Weighing the Costs of Waiting

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The views expressed by the author are her own and do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives.

Seven years ago, our economy was dealt a tremendous blow. The financial crisis and deep recession required massive bailouts and aggressive, unconventional monetary policy actions to restore financial stability and economic growth. And yet, seven years later, uncertainty lingers about the durability and strength of financial reforms and of the economy itself. Clearly, the financial crisis of 2008 cast a long shadow.

In my remarks today, I will offer my own observations about the current state of the economy and why I believe the Federal Reserve should start the process of interest rate normalization sooner rather than later. I'll close with some perspectives on the state of key regulatory reforms affecting the banking industry and, in particular, the nation's community banks.

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The economic outlook

In 2013, during my first voting rotation on the Federal Open Market Committee, I did not support additional stimulus in the form of a third round of asset purchases. By then, the immediate crisis had passed, the economy was slowly expanding for its third consecutive year, and monetary policy settings remained extraordinarily accommodative. At the end of my voting cycle, I fully anticipated that a return to more-normal interest rates would require a lengthy and gradual adjustment process. But, I did not imagine that in 2015 we might still have the same policy stance.

During the past five years, the U.S. economy has grown at a moderate pace each year, labor markets have healed—albeit with scars from the recession—and inflation has remained low. This year, the economy had a slower-than-expected start. The soft GDP report for the first quarter reflected some temporary factors that held down growth but are unlikely to persist going forward. Looking ahead, I expect the economy to resume its expansion at an above-trend growth rate through the end of the year and labor market conditions to continue improving.

Consumer spending, the largest part of our economy, will likely grow at a healthy rate in the quarters ahead due to an improving labor market, rising wealth and lower gasoline prices relative to where they were last year. Moreover, as the economy continues to heal and domestic demand continues to strengthen, businesses should have more incentives to increase capital expenditures. I also expect housing construction to provide a tailwind to growth as more adults pack up and move out of their parents' home or away from living with roommates to start their own households. Construction of multifamily units, in particular, has been strong due to rising demand from younger workers and the decisions of some baby boomers to downsize.

In terms of the labor market, the economy added 3 million jobs over the past year. For perspective, consider that the economy did not even add this many new jobs over a one-year period at any point during the housing bubble years. You would need to go back to the late 1990s tech-bubble era to find a period when jobs were being added at a similar pace. In addition to the number of jobs, we are seeing better jobs. For example, workers today are flowing into more-stable employment relationships, and workers with a high-school diploma or some college are finding employment in higher-skilled occupations, something that was not occurring in the years following the crisis.[1]

Taken together, the economic data generally point to an economy that is moving in the right direction and has consistently sustained growth over the past five years. This is not to say

[1] See "Opportunity Knocks: Improved Matching of Jobs and Workers" by Didem Tuzemen and Jonathan Willis. *The Macro Bulletin*, Federal Reserve Bank of Kansas City, May 13, 2015.

the economy is issue-free. There are pockets of the labor market that continue to struggle. Research shows that workers who enter the labor force during the lean years of a recession and recovery experience long-lasting scarring effects on their earning potential.[2] Millions of workers had difficulty finding employment and missed some experience needed to jump-start their careers, resulting in fewer skills, underdeveloped resumes and lower earnings. In addition, productivity growth, which ultimately drives living standards higher, has been notably soft in recent years. And, global economic concerns can pose unpredictable risks to our economy.

Unfortunately, although we might wish it so, monetary policy is not the proper tool to address all of these issues. The aggressive monetary actions over the past few years were intended to support economic activity, help labor markets heal and move inflation toward the Fed's target. I view the considerable progress in labor markets and the relatively steady inflation rate as encouraging. However, keeping interest rates near zero to achieve still further progress toward labor market improvement and higher inflation is risky in my view.

In a protracted period of exceptionally low rates, investors seeking out higher returns are willing to take on more risk or seek out more creative financing approaches. When the economy is expanding and rates remain low, adverse events may appear less likely or far into the future, potentially resulting in the mispricing of risk and financial assets. Waiting too long to adjust rates, as we've seen in the past, can leave policymakers with few and possibly poor options.

Separating the signal from the noise

The FOMC has been talking about its exit strategy since 2011. And since March of this year, the Committee has been emphasizing that a decision to raise interest rates would be data

[2] See "Long-Term Nonemployment and Job Displacement" by Jae Song and Till von Wachter, presented at the Federal Reserve Bank of Kansas City's 2014 Jackson Hole Economic Policy Symposium.

dependent. In other words, economic data that confirms further gains in the economy's performance will drive the timing of the Committee's actions.

So, why hasn't the FOMC yet raised rates? There are of course different views on the economic data we receive and analyze that lead to legitimate, differing views about what is best for the economy. The Federal Reserve is charged with objectives that take into account employment and inflation in order to foster stable long-term growth in the economy. The FOMC is committed to pursuing those objectives, but policymakers may differ on the appropriate path to achieve these long-run goals.

Of course, the economic data we rely on can, and often does in the short run, send conflicting signals, and it is quite challenging to measure economic activity in an $18 trillion, dynamic economy. As a result, policymakers are faced with an unclear path for moving interest rates. Those choices are all the more difficult as we must rely on backward-looking data to frame a forecast that takes into account the long lags of interest rate changes.

Under such circumstances, the Federal Reserve must be especially careful to avoid reacting to the last data point to determine policy. Instead, it should focus on longer-run trends as it seeks to understand the economy's future course and to map the best policy to assure it remains on course. The real challenge when the data disappoints is discerning whether it is due to temporary factors or an early signal that underlying momentum in the economy is changing.

Take the first quarter of this year as an example. The current estimate is that the economy contracted in the first quarter after three quarters of relatively strong growth. While this headline number raises caution for policymakers, other factors, as I mentioned earlier, suggest the slowing is likely to be temporary. Severe winter weather and labor negotiations concerning dock workers likely took a short-lived toll on growth. At the same time, however, the economy added nearly

600,000 new jobs in the first three months of this year. So even though the economy appeared to slow a bit in the first quarter, businesses kept hiring, and the data for the second quarter suggest the economy is again expanding. Thus, in the face of consistent positive trends, delaying actions for more positive data can be unwise.

Consider as another example measures of inflation, which have been running below the Fed's stated inflation goal. Since 2012, the Federal Reserve has defined 2 percent inflation as "most consistent over the longer run with the Federal Reserve's statutory mandate" of price stability. Does inflation below 2 percent justify waiting longer to raise rates? The answer requires a deeper look at the data. Much of the decline in inflation comes from a dramatic fall in energy prices throughout the second half of 2014 and low import prices from a strong dollar. The swings in energy and food prices certainly matter for households and are an important component of the inflation measure, but sometimes it's also sensible to look at price changes that exclude these volatile goods. Along these lines, the core measure of inflation is running at 1.2 percent over the past year and has moved up to a 1.7 percent pace over the past three months. This data suggest to me that we understand why inflation has been low, and as some temporary factors fade, it will likely move back toward the Fed's goal.

Part of our job is to look through the noise and act in the economy's long-run best interest. Separating the signal from the noise is always difficult and is usually clear only with hindsight. Because monetary policy decisions are made in real time, waiting for more data before taking an action can be a trap. More data is always on its way, and waiting for clarity too often causes decisions to be persistently postponed.

Timing is everything

The continued improvement in the labor market, combined with low and stable inflation, convince me that modestly higher short-term interest rates are appropriate. Current guideposts, or “policy rules,” often used to inform monetary policy decisions also have been signaling that interest rates should be higher.

I recognize that a rate increase, however, would be the first one in nearly a decade. So I am not suggesting rates should be normalized quickly or that policy should be tight. Although the economy has improved, economic fundamentals could well mean an accommodative stance of policy is appropriate for some time. I would like to avoid the cost of waiting for more evidence and further postponing liftoff, drawing on a valuable lesson from monetary policy decisions in 2003.

At that time, the federal funds rate was held at a very low level—1 percent—because policymakers were concerned about low inflation and had postponed initiating the tightening cycle in response. Inflation excluding food and energy in late 2003 was running at about 1.3 percent, not dissimilar from today. The unemployment rate was slightly below 6 percent, again, not dissimilar from today.

By the middle of 2004, core inflation increased to 2 percent as the unemployment rate continued to decline. A gradual tightening cycle began in June of 2004. Core inflation then moved persistently above 2 percent, and the labor market began to overheat amid one of the most historic credit bubbles in U.S. history.

Of course, many would argue that we do not face a similar buildup of leverage today and that the recovery remains fragile. Perhaps so, and perhaps this time it's different. However, economic trends and experience suggest otherwise. And we would be wise to act modestly but act now.

Progress on regulatory reforms

In addition to the lessons for monetary policy, the recent crisis taught us of the expanding challenges following from an increasingly concentrated and fragile financial system. While the largest financial institutions are meant to be engines of growth, they also pose outsized risk to the economy. With that in mind, I take note that this month marks the fifth anniversary of the signing of the Dodd-Frank Act, the law that aimed to remedy problems associated with the 2008 financial crisis and, in particular, sought to end the status of "too big to fail." While regulators have worked diligently over the past five years to implement new rules, debate about the law's various provisions continues.

Implementing rules focused on limiting certain risky activities has proved difficult. For example, the law prohibits banks from conducting proprietary trading and from investing in hedge and private equity funds. Regulators have struggled with complexity in writing this rule, and banks have lobbied heavily against it. The final rule was not approved until late 2013 and did not go into effect until April of last year. The deadline for fully complying with the rule could extend into 2017.

Another provision aimed at limiting risky activities has already been repealed. The so-called push-out rule was designed to move trading of credit default, commodity and equity swaps out of federally-insured depositories to non-insured operating affiliates. Congress reversed this part of the law last December, allowing the nation's largest banks to continue their swaps trading with the benefit of public safety nets.

Also core to the objectives of the Dodd-Frank reforms was preventing future government rescues of big banks. Last week, another round of resolution plans, referred to as living wills, was submitted to the regulators. It remains open, if not doubtful, whether a credible resolution process can be codified so as to eliminate—or even minimize—the pressure to rescue a large insolvent bank with taxpayer money.

Of course many point to the progress made in strengthening capital levels of the largest banks. Today, the 10 largest banks hold $8 of tangible equity for every $100 of assets, far more than the $3 held in 2008. However, if the full value of derivatives is included in assets, as required under international standards, the ratio of capital-to-assets is only 5 ½ percent. Compared to more than 10 percent held by the nation's community banks, further progress is needed.

Finally, a large segment of the banking industry composed of thousands of community banks faces a regulatory overlay intended for those engaged in global markets and riskier activities. Multiple bills to provide relief from certain provisions of the Dodd-Frank Act have been proposed. Most practical and promising is a proposal by FDIC Vice Chairman Tom Hoenig that focuses on calibrating regulation according to a bank's activities and complexity rather than size. I hope it is receiving serious consideration in the interest of a stronger and more-stable financial system.

Conclusion

The U.S. economy and its financial system have made notable progress over the past five years. Regulatory reforms and monetary policy have been necessary ingredients in achieving this progress. But it is time to recalibrate these measures.

Our regulatory efforts must remain centered on ending too big to fail without undermining the health and diversity of the financial system. Likewise, monetary policy must step back and allow market forces to resume their critical role of pricing risk and allocating capital to its best use. Although an accommodative stance of policy may be needed for some time during this transition, monetary policy cannot solve every economic challenge we face. Starting now to move rates up slowly and deliberately will allow the economy to adjust to a more-normal and, in my view, appropriate stance of monetary policy that will lead to long-term growth.