

Discussion of:

Financial Stability Considerations and Monetary Policy?

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## KS: Three Main Points (with which I mostly agree)

1. Federal Reserve should have central role in maintaining financial stability.
2. Macroprudential policy provides best way to reduce likelihood of a crisis:
  - As opposed to monetary policy
3. Existing macroprudential toolkit may not be adequate
  - Some tools do not exist
  - Some are ambiguous or at least not "battle tested"

\* Qualification: reg/sup advances post Dodd Frank → banking system much safer

## Monetary Policy and Financial Stability: Big Picture.

- Policy objective: Output at full capacity with price stability .
- Maintaining financial stability an intermediate target.
  - Critical for achieving output and price stability goals.
- Not new idea: Lender of last resort function key motive for founding of Fed
- What's different today? Evolution of financial markets:
  - Liquidity provision and systemic risks extend beyond commercial banking→
  - LOLR policies extend beyond commercial banking sector
  - Requires broader measures to protect financial system (e.g. macropru)

## MP Framework Under Frictionless Financial Markets

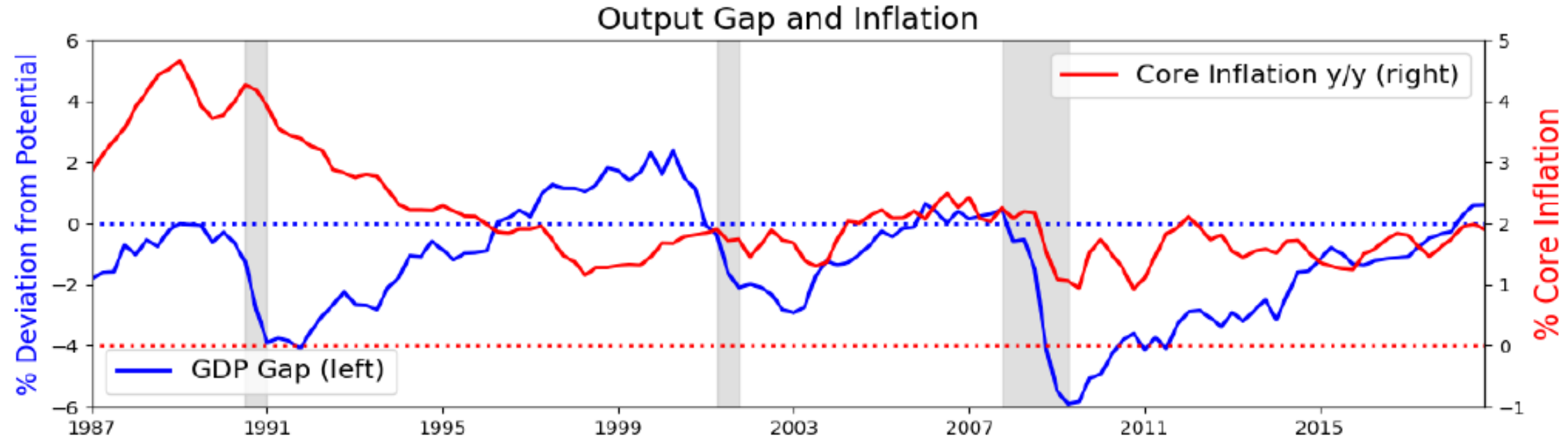
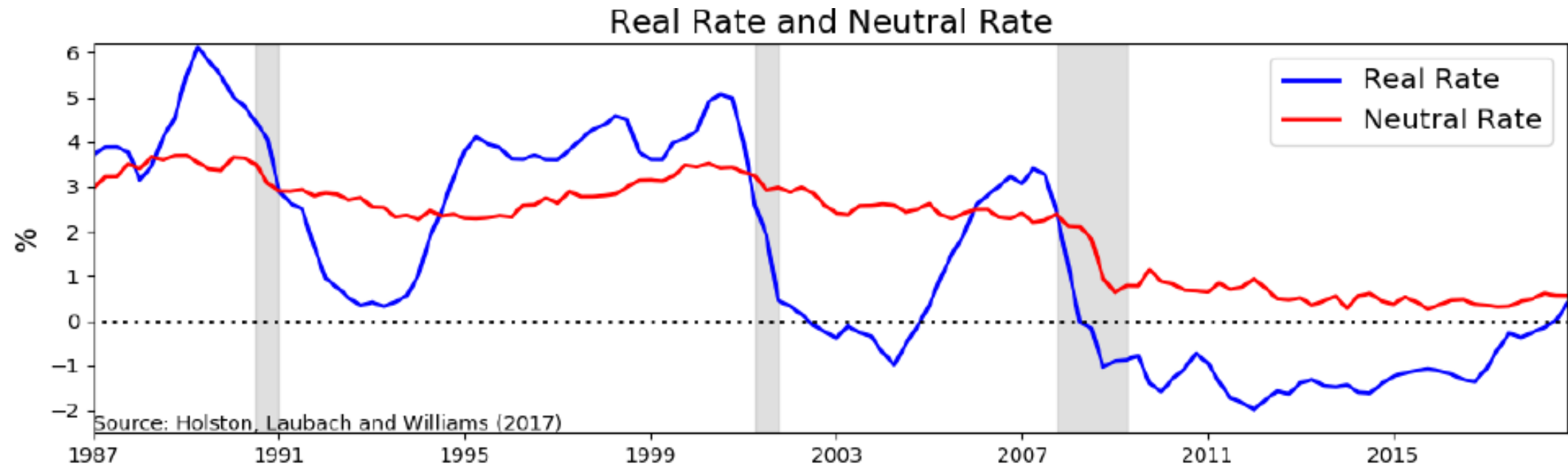
$$\hat{y}_t = f[(r_t^n - E_t \pi_{t+1}) - r_t^*, x_t]; \quad f_1 < 0$$

$$\pi_t = g(\hat{y}_t, z_t); \quad g_1 > 0$$

$$r_t^n = r_t^* + \bar{\pi} + \phi_\pi(\pi_t - \bar{\pi}) + \phi_y \hat{y}_t$$

"Neutral" real rate  $r_t^*$  provides benchmark for policy but also constrains policy

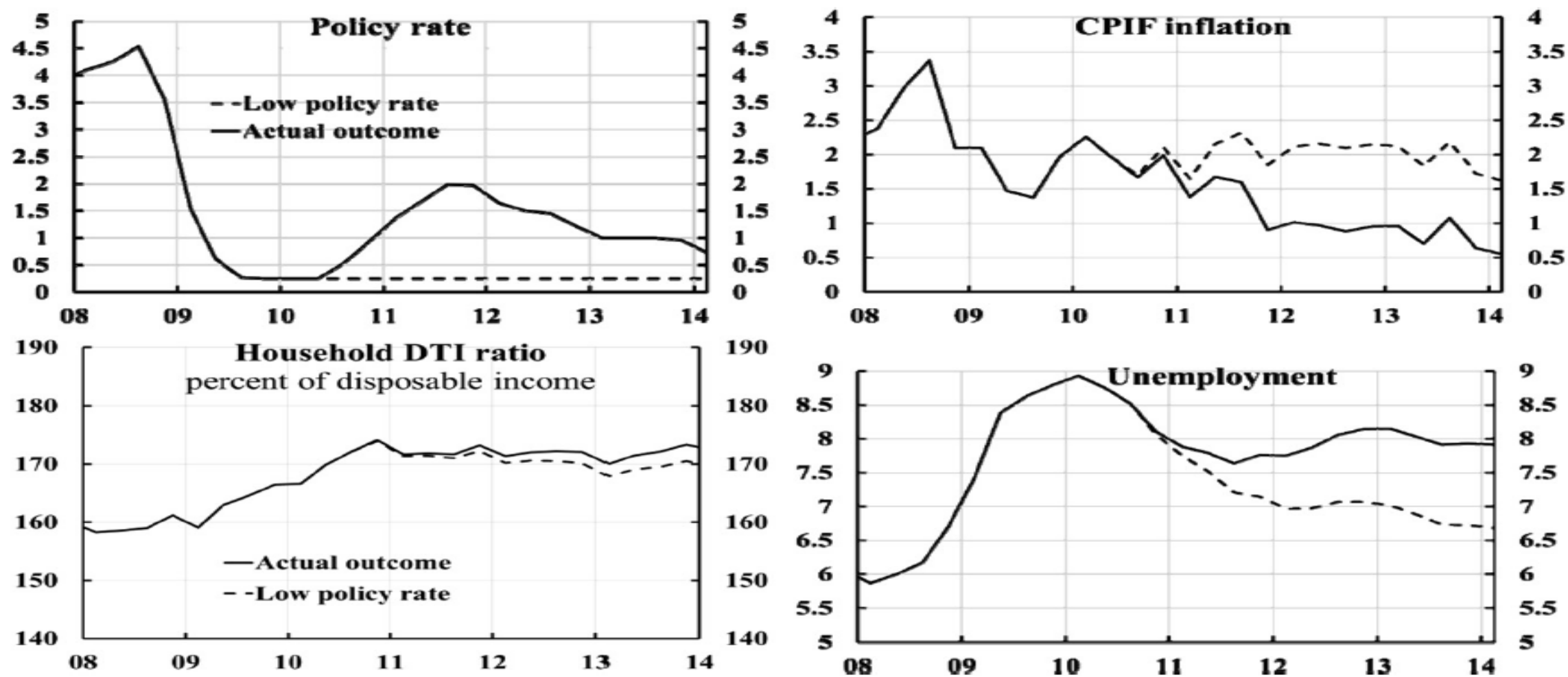
$r_t^*$  is a moving target: depends on growth, saving, preference for safety, etc.



## Adjustment for Financial Imbalances?

- Should Fed raise rates to offset "excess" credit or asset price growth?
- Issues
  - Trade-off: reduces output/inflation (also potential loss of credibility)
  - Difficulty identifying imbalances
    - \* Credit booms can be "good" as well as "bad"
    - \* True also for asset price booms
      - Not all asset price busts have disastrous effects (2001 Nasdaq correction)
  - Uncertain how rate increases will affect credit/asset prices
  - Not clear that raising rates reduces financial vulnerability
    - \* Rate increases reduce asset prices.

**Figure 1. Actual and Counterfactual Outcome for the Policy Rate, Inflation, Unemployment, and the Household DTI Ratio**



Source: Svensson (2014a).

## Integrating Financial Stability Considerations

$r_t^k \equiv$  required return on capital;  $\chi_t \equiv$  excess return

Conditional on a financial crisis:

$$r_t^k = \chi_t + r_t^n - E_t \pi_{t+1}$$

→

$$\hat{y}_t = f[(\chi_t + r_t^n - E_t \pi_{t+1}) - r_t^*, x_t]$$

Financial Crisis

$$\chi_t \uparrow \rightarrow \hat{y}_t \downarrow$$

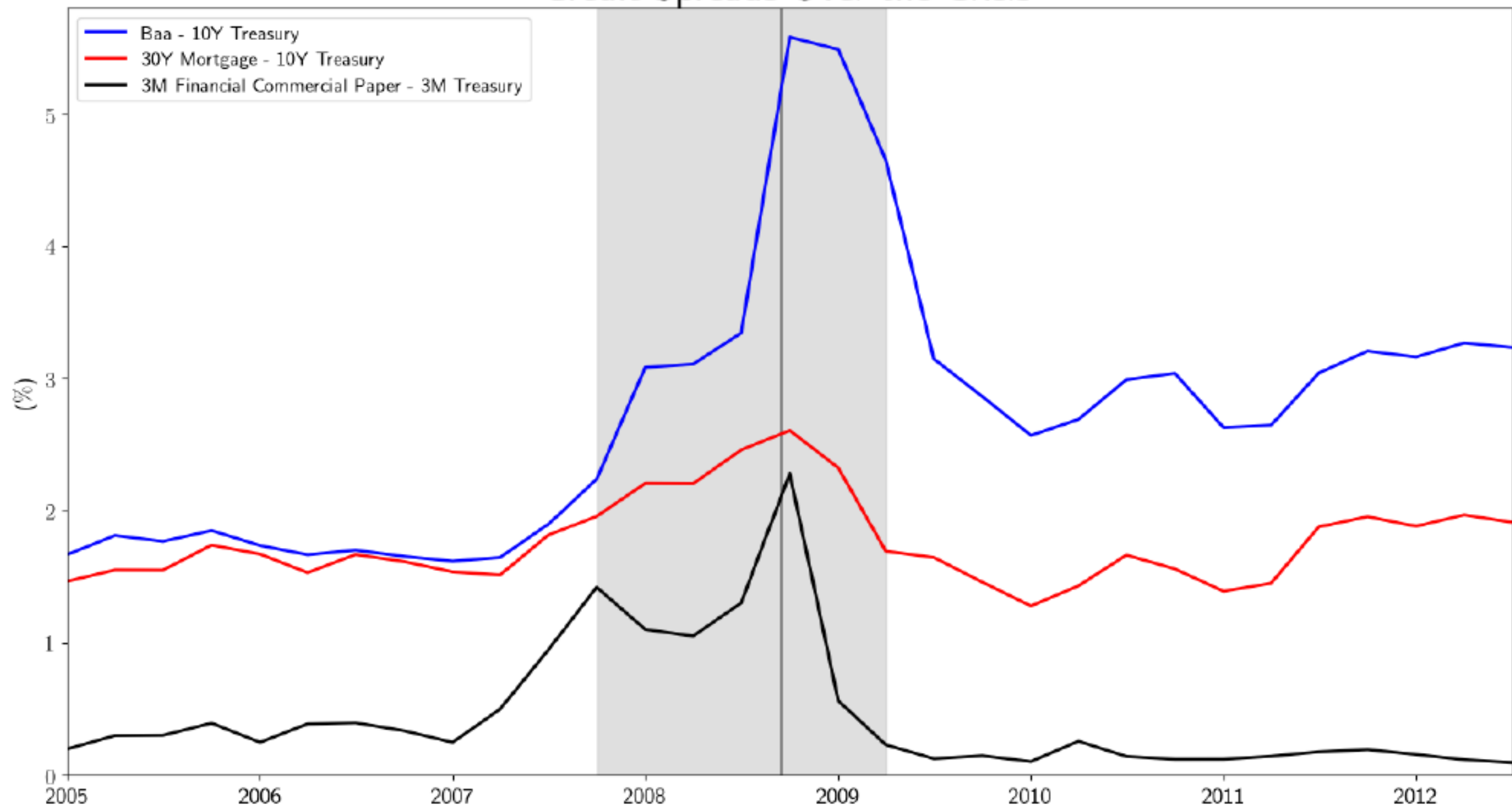
Challenges for central bank

Ex post: offset the impact of  $\chi_t$  (via monetary and LOLR policies)

Ex ante: reduce likelihood of crisis (via macroprudential versus monetary policies)



## Credit Spreads Over the Crisis



## Ex Post Interventions

- Ex post: Use monetary policy tools
  - Conventional interest rate adjustment (including forward guidance)
    - \* Offset impact of  $\chi_t$  on cost capital  $\rightarrow$
    - \* Deviate from Taylor rule

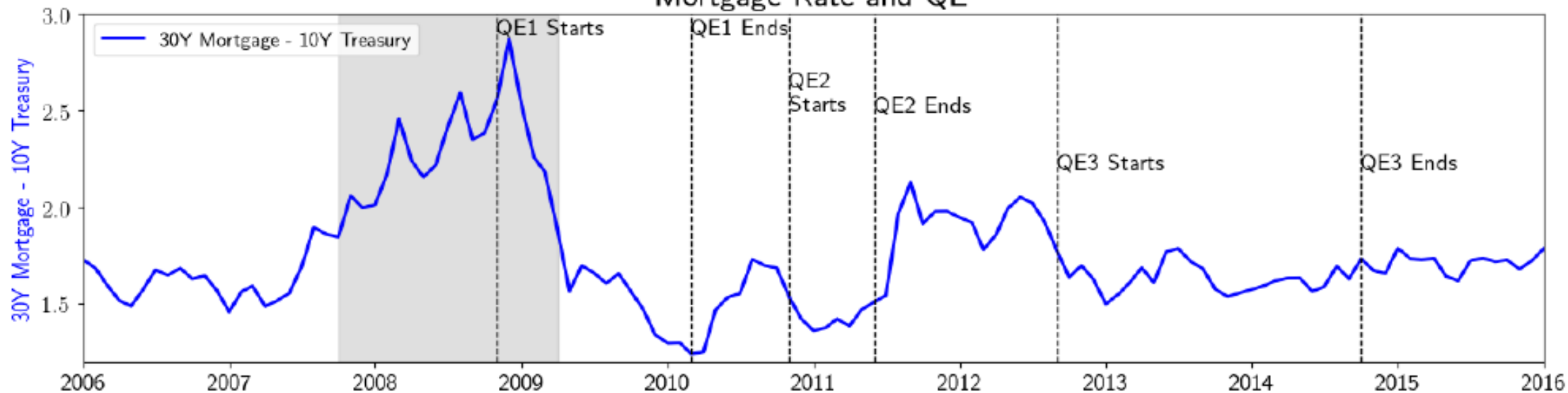
$$r_t^n = r_t^* + \bar{\pi} + \phi_\pi(\pi_t - \bar{\pi}) + \phi_y \hat{y}_t - \phi_\chi \chi_t$$

- Unconventional
  - \* Directly reduce  $\chi_t$
  - \* Examples
    - Libor spread  $\rightarrow$  Term Auction Facility and related liquidity policies
    - Commercial paper spread  $\rightarrow$  CP funding facility
    - Mortgage Spreads and Term Premia  $\rightarrow$  LSAPs (i.e. QE)

## Larger Scale Asset Purchases as "Ex Post" Interventions

- LSAPs reflect central bank intermediation.
  - Fed funds long term assets with short term debt (interest bearing reserves).
    - \* Government bond LSAPs reduce "excess" term premia
    - \* AMBS purchases reduce "excess" mortgage spreads and term premia
- LSAPs most effective when private intermediaries are under stress
  - Useful crisis tool:
  - Limited effect in normal times:
    - \* Term premia may vary for reasons other than LSAPs
    - \* i.e., Currently compressed term premia likely reflect forces beyond the Fed!

### Mortgage Rate and QE

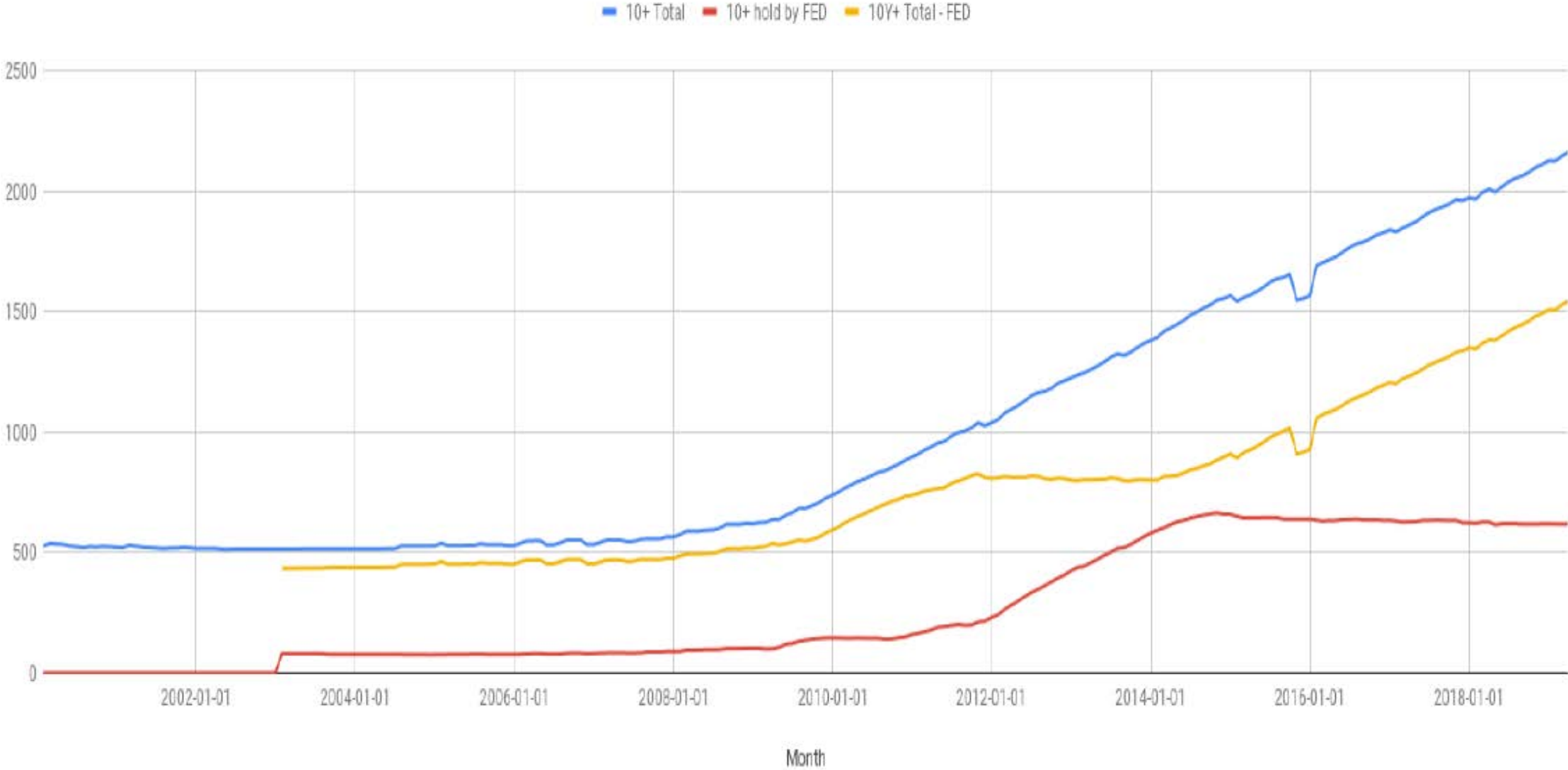


### Term Premia and QE



Source: Adrian Crump and Moench

# Total Outstanding Debt - 10Y+ Maturity



## MacroPrudential as "Ex Ante" Policy

- Three (interdependent) spheres of potential financial vulnerability:
  1. Commercial banking
  2. Nonbanks just outside the regulatory perimeter (e.g. shadow banks)
  3. Non-financial borrowers
- General consensus: macropru has reduced risks in commercial banking (1)
  - Higher capital/liquidity requirements; stress tests; FSR, CCyB
- KS: Less progress with (2) and (3)
  - FSOC has limited authority: Main tools: "Comply or Explain"
  - Though norm amongst financial stability committees (Edge/Liang, 2017)

## MacroPrudential Policy in the Interim

- First objective of macropru: avoid disasters
  - Protect core banking system
  - Banking collapse accounted for  $\geq$  half the output decline during GR
    - \* Gertler/Gilchrist, Aikman et. al., Bernanke
- Strong capitalization of banking system a good first step.
  - Well capitalized banks can't perfectly offset limits to macropru toolkit
  - But can help avoid disasters
- Also critical to have leverage over systemically relevant financial institutions on regulatory perimeter (think Lehman, AIG, etc)
- While threats may currently not exist, history suggests regulatory migration
  - Next crisis will likely involve new generation of shadow banks.