Interesting Times

The Center for Financial Stability
New York, NY (in-person and virtual)

March 29, 2022

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President and Chief Executive Officer
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Hello! It's great to be here. And I mean it today more than ever, because this is my first in-person speech in more than two years. I know I'm a little out of practice, because just as I was about to begin speaking, I made sure my mute button wasn't on. Old habits die hard, it seems.

In all seriousness, thanks so much for having me. I'm very much looking forward to today's conversation. I plan to discuss the economic outlook, monetary policy, housing, and a bit about money market funds. And then we can have an open discussion.

But before I begin, I need to give you my standard Fed disclaimer. The views I express today are my own and do not necessarily reflect those of anyone else on the Federal Open Market Committee (FOMC) or in the Federal Reserve System.

Economic Outlook

When I look at the current state of the world, I can't help but think of the old curse about living in "interesting times."

We've made significant progress, particularly on vaccinations, but remain mired in the midst of a now two-year global pandemic that has, tragically, killed at least 6 million people globally and around 1 million here in the United States. That's the equivalent of a city larger than San Francisco or Seattle being felled by this virus. Russia has invaded Ukraine, fomenting death and destruction and spurring a humanitarian crisis in the heart of Europe. And as policymakers, we at the Fed are confronting inflation running at multidecade highs, a subject I will touch on shortly.

Now, all of that said — and given these extraordinarily trying and tragic circumstances — one can't help but feel a little bit of awe at the underlying strength of the U.S. economy.

In the fourth quarter of last year — coinciding, at least in part, with the Omicron surge — GDP grew at an annualized rate of 7 percent, with strong inventory investment and a healthy demand for capital goods. For the totality of 2021, U.S. GDP growth was a very healthy 5.7 percent.

While delivery times remain elevated, there are some signs in the data, and in what we hear from our contacts, that supply chain constraints are finally easing. This should pave the way for healthy sales of durable goods like automobiles and appliances.

Job growth, a key component of the Fed's mandate, remains robust. For 10 straight months, new job creation has topped 400,000. But if you think that has led to a decline in Help Wanted signs, you're wrong. Even with all this job creation, vacancy rates remain elevated.

Nominal wage growth, as one would guess given these conditions, has been strong. Labor participation rates are edging up as well, though they remain below where they were before the pandemic. I suspect that the waning of the virus — at least here in the United States — as well as uncertain equity markets and even inflation may lure people back into the workforce and persuade others to delay retirement. The unemployment rate, below 4 percent, should continue to fall this year.

Now to the "10 percent" elephant in the room.

Inflation is running far too high, and I am acutely concerned about this. The consumer price index (CPI) was up 10 percent annualized in February, led by another significant increase in energy prices. Over the past year, CPI is up 7.9 percent. Core CPI, stripping out energy and other volatile indicators, remains very high as well, with 6.2 percent annualized growth in February. Russia's invasion of Ukraine will add to inflation pressure, not only hiking oil and gas prices but other commodities, like wheat and fertilizer, as well.

Inflation is widespread. It is showing up throughout a vast array of goods that comprise the CPI "basket" — and among some of those that aren't in the basket. One of our contacts, for instance, mentioned whopping membership fee increases at his golf club, suggesting this summer may be a good time to play at your local muni instead.

The bottom line is that generous fiscal policies, supply chain disruptions, and accommodative monetary policy have pushed inflation far higher than I — and my colleagues on the FOMC — are comfortable with. I'm also worried that inflation expectations could become unmoored.

Which is why last week we announced we were raising the federal funds rate for the first time since 2018. We raised our target by 25 basis points, and I expect a series of deliberate, methodical hikes as the year continues and the data evolve. I also anticipate that we will begin to reduce our holdings of Treasury securities, agency debt, and mortgage-backed securities soon.

With the runoff of pandemic support, tightening monetary conditions, and the war in Ukraine pressuring commodity prices, I think growth will moderate this year. We can probably expect to come in around 3 percent to 3.5 percent GDP growth this year — and then falling to trend growth of 2 percent to 2.5 percent during the next couple of years.

I do see a potential for a significant uptick in the service sector in large, politically "blue" cities that are only now waking up after a two-year pandemic-induced hibernation. Central business districts in cities like New York, San Francisco, and Philadelphia should get a boost as more workers return to their offices — the staff of the Philadelphia Fed included. The rise of hybrid work may moderate the potential for a huge boom, however. There is a big question mark hanging over the future of commercial real estate.

Inflation should begin to taper this year too — though remain elevated, probably around 4 percent for 2022. The following two years should bring it back to our target of 2 percent.

All of these forecasts are freighted with uncertainty. Recall, again, that we live in "interesting times."

Housing

Now, before we move to the open discussion, I'd like to turn to housing, which comprises a huge and vitally important sector of the U.S. economy — and, I've found, is a topic of particular interest here in New York. With a fairly weak social safety net, for Americans, houses are not only their shelters — they are a significant source of their household wealth and retirement savings as well.

In general, the housing market is largely healthy; if anything, it's not keeping up with demand. Housing starts are robust, but inventories are low and price growth is strong. Policies that make construction arduous in certain states and municipalities continue to impede efforts to meet demand.

I’d now like to turn specifically to mortgage forbearance, a subject that the staff at the Philadelphia Fed has been doing some very important research on.

As many of you will recall, at the outset of the pandemic, the CARES Act mandated that borrowers of federally insured mortgages be granted forbearances. To ensure widespread take-up, the law said borrowers could be granted forbearances by simply requesting it; they did not even need to prove hardship. The upshot was that homeowners could temporarily pause their mortgage payments without penalty and stay in their homes, without dinging their credit scores.

The CARES Act also put into place a foreclosure moratorium, followed by temporary protections against foreclosure. Private sector lenders adopted the same practices.

Perhaps not surprisingly, as the pandemic began and the economy was shut down, Americans took this opportunity in droves: More than 8.5 million borrowers entered forbearance at some point during the pandemic — more than 15 percent of the total mortgage market.

That was then, though.

As of last month, the number of loans in forbearance had declined by more than 90 percent, down to around 680,000 mortgages.

So, what has become of the nearly 8 million households that entered forbearance and have since come out of it? Our researchers at the Philadelphia Fed have been tracking this and have made some important findings.

I’ll begin with the positive news. Nearly three-quarters of those who have exited forbearance have paid off or are performing, many making use of payment deferrals or loan modifications. For borrowers able to resume timely payment, a deferral creates a no-interest subordinated lien out of their missed payments not due until loan payoff. Meanwhile, loan modifications offer lower interest rates and extend loan terms up to 40 years while offering payment reductions of 20 percent or more.

Moreover, our exceptionally strong housing market has kept home prices elevated. While this has had undeniably negative impacts on those seeking to enter the housing market, it does ensure that borrowers can avoid losing their homes and that banks won’t suffer losses large enough to meaningfully affect their capital positions. Homeowners are sitting on more than $10 trillion of tappable equity — a record. The contrast with the Great Recession is remarkable; you’ll recall back then that nearly half of all distressed borrowers were “underwater.”

Still, nearly 1 million mortgages are seriously delinquent, split evenly between those classified by servicers as in loss mitigation and those not in loss mitigation. Most borrowers who remain seriously delinquent and not in loss mitigation never entered forbearance at all. Many were in nonpayment before the pandemic struck.

And of the borrowers classified as in loss mitigation, three-quarters are still in process and have not, as of yet, resumed timely payment on their mortgages. Black and Hispanic borrowers have much higher shares of nonpayment, either being in forbearance or delinquency. Interestingly, just as the unemployment rate has returned to pre-pandemic levels, the number of delinquent mortgages has also returned to pre-pandemic rates.

Lenders may want to consider solutions that limit the costs of modification while providing more payment relief to borrowers. One such solution is for the Federal Housing Administration to offer 40-year mortgage modifications. This will lower the cost relative to the 30-year option and provide more relief to borrowers. While the Department of Housing and Urban Development has proposed a program to facilitate a 40-year mortgage, it has yet to materialize. It's worth noting that protections against foreclosure expired on December 31, 2021, and foreclosure starts are back to their pre-pandemic levels too.

Money Market Funds and COVID-19

Now, I'm certain you're eager to grill me, but I want to close with a few words on what happened with money market funds (MMFs) almost exactly two years ago, just as the pandemic struck. I realize this is not a happy memory, so apologies for bringing this up. COVID-19 may have been a true black swan event — and we all fervently hope, a truly once-in-a-lifetime experience — but that must not preclude us from drawing lessons that we can use going forward.

March 2020, you'll recall, was characterized by a dash for cash. (It was also characterized by a dash for toilet paper and hand sanitizer, but that is a story for another day.) Net outflows from prime MMFs, which provide crucial investment in various forms of short-term debt, was more than 17 percent — roughly equivalent to the outflows experienced during the 2008 financial crisis. All told, more than $140 billion evaporated from domestic MMFs between March 6 and March 26, 2020.

As you can imagine, this run on MMFs imposed huge pressure on the kinds of short-term funding that companies rely on to stay afloat. The consequences for financial stability, and the U.S. economy at large, were profound.

So, for the second time in 12 years, a significant outflow from MMFs ensured a concerted policy response. The Fed, in conjunction with the Treasury Department, stepped in, and on March 18, 2020, we announced we were launching the Money Market Mutual Fund Liquidity Facility, which was formally initiated on March 23. Ultimately, 47 out of 95 domestic prime MMFs accessed the facility.

What's important to note is that as soon as we announced the advent of the liquidity fund, outflows from MMFs declined substantially. From March 23 to the end of the month, outflows were $28 billion, and by April, these funds were actually seeing inflows. Correlation is not causation, of course, so we can't be sure it was solely the Money Market Mutual Fund Liquidity Facility that provided this stabilization, though researchers at the New York Fed have found compelling data that suggest it did have an effect.

And indeed, one thing I noticed throughout the 2020 crisis was that every time we launched a new lending facility — and we ended up launching quite a few — the mere *announcement* of it had a fairly significant effect on calming markets, even before the facility was actually up and running.

While the Fed's actions were largely successful, I would argue that we do not want the public sector to step in to aid MMFs for a third time. Proposals such as introducing swing pricing requirements, eliminating redemption gates and liquidity fees tied to the level of weekly liquid assets at prime and tax-exempt funds, and increases in liquid asset requirements for all funds are proposals well worth considering. When we say the Fed is the lender of last resort, we mean it.

So, again, thank you so much for having me. Interesting times call for, I'm certain, an interesting discussion, and now I'm happy to take questions.