Michael Strain:

Good afternoon. Thank you for joining us for this live stream and thanks to all of you who will watch the video of this event later at your convenience. I am Michael Strain. I'm an economist and senior fellow here at the American Enterprise Institute. It's my pleasure this afternoon to welcome to AEI Michael Barr, vice chair for supervision of the Board of Governors of the Federal Reserve System, who will offer remarks on how the Federal Reserve's capital framework supports a resilient financial system. Mr. Barr took office in July of 2022. Prior to his appointment to the Federal Reserve Board, Mr. Barr was at the University of Michigan where he was dean of the Gerald R. Ford School of Public Policy and a professor of public policy and professor of law. He served as the assistant secretary of the Treasury for Financial Institutions from 2009 to 2010.

Under President Clinton, he served as the Treasury secretary special assistant as deputy assistant secretary of the Treasury, as special advisor to President Clinton and as a special advisor and counselor on the policy planning staff of the U.S. Department of State. He also served as a law clerk to Supreme Court Justice David Souter. The run of show for this event will be straightforward. Mr. Barr will offer remarks, after which he and I will have a conversation about bank regulation, as well as about his outlook for the economy and for monetary policy. Viewers are welcome to submit questions for the vice chairman to my colleague, John Towey. You can submit those questions by email, john.towey, T-O-W-E-Y, @aei.org, John's email address that's on the webpage for this event. And viewers are also welcome to submit questions via Twitter using the #askaeiecon. That's #askaeiecon.

And with that, let me thank Mr. Barr for being here. It's an honor to have you and we look forward to hearing your remarks.

Michael Barr:

Thank you so much, Michael. And thanks you too AEI and all of you listening today for inviting me to talk this afternoon. In my first speech as vice chair for supervision in September, I said that the Federal Reserve Board would soon engage in a holistic review of capital standards. My argument then and now is that our review of regulatory policy must be a periodic feature of bank oversight. Banking and the financial system continuously evolve and regulation must adapt to address emerging risks. Bank capital is strong, but in doing our review, we should and are being humble about our ability or that of bank managers to predict how a future financial crisis might unfold, how losses might be incurred and what the effect might be on the financial system and our broader economy. That humility, that skepticism will serve us well in crafting a capital framework that is enduring and effective.

It will help make sure that we do not lose the hard fought gains and resilience over the past decade and that we prepare for the future. That review is still underway and I have no firm conclusions to announce today. Rather, I thought it would be helpful at this early stage to offer my views on capital regulation and the role that capital standards play in helping to advance the safety and soundness of banks and the stability of the financial system. By holistic, I mean looking not only at each of the individual parts of capital standards, but also at how those parts may interact with each other, as well as other regulatory requirements and what their cumulative effect is on safety and soundness and risk to the financial system. This is not an easy task, because finance is a complex system. And to make the task even harder, we are looking not only at how capital standards are working today, but also how they may work in the future when conditions are different.

As I mentioned, we're approaching the task with humility, not with the illusion that there is an immutable capital framework to be discovered, but rather with the awareness that revisions we conceive of today will reflect our current understanding and will inevitably require updating as our understanding evolves. Let me start by explaining why banks have capital. Banks play a critical role in

the economy by connecting those seeking to borrow with those seeking to save. A bank lends to its customers, including individuals and businesses based on its assessment of the customer's credit worthiness. A bank's depositors benefit from having bank accounts that allow them to easily make payments to others and to maintain a balance of money in a safe and liquid form. A healthy banking sector is central to a healthy economy. The nature of banking, however, along with the interconnectedness of the financial system can pose vulnerabilities.

Even if a bank is fundamentally sound, it can suddenly be threatened with failure if its customers lose confidence and withdraw deposits. This inherent vulnerability can pose risk to the entire economy. In the 19th and early 20th Centuries before the creation of the Federal Reserve and the Federal Deposit Insurance Corporation, banking panics were frequent and costly to the economy. Based on this experience and similar experiences around the globe, many countries employ deposit insurance and other forms of a safety net to protect depositors and banks. But offering this protection, shielding depositors and banks from risk can have the perverse effect of encouraging risk taking, creating what is called moral hazard. Supervision and regulation, including capital regulation provides a critical counterbalance to ensure that banks, not the taxpayers internalize the cost to society of that risk taking. The impact of inadequate supervision and regulation was starkly revealed in the global financial crisis, as banks and their functional substitutes in the non-bank sector barred too much to fund their operations.

While nearly all were adequately capitalized in theory, many were under capitalized in practice, since their capital levels did not reflect future losses that would severely weaken their capital positions and banks lacked appropriate controls and systems to measure and manage their risks. That crisis also exposed the extent to which banks and broader financial system participants had become reliant on short-term wholesale funding and prone to destabilizing dynamics. The sudden shutdown of short-term wholesale funding posed severe liquidity challenges to large financial intermediaries, both banks and non-banks, and caused significant dislocations in financial markets. The cost to society was enormous with widespread devastation to households and businesses. Even with an unprecedented large response by government, 6 million individuals and families lost their homes to foreclosure. The crisis brought on the worst and longest recession since the Great Depression. It took six years for employment to recover, during which long term unemployment ran for long periods at a record high and more than 10 million people fell into poverty.

The crisis left scars on families and businesses that are evident even today, and it was in part driven by imprudent risk taking by banks and non-bank financial institutions. This experience prompted the United States and other jurisdictions to revisit how supervision and regulation, including capital regulation could have better contained that risk in both the bank and non-bank sectors. That is why capital levels today are strong. We have learned from and adapted to the lessons from the global financial crisis. This experience underscores the need for humility and continued villages about the risk we may not fully appreciate today. Capital regulation requiring a bank to operate with what is deemed to be an adequate level of equity based in its asset size and its risks is a useful tool to strengthen the incentives for banks to lend safely and prudently.

First, I'll begin with what capital is. Essentially shareholder equity in the bank. People sometimes use the shorthand of banks holding capital when speaking of capital requirements. However, it's helpful to remember that capital is not an asset to be held, reserves to be set aside or money in a vault. Rather, it is the way along with debt that banks fund loans and other assets. Without adequate capital, banks can't lend. Higher levels of capital mean that a bank's managers and shareholders have more skin in the game and have incentives to prudently manage their risks because they bear more of the risk of the bank's activities. Next, let me speak to how capital and debt work together to fund a firm's operations.

In theory, companies should be indifferent to the mix of equity and debt they use to fund themselves, since the creditors of a safer firm will lend to it at lower rates and shareholders of a safer firm will accept a lower return on their investment. That may not fully hold for banks, because insured depositors are made risk insensitive through deposit insurance and other creditors may provide lower cost funding if they believe the government may bail out banks in distress. Forcing banks to fund more of their activities with equity instead of debt could thus raise the private costs of funding to the bank and cause banks to pass those higher costs of credit to consumers. These considerations must be balanced against the public benefits of higher capital.

Empirical research supports the social benefits of strong capital requirements at banks, particularly when economic conditions weaken. While poorly capitalized banks may be forced to shrink during bad times, better capitalized banks have the capacity to support the economy by continuing to lend to households and businesses through stressful conditions. And to the extent bank capital reduces the frequency or severity of financial crisis, the public is much better off with strong capital. Lastly, the highest standard should apply to the highest risk firms. Larger, more complex banks pose the greatest risk and impose greater costs in society when they fail. Higher capital requirements help to ensure that larger, more complex banks internalize this greater risk and counterbalance the greater cost to society by making these firms more resilient. Further, matching higher capital standards with higher risk appropriate limits the regulatory burden on smaller, less complex banks whose activities pose less risk to the financial system.

This helps to promote a diverse banking sector that provides consumers greater choice and access to banking services. Banks, of course, are part of a broader financial system. The share of credit intermediated outside of banks has grown considerably over the last 40 years. In fact, non-bank financial intermediaries broadly defined fund nearly 60% of the credit to the U.S. economy today as compared to approximately 30% in 1980. Non-bank financial firms include money market funds, the insurance sector, the government sponsored enterprises, including Fannie Mae, Freddie Mac and the Federal Homeland Bank system, hedge funds and other investment vehicles, and still many other types of non-bank lenders. There are lots of reasons for these trends, including technological advancements, financial innovation, regulatory arbitrage and quirks of history. Bank capital requirements combined with a lack of strong or sometimes any capital requirements in the non-bank sector are also part of that.

We should monitor the migration of activities from banks to the non-bank sector carefully, but we shouldn't lower bank capital requirements in a race to the bottom. In times of stress, banks serve as essential sources of strength to the economy and they need capital to do so. We need to worry a lot about non-bank risk to financial stability. During the global financial crisis, many non-bank financial firms had woefully inadequate capital and liquidity, engaged in high risk activities and were faced with devastating runs that crushed the financial system and caused enormous harm to households and businesses. The collapse of Bear Stearns and Layman Brothers, the failure of Fannie Mae and Freddie Mac, the implosion of the insurance conglomerate AIG and many others laid bar. The weakness of non-bank intermediation and the need to regulate risks outside the banking system. Many of those risks remain today. In far too many cases, non-banks rely on funding sources that are prone to runs and do not maintain sufficient capital to internalize their risk to society.

The answer, however, is not lower capital requirements for banks, but more attention to those very risks. Further, as stress in non-bank financial markets is often transmitted to the banking system, both directly and indirectly, it is critical that banks have enough capital to remain resilient to those stresses. One of the threshold questions is how we should think about calibrating bank capital to a socially optimal level. There is not an easy answer to that question. In my mind, as I said at the outset, it starts with humility. Bank capital should be sufficient to enable the bank to absorb unexpected losses and continue operations through severely stressful but plausible events. Yet translating that principle into a

quantum of capital involves an estimate of what future risks will emerge and what losses bank will suffer. I'm skeptical that regulators or bank managers know the answers to these questions. Despite complex regulatory risk weights, or simple leverage ratios, or the internal models used by banks, at bottom bank capital ought to be calibrated based on that humility, that skepticism. Capital provides a cushion against unexpected risks and unforeseen losses.

Those a humble and skeptical person might be careful to not try to predict with too much precision. Those a humble and skeptical person might guard against. That's the spirit in which I'm approaching the Fed's holistic review of capital standards. There's a body of empirical and theoretical research on optimal capital which attempts to determine the level of capital that equalizes the marginal benefits of capital with a marginal cost. While the estimates vary widely and are highly contingent on the assumptions made, the current U.S. requirements are toward the low end of the range described in most of the research literature. International comparisons also suggest strong capital requirements support banks and the U.S. economy. We have strong capital levels today, and generally higher bank capital requirements in the United States after the Dodd-Frank Act have corresponded with healthy economic growth and have supported the competitiveness of U.S. firms in the global economy. Finally, some banks have asserted that the resilience of the banking system in the pandemic suggest that bank capital is already high enough.

There were some positive signs from a Federal Reserve conducted sensitivity analysis and subsequent stress test. Banks did their part and lend strongly based on their strong capital positions as well as widespread government support. But we didn't get a real test of resilience, because Congress, the president and the Federal Reserve rightly stepped in with massive assistance to avert an economic disaster. Furthermore, I'd observe that the recent experience of the pandemic suggest that large, unexpected shocks can occur with little notice. Our inability to predict such events would argue for a higher overall capital level than one based solely on historical experience. So let me return to where I began on this topic. Figuring out what the right level of capital is requires one to be humble and skeptical. Let's turn to the design of capital requirements. U.S. capital rules contain many individual elements, including risk-based requirements, leverage standard stress testing and long-term debt requirements for the largest banks. The risk-based capital requirement is premised on the fact that a firm is likely to experience higher losses from its riskier activities.

The sizing capital requirements based on risk will better estimate a firm's capital needs so that it internalizes the risks of its activities. The Basel III capital reforms as implemented in the United States aim to address many of the shortcomings identified during the global financial crisis. The international standards were developed to enhance the quantity and quality of regulatory capital, better reflect risks of bank's activities, impose a heightened capital requirement on global systemically important firms, and reduce procyclical and promote countercyclical buffers among others. The last set of comprehensive adjustments to the Basel III accord now under consideration in the United States would further strengthen capital by reducing reliance on internal bank models and better reflecting risks from a bank's trading book and operational risks. I'm working closely with my counterparts at the FDIC and the OCC on the U.S. version of the Basel III end game reforms.

Any rule changes that might be proposed in capital standards would be deliberate, adopted through the notice and comment process so that we have the benefit of public perspectives and implemented with appropriate transition periods to achieve the long-term goal of improving capital regulation. Risk-based requirements are important tools, however they are complex, under inclusive under some conditions, and like all capital requirements, can be gamed. Thus, a non-risk based leverage measure can provide transparency and a further measure of resilience. Of course, one also needs to pay attention to how different capital measures interact with one another. And some have indicated that the leverage requirement for large banks is overly binding and they contribute to lower liquidity and treasury

markets, especially in stress scenarios. We're exploring the empirical evidence and examining whether adjustments to the leverage ratio might be appropriate in the context of our holistic capital review, as well as in the context of broader reforms being undertaken by the Federal Reserve and a range of other agencies.

In addition to risk based capital requirements, the Federal Reserve Board implemented a supervisory stress test that is used to set dynamic and risk sensitive capital requirements for large banks. The stress test adds risk sensitivity to the capital requirements and provides the public with information about the bank's risks and resilience. Moreover, the stress test can achieve a higher degree of risk sensitivity than the standard Basel risk weights. The stress test can also be more dynamic than the capital rules, because a new test is conducted each year reflecting a new set of hypothetical financial and economic conditions and updates to the bank's risk profile. Lastly, the stress test can potentially counteract actions by a bank to optimize against the capital regime. For instance, lowering its risk weighted assets without reducing its risk. In this way, the stress test, along with strong supervision, can serve as a check on excessive bank risk taking.

As I'll return to in a moment, we're focused on ensuring that stress testing remains forward looking and effective at requiring banks to have capital to cushion losses from emerging risks. A final prudential requirement, a long-term debt requirement compliments the regulatory capital system. Unlike regulatory capital, which helps a firm absorb losses as it continues operations through times of stress, long-term debt becomes especially relevant once a firm has already entered bankruptcy or resolution. At the point of resolution, equity can be written off and certain long-term debt claims can be written down to absorb losses. The remaining debt claims can be effectively converted to equity to provide flexibility to a bankruptcy court or resolution authority in managing the firm's path through resolution. In particular, this equity can be used to help the firm continue critical operations as its operations are restructured, wound down or sold in order to minimize disruptions to the larger financial system.

Long term debt requirements were initially applied to global systemically important banks. The board and the FDIC are currently considering whether the costs of a resolution of a large non G-SIB may also justify the imposition of long-term debt requirements on such firms as well. As I've said before, it's critical that our capital regime is forward looking, and while the stress test is the most dynamic and risk sensitive component of our regulatory capital framework, history has taught us not to become complacent or to shed our humility. In an environment of ever-changing risks, stress tests can quickly lose their relevance if their assumptions and scenarios remain static. Let's not forget that for some years before the financial crisis, the agency regulating Fannie Mae and Freddie Mac conducted a regular stress test. Unfortunately, that test used models and scenarios that weren't regularly updated, a key reason why the test failed to detect risk building up for years before the global financial crisis, and why capital levels at Fannie and Freddie prove to be woefully inadequate.

Stress tests are not meant to be predictions about the future. Humility suggests caution in that regard. But they should be stressful, poking and prodding at the system so we can attempt to uncover hidden risks that could become manifest under certain scenarios. This is particularly important in today's complex and interconnected financial system in which problems can spread and lead to unexpected losses. For instance, we recently saw how exposure to interest rate risk at a set of leverage pension funds in the UK coupled with unprecedented large movements in rates caused significant disruptions to the gilt market. This was not a risk that anyone saw coming, but it's spilled over to the UK financial markets in a way that required a large scale intervention by the government. Other recent examples, to name a few, including the messy failure of Archegos last year, Russia's war against Ukraine, tensions in and with China, the implosion of the crypto asset exchange FDX and the resulting crypto asset market dislocations, and volatility in the markets for fixed income securities affecting market liquid.

We're currently evaluating whether the supervisory stress test that's used to set capital requirements for large banks reflects an appropriately wide range of risks. In addition, we're considering the potential for stress testing to become a tool to explore different sources of financial stress and uncover channels for contagion that lead to unanticipated consequences. Using multiple scenarios or adapting the stress test in other ways to better account for the high degree of interconnectedness between banks and other financial entities could allow supervisors and banks to identify those conditions and take action to address them. And banks should continue to invest in and prioritize development of their own stress testing and scenario design capabilities, regularly run scenarios to understand the changing risk environment and incorporate the results of these stress tests into the bank's own assessment of its risks and capital needs.

Stress testing in all the other aspects of capital regulation that I have discussed today will be considered as part of our holistic review. We're starting from a good place because capital today is strong. I hope to have more to say about that review early in the new year. As I've argued today, capital plays a central role in how a bank manages its risks and capital regulation is fundamental to bank oversight. History shows the deep cost to society when bank capital is inadequate. And that's how urgent it is for the Federal Reserve to get capital regulation right. In doing so, we need to be humble about our ability, or that of bank managers or the market to fully anticipate the risks that our financial system might face in the future. Thank you very much.

Michael Strain:

Thank you very much. That was terrific. Let's have some discussion about capital requirements before we turn to a discussion of your outlook for the economy and for monetary policy, if that's all right. We also have some questions coming in from the audience, which I'll ask as well. But let me start with one of my own. You talked quite a bit about risks that could materialize, that would be hard to forecast, for which higher bank capital would be very helpful. I think there's another risk as well, which you also mentioned, but which I think you emphasized less, which is the risk of a long period of time where things are going pretty well and in which banks might need less capital. And I wonder if you could talk a little more about the drawbacks of too much capital in that type of an environment and a little more about how you're thinking about how those drawbacks could outweigh the benefits?

Michael Barr:

Thanks, Michael. It's a great question. And I think one of the difficulties in this space is it's very difficult to draw the exact line where you think the cost and benefits of capital exactly are in equipoise. And so one of the things I was trying to describe in the literature is the fact that there may be this trade off between the cost of credit that banks provide, and therefore the capital level that you might want and other values we have in the system, like not destroying the economy in bad times. And I think what we found in the global financial crisis is the level of capital that we had in that situation was woefully inadequate for the risks that the financial sector faced, and as a result, it crushed the American economy. We had millions of people out of their jobs, millions of businesses shuttered their doors. I know in Ann Arbor, Michigan where I'm from, families were disrupted, harmed, had lots of dads and moms who lost their jobs and had difficulty taking care of their families.

And that's just devastating for the economy. And so we have to figure out levels of capital in the system that are sufficiently protective against those kinds of risks. And in good times we want to be able to build that capital level up when the banks are doing well, and when the financial system is doing well and asset values are rising so that there's that ample cushion when things go bad and banks can continue to lend and support the economy, even though they may be suffering losses because of

broader dislocations. So that's the overall goal. But as I said at the outside, I think we need to be quite humble about this. It is very hard to predict what's going to happen in the future. Certainly if you asked experts in finance before the global pandemic what the top list of their concerns were about economic and financial risks, a global pandemic wasn't on that list. And we just need to be quite humble about our ability to predict the future, and therefore think about a risk management approach to capital regulation.

Michael Strain:

So let me ask you more about that kind of building off a comment you made about the pandemic. You mentioned that it's been argued that the pandemic demonstrated that we don't need more onerous capital requirements. And if I understood you correctly, you were saying that you didn't find that argument compelling because Congress stepped in with a substantial amount of support for the financial system and for the economy as a whole. I guess I wonder how do you think about potential congressional action or potential action from the Treasury Department or from the Executive Branch when thinking about how the Fed should set this kind of regulation? My baseline expectation would be that if we had another event like the pandemic, there would be substantial support from Congress, substantial support from the Executive Branch. I think the CARES Act passed the Senate 96 to nothing. It was hugely bipartisan. I could be wrong about that, but something like that. And do you think that when you're thinking about these sorts of requirements for the financial system, should you assume a big response by Congress? And if so, doesn't that mean relatively less onerous capital requirements?

Michael Barr:

Michael, I think first of all, I think it was good that the Federal Reserve, and Congress and the President stepped in the way they did. Democrats and Republicans came together in a very positive way. And the Federal Reserve did its part supporting the financial sector. And that really muted the economic effects of the onset of the pandemic, which could have been much, much, much worse. It was devastating in so many ways to so many people, but it could have been even worse. And banks did their part in the crisis. As I said in my speech, banks were able to lend, both because they had strong capital and because of the government support, for example, through the PPP program. And that's all to the good, so it's not an argument about that. But I don't think that we should be in the business of setting capital requirements with the expectation that essentially the taxpayer will step in to support the financial sector or the economy.

I don't think that's a prudent approach to thinking about capital regulation. We really want to think about capital as having the banks in this case internalize the costs that might happen if they were to get into trouble. And that would not include planning on having government support, whether directly or indirectly to the bank. So I think it's quite important that we not assume the taxpayers step in, that we assume rather the opposite, that banks are able to stand on their own bottom and continue to support the economy. And if they get into trouble, that the capital will be sufficient to handle any risks and not externalize those risks on everybody else.

Michael Strain:

Let me stick with the pandemic. Several countries activated flexible capital requirements during the pandemic. The U.S. has a flexible capital requirement called the countercyclical capital buffer. It has not been used. Do you expect that will change in the future and will you be looking at that anytime soon?

Michael Barr:

Michael, the countercyclical capital buffer is an important potential tool. As you mentioned, a number of countries have deployed that during the pandemic and in other periods of financial stress. We are looking at the countercyclical capital buffer as part of this holistic review that I described. That probably means we won't be taking action on it in the short term. We're thinking about it as part of this holistic review. And I'll have more to say about that early next year. But we're definitely looking carefully at that.

Michael Strain:

We're getting some questions on monetary policy, which I want to save until after we're done discussing capital requirements. But let's do another one or two on capital requirements. So are you worried if the Fed increases capital requirements, increases the ability of these financial institutions to absorb shocks and to handle risks when they materialize, that this could push more activity out of the banking sector? There are costs and benefits to higher capital requirements for a given bank to society as a whole. There's a socially optimal amount of big capital, as you mentioned. But I think there's also a balance between banks and non-banks. And I just wonder how do you think about that? And one question we're getting from the audience related to that I can fold in, what does that mean for the regulation of non-banks?

Michael Barr:

Michael, it's a great question and I talked a little bit about this in my speech. I mean, this is an area before I came to the Fed and before I became a dean, I was a law professor and I taught banking regulation. And I can tell you that one of the things that we talk about often in the history of bank regulation is that there's always this question of the regulatory perimeter. There's always something inside the perimeter that gets regulated in a certain way and things that are outside that perimeter. And there's always the risk that, like the squeezing balloon, if you squeeze the balloon on one side, it kind of blows up on the other. And so you have to be attentive to risk both in the banking system and in the non-banking system. And what I tried to explain in my speech is that that's not really an argument for saying we shouldn't have good bank regulation, but we should. Banks are just absolutely central to our economy. They're the core of the functioning of our financial system.

But we also need to pay careful attention to all the risks in the non-bank sector. And if you think about the global financial crisis, we kind of had a version of a run on the banking system, but it started in the non-bank sector. It was a run on the non-bank system in the first instance and on non-bank activities. Or if you go back to the financial crisis of 1907, 100 years before, that was a crisis that was rooted in the trust system and the non-bank part of the financial system that started with the fire in San Francisco and became engulfed basically the whole financial system. And so you can't ignore the risks in the non-bank sector. You've got to do what you can to regulate those risks. That's one of the reasons, for example, in the Dodd-Frank Act, there was this process for designating things like financial market utilities, designating non-bank systemically important financial institutions to expand that perimeter where needed to be able to apply stricter rules so that you didn't have that migration of risk out of the banking system into a sector that was not fully regulated.

And as I indicated, I'm worried about those risks today. I think it's important to stay quite focused on risks in the non-bank sector, but not as an excuse to not regulate the banks anymore.

Michael Strain:

Yeah. So speaking of activity outside the baking sector, I have to ask you about the turmoil in the crypto sector. What's your view on that vis a vis financial regulation on everything we've been seeing happening?

Michael Barr:

Well I think, Michael, it's a pretty good example of what happens when you have firms that are trying to set themselves up to avoid a regulatory structure. We have very well established rules for exchanges. We have well established rules for custody. We have well established rules with respect to anti-fraud measures. We have rules about lending out customer funds or using customer funds. So if we had a regulatory system that was applying fully at full force to that sector, I think that we would've had the ability to minimize some of those risks that we saw. Now thankfully, the risks to the core of the financial system had been pretty muted in the aggregate. There aren't today tight linkages between the financial sector and the crypto sector at a very large level. We have some small sets of interactions with the traditional banking system where there might be risks, but not at a broad scale.

And so I think it's really important as we go forward in thinking about regulation of crypto related assets and activities that we think about those risks. I also want to be clear at the same time, Michael, it's important for us not to set up a regulatory environment that stifles innovation. Innovation is really critical to the financial sector, it's critical to the American economy. It's one of the reasons we have amazingly vibrant economic system is because we permit, encourage, allow that kind of innovation. And so we've got to get the balance right. We have to have really good guardrails so that investors and consumers are protected, so that the safety and soundness of the financial system is protected. And then we need to let innovation flourish within those guardrails so that we don't lock in old technology or incumbents. And getting that balance right is very, very tricky. We clearly don't have it right now in the world that we're seeing.

Michael Strain:

Rich Miller at Bloomberg has a question that's a nice transition from questions about the financial system to questions about the outlook for the economy and monetary policy. Miller writes, "The Fed is in the midst of the most aggressive tightening of monetary policy in decades. So far it seems like the financial fallout has been limited. What does that say about the vulnerability of the U.S. financial system to accidents and instability going forward? Does that vulnerability argue for a slower increase in interest rates going forward now that the Fed has raised rates into what's widely viewed as restrictive territory?"

Michael Barr:

Michael, it's a great question. It combines a lot of the themes that we were talking about. Let me start with just the basic facts, which are inflation today is still far too high. The Federal Reserve is quite focused on bringing inflation down to the Federal Reserve's target of 2%. We've done a lot of work to get interest rates up to restrictive territory. We moved very, very quickly this year to move into restrictive territory. And we are now at a point, as I think you heard Chair Powell say just yesterday, where those of us who are working on these issues can begin to spend a little bit more attention trying to make sure we're thinking about the right rate we're trying to get to and less attention on the pace that we're doing to get there.

And that might let us shift to a slower pace of rate increases going forward as early as the next meeting I imagine we're going to be considering this. And I think that's smart. It'll give us space to begin to modulate a bit and then think about, again, what that rate is, how high it needs to be, how long we need to keep it at that rate in order to get the job done, which we're quite committed to do. Obviously as we're doing that, we're paying careful attention to financial conditions as part of that work. So we're looking at issues like the question posed around financial stability. We want to make sure that there aren't aspects of the financial system that could lead to disruptions.

I think the example that I mentioned in the speech with respect to UK pension funds and the UK gilt market is instructive. Part of the reason for the concern there was rapid increase in rates. There are obviously other factors at play. But what we want to make sure that we're looking for risk throughout the financial system, we're looking for other kinds of liquidity traps where firms might be exposed to sudden rate increases and not have sufficient liquidity to handle that. Those are the kinds of things we're looking at right now. We're paying careful attention as we always do to financial stability issues.

Michael Strain:

So let me ask you a question. The previous question, I think correctly stated that the Fed is widely viewed as having taken interest rates into restrictive territory, and you see some evidence of that certainly in the housing sector, for example. But Chair Powell yesterday, whose speech you mentioned, left me scratching my head a little bit about whether or not he thinks that the funds rate is currently in a restrictive territory. I don't want you to speak for him, but I would like to ask you about your view. So Chair Powell said that wages are running about 1.5 percentage points faster than is consistent with the fed's 2% target, which suggests to me that the Fed is still a little bit below the nominal neutral rate. If underlying inflation is 3.5%, the nominal neutral rate is 4%. That's a little bit above where the funds rate currently is. Do you view the current level of the funds rate as restrictive, or do you think it's still a little bit accommodated, maybe close to neutral?

Michael Barr:

Michael, lots of people have different ways of estimating the factors that you just described. But I would say, and I think this is broadly the view of my colleagues, that we're in restrictive territory now. You can see that in real rates that are quite positive across the spectrum, except at the very shortest ran. And certainly how households and businesses borrow, they're in positive territory. And I think it's fair to say that we're in restrictive territory. The question that we're working on is, is it sufficiently restrictive, how much more restrictive do we need to be in order to see the kinds of changes in the economy that will eventually lead to a reduction in inflation?

And I think that we have some work still to do on that. So we're not done. We have more work to do later this year, and I imagine next year as well. And it's just that as we get closer to a rate that we believe is sufficiently restrictive, we have the ability to do that at a pace that is somewhat slower than we do in the past. That the past rate increases have been really quite unprecedented in size and in speed. And now we're at a point since I believe we're in restrictive territory, that we can get to a sufficiently restrictive rate at a slower pace.

Michael Strain:

Let me ask a question that came in from the audience. We're seeing inflation in many sectors of the economy. What is most concerning to you?

Michael Barr:

Well really we're looking broadly, Michael, at indicia of inflation. Inflation is hurting families and businesses today in a way that really is unacceptable. It's true in the parts of the inflation that are really quite volatile and outside of core, food prices, energy prices, obviously earlier this year energy prices were extremely high, they've come down, food inflation is still quite elevated, so it matters even outside what people think of as the core of inflation. And then within the core it really is looking at goods inflation, looking at services inflation and looking at housing inflation in three big groups. And we're concerned about all of them. We pay attention to all of them. There's some positive signs on goods

inflation in the sense that we haven't really seen it yet in price levels, but you can see in terms of easing of supply chains, the prices of shipping have come way down. Inventory seem in better shape.

And so those kinds of measures suggest that we're going to see moderation in the goods' sector. The housing sector is obviously very exposed to the changes in interest rates. And we're beginning to see significant changes in housing prices and in rents. Those will eventually flow through to housing services inflation, but it's going to take quite a long period of time for that to play through. Rent increases are decelerating, but that means that rents are still going up, and that's with respect to new leases. And existing leases, when they roll, will see also rises. So we're going to continue to see some housing services inflation well into the middle of next year. But hopefully the effect of interest rate increases will begin to see progress in that score. And then on services more broadly, I think the question is what's going to happen with wages? What's going to happen with business margins? And do those get compressed? Are we going to see some of the competitive effects kick in as demand slows so that price increases come back down? And that's going to take us a while to see.

Michael Strain:

So you mentioned kind of three big buckets for inflation, goods, prices, housing prices, and then what I'm interpreting is services less housing, so all of services except for housing. And I agree with you, I think there's pretty good reason to feel positive about the trajectory of housing, pretty good reason to feel positive about the trajectory of goods. The big one I'm concerned about is services less housing. That's the one that's most exposed to the labor market, of course. The labor market in my view is still very, very tight and is characterized by labor demand, well in excess of labor supply. I was surprised that Chair Powell spent so much time talking about labor supply in his speech yesterday while acknowledging that that's not really anything the Fed can affect.

I wonder what your view is. What do we need to see in order for the labor market to reach an equilibrium where wage growth can start to cool? There's one school of thought that holds that we can see, that we can reach a better place in the labor market through the destruction of job vacancies and that we can avoid substantial increases in the unemployment rate. Other economists believe that that's perhaps too optimistic of a forecast and that we're going to have to see the unemployment rate get into the fives at least in order to bring wage growth down to a level consistent with the Fed's 2% target for consumer price inflation. What's your view on those questions?

Michael Barr:

Michael, I think it's very hard to parse. I mean, you have to take a step back and remember, as I know everybody does, we have just been through an extraordinary experience as an economy and as a society. We entered this pandemic with actually quite low unemployment rates and nice growth and no inflation. In fact, the Federal Reserve was worried that they couldn't get inflation up to 2%. We had this extraordinary event, this global pandemic that massively disrupted our economy, our labor markets, the way people work, how we commute, how we live our lives, the basic choices we make. And that disruption is still with us today. So it's very hard to know whether the relationships that existed in the past between unemployment and inflation, for example, are still very useful. We have labor force participation rates that are quite different than we had before, so that we're below trend on labor force participation.

We have excess retirements that are hard to explain except through the lens of thinking about the pandemic. We have people who need access to elder care, or childcare, or friend care that they don't have in our society. We have a much lower levels of immigration, that mean that labor supply is significantly constrained. So these kinds of factors are playing in. We're also watching how people think

about jobs in the future, how much are they going to be focused on wages versus other kinds of attributes of a job, like the ability to work remotely or engage in hybrid activities? Certainly the kind of event that you and I are doing today would be relatively rare just a couple years ago and is now quite commonplace. So those factors, those changes that are working their way through the economy, I think make it very hard to know.

We do have vacancy rates right now, the 1.7% vacancy rate that is extremely high. And I think you'd have to see that coming down. I think all FOMC participants, as you saw in the September forecast, are suggesting rises in unemployment as part of this. But we don't know. And we're going to be watching carefully to see how these interact, what's going on, as I mentioned, with respect to price pressures, whether competitive effects end up reducing margins in a way that they haven't up to this point. And we're just going to have to be patient and watch carefully as we get more data.

Michael Strain:

Yeah, I obviously agree with you that it's been hard to forecast the future path of economic activity given how unusual this environment has been. One of the aspects of the economy that has been most surprising to me is how consumer spending has held up. I expected consumer spending to soften substantially in the current quarter, the fourth quarter of 2022. That has not happened. The consumer has been going strong through four decade highs of inflation. We are now seeing big increases in interest rates hit consumers. We're seeing credit card balances increase substantially, for example. It's much more expensive to take out a loan than it used to be. This is clearly hitting the housing sector, but it doesn't yet seem to be hitting overall consumer spending, at least to the degree that I would've thought. Are you similarly surprised? And what do you think is going to be needed to get consumer spending to reduce? And when do you expect that to happen? Do you think that's a early 2023 outcome?

Michael Barr:

Michael, I think part of what we're seeing is that in part because of the government programs that you and I were discussing earlier, household balance sheets were very, very strong coming into this period. So households had a lot of what economists call excess savings. It probably doesn't feel excess to ordinary households. But economists think of it as savings more than you would otherwise have had, more than we would expect. And those levels of excess savings were quite high and they permitted consumer spending to continue. And they've only slowly been brought down over time. Part of that was because of the pandemic, which changed everybody's behavior quite a bit. There was a lot of pressure to buy goods at the beginning. It was very hard to get goods, so we had goods inflation. Then people sort of rotated as the economy reopened into services. It was very hard to get labor supply into services, so we saw some inflation in that sector.

And then in terms of consumer spending overall, we're starting to see that excess savings level go down. It's going down fastest, earliest, most as you would expect at the lower income levels, a little bit less at the middle income and so on. And the higher levels, there's still quite a lot of savings there. And part of the question is how do people think about those savings? If you're a low income person, you really don't have any choice. You got to buy food and you got to get gas. And those things, the prices were going up and those families got hurt very badly by early inflation in those sectors. There's a little bit more discretion as you move further up the income ladder. So families are going at the very highest levels are making choices about how to think about that savings. Is it investment they're going to hang onto for precautionary reasons? Is it investment they're hanging onto for the long term? Or are they still going to spend a little bit of it? And I think you're starting to see families begin to make those kinds of choices.

Michael Strain:

Let me ask you about monetary policy, more specifically the meeting coming up this month. I think yesterday it seemed that Chair Powell pretty much locked in a step down. The Fed has been increasing interest rates by 75 basis points. It looks like the next meeting, which will be held in December, there will be a 50 basis point increase. Do you support stepping down to 50 basis points?

Michael Barr:

Well, as I was saying before, Michael, I think it makes a lot of sense. We've been moving very, very rapidly into restrictive territory. And now that we're closer to where we may need to be in terms of being sufficiently restrictive, I think it makes sense to slow the pace at which we're increasing rates. And it makes sense. I assume we're going to be considering it at this next meeting. I think that makes a lot of sense. And then have the ability going forward to moderate the pace so that as we're getting closer to what we might think of as the sufficiently restrictive rate, we're able to do that in a more measured way. I think that makes a lot of sense.

Michael Strain:

So markets seem to interpret that as dovish, or at least did yesterday. There was some concern that the recent easing of financial conditions that we've seen might lead you and your colleagues to stick with 75, an indication that that wouldn't happen and that 50 would be viewed as sufficient was taken, I think to suggest that you and your colleagues, that your alarm about inflation combined with the easing of financial conditions isn't increasing. Is that a reasonable read? You've clearly indicated that you're very concerned. I guess I'm asking about the first derivative of your level of concern. Are you becoming less concerned? Or is your level of concern constant? Are you becoming more concerned?

Michael Barr:

I think, Michael, it's a misreading to think about changes in the pace of increases as reflecting a change in the seriousness of the project at hand. We're all quite committed. I'm personally committed. We're all quite committed to bringing inflation down to 2%. And we have a lot of work to do. We have a long way to go. And we're quite focused on making sure our rate is sufficiently restrictive to get there, and we're not there yet. So I think it would be a mistake to interpret a change in the pace of our work as any lessening in any way of the commitment to do the work, to get to the sufficiently restricted rate we need and to stay there as long as we need to get the job done. We are 100% committed to that. There is no wavering, no change, no deviation, no diminution in any of that.

Michael Strain:

So you talked about two big questions. How high should the rate go and how long should it stay at that high level? And I think we've talked more about how high than we've talked about how long. Do you expect the funds rate to be lower in 2024 than it will have been in 2023?

Michael Barr:

Well, Michael, let me just put it this way. I think that the rate is going to have to stay high for a long period of time, and that's because it's going to take us a long period of time to really bring inflation down to 2%. It's really quite critical that we stay in that sufficiently restrictive territory so that we can reach that target. And these things, famously monetary policy works with long and variable lags. And we're paying quite close attention to that. The mistakes in the past have been when loosening happens too early. We're not thinking about loosening. We're still very much 100% focused on getting to a

sufficiently restrictive rate and staying at a restrictive rate for a long enough time to bring inflation down to 2%.

Michael Strain:

So let me ask you, and this will be our final question, let me ask you to kind of project beyond this current situation. So the Fed has succeeded in getting inflation back down to its 2% target, and a year or two have gone by, or something like that. You're thinking a lot about changes to financial regulation. Let me ask you about the monetary policy framework. There's a renewed discussion about increasing the inflation target. The Fed target's 2%. There's nothing magic about a 2% target. An argument against 2% when the Fed adopted the target was that that was a little too close to zero. And that argument wasn't viewed as persuasive at the time, or at least adequately persuasive.

But the Fed has spent a lot of time at zero over the past 10 years. Now we're in an inflationary environment where I think your job would be a lot easier if the inflation target were say 3% rather than 2%. Does the combination of a binding zero lower bound, of spending so much time at zero and of now being in an inflationary environment where two is a lot harder to hit than three, does that make you think that in addition to looking at financial regulation, which you're doing, the Fed should also take another look at its monetary policy framework?

Michael Barr:

Michael, let me just say we're not at all thinking about revising the target. We're quite committed to the inflation target of 2%. We're quite committed to taking the steps necessary to get to 2%. And it might be useful after we're through this inflationary period as is contemplated in the monetary policy framework to review that framework on a periodic basis. I think it makes sense to review the framework. And when we're reviewing the framework, I think it makes sense to think about the whole sweep of the time period under which this framework and previous frameworks operated and to make assessments about them with a long term view. But what we're not close to being in that point. And we are quite focused on not revising the target and hitting the target of 2%.

Michael Strain:

Excellent. Well, we're two minutes over and I want to be respectful of your time. I feel like we could probably keep going for at least another hour. But let me thank you for being with us today. We were honored to host you, Michael Barr, vice chair for supervision at the Board of Governors of the Federal Reserve System. Thank you for your service and thank you for being with us here today.

Michael Barr:

Thank you, again. My pleasure.