Ethics and Economics: Making Cyclical Downturns Less Severe

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bostonfed.org
John Olcay was an astute student of financial markets

I had the pleasure of getting to know John through periodic trips he made to Boston during the financial crisis

He was concerned about the implications of serious economic downturns – my topic today

Ethics is not a prevalent part of the curriculum of economics
More Attention to Distributional Implications of Policy

▶ My view – negative outcomes in the economy, and subsequently their costs, are distributed disproportionately, which has ethical dimensions

▶ Policymakers can make policy choices that mitigate the impact of economic downturns – which would help those who can least afford the costs

▶ Today will focus on state and local government spending, bank regulatory policy, and monetary policy – though there are many other examples
Figure 1: Inflation Rate: Change in Core Personal Consumption Expenditures (PCE) Price Index
1960:Q1 - 2018:Q1

Note: Core PCE excludes food and energy.
Source: BEA, NBER, Haver Analytics
Figure 2: Unemployment Rate
1960:Q1 - 2018:Q1

Percent
12
10
8
6
4
2

Recession

Source: BLS, NBER, Haver Analytics
What are the Consequences of Not Mitigating Downturns?

- Parts of our population are disproportionately hurt in economic downturns
- Those with less education are more likely to experience unemployment
- Dependents of the unemployed are severely impacted
Figure 3: Unemployment Rate by Race and Ethnicity
1972:Q1 - 2018:Q1

Note: Based on labor force age 16 and older. Persons whose ethnicity is identified as Hispanic or Latino may be of any race.

Source: BLS, NBER, Haver Analytics
Figure 4: Unemployment Rate by Educational Attainment
1992:Q1 - 2018:Q1

Note: Based on labor force age 25 and older.
Source: BLS, NBER, Haver Analytics
Figure 5: Poverty Rate of Children Under Age 18 and the Unemployment Rate 1960 - 2016

Note: The poverty rate is annual, the unemployment rate is quarterly. The most recent poverty rate is for 2016.

Source: U.S. Census Bureau, BLS, NBER, Haver Analytics
State and Local Government Spending

- Current policies are procyclical – aggravate a downturn or add additional fuel to an already humming economy
  - Balanced budget requirements result in government spending declines at times when spending is most needed
  - Focus on federal fiscal policy but state and local government spending is large
    - State and local government spending accounts for 11 percent of U.S. GDP
    - Residential investment is 4 percent and federal government spending is 7 percent
Figure 6: Growth in Real State and Local Government Spending and the Unemployment Rate 1960:Q1 - 2018:Q1

Source: BEA, BLS, NBER, Haver Analytics
## Figure 7: Changes in S&P State Credit Ratings
June 1, 2013 - June 1, 2018

<table>
<thead>
<tr>
<th>Changes</th>
<th>Number of States</th>
<th>1 Change</th>
<th>2 Changes</th>
<th>3 Changes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Downgrades</td>
<td>24</td>
<td>14</td>
<td>7</td>
<td>4</td>
</tr>
<tr>
<td>Upgrades</td>
<td>9</td>
<td>8</td>
<td>7</td>
<td>1</td>
</tr>
<tr>
<td>No Change</td>
<td>29</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: While 29 states saw no change, one state saw both an upgrade and a subsequent downgrade. As a result, the states add to 51. In some instances an Issuer Credit Rating is used instead of a general obligation debt rating.

Source: S&P Capital IQ
Structure of State and Local Government Spending

- Little focus on macroeconomic consequences
  - Tax code can be highly cyclical
  - Spending cut in economic downturns
  - Small rainy day funds and lingering pension problems

- My view – now is the time, when the economy is robust, to make changes that will mitigate the next downturn

- While hard, given competing goals, states should reassess their revenue structure and fiscal approach with an eye on cyclical downturns
Bank Regulation

- Focus on safety and soundness – viability of financial institutions is important
- Structure currently encourages banks to shrink during economic downturns to maintain minimum capital-to-assets ratios
- A bank can choose to either raise capital or shrink assets to restore the ratio
  - Raising capital is costly during economic downturns and generally opposed by existing shareholders
  - Banks most often shrink assets (loans are key assets) which results in less lending at just the time the economy may need stimulus
Figure 8: Nonperforming Loans at U.S. Banks and the Unemployment Rate
1989:Q1 - 2018:Q1

Note: Nonperforming loans are loans 90 or more days past due plus loans in nonaccrual status. U.S. banks include commercial and savings banks throughout the period and the former OTS-regulated thrifts beginning in 2012.

Source: Quarterly Bank Call Reports, BLS, NBER, Haver Analytics
**Figure 9: Stylized Depiction of the Impact of the Countercyclical Capital Buffer (CCyB)**

<table>
<thead>
<tr>
<th>Impact of a 3% Loss on Capital [without CCyB]</th>
<th>Impact of a 3% Loss on Capital [with CCyB]</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Pre-Loss Capital Position</strong></td>
<td><strong>Pre-Loss Capital Position</strong></td>
</tr>
<tr>
<td>Mgmt Excess Buffer (2.0%)</td>
<td>Mgmt Excess Buffer (2.0%)</td>
</tr>
<tr>
<td>Required Buffer 1 (2.5%)</td>
<td>Required Buffer 1 (2.5%)</td>
</tr>
<tr>
<td>Required Buffer 2 (2.5%)</td>
<td>Required Buffer 2 (2.5%)</td>
</tr>
<tr>
<td>Minimum Capital Requirement (4.5%)</td>
<td>Minimum Capital Requirement (4.5%)</td>
</tr>
<tr>
<td>Losses (3.0%)</td>
<td>Losses (3.0%)</td>
</tr>
<tr>
<td>Minimum Capital + Required Buffers</td>
<td>Minimum Capital + Required Buffers</td>
</tr>
<tr>
<td><strong>Post-Loss Capital Position</strong></td>
<td><strong>Post-Loss Capital Position</strong></td>
</tr>
</tbody>
</table>

**Note:** Required Buffer 1 is the Global Systemically Important Bank (GSIB) surcharge, which is the additional capital held by the largest, most systemically important banks. The 2.5 percent level is an average calculated using FR Y-15 data as of December 2017. Required Buffer 2 is the Capital Conservation Buffer, which is set at 2.5 percent and applies to all supervised financial institutions. The 2 percent Management Excess Buffer is computed as the median buffer for the largest, most systemically important banks in the U.S., as of March 2018.

**Source:** Federal Reserve Bank of Boston
Bank Regulation Could Reduce Procyclicality

- Countercyclical Capital Buffer – a regulatory tool that can be used to build buffers in good times, when there are relatively rich asset valuations
- Countercyclical Capital Buffer currently used in many European countries and Hong Kong
- Would enable more flexibility in the next downturn to avoid pullback in lending
Figure 10: The Federal Funds Rate and the Unemployment Rate
1960:Q1 - 2018:Q1

Source: Federal Reserve Board, BLS, NBER, Haver Analytics
Figure 11: Forecasts for the Longer-Run Federal Funds Rate from the Summary of Economic Projections

January 2012 - June 2018

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

Source: FOMC, Summary of Economic Projections (SEP)
Avoid Hitting Zero with Short-Term Interest Rates

- Monetary policy cannot change productivity or demographics – so a federal funds rate of zero is a real possibility in future downturns
- Have tools, such as the balance sheet, but these alternative tools may be less effective and are certainly less well understood
- Proposals that provide more flexibility with the inflation target – possibly with more focus on an inflation range – lower the risk of short-term rates hitting zero in the future
Figure 12: The Unemployment Rate and the Natural Rate of Unemployment
1960:Q1 - 2018:Q1

Note: The vertical lines mark the beginnings and ends of recessions.
Current Policy

- When the economy runs significantly above capacity, a recession normally ensues
- Correcting imbalances – higher wages and prices or higher asset prices – can be quite difficult
- Focus on getting a long recession-free period rather than pushing the economy too hard
- In my view, the policy path that will increase the probability of a longer recession-free period is the path where the economy does not run above capacity and thus fall far below the sustainable unemployment rate
Concluding Observations

- The costs of economic downturns – and the uneven distribution of their impact – are in fact ethical issues
- In my view, policy can significantly mitigate downturns
  - More active discussion of possible alternative policies, such as I have highlighted for fiscal, supervisory, and monetary policymakers, are needed
  - Take precautions during the good times for the inevitable future downturns
  - Policymakers could continue and perhaps expand their efforts to make cyclical downturns less severe