Monetary, Fiscal, and Financial Stability Policy Tools: Are We Equipped for the Next Recession?

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Jan Hogendorn – First Grossman Professor

- 1978 Inaugural Grossman Lecture
- 1978 - 2001 Jan gave this lecture
  - 1979 “Economics of War”
  - 1986 “The Economics of Health Care – a Prescription”
  - 1987 “The False Promise of Protectionism”
  - 1996 “Our Banks Are Changing and We Must Be Sure that They Are Safe”
  - 2001 “175 Years of Economics at Colby”
Much of my own research has focused on the ways that problems in the financial system can ripple through to the real economy.

Certainly the last financial crisis – and the ensuing Great Recession and very slow recovery – underlined the role that financial instability can play in disrupting the economy and in slowing its recovery.

Emphasized the need for policy tools that can be deployed to attempt to prevent financial instability, as well as minimize the effects of instability when it does emerge.
Financial Stability Tools

- Generally associated with regulatory and supervisory measures
- Often viewed as independent from the stance of monetary and fiscal policy
- I view financial stability tools more holistically
  - Integrally related to the ability to fully utilize fiscal and monetary tools to respond to adverse shocks
  - If other tools are limited (fiscal and monetary), need greater financial stability policy buffers
Figure 1: Mentions of Financial Instability in FOMC Meetings and Periods of Instability

Response to Adverse Shocks

- Prevention of financial stability problems is critically important but not the focus of my talk tonight.

- Focus tonight is on tools that are available to policymakers once a significant adverse financial shock occurs (that is, crisis response):
  - Fiscal, monetary, and financial tools can all play a role in offsetting the economic fallout.
  - If monetary and fiscal policy have limited capacity to respond to such shocks – then need greater buffers from financial stability tools.
Responses to Large Adverse Financial Shocks Require a Broad Set of Tools

- Fiscal tools – cutting taxes and increasing government spending
- Monetary policy tools – reducing interest rates and expanding the central bank’s balance sheet
- Financial stability tools that provide sufficient buffers
Calibration of Financial Stability Tools

- Normally calibrated to the severity of likely economic stresses
- But important to take into account, how equipped fiscal and monetary policy are to respond
  - If government-debt-to-GDP ratio is high – limits the ability or willingness to use fiscal tools to offset financial and other shocks
  - If interest rates are already at or near the effective lower bound, and the country is unable or unwilling to use less-conventional monetary tools – limits capacity of monetary policy to respond
Good Current Conditions in U.S., But are We Ready for Hypothetical Adverse Shocks?

- U.S. has actually seen a reduction in the capacity of these so-called “buffers” across the policy tools
- There are implications if fiscal and monetary policy tools are likely to be limited
- Need to create greater capacity and flexibility within the tools currently available, including those most directly related to financial stability
Figure 2: Federal Funds Rate
January 1987 - December 2008

Source: Federal Reserve Board, NBER, Haver Analytics
Figure 3: Forecasts for the Longer-Run Federal Funds Rate from the Summary of Economic Projections

January 2012 - March 2018

Note: The central tendency excludes the three highest and three lowest observations.

Source: FOMC, Summary of Economic Projections (SEP)
Figure 4: Federal Funds Rate, Noting Peaks and Troughs
January 1960 - March 2018

Source: Federal Reserve Board, NBER, Haver Analytics
Alternative Monetary Policy Framework

- Given low prevailing rates, could reduce likelihood of hitting effective lower bound, particularly if unconventional policy has limits
- Other monetary policy frameworks may reduce likelihood of hitting effective lower bound
- Alternatively, if monetary policy may be limited may want greater fiscal or financial stability buffers
Figure 5: Federal Government Surplus or Deficit as a Percentage of GDP

1987:Q1 - 2008:Q4

Note: Figures are four-quarter moving averages.
Source: BEA, U.S. Treasury, NBER, Haver Analytics
Fiscal Limitations

- Impact the choices that policymakers have to utilize potential financial stability tools
- In the last crisis the U.S. provided direct capital infusions into the financial system
  - Arguably limited the severity of credit crunches
  - Promoted a quicker recovery in the financial sector in the U.S. relative to Europe
- Such actions require a fiscal buffer making it possible to finance the effort
Figure 6: General Government Gross Debt as a Percentage of GDP
1990 - 2022

Note: Actuals are through 2017 for the U.S. and 2016 for all other countries. CBO projections for the U.S. (2018 - 2022) were released on April 9, 2018 and include the recent tax changes and increases in the federal budget.

Source: OMB (U.S.), CBO (U.S.), IMF (France, Germany, U.K.), Haver Analytics
European Challenges in the Last Recession

- Southern European countries experienced serious fiscal problems in addition to serious banking problems.
- Those countries in Europe with less severe banking problems but substantial fiscal capacity, did not want to use their fiscal capacity to resolve banking problems in other European countries.
- As a result, the banking problems could not be easily resolved with capital infusions.
- Fiscal capacity problems caused difficulties in resolving financial stability problems, making both worse.
Financial Stability Tools in the U.S. are Limited

- The two primary financial stability tools available to the Federal Reserve
  - Altering the scenarios used in the bank stress tests that are applied to the largest banks
  - Setting of the countercyclical capital buffer
- Other countries have much larger set of tools and more flexibility to use them
The stress test is primarily a microprudential tool.
- Designed to ensure sufficient capital for banks in the event of a large financial shock.
- By “stressing” particular assets, the test alters the cost of capital for that asset class.

Firms’ post-stress capital may decrease (or increase) relative to reported capital by varying magnitudes, depending on the mix of assets and hence the mix of risks.
Countercyclical Capital Buffer

- The countercyclical capital buffer is intended to be a macroprudential tool.
- The buffer increases capital for all financial firms it applies to during periods of financial excess, but is intended to release capital during stressful periods.
- Because it is not related to particular stress scenarios, it does not alter the cost of capital for specific assets.
Figure 7: Unemployment Rates and Stress Tests: Actual and Severely Adverse Scenario Peak

2009 - 2018

Note: There was no stress test in 2010.
Source: Federal Reserve Board
Stress Tests and Credit Availability

- Stress tests as currently utilized may not effectively release capital in a crisis
- Could encourage banks to reduce credit availability to shrink assets to satisfy binding capital constraints
- Examine the possibility of unintended consequences and assess whether stress tests may work at cross purposes to other tools designed to speed the recovery from a negative financial shock
- Other tools may be better designed to release capital to avoid reductions in credit availability
Note: Based on implementation date, which is generally twelve months after announcement. The U.K. initially announced a CCyB of 0.5% in March 2016, with an implementation date of March 2017, however in July 2016 the CCyB was lowered to 0%.

Source: European Systemic Risk Board, Bank of England, Hong Kong Monetary Authority
Figure 9: Capitalization Rates by Property Type

2001:Q1 - 2017:Q4

Note: The capitalization or “cap” rate is the ratio of net operating income produced by a property to the price paid, calculated at the time of a transaction. Based on properties of $2.5 million or more.

Source: Real Capital Analytics, NBER, Haver Analytics
Figure 10: Real Commercial Property Price Indices by Property Type
2000:Q4 - 2017:Q4

Note: Indices are adjusted for inflation using the GDP deflator. Indices are repeat-sales based and include properties of $2.5 million or more.

Source: Real Capital Analytics, BEA, NBER, Haver Analytics
Figure 11: Distribution of S&P 500 Composite Price to Earnings Ratios
June and December, 1968 - 2017

Note: Excludes 2 outliers – Dec 2008 (60.7) and Jun 2009 (122.4)

Source: S&P, Haver Analytics
Figure 12: Distribution of Shiller Cyclically-Adjusted S&P 500 Composite Price to Earnings Ratios
June and December, 1968 - 2017
Concluding Observations

- Now is the time to assess and strengthen the various policy tools – yet the tools have actually been diminishing
  - Monetary policy buffer has essentially been depleted as the nominal equilibrium interest rate has fallen
  - Government-debt-to-GDP ratio is high by historical standards in many countries, but we see that it is rising in the U.S., potentially constraining flexibility to respond to a shock
  - Countercyclical capital buffer, which was designed to be released in response to a large adverse financial shock, is currently set at zero
Many countries are not well equipped to address an adverse financial stability shock.

In the U.S., one can see that monetary, fiscal, and macroprudential buffers are modest, and in many cases are being drawn down further.

Now should be the time that policymakers assess which tools could provide more potent buffers to draw upon should a large adverse financial shock occur.