business models will continue to disrupt and reshape the financial services industry. Bank strategies for the future are taking a fresh look at providing payments services, including innovation through new services, such as FedNow, or new partnerships with fintechs and other financial services providers. Your customers' changing needs and preferences will be key to the strategies you pursue, as they have been for decades.

[9] https://www.frbservices.org/financial-services/fednow/community/index.html