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The Limitations of Monetary Policy as a Financial Stability Tool

By Marc Jarsulic and Michael Madowitz December 14, 2016

There is plenty of evidence that recent Federal Reserve interest rate policy has been generally on target, especially considering the challenges the Fed faced in easing monetary policy during the deepest parts of the Great Recession. Actual long-term interest rates have moved in the direction of the natural rate of interest, inflation remains subdued, and while the U.S. economy has continued to recover, it is not yet running out of room to grow.[1] Nonetheless, Fed policy continues to be the subject of criticism, with some observers and actors on Wall Street and policymakers calling for increased interest rates.

While critics' predictions of accelerating inflation have been consistently knocked down by month after month of concrete data, criticism has increasingly focused on the dangers of asset bubbles. A persistent theme is that low rates are distorting asset prices by pushing financial market participants to buy higher-risk assets as they reach for yield.[2] The more formal version of this claim is that low interest rates increase systemic risks—that is, asset bubbles will form and produce destabilizing shocks, including negative consequences for the real economy—a hypothesis that has the strength of being much harder to falsify with objective data.

Some of the banking community's concern about asset prices may actually reflect self-interest. For example, low interest rates have a negative effect on bank profitability, therefore, banks and their allies have reason to highlight stability issues, even though that is not their primary worry.[3] The same critics raised similar concerns about implementing the Volcker Rule, which prohibits proprietary trading by bank broker-dealers. For instance, banks engaged in speculative dealing of bonds and derivatives claimed that limitations on their inventories would be a bad thing because the limits would make Treasury markets less liquid. In fact, evidence on Treasury market liquidity indicate that this is not a problem. For example, bid-ask spreads—a key measure of liquidity that amounts to the difference between the price sellers demand and the price buyers offer—do not show signs of the illiquidity banks warned of.

However, concern over the financial stability effects of interest rate policy has gained traction within the Fed system. A very thoughtful staff report from the Federal Reserve Bank of New York summarizes a wide variety of technical work on this issue.[4] The report identifies a set of channels through which accommodative monetary policy might improve current financial conditions while increasing future vulnerabilities. As the authors explain:

> *When interest rates are low and asset values rise, higher net worth of borrowers arising from higher collateral values eases borrowing constraints and allows for excess credit accumulation. In addition, accommodative monetary policy may lead to an increase in risk taking by financial institutions and investors: Low interest rates could incent investors who have nominal return targets to reach for yield. Low rates could pressure profit margins of banks and incent them to hold riskier assets, or higher asset values could lead them to underestimate risk, given their risk-management models and limited liability corporate structures. Low rates that boost asset values also may incent carry trades based on short term funding, often secured by the assets, and allow for excessive maturity transformation. These channels for monetary policy lead to an increase in vulnerabilities, leaving the financial system less resilient to adverse shocks, and hence raising future risks to financial stability.*[5]

This sets up potentially important short- and long-run trade-offs. To the extent that monetary policy decisions increase financial instability in the future, they raise the vulnerability of the economy to an adverse shock. For example, a banking system that is highly dependent on short-term, uninsured borrowing to fund its assets can be forced to contract lending or sell off assets if expected losses causes a run on its short-term liabilities. This shock to credit availability can raise the probability of a future recession. Moreover, it is possible that the buildup of individual vulnerabilities can increase the overall effect of an adverse shock. As was the case in the runup to the 2008 financial crisis, if short-term liabilities are leveraged to fund large volumes of overpriced assets, the effects of a crash on household balance sheets can lead to sluggish growth and high unemployment for a very long duration.[6] The brilliant work of economists Atif Mian and Amir Sufi on the connection between high-risk mortgage lending, the bursting of the house price bubble, and the collapse of aggregate demand makes this point with great clarity.[7]

A key development in financial stability over the past decade has been the adoption of macroprudential regulatory tools—rules designed to protect the financial system as a whole, rather than individual actors. A core concern in the New York Fed report is that while financial regulators have a variety of macroprudential policy tools to guard against the buildup of vulnerabilities in the financial system, and that most observers believe that these tools are the first line of defense against such a buildup, macroprudential policies "only directly affect a limited set of financial institutions due to shadow banking, have limited international reach, and are potentially subject to long implementation lags."[8] Hence, the authors believe that the Fed's employment mandate is consistent with considering the effects of financial instability on employment.

The general stance taken in the report is consistent with recent statements by Eric Rosengren, president and CEO of the Federal Reserve Bank of Boston.[9] He has warned against a possible bubble in the commercial real estate, or CRE, market and has advocated for raising interest rates to prevent further inflation of the bubble. Rosengren points to rising prices across many classes of CRE, particularly in the Northeast, Southwest, and Western regions of the United States. He also notes that rising prices for CRE assets do not seem to be accompanied—in the aggregate—by rising profitability of these assets. In fact, across CRE classes, capitalization ratios—or the ratio of net operating income to property price when properties are sold—are declining.

Rosengren also shows about half of CRE lending has been done by banks, with the majority of loans held on the balance sheets of banks with less than $50 billion in assets. He argues that should there be a downturn, a decline in CRE values and increase in defaults could cause banks with CRE exposure to compensate by reducing lending to other borrowers, thus allowing a CRE downturn to spill over into other sectors of the economy. This has all the elements of the New York Fed story regarding vulnerability, financial instability, and employment.

To be clear, this scenario is exactly the kind of risk the Federal Open Market Committee, or FOMC, should focus on, and this analysis is defensible. However, the conclusion that interest rate policy should be used to prevent the formation of a CRE bubble in order to avoid harms to output and employment in the future is somewhere between less defensible and a little troubling.

CRE boom and bust is nothing new in the United States. Between the late 1970s and the mid-1980s, the real value of office construction tripled, followed by a sharp increase in vacancy rates, a decline in rents, and falling property values.[10] The pattern was repeated in the runup to the 2008 financial crisis, with CRE capitalization rates declining by about 50 percent between 2001 and 2008, while CRE prices—adjusted by the gross domestic product, or GDP, deflator—rose by about two-thirds.[11]

Given the familiarity of the problem and the macroprudential responsibilities assigned to the Fed and Financial Stability Oversight Council, or FSOC, it would be reasonable to expect a regulatory response. In fact, there has been explicit recognition of the persistent problem posed by CRE price bubbles as part of new bank capital requirements, and regulators have already moved to address this concern. Under regulations jointly issued by the Fed; the Office of the Comptroller of the Currency; and the Federal Deposit Insurance Corp., or FDIC, 2015, banks are required to apply a 150 percent risk weight—as opposed to the 50–100 percent weights used for residential mortgages—to loans against high volatility CRE loans. [12] These are defined as loans on CRE where the loan-to-value ratio exceeds a threshold and when the borrower does not contribute at least 15 percent to the completed value of the project prior to disbursal of the loan funds.[13] The idea is that sufficient skin in the game—on the part of both the lender and the borrower—will deter very high-risk lending and therefore reduce the likelihood of a bubble.

Since this regulation has not been in place very long, it is difficult to measure its effectiveness. But if the regulation is not doing the job, the correct response is to fix it, not to slow the economy down. Could the regulation's parameters be adjusted? Could the risk weight and the minimum investor equity position be increased? Could the FDIC risk fee be raised for banks with a high CRE lending and equity ratio? Would this not be preferable to putting people out of work and lowering incomes? Substituting contractionary monetary policy for appropriate financial regulations is not a short-term policy choice, it is a long-run decision to accept a trade-off of slower GDP growth and insufficient regulation.

Moreover, the invocation of financial instability as a justification for interest rate increases ignores the fact that higher rates themselves are a key trigger of financial instability, contributing measurably to run risk in the financial system. Thus, even if raising rates is an effective policy response to one risk to financial stability, any stability gains may be offset by increased risks elsewhere. Recent research has shown that increases in short-term rates causes cash to migrate from the banking sector to the shadow banking sector.[14] That is, households and nonfinancial firms shift from more traditional insured deposits to uninsured money-like debt created by the private sector—such as open market paper, repurchase agreements, and foreign deposits—as the Fed funds rate rises. The reason for this shift is that the rate of interest on privately issued liabilities is closer to the Fed funds rate than the rate of interest offered on bank deposits.

But because these privately created liabilities are not insured like deposits, they are the source of run risk in the financial system. During the 2007-2008 financial crisis, there were widespread runs on privately created short-term liabilities—including asset-backed commercial paper, money market funds, and repurchase agreements. These runs threatened to produce a massive fire sale of assets and forced the federal government to replace the lost funding through the creation of huge lending facilities to stem the runs.

The Fed has acknowledged that the risks created by so-called runnable private liabilities are significant and remain unresolved.[15] Under these circumstances, using interest rate policy to address problems in the CRE market would not necessarily increase overall financial stability. Raising rates to prevent one bubble does not increase overall financial stability if it increases run risks elsewhere in the system.

Considering the wider financial system, it is not at all clear why monetary policy should be a first option when policymakers are confronted by potential stability issues. While former Fed Governor Jeremy Stein has pointed out that interest rate policy is effective because it "gets in all the cracks," that same characteristic means that policymakers need to seriously think about alternatives with more targeted impact.[16] It is true that there is talk of a push to deregulate finance, and that repeal of the Dodd-Frank Wall Street Reform and Consumer Protection Act would force the Fed to slow long-term GDP and employment growth by leaning more heavily on monetary policy in order to achieve financial stability.[17] However, that is precisely why defending financial regulation is an

important tool to create faster, long-term GDP growth. Even a casual look at the provisions of the Dodd-Frank Act demonstrates that Congress gave the FSOC a very large set of tools precisely so that it could get into all of the cracks by changing the incentives of financial market participants and the structure of financial markets when necessary to prevent significant financial instability. If these tools are used effectively and judiciously, monetary policy can focus more consistently on the problem of steering the real economy toward full employment and higher wages.

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Endnotes

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8 Adrian and Liang, "Monetary Policy, Financial Conditions, and Financial Stability."

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10 Lynn E. Browne and Karl E. Case, "How the Commercial Real Estate Boom Undid the Banks." In Browne and Eric S. Rosengren, eds., *Real Estate and the Credit Crunch* (Melvin Village, NH: Federal Reserve Bank of Boston, 1992); For a description of the regulatory and market changes that contributed to the commercial real estate bubble, see Federal Deposit Insurance Corporation, "An Examination of the Banking Crises of the 1980's and Early 1990's" (June 5, 2000) available at https://www.fdic.gov/bank/historical/history/167_188.pdf.

11 Rosengren, "Observations on Financial Stability Concerns for Monetary Policymakers."

12 A risk weight is the number used to weigh the value of an asset in a bank's regulatory capital calculation. Banking rules require that the sum of bank equity and certain other liabilities be greater than or equal to a given fraction of risk-weighted assets. Therefore, a higher risk weight increases the charge against equity for an asset, which raises the implicit relative cost of purchasing the asset.

13 12 C.F.R § 324.2. 2013, available at https://www.fdic.gov/regulations/laws/federal/2013/2013-09-10_final-rule-inter-im.pdf.

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17 Victoria Pinkle, "A Dodd-Frank Rollback Bill Clears a House Committee," *The New York Times*, September 13, 2016, available at http://www.nytimes.com/2016/09/14/business/dealbook/a-dodd-frank-rollback-bill-clears-a-house-committee.html.