Record of Meeting

Federal Advisory Council and Board of Governors

Thursday, February 6, 2025

Item #1: Economic Activity

Based on Council members' own experience and that of their clients and contacts, are Council members observing any trend or change in business investment plans in various sectors? What is the Council's outlook for the pace of spending by businesses in 2025? What is the Council's outlook for the pace of spending by consumers in 2025?

Businesses are cautiously optimistic and expect to increase their investment expenditures in 2025. Following solid momentum in the second half of 2024, businesses anticipate economic expansion given (1) a more favorable regulatory environment, (2) the potential for lower income taxes, and (3) stronger sales growth. This optimism is tempered by concerns about potential trade policies and any associated impacts on supply chains—such as keeping the cost of goods elevated—and uncertainty regarding the direction of interest rates. Business leaders' recession expectations have fallen, with most leaders expecting a soft landing.

An increase in commercial loan requests reflects an anticipated rise in investment and mergers and acquisitions; however, utilization remains relatively low. Additionally, there is variability across industry sectors. Spending in categories such as information processing equipment has been offset by weakness in construction machinery and mining machinery. Variation across firm sizes has been observed; large firms are the most optimistic and are considering higher relative levels of capital investment. Small businesses also have a positive outlook, though it is more muted, and plan to hire additional staff and increase hours. A majority of businesses, regardless of size, expect increases in revenues and profits in 2025.

Consumer spending remains strong, and expectations for 2025 are for continued growth, though at a slower rate as compared to 2024. This sentiment is based primarily on a resilient labor market with wage growth outpacing inflation, a high volume of accumulated savings, record household wealth, and improving home equity. With cash buffers stabilizing and inflation cooling, higher-net-worth clients are spending on predominantly high-end products and services, such as health care and travel. While many Council members agree that overall consumer spending will be a positive this year, Council members generally believe that lower-income households will continue to face significant headwinds given the disproportionate impact of inflation on this cohort of the economy.

Item #2: Labor Markets

How would Council members describe the balance between demand and supply in the labor market at this point in the year? Are businesses in some sectors expecting difficulties hiring workers in 2025? How do Council members foresee employment levels and compensation rates evolving across sectors in 2025?

The start of 2025 has seen the labor market continue to come into better balance. The pace of job growth has moderated primarily as a result of slower hiring rather than rising layoffs. Council members view the labor markets as stable and the supply of lower-skilled workers as improving. Higher-skilled workers are still in demand, but that demand has cooled and, broadly speaking, fewer workers are voluntarily quitting their jobs. While the availability of labor has improved, the compensation level is elevated. Employers are paying more to attract and retain talent.

The rate of wage growth has slowed across most industry groups given the slowing demand for labor. Exceptions include labor demand in health care as well as the demand for specialized skills that are needed for high-skill manual-labor positions in commercial construction and manufacturing. Many businesses are investing in early recruitment programs for skilled labor. Most Districts are concerned that potential changes in immigration policy could lead to negative labor supply shocks, primarily affecting lower-skilled labor. The most vulnerable industry groups here are agriculture, construction, household services, leisure, and hospitality services.

One Council member noted that in a survey of middle-market businesses, about half of the respondents view labor shortages, retention issues, recruiting, and hiring as persistent challenges. However, roughly half of those surveyed plan to expand their workforce in 2025. And according to a recent American Bankers Association survey, roughly one-third of small businesses—which are also finding it difficult to fill positions—are also planning for workforce expansion this year.

Overall, the labor supply for most positions is stable to improving and appears to be shifting in favor of employers, with certain geographies still challenged from a cost or talent-supply perspective. Council members foresee that wage growth will be in the low single digits in 2025. They have also expressed concern about the impact of potential changes in immigration policy, especially with respect to the availability of lower-skilled labor.

Item #3 Inflation

Are businesses reporting pressures to their input and labor costs, or concerns about how such pressures might evolve across sectors in 2025? Are Council members observing or foreseeing any trend in business's pricing power or pricing behavior?

Generally, Council members reported that pressure on business input and labor costs has stabilized; however, there are sectors where input costs remain elevated, including specialized manufacturing and construction. Labor costs, a significant driver of recent input inflation, are moderating as the labor market becomes more balanced, although one Council member has observed rising labor costs, especially for skilled workers and entry-level positions. To help relieve pressure on labor costs, businesses have been focused on operational efficiency and productivity improvements.

Certain businesses are concerned about the potential pressure from (1) higher input costs due to tariffs and (2) stronger wage growth due to immigration restrictions. One industry that is particularly vulnerable to the effects of immigration restrictions and expanded tariffs is construction. Expanded tariffs could push prices for many construction materials higher, and immigration restrictions could impact labor supply. The significant destruction in Los Angeles due to the wildfires, and the subsequent rebuild, could also impact the cost of building materials. Some manufacturing businesses have taken actions over the last few years to diversify sourcing to reduce the impact of tariffs. Inflation pressure continues to impact multifamily rents and residential costs.

Council members have observed that businesses are finding it difficult to increase prices and are remaining cautious about future pricing decisions. Pricing power remains strong in pharmaceuticals, health care, and other service sectors. Profit margins remain under pressure for small businesses, which may need to increase prices if input and labor costs increase further. Consumer savings continue to decrease, and some providers of discretionary services are offering discounts or payment plans to adapt to changing consumer behavior. The uncertainty regarding the cost impact of tariffs and immigration policy could impact business pricing behavior in 2025.

Item #4: Federal Reserve Policy

What are the Council's views on the stance of monetary policy, including portfolio activities?

Policy Rate

Council members generally are supportive of recent monetary policy, including the 100 basis points of cumulative rate cuts in the second half of 2024; however, they now believe that the Federal Open Market Committee (FOMC) should exercise patience based on recent trends in data. The unemployment rate increased from its historic lows, but the cooling in labor markets appears to be stalling with the rate now normalizing near its longer-run normal levels. Inflation continues to trend lower toward 2 percent; however, recent readings on core personal consumption expenditures have settled in between 2.5 and 3.0 percent, which remain measurably above the FOMC's 2 percent goal and do not yet reflect a complete return to price stability. Additionally, the threat of substantial tariffs on major trading partners is an important upside risk to near-term inflation forecasts and may challenge the Federal Reserve's ability to return inflation to its medium-term target. Given these recent trends and the uncertainty regarding potential fiscal policies, Council members recommend exercising patience during the first half of 2025 with a potential return to easing rates midyear if data warrants.

Portfolio Activities

Balance sheet normalization continues to run smoothly, with the quantitative tightening program draining more than $2 trillion in assets from the Federal Reserve's balance sheet since May 2022. In the near term, Council members expect it will be more challenging to discern changes in liquidity and funding conditions due to debt ceiling dynamics. The debt ceiling suspension ended at the beginning of January, and the Treasury Department will likely need to run its Treasury General Account (TGA) down in coming months to continue providing operational funds for the government while congressional leaders negotiate new legislation. The decline in the TGA may boost some combination of reserves and reverse repurchase agreements by a combined magnitude of approximately $750 billion, making liquidity conditions appear more ample. However, this improvement is purely optical and will disappear once new debt ceiling legislation is passed and TGA balances are restored to typical operational balances of $600 to $800 billion. Inferences around ample reserves should be made cautiously given the TGA and debt ceiling dynamics.

Item #5: The Outlook for Banking in 2025

What is the outlook for loan volumes, deposit flows, and credit quality in 2025? What will be the primary drivers of revenues, costs, and profitability? What sorts of risks and contingencies warrant particular attention?

Council members remain cautiously optimistic for the banking sector, as it is supported by resilient consumer and labor markets and easing interest rates. Looking ahead, Council members expect a gradual pickup in commercial bank loan volumes in 2025 driven by pent-up demand and improved corporate confidence. Council members anticipate modest consumer loan growth in 2025 and a gradual increase in commercial and industrial (C&I) loans as nominal interest rates and inflation gradually ease, and moderate real consumer spending and business investment growth continue. Lower interest rates and a business- and regulation-friendly administration could boost new loan demand and improve the borrowing environment as forecasted above. Additionally, banks have taken various measures to free up their balance sheets and now have more liquidity available.

Council members suggested that loan demand remains generally weak for consumer and commercial real estate (CRE) loans, though in most categories they are beginning to see some improvement in the trend. Consumer loan demand remains weakest for auto loans, and to a lesser extent for other consumer loans. Demand for residential mortgages remains historically weak but has improved in recent months. Demand for CRE loans continues to weaken, though the deterioration appears to have slowed in Q4 2024.

Bank deposits have been growing modestly and were up 1.9 percent year over year through early January 2025. Large time deposits are up 4.2 percent year over year, and other deposits were up 1.6 percent year over year. Deposit growth has slowed in all three of these deposit categories since November. Since the

Federal Reserve started hiking interest rates in March 2022, total bank deposits have fallen 2.3 percent and other deposits have declined 7.9 percent, but large time deposits have increased 70 percent from their pandemic low. Moving forward, Council members expect deposits to grow modestly in 2025 based on loan growth resuming, quantitative tightening ending, and an overall lower level of interest rates, which could drive more deposits back into the banking system. In the short term, Council members believe deposit rates will increase.

Credit availability and credit quality for consumer and C&I loans are expected to remain relatively unchanged in the year ahead. Credit quality remains relatively strong with the exception of CRE, health care, and higher education, which continue to experience significant deterioration. Provisions for credit losses appear to be plateauing, with only one-third of institutions recently increasing provisions and one-third keeping them unchanged. Those institutions increasing provisions cited loan growth, deterioration in the office markets, and elevated charge-offs in their credit card loan portfolios. Past-due and nonaccruals continued to rise in the third quarter of 2024 for nonfarm nonresidential CRE, credit card, multifamily, and auto loan portfolios.

Council members anticipate that 2025 will be a stronger year for revenue growth, positive operating leverage, and earnings growth for the industry after several years of weak loan demand and margin compression due to rising deposit costs. Banks are generally seeing improvement in net interest income and net interest margins as earning asset yields start to surpass the growth in cost of funds. Asset quality generally remains favorable with past-due nonaccruals remaining below the pre-pandemic average even as weakness in some portfolios persist. Stabilizing asset quality and improving net-interest margins are expected to be important drivers of bank profitability in 2025. Non-interest income has been held back by declining service fee revenue, though some banks are making up for this with higher trading revenues. Revenue growth will be influenced by balance sheet growth, the level of interest rates, the shape of the yield curve, as well as the ability to generate growth in fee income. Non-interest expense continues to rise, primarily due to rising salaries and benefit costs.

Several risks and contingencies with the potential to impact the outlook for banking in 2025 include geopolitics, trade protectionism, regulatory uncertainty, persistent inflation, interest rates staying high for an extended period of time, oil and gas prices, food costs, and potential supply chain issues. As mentioned earlier, CRE continues to be a watch item. Also, while borrowers are cautiously optimistic, it may take time to see growth as borrowers await final policies from the new administration. Uncertainties around trade, tariffs, and immigration policies create risks to growth. One District noted agricultural risks are particularly acute with persistently high production costs, lower commodity prices, and potential tariff-driven trade disruptions threatening farm incomes. Community banks in rural areas that are heavily reliant on agriculture should prepare for possible adverse impacts on their loan portfolios and broader economic conditions in their communities. Lastly, rising costs of managing both cyber and fraud risks, given the increasing sophistication of bad actors, negatively impact the outlook.

Item #6: Housing Supply

What are the most significant barriers to increasing the supply of housing? Have Council members observed or participated in any noteworthy initiatives or programs to increase housing supply? What are the "lessons learned"? To what extent are the successes replicable?

Barriers to Housing Supply

Housing supply has been inhibited by rising hard costs, increased permitting time, and higher interest rates impacting the affordability of housing—both in the multifamily and single-family spaces.

Hard construction costs, which make up 65 percent of a project's total cost and consist of 50/50 labor and materials costs, are 40 percent higher today than they were five years ago. The increase is attributable to several economic factors, including the following:

- *Longer project timelines* due to revolving and varying building standards; regulatory burdens at the state, county, and municipal levels in obtaining permits and managing zoning restrictions; and challenges to construction by residents. Projects in red states, such as Texas, typically take half the time to complete than projects in blue states, such as California and New York, though all project timelines have doubled regardless of geography in recent years (with increased delays in red states primarily resulting from overbuilding in coastal areas).
- *Labor shortages*, which are expected to continue to grow given that a significant number of hourly construction workers are likely undocumented.
- *Increasing materials costs* partly because of more stringent energy-efficiency requirements.

While it has been reported that hard costs decreased in the last six months by 2–4 percent, Council members noted that this is due to decreasing profit margins of general contractors and not to decreasing labor or material costs.

The aforementioned factors, coupled with mortgage financing costs that are more than 100 percent higher than they were a few years ago, have put home affordability out of reach for a large percentage of first-time home buyers.

Observations on Multifamily Housing

Today, more households are opting to rent than buy in part because the income required to rent a median apartment is more affordable today than it has been for the last 25 years. In contrast, the cost to own is high: nearly 60 percent of median household income. On average, it is at least 50 percent more expensive to own than it is to rent.

The math for affordable multifamily housing is simply hard to make work even with tax credits. Promotion of naturally occurring affordable housing projects—including by defining affordable rents for this purpose as affordable market rents, which are above government-subsidized rents, and ensuring broad permissibility for bank investment—is necessary to encourage development of additional affordable multifamily housing.

Observations on Single-Family Housing

With years of underbuilding of single-family homes after the 2008 financial crisis, the current shortage in single-family homes, including affordable housing, is estimated to be anywhere between 800,000 and 5,000,000 homes. As illustrated below, the cost to build an average single-family home (e.g., 2,200 square feet, three bedrooms, two and one-half baths, and a garage) increased by around 40 percent in the last five years. This is also reflected in the increase of the sales price and almost doubling of the mortgage payment on such homes.

Single-Family Home[1] 2,200 sq ft, 3 bedrooms, 2 ½ baths, and garage		
	2019	**Today**
Median Construction Cost	$114/sq ft = $250,800	$162/sq ft = $356,400
Median Net Sales Price	$138/sq ft = $303,600	$191/sq ft = $420,200
Mortgage Payment	3.9 percent	7 percent

[1] Construction costs and sales prices may vary based on a number of factors, including geography.

(30 year, 20 percent down)	$1,145/month	$2,236/month

In addition, the recent increases in insurance premiums due to natural disasters have put home ownership further out of reach.

Effectively addressing housing supply will require focus on the root causes of housing project delays to reduce hard costs of construction. Reducing regulatory burdens—particularly at the local level—by addressing complex zoning, permitting, and land use requirements could boost housing supply and increase housing affordability. Many areas of the country where the crisis is most acute (e.g., Los Angeles) have acted aggressively to ease regulatory delays.

Beyond this, financial assistance from banks, states, and local authorities has helped at the margin for first-time buyers. However, the variety of programs is almost endless, varying by state and county, and is exceptionally difficult for first-time buyers to navigate. More recently, banks have worked with community development financial institutions and their local communities to put in place dedicated non-commission-based loan officers to navigate the process.

Item #7: Downtown Office Space

Declining valuations for downtown office buildings pose ongoing financial challenges to their owners and their lenders, and ongoing economic and fiscal challenges to municipalities and their surrounding areas. Have Council members observed or participated in financially and economically viable initiatives to repurpose these buildings? What are the "lessons learned"? To what extent are the successes replicable?

Although office vacancy rates appear to be plateauing, they are nonetheless 50 percent higher than pre-pandemic levels in most major metropolitan markets. As a result, office real estate valuations are under increasing downward pressure due to (1) reduced cash flows and (2) loan renewals requiring updated appraisals. While most buildings continue to be able to cover debt service requirements, even given higher interest rates and other operating costs, the need to make greater equity investments in the property or pay down loan outstandings to recalibrate loan-to-value ratios is increasingly causing property owners to be in a standoff with their lenders or to simply walk away—leading to short sales that further drive down values, in many cases by 40–75 percent of 2019 levels. However, unless their buildings are vacant or substantially vacant with little hope of increased leasing activity, property owners are unlikely to capitulate to such a discount if they have the necessary resources to wait until market conditions improve or if they have an incentive to consider alternatives.

Coupled with a severe housing shortage, the increase in vacant space (currently estimated at about 1 billion square feet in the United States, an all-time high and enough to fill One World Trade Center in New York City 300 times) has naturally led to greater interest in exploring the potential for converting unused office space to multifamily residential and mixed-use properties. Unfortunately, given the inherent structural limitations of most office buildings—such as large floor plates, limited access to windows, high ceilings, centralized plumbing, and commercial HVAC and electrical systems—coupled with zoning requirements and higher construction costs, conversions to residential spaces are usually uneconomical, even if the value of the property has dropped to zero. And although the conversion of smaller, older, and more compartmentalized office space offers more viable opportunities, making those conversions work financially remains challenging.

The resulting negative impacts of (1) declining commercial property tax revenues upon municipal finances and (2) a reduction in downtown foot traffic on small businesses—whose financial models were built on a higher level of worker patronage—have caused city and state governments to provide increased incentives to facilitate office-to-residential conversions. These incentives typically have taken the form of expanded housing and historic tax credit programs, tax abatements, the relaxation of green energy requirements, municipal loan pools, and equity funding programs such as tax increment financing. Despite the rising attention and resources, office-to-residential conversions remain relatively rare, with current projects representing only about 2 percent of U.S. office inventory. To address the growing strain upon office real estate values and municipal finances, as well as the viability of downtown urban areas—while alleviating the lack of more affordable workforce housing—a greater public-partnership effort led by the federal government is necessary. For example, the Revitalizing Downtowns and Main Streets Act, which was introduced but not passed during the last congressional session, proposes to amend the Internal Revenue Code to provide an investment credit for converting nonresidential buildings to affordable housing.

Given the physical and economic challenges associated with office-to-residential conversions, greater creativity is also necessary with respect to the design of these new living spaces. Office space is, by definition, essentially communal living. Providing incentives for downtown colleges and universities to acquire and repurpose office buildings into dormitories could not only provide an additional profit center through expanded room-and-board revenues but also facilitate a reduced absorption of rental properties by college students, making those properties more available to individuals and families. Similarly, partnerships with industries such as retail, hospitality, and health care to make such temporary or permanent housing available to their employees and other young professionals would further alleviate the strain on apartment supply.

Although increased tax incentives and other sources of government funding are critical to facilitating a greater degree of office-to-residential conversions, greater coordination among these programs is needed to ensure a more efficient and effective impact by overcoming often conflicting specifications and requirements. Other success factors are required such as strong development experience; streamlined zoning, permitting, and other regulatory processes and requirements; and greater efforts to overcome the "not in my backyard" resistance. Cities such as Chicago, Cleveland, Cincinnati, Dallas, Minneapolis, New York, and Washington, D.C., are demonstrating increasing success in building their office-to-residential conversion pipelines; thus, greater investigation into identifying replicable approaches is warranted.

Unfortunately, even allowing for substantially more financial and other resources, demolition of many office buildings remains a more likely and efficient outcome, albeit a more painful one. While demolitions will place additional pressure on bank credit losses, Council members believe this remains a very manageable risk given the relatively low proportion of industry loan portfolios comprised of investor office real estate loans. Greater exposure to a permanent impairment in office real estate values is borne by life insurance companies, pension plans, the commercial mortgage-backed securities market, private lenders, and other investors—but that exposure is distributed among these various sectors and parties. Overall, the most significant negative impacts will likely be experienced by municipal budgets in major urban markets. Although residential conversions can increase downtown vibrancy, the increase in downtown economic activity will be significantly and perhaps entirely offset by the negative differential between commercial and residential property tax rates as well as the cost of tax abatements and other incentives necessary to facilitate them.