“Financial Stability Considerations and Monetary Policy?”

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Anil K Kashyap and Caspar Siegert*

** These our own views and not those of the Bank of England or its policy committees*

CHICAGO BOOTH
The University of Chicago Booth School of Business

Basic Argument

- Both during the GFC and now (according to the Fed's Financial Stability Report), major vulnerabilities exist with respect to:
  - Activities outside the traditional banking system.
  - Excessive real economy debt build ups.

- Neither the Fed nor the Financial Stability Oversight Council can do much about these kinds of problems.

- Two way interactions between monetary policy and financial stability
  - When these threats metastasize, they make it hard for monetary policy to operate effectively.
  - And monetary policy choices can increase the odds of the problems arising.

- So it's in the Fed's interest for Congress to fill the void in the responsibility and the ability to deal with these problems.
  - We suggest a technical advisory Commission

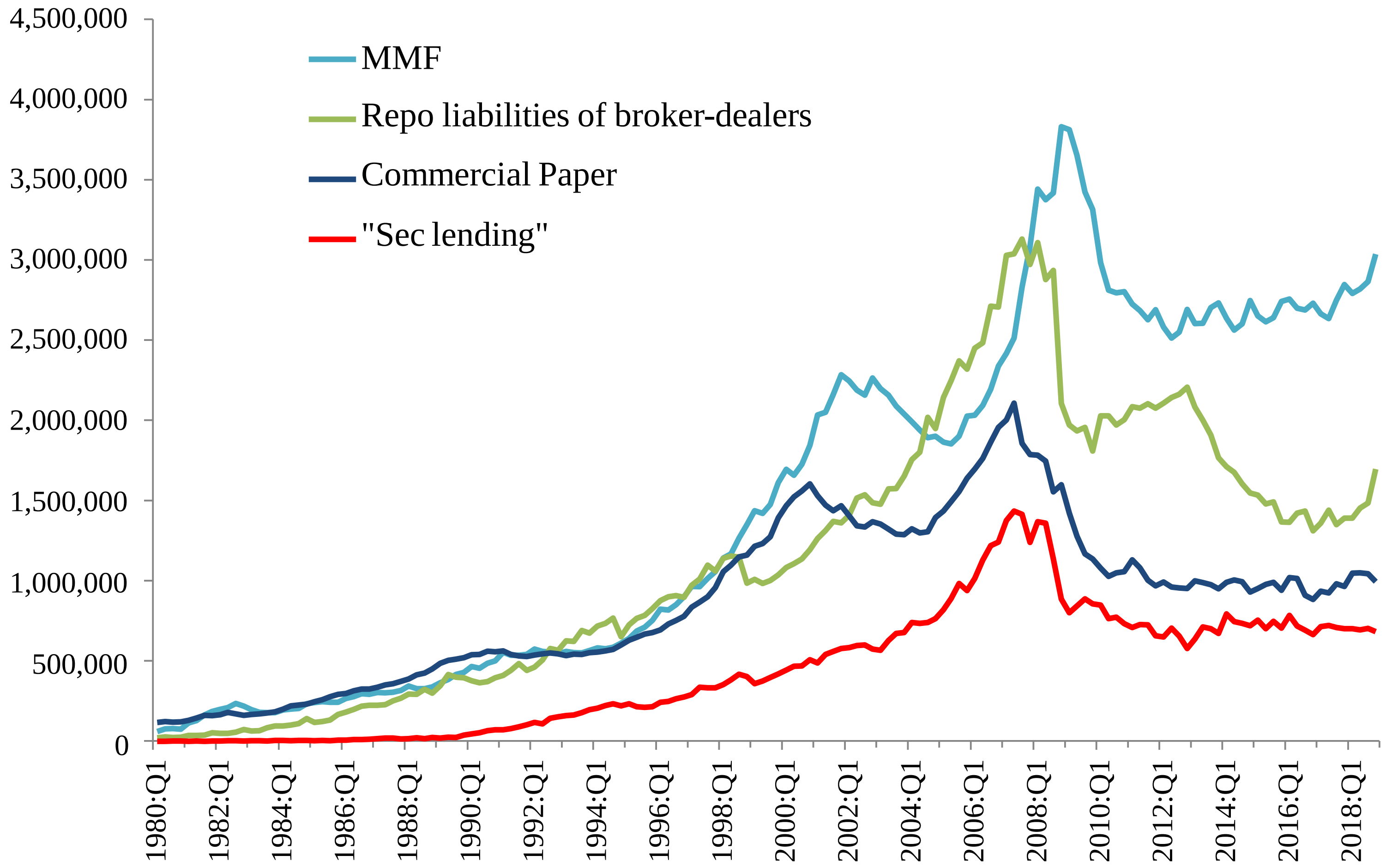
Fault lines that led to the global financial crisis

1) Build-up of leverage in the shadow-banking system

Size, leverage, and liquidity risk of leveraged financial institutions								
	2001Q4				2007Q4			
	Assets ($bn)	Leverage	Liquid assets	Short-term funding	Assets ($bn)	Leverage	Liquid assets	Short-term funding
Commercial banks	6,552	11.0	6.6%	26.5%	11,182	9.8	4.6%	33.2%
Savings Inst.	1,317	11.6	3.0%	18.2%	1,852	9.1	2.3%	22.6%
Broker-dealers	2,376	28	2.4%	57.3%	4,686	45	0.4%	63.4%
GSEs	1,417	42.3	0.2%		1,677	23.7	0.7%	
Total	12,657				19,397			

Fault lines that led to the global financial crisis

2) Growth of short-term funding in the shadow-banking system



Fault lines that led to the global financial crisis

3) Increase in the share of highly indebted households

The heavily-indebted tail and marginal borrowers					
	2001Q4	2004Q4	2006Q4	2007Q4	2017Q4
			-		
LTV > 90%	9.5%	9.4%	-	9.4%	10.6%
Debt to income >4x	6%	11%	-	13.2%	10.7%
DSR > 40%	16.9%	17.3%	-	20.2%	13.9%

What would it have taken? What is feasible?

1) **Impose higher capital and liquidity requirements on broker-dealers and other shadow-banks.**

- FSOC could issue a "comply or explain" recommendation to primary regulator. But <u>no clear process for extending regulatory perimeter.</u>

- Fed now has authority over banking groups. But also <u>no clear process for extending regulatory perimeter.</u>

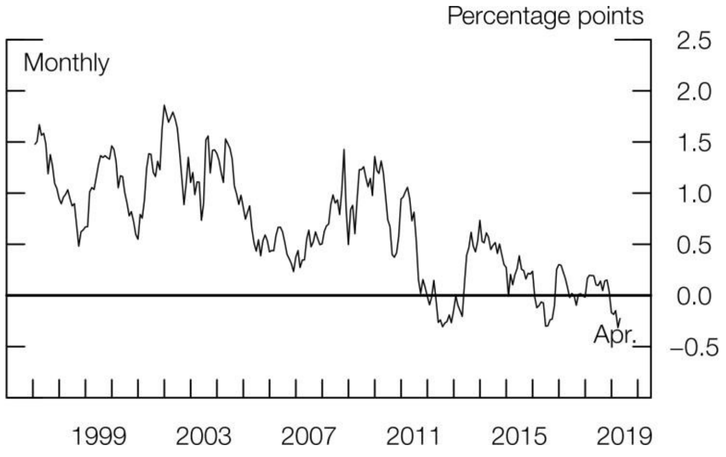
2) **Limit the build-up in household debt**

- U.S. regulators <u>lack a clear mandate and tools</u> to lean against a dangerous build-up in borrower indebtedness.

Risks identified in the current FSR

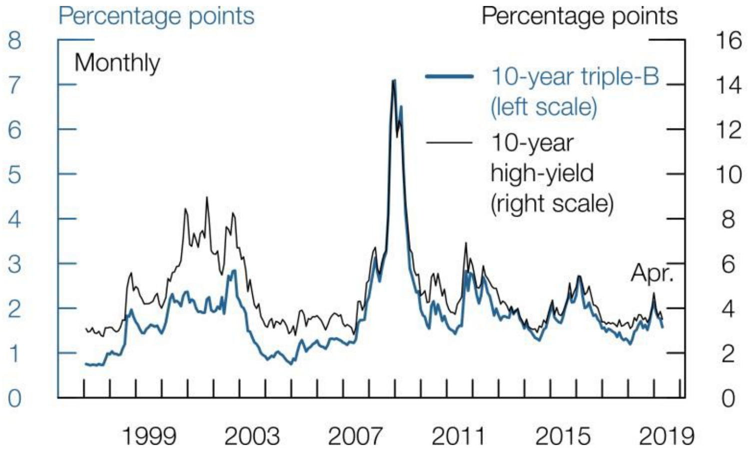
1) Elevated Asset Valuations

Term Premium on 10-Year Nominal Treasury Securities



Source: May 2019 FSR

Corporate Bond Spreads to Similar-Maturity Treasury Securities

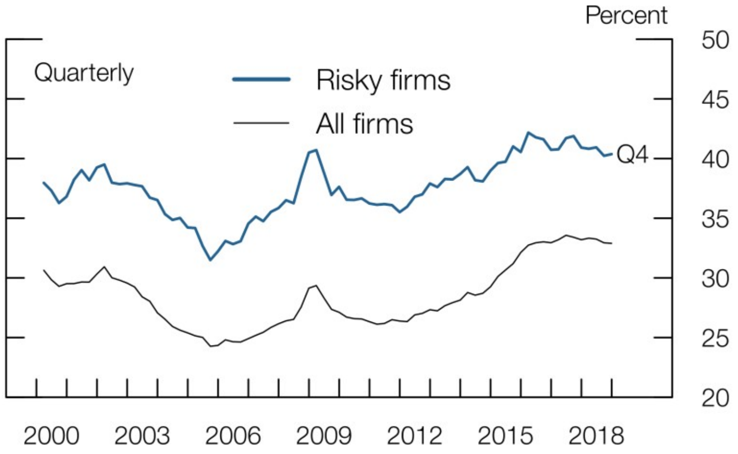


Source: May 2019 FSR

Risks identified in the current FSR

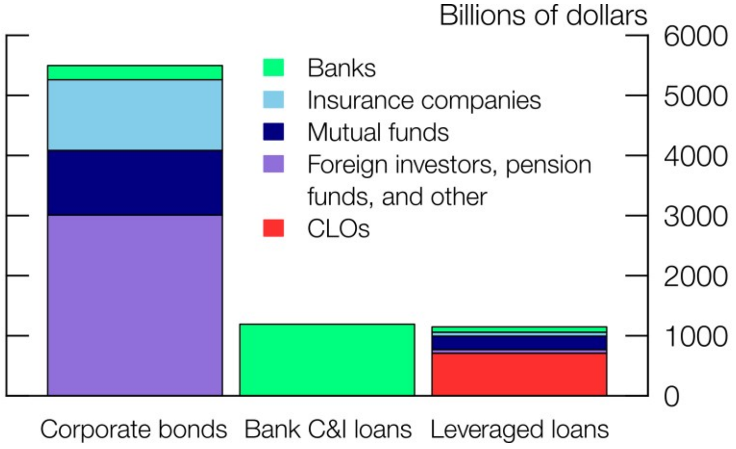
2) Corporate Indebtedness

Gross Balance Sheet Leverage of Public Nonfinancial Corporations



Source: May 2019FSR

Corporate Debt, by Type of Debt and Holder



Source: May 2019FSR

What might it take? What is feasible?

1) **Build resilience against potential fall in asset prices.**

- FSOC could issue a "comply or explain" Recommendation to primary regulator to increase resilience. But many assets (incl. CLOs) are held by non-banks and no clear process for extending regulatory perimeter.

- Fed also does not have a clear process for extending regulatory perimeter.

2) **Limit the build-up in corporate debt.**

- U.S. regulators lack a clear mandate and tools to lean against a dangerous build-up in corporate indebtedness – see controversy around "*Interagency Guidance on Leveraged Lending*"

Why worry?

Because Monetary Policy and Financial Stability are Intertwined

- The two examples above show that the Fed can not count on others to address all potential financial stability risks. Nonetheless,

A. Financial instability can threaten price stability

- Estimates of the neutral nominal interest rate: $\approx$ **2.5%**
- Reduction in Fed funds rate in an average recession: **5-6pp**
- Appropriate reduction in the global financial crisis: **9pp**
- So following another financial crisis the Fed would likely be stuck at the effective lower bound.

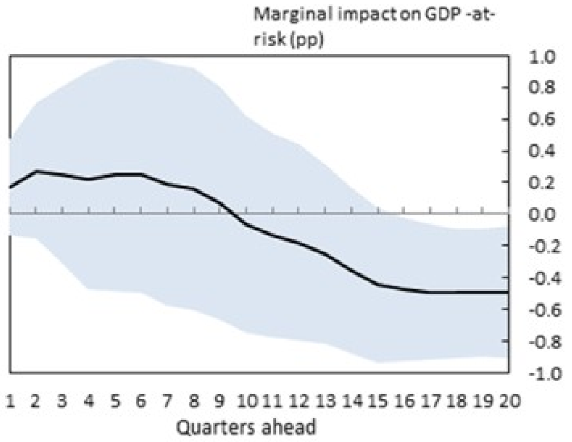
Why worry?

Because Monetary Policy and Financial Stability are Intertwined

B. And monetary policy can affect financial stability

- E.g.: quantitative easing can lead to a compression in term premia.
- Compressed term premia mean investors receive less compensation for interest rates risk.
  - This might support asset prices in the near term – but leave investors more vulnerable to changes in interest rates in the future.
  - Similarly, it can reduce DSRs in the short-run – but encourage higher leverage in the long-run

Impact of a one std. deviation compression in term premia on the 10th percentile of GDP (in percentage points)



Conclusion

- It does not seem credible for the Federal Reserve to just ignore regulatory underlap. This leaves three options:
    - Hope Congress reviews the design and powers of the FSOC.
    - Ask Congress to give the Fed an explicit financial stability mandate and the necessary tools to deliver.
    - Conclude financial stability is a necessary condition for monetary stability, and use monetary policy to "lean against the wind".

- Lots of rethinks about the appropriateness of post-crisis reforms. As part of this, we should also consider regulatory underlap.

- **Ask for an expert commission (similar to Commission on Evidence Based Policymaking) to consider these alternatives.**