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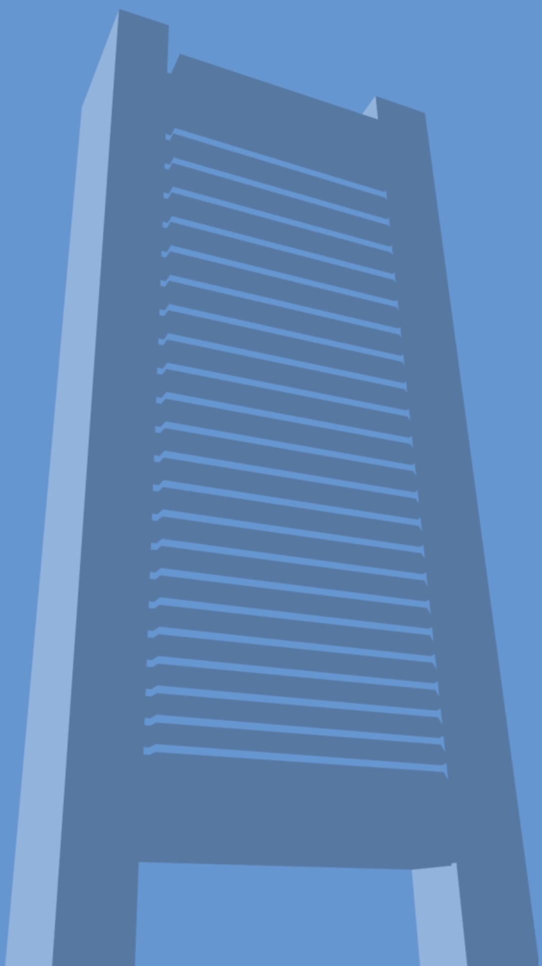
Ethics and Economics: Making Cyclical Downturns Less Severe



Eric S. Rosengren
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Federal Reserve Bank of Boston

June 27, 2018

Fourth Annual O. John Olcay Lecture on
Ethics and Economics at the Peterson Institute for
International Economics
Washington, D.C.

bostonfed.org

John Olcay and Ethics and Economics

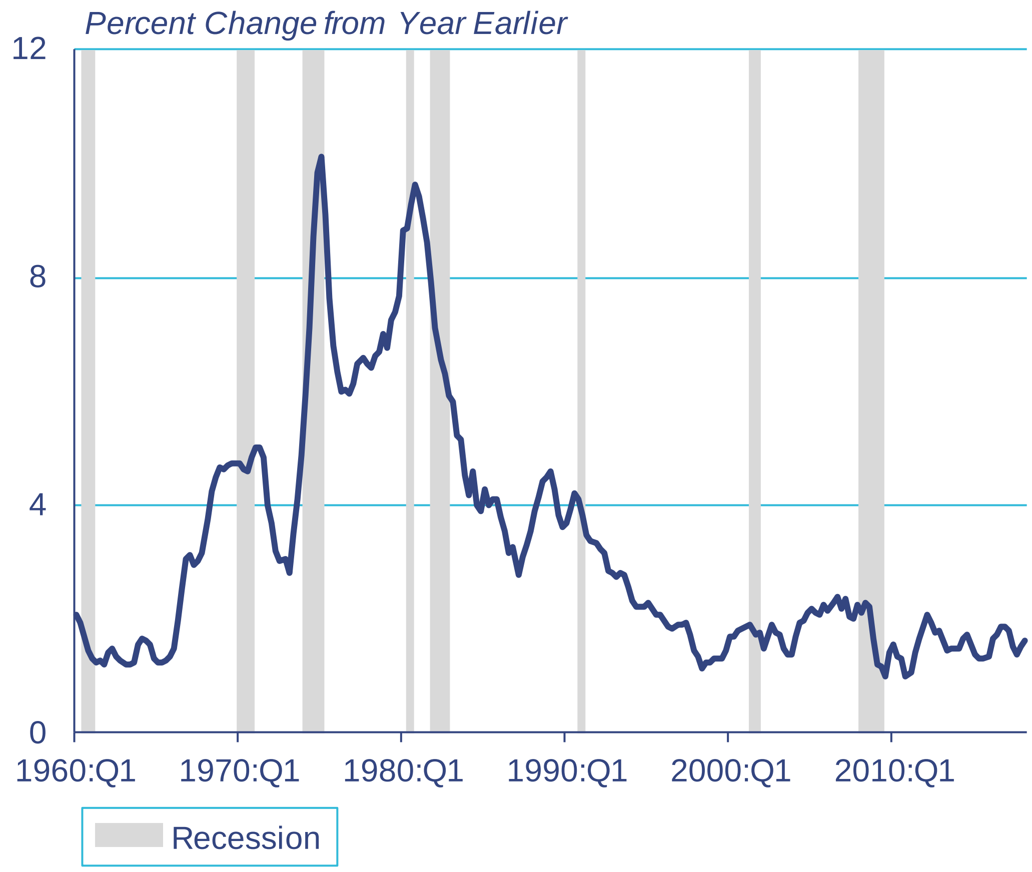
- John Olcay was an astute student of financial markets
- I had the pleasure of getting to know John through periodic trips he made to Boston during the financial crisis
- He was concerned about the implications of serious economic downturns – my topic today
- Ethics is not a prevalent part of the curriculum 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

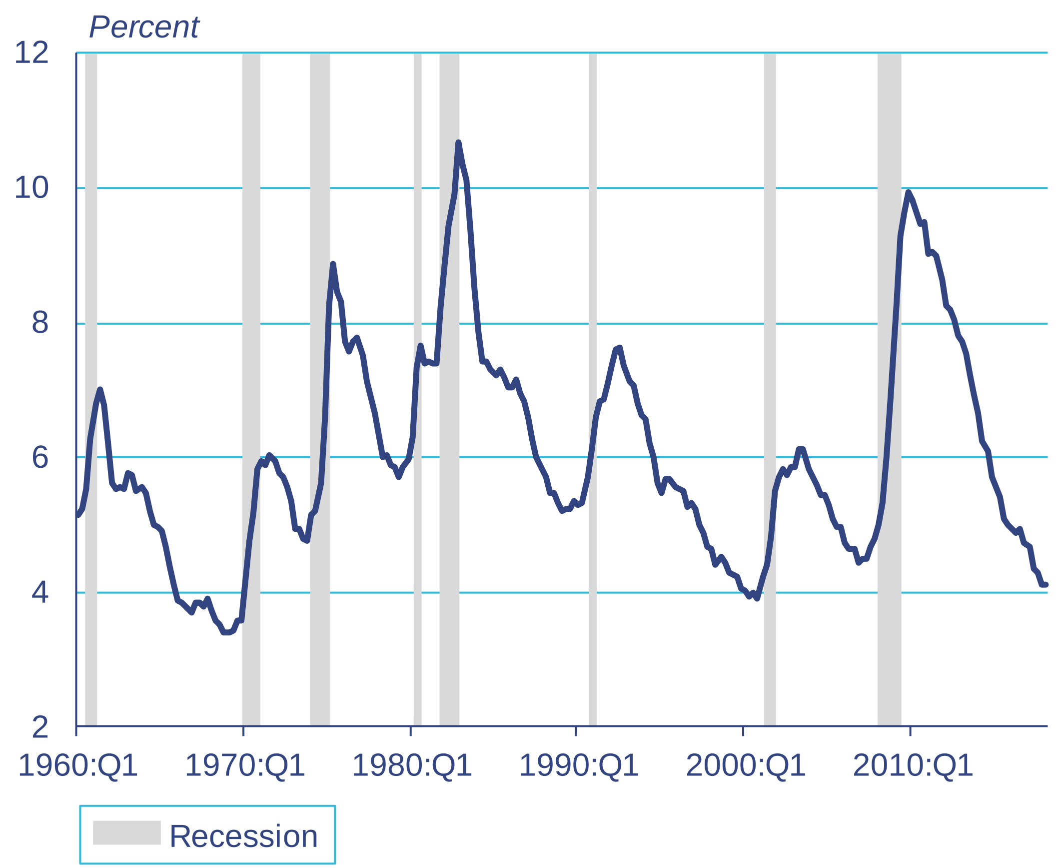


Note: Core PCE excludes food and energy.

Source: BEA, NBER, Haver Analytics

Figure 2: Unemployment Rate

1960:Q1 - 2018:Q1



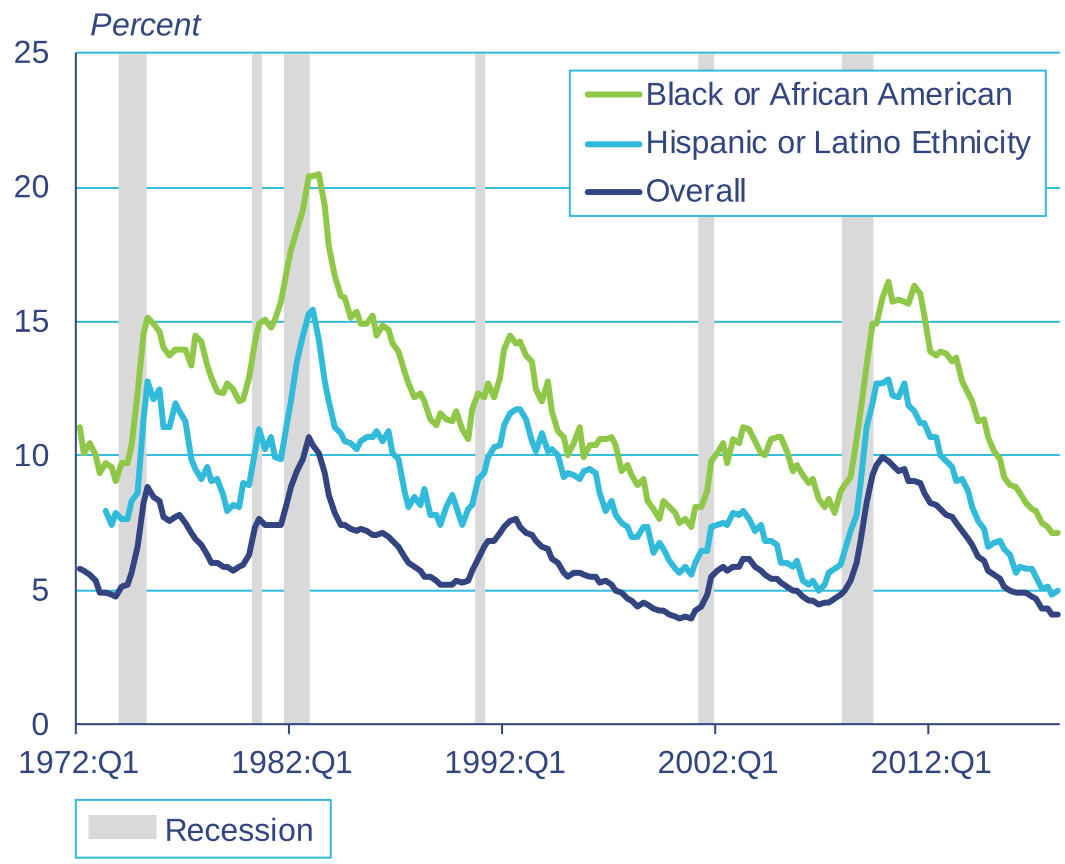
Source: BLS, NBER, Haver Analytics

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

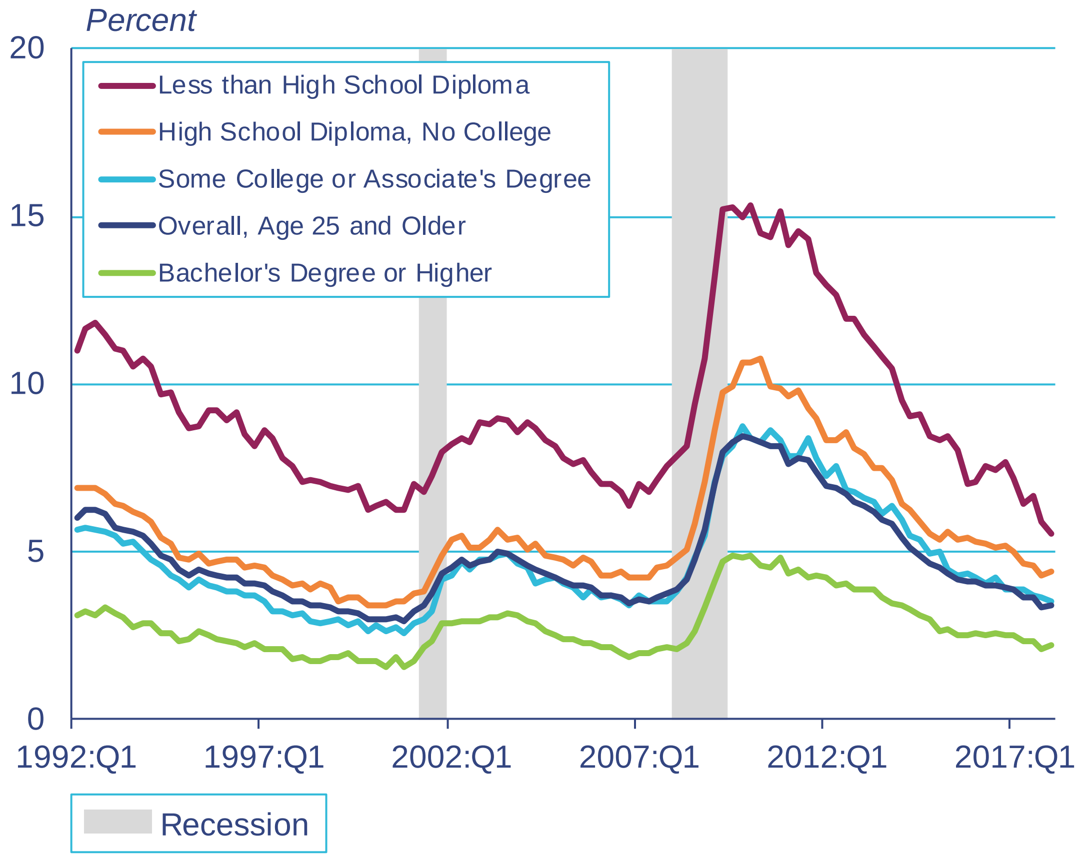


Note: Based on labor force age 16 and older. Persons whose ethnicity is identified as Hispanic or Latino may be of any race.

Source: BLS, NBER, Haver Analytics

Figure 4: Unemployment Rate by Educational Attainment

1992:Q1 - 2018:Q1

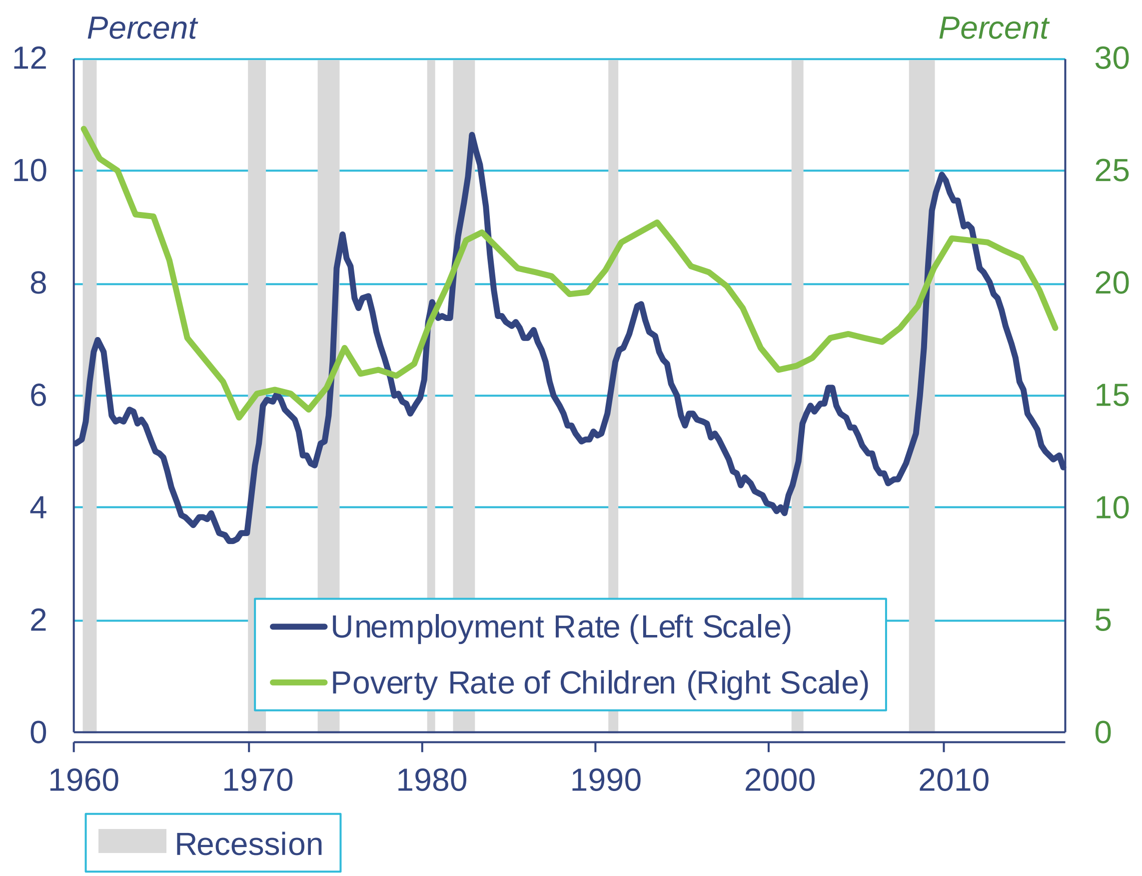


Note: Based on labor force age 25 and older.

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.

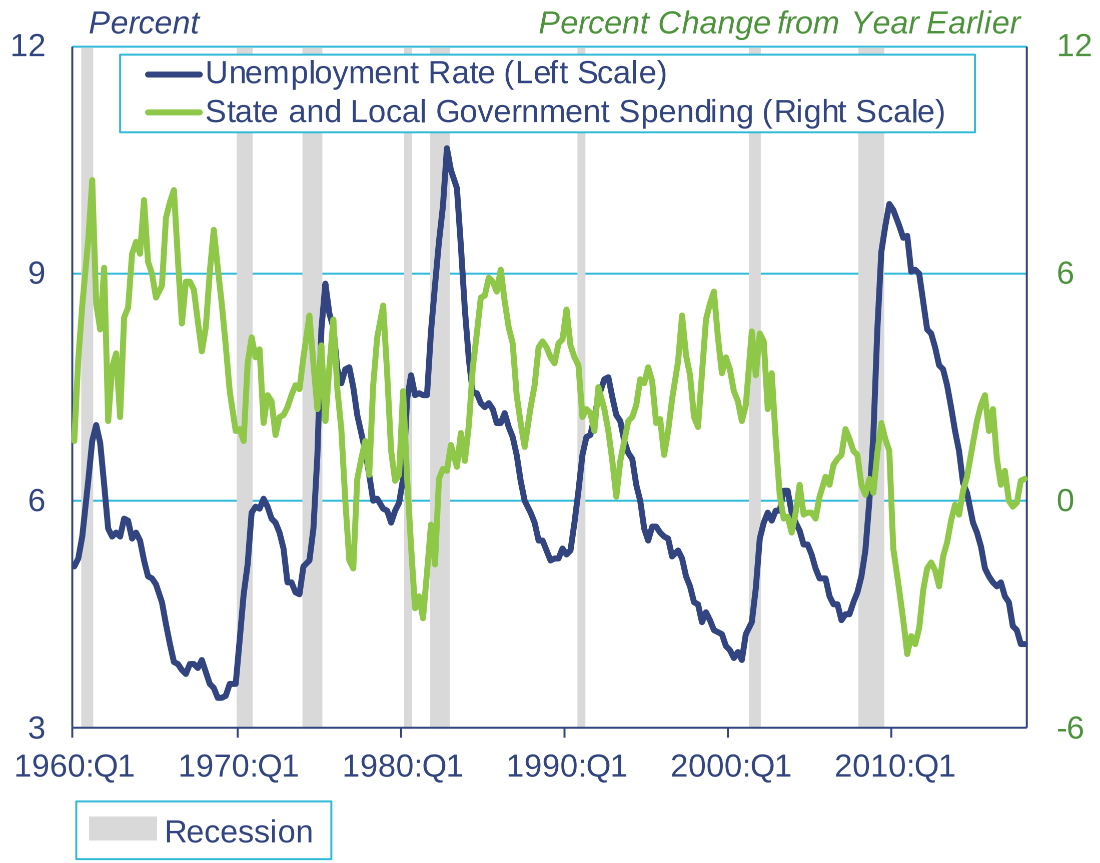
Source: U.S. Census Bureau, BLS, NBER, Haver Analytics

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

Changes	Number of Changes	Number of States	Number of States by Number of Changes: 1 Change	2 Changes	3 Changes
Downgrades	24	14	7	4	3
Upgrades	9	8	7	1	
No Change		29			

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

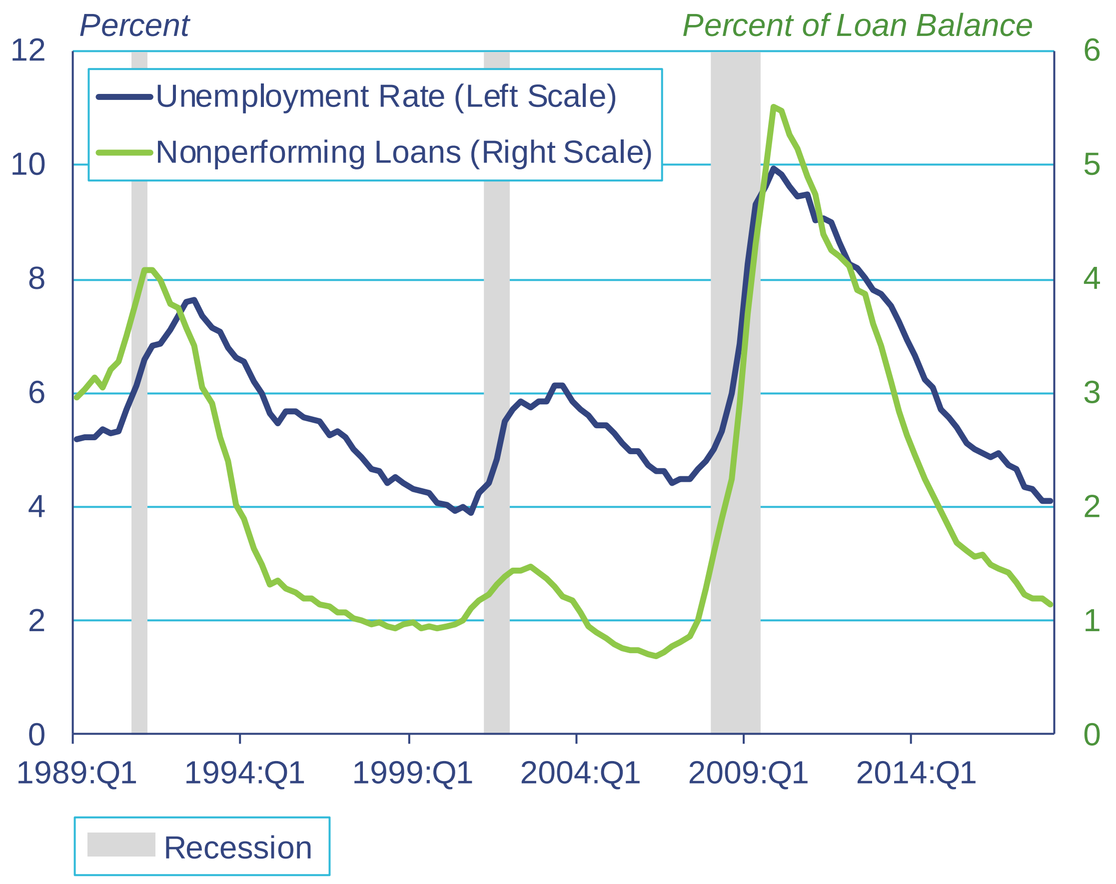
- Little focus on macroeconomic consequences
  - Tax code can be highly cyclical
  - Spending cut in economic downturns
  - Small rainy day funds and lingering pension problems
- My view – now is the time, when the economy is robust, to make changes that will mitigate the next downturn
- While hard, 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

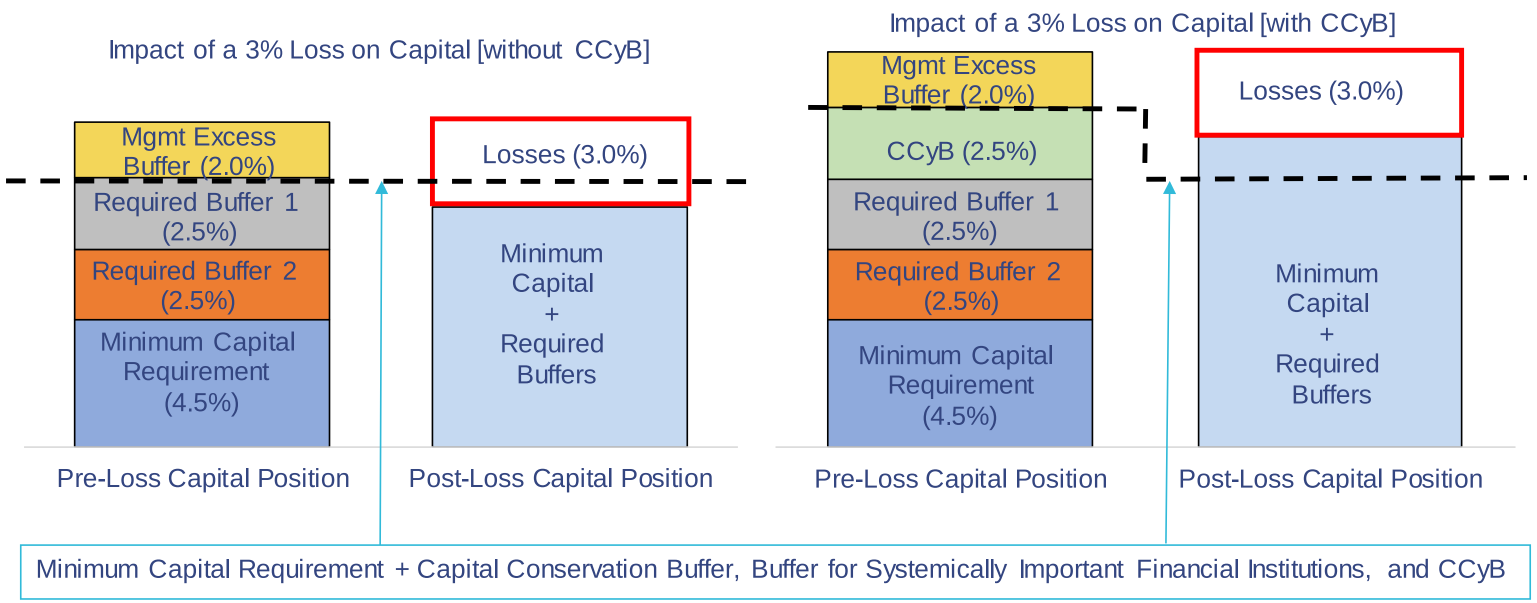
1989:Q1 - 2018:Q1



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)



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.

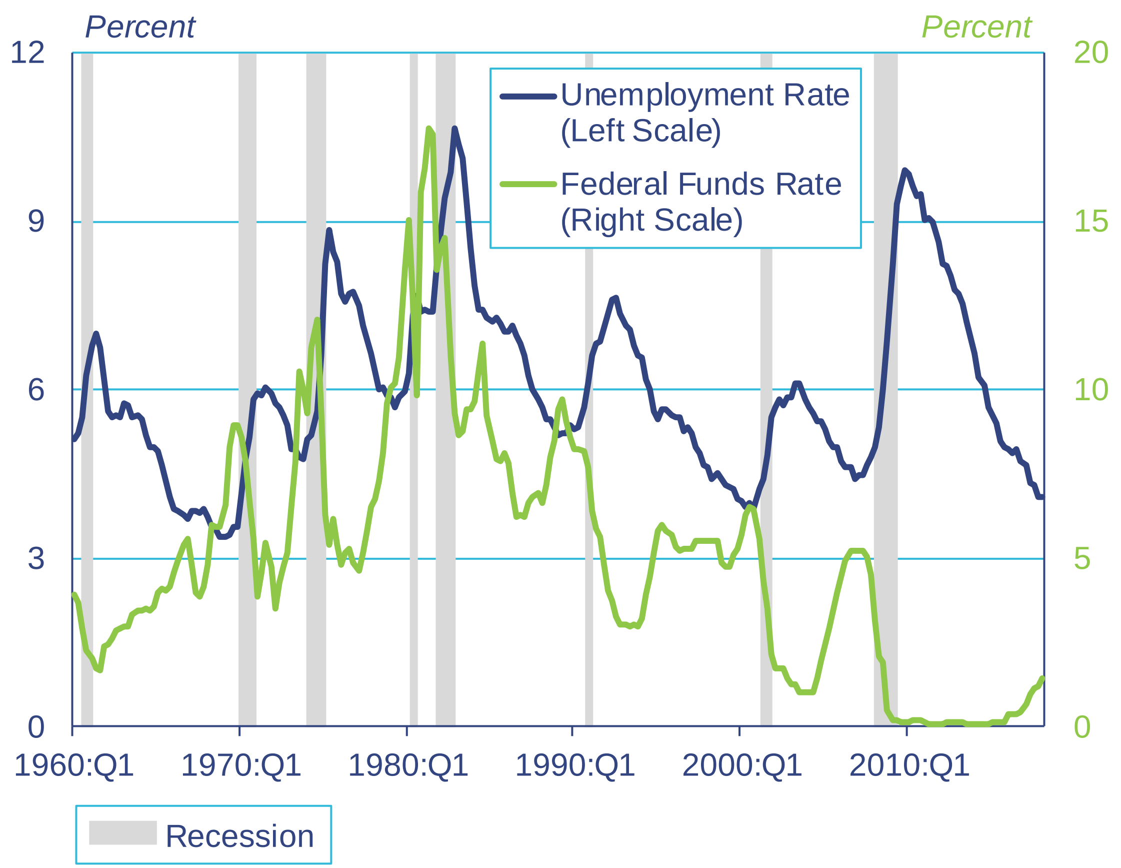
Source: Federal Reserve Bank of Boston

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

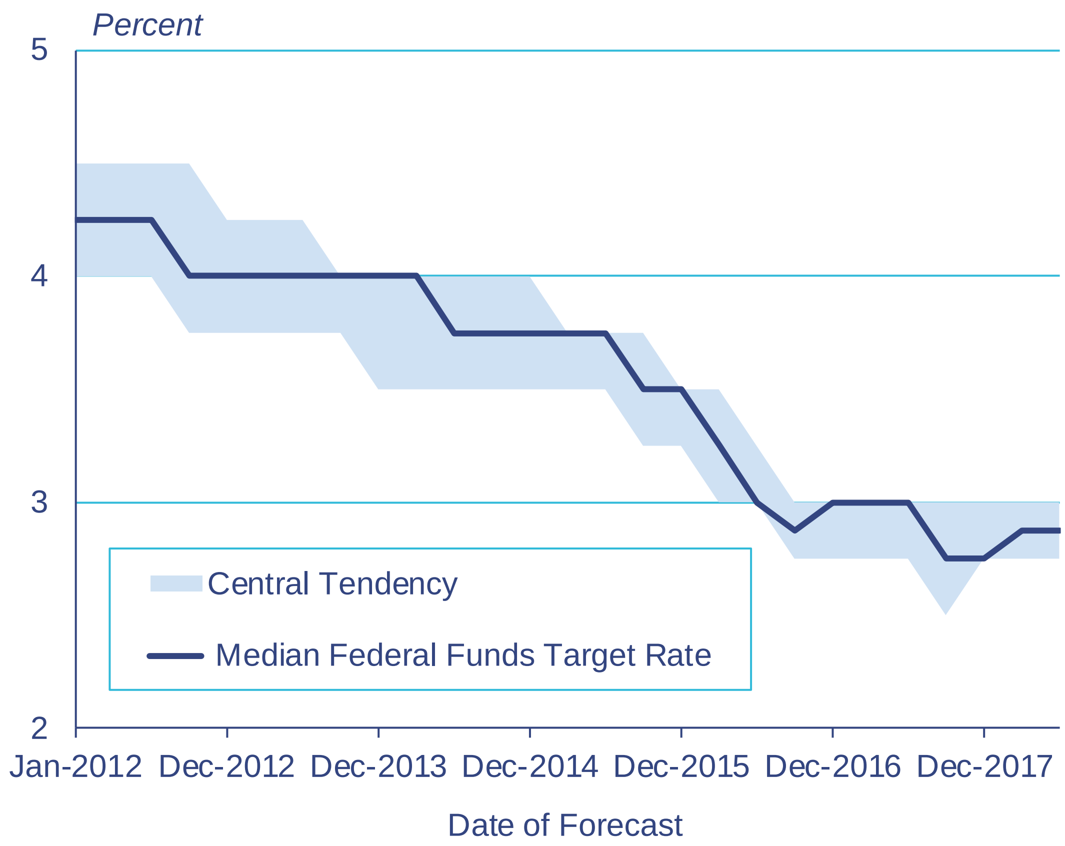
1960:Q1 - 2018:Q1



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.

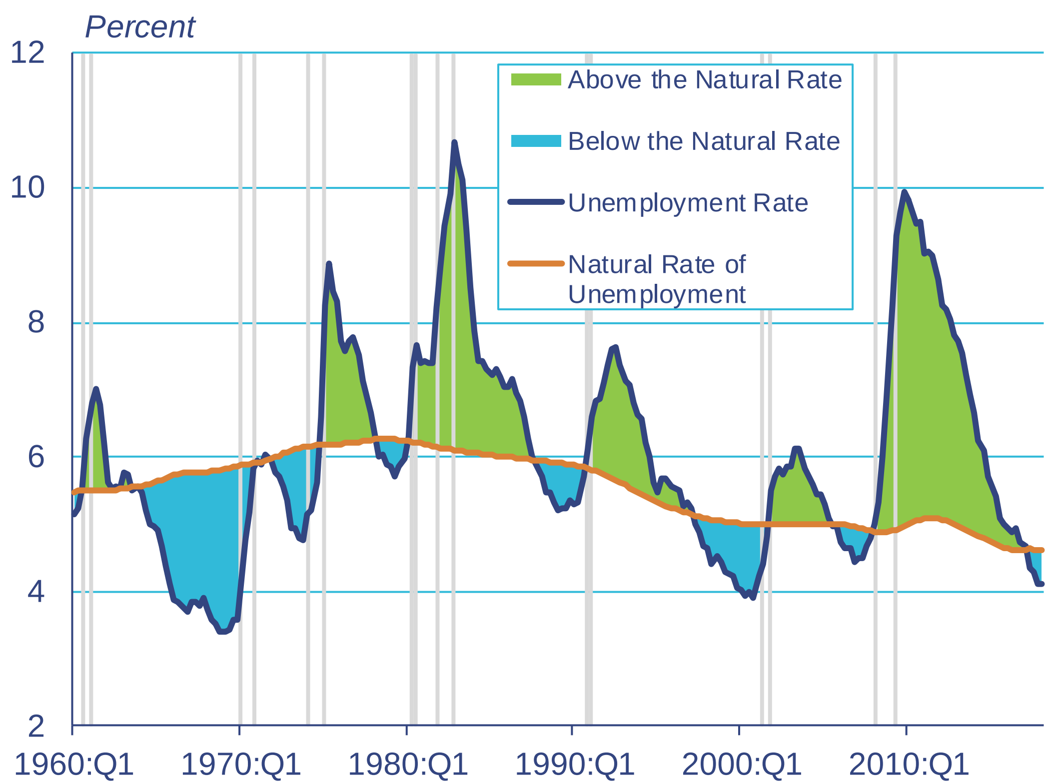
Source: FOMC, Summary of Economic Projections (SEP)

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.

Source: BLS, CBO, NBER, Haver Analytics

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