Monetary Policy and Financial Stability

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Manchester, New Hampshire
March 27, 2013
Economy Improving Slowly

- Despite headwinds – problems in Europe and more fiscal austerity in the U.S. than many expected – the economy is slowly improving

- Large-scale asset purchases (LSAPs) have helped interest-sensitive sectors and are helping to offset fiscal headwinds

- With unemployment at 7.7 percent and PCE inflation at 1.2 percent, the economy remains far from where we want it to be
Despite benefits of LSAPs, how large are the costs?

Inflation remains low, and that is expected to continue

Financial stability – need to monitor closely, but seeing little evidence that monetary policy is causing significant financial stability problems at this time

In short, benefits currently outweigh costs
Figure 1
Growth in Real GDP Components
2011 and 2012

Percent Change from Year Earlier

Residential Investment
Consumer Durable Goods
Federal Government Spending
State and Local Government Spending

Source: BEA / Haver Analytics
Figure 2
Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents

September 2012 and March 2013

Source: Federal Reserve Board
Benefits of LSAPs

- Help reduce longer-term rates – promote economic growth and more quickly return to full employment with stable prices
- FRB Boston uses two models – one structural, one statistical
- Both imply roughly $500 billion in asset purchases result in one-quarter point reduction in unemployment – almost 400,000 jobs
- Estimate is model dependent, subject to estimation error
Potential Cost: Inflation

- Potential that inflation or inflation expectations could rise too quickly
- Federal Reserve balance sheet expanded significantly in 2008, and almost five years later, PCE inflation is 1.2 percent – well below 2 percent target
- This provides the Fed the ability to take monetary policy actions to encourage stronger growth
Potential Costs: Financial Instability

- Potential that interest rates at zero lower bound may induce investors to take on excessive risk
  - Too much credit risk
  - Too much interest rate risk

- Intent of policy, in part, is to encourage households and firms to not be excessively risk averse – i.e., to encourage responsible risk-taking that advances real economic activity and growth
Figure 3
S&P 500 Composite Stock Price Index

January 1993 - February 2013

Source: S&P, NBER / Haver Analytics
Figure 4
S&P 500 Composite Price/Operating Earnings Ratio

January 1993 - February 2013

Source: S&P, NBER / Haver Analytics
Figure 5
U.S. Regional Home Prices:
S&P/Case-Shiller Metro Area Indexes

March 2006 - January 2013
Index Level March 2006 = 100

Source: S&P/Case-Shiller / Haver Analytics
Figure 6
Price-to-Rent Ratio
1993:Q1 - 2012:Q4

Index Level 1993:Q1=100

Source: S&P/Case-Shiller, BLS / Haver Analytics
Figure 7
High-Yield Bonds:
S&P 10-Year BB+ Industrials Bond Yield

March 1996 - February 2013

Source: S&P / Haver Analytics
Figure 8
High-Yield Bond Spread: S&P 10-Year BB+ Industrials Bond Yield to 10-Year U.S. Treasury Yield

March 1996 - February 2013

Source: S&P, Federal Reserve Board / Haver Analytics
Figure 9
Rates on Mortgage Loans, Auto Loans, and High-Yield Bonds
January 2011 - February 2013

Source: FHLMC, WSJ, S&P / Haver Analytics
Figure 10
Tier 1 Common Capital Ratio for Large U.S. Banking Organizations
2007:Q1 - 2012:Q4

Note: Includes 14 large banking organizations that filed the FR Y-9C throughout the six-year period
Source: Consolidated Financial Statements for Bank Holding Companies (FR Y-9C)
Figure 11
Agriculture-Related Loans as a Share of Assets at Commercial and Savings Banks by Asset Size

December 31, 2012

Bank Asset Size as of December 31, 2012

Note: Includes agricultural production loans and real estate loans secured by farmland
Source: Commercial and Savings Bank Quarterly Call Reports
Risks Seem Manageable

- Broad-based financial stability concerns do not seem acute at this time
- Falling interest rates and rising asset prices are expected results of the policy
- With improvement in economic outlook, accommodation can be withdrawn
- Nonetheless, financial stability concerns need to be monitored
Areas to Monitor Closely

- Underwriting standards – decline in covenant quality for leveraged loans and high-yield bonds
- Short-term borrowing to finance long-term assets – e.g., agency REITS
- Run risks exposed in financial crisis and not yet resolved – e.g., MMMFs, reliance on wholesale funding, broker-dealers
Concluding Observations

- The economy continues to improve, but at a painfully slow pace
- Benefits of Fed policy actions are clear from improvement in interest-sensitive sectors
- Need to monitor for potential financial stability problems – but at this time the benefits of our programs outweigh the costs