Observations on Financial Stability Concerns for Monetary Policymakers

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Global Growth

- The global economy continues to underwhelm
  - Disappointing economic performance has led central banks in many developed countries to reduce interest rates
  - Low rates have impacted financial intermediaries
  - Many developing economies are still suffering from the decline in global commodity prices
- United States: real GDP growth below 2 percent in the first two quarters of 2016
U.S. Economy Still Fundamentally Strong

- Unemployment is currently 4.9 percent – close to “full employment”
- Core inflation gradually rising – currently 1.6 percent
- Expect inflation target of 2 percent and full employment – goals of U.S. monetary policy – to be achieved relatively soon
- Monetary policy in the U.S. has been appropriately patient – in support of improving labor markets and reaching our 2 percent inflation target
Potential Risks to a Prolonged Period of Low Interest Rates

- Potential “Reaching for Yield” – buying riskier assets to achieve a desired profit or savings goal
  - Firms take on risk to achieve profit margins
  - Households take on risk to achieve savings goals
- May generate costs in the future if there is a large negative shock
- Policymakers must weigh this risk against the benefits of low rates in supporting the economy
- Possible example – commercial real estate, where prices have risen significantly and cap rates are hitting historic lows
Figure 1: Growth in Real GDP and Real Commercial Real Estate Prices in the United States
1986:Q1 - 2016:Q1

Note: The commercial real estate price index is adjusted for inflation using the GDP deflator.
Source: BEA, Federal Reserve Board, NBER, Haver Analytics
Figure 2: U.S. Commercial Real Estate by Lender Type

2016:Q1

<table>
<thead>
<tr>
<th>Lender Type</th>
<th>Commercial Mortgages</th>
<th>Multifamily Residential Mortgages</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Billion Dollars</td>
<td>%</td>
<td>Billion Dollars</td>
</tr>
<tr>
<td>Banking Institutions¹</td>
<td>1,494.0</td>
<td>59</td>
<td>388.6</td>
</tr>
<tr>
<td>Banks with over $50 Billion in Assets²</td>
<td>552.7</td>
<td>164.6</td>
<td>717.3</td>
</tr>
<tr>
<td>Life Insurers and Other Long-Term Investors³</td>
<td>369.7</td>
<td>15</td>
<td>66.4</td>
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<tr>
<td>GSEs &amp; Agency CMBS</td>
<td>0.0</td>
<td>0</td>
<td>472.5</td>
</tr>
<tr>
<td>Non-Agency CMBS</td>
<td>498.1</td>
<td>20</td>
<td>61.2</td>
</tr>
<tr>
<td>Finance Companies</td>
<td>27.8</td>
<td>1</td>
<td>1.2</td>
</tr>
<tr>
<td>Nonfinancial (Other)⁵</td>
<td>133.1</td>
<td>5</td>
<td>121.2</td>
</tr>
<tr>
<td>Total</td>
<td>2,522.8</td>
<td>100</td>
<td>1,111.1</td>
</tr>
</tbody>
</table>

¹Includes U.S.-chartered depository institutions, foreign banking offices in the U.S. and banks in U.S.-affiliated areas.
²Includes commercial and savings banks and thrifts with assets over $50 billion. Author’s estimates using call report data.
³Includes life and property-casualty insurance companies, private pension funds, and state and local government retirement funds.
⁴Includes REITs.
⁵Includes households, nonfinancial corporate and noncorporate businesses and federal and state and local governments.

Source: Federal Reserve Board, Financial Accounts of the United States, Quarterly Call Reports, Haver Analytics
By themselves, exposures unlikely to trigger problems – could aggravate economic downturn

- Weaker economy could trigger lower commercial real estate collateral values with potential problems for leveraged firms
- Banks may pull back on lending, reducing access to credit for firms and households
- Consistent with recession where collateral values declined in the U.S.

- Real estate is a particular problem because it is widely held by leveraged institutions
Figure 3: National Annual Apartment Occupancy

Source: AXIOMetrics/Risk Analysis Unit, FRB Atlanta
Figure 5: U.S. Real Commercial Property Price Indices by Property Type

2000:Q4 - 2016:Q2

Note: Indices are adjusted for inflation using the GDP deflator. Indices are repeat-sales based.

Source: Real Capital Analytics, BEA, NBER, Haver Analytics
Figure 6: U.S. Real Commercial Property Price Indices by Region
2001:Q1 - 2016:Q2

Index, Previous Peak=100

- Northeast/Mid-Atlantic
- Midwest
- Southeast
- Southwest
- West

Note: Indices are adjusted for inflation using the GDP deflator. Indices are repeat-sales based.

Source: Real Capital Analytics, BEA, NBER, Risk Analysis Unit/Federal Reserve Bank of Atlanta
Figure 7: Apartments: Boston vs Six Major Markets
Real Commercial Property Price Indices
2001:Q1 - 2016:Q2

Note: Indices are adjusted for inflation using the GDP deflator. Indices are repeat-sales based. The six major markets are Boston, Chicago, DC Metro, LA Metro, NYC Metro and SF Metro.

Source: Real Capital Analytics, BEA, NBER, Risk Analysis Unit/Federal Reserve Bank of Atlanta
Figure 8: U.S. Capitalization Rates by Property Type
2001:Q1 - 2016:Q2

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. Thus, aggregate cap rate statistics only include cap rates from recent sales.

Source: Real Capital Analytics, NBER, Haver Analytics
Figure 9: U.S. Apartment Capitalization Rate and Ten-Year Treasury Yield

2001:Q1 - 2016:Q2

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. Thus, aggregate cap rate statistics only include cap rates from recent sales.

Source: Federal Reserve Board, Real Capital Analytics, NBER, Haver Analytics
Figure 10: Foreign Capital Invested in U.S. Commercial Real Estate
2001:Q1 - 2016:Q2

Billions of Dollars, Four-Quarter Rolling Sum

- Australia
- Latin America
- Middle East & Africa
- Europe
- Canada
- Asia

Note: Latin America is defined as any country in North or South America except Canada and the United States.
Source: Real Capital Analytics
Figure 11: Share of Commercial Real Estate in Banks with CRE Greater than or Equal to 350% of Risk-Based Capital by State for Banks with Assets Under $1 Billion

2016:Q1

Note: Loans secured by owner-occupied nonfarm nonresidential properties are included in the definition of commercial real estate for this analysis.

Source: Quarterly Call Reports
Trade-Offs Related to Low Rates

- Low rates help us reach inflation and employment goals more quickly – but at what cost?
- Potential cost is increasing imbalances that result in a worse outcome in the future if an economic downturn occurs
- This trade-off may be particularly unfavorable when already close to achieving goals (full employment and inflation target)
Figure 12: U.S. Civilian Unemployment Rate and the Natural Rate of Long-Term Unemployment
1996:Q1 - 2016:Q2

Source: BLS, CBO, NBER, Haver Analytics
Risk if Financial Conditions Change

- Commercial real estate has been appreciating
  - Rents rising rapidly
  - Occupancy rates high
  - Interest rates low
- How might prices and the economy react if these factors become less favorable, or are reversed?
- Such a revaluation could make a downturn more severe – i.e., missing our goals by more in the next downturn – than if normalization had occurred more rapidly
Concluding Observations

- Central banks need to achieve their goals not only at the current time, but through time.
- Weigh benefits of low interest rates now against potential costs for the future of creating imbalances now.
- Commercial real estate currently an attractive asset class in the U.S., but could become a concern should conditions change in an economic downturn.