Minutes of the November 22, 2019, Financial Advisory Roundtable Meeting

Present:

FAR Members: Hayley Boesky, John H. Cochrane, Bennett Golub, Robin Greenwood, Bradford Hu, Deborah Lucas, Ralph Koijen, Lynn Paquette, Srini Ramaswamy, Antoinette Schoar, Til Schuermann, Jeremy C. Stein, Heather E. Tookes

FRBNY: Gianluca Benigno, Kristian Blickle, Nina Boyarchenko, Gianluca Corsetti, Rita Csejtey, Dianne Dobbeck, Fernando Duarte, Thomas Eisenbach, Simon Gilchrist, Linda Goldberg, Michael Held, Katherine Hill, Beverly Hirtle, Darau Johnson, Anna Kovner, Gabriele La Spada, Michael Lee, Sandra Lee, Matt Lieber, Haoyang Liu, Lorie Logan, Stephan Luck, Meg McConnell, Paolo Pesenti, Matt Plosser, Joshua Rosenberg, Or Shachar, Kevin Stiroh, Andrea Tambalotti, Peter Van Tassel, Desi Volker, John Williams.

Summary:

The main topic of discussion at the Financial Advisory Roundtable (“FAR”) meeting was how policy should respond to economic and financial activity – and what financial signals best capture real economic activity. The meeting included two presentations: (1) Jeremy Stein discussed the possibilities and limitations for policy to affect the credit cycle. (2) Srini Ramaswamy discussed financial activity indicators and their application to informing policy. These presentations were followed by an open discussion on the topics listed on the meeting agenda.

The Credit Cycle, Capital Requirements, and Monetary Policy

FAR members began with a discussion of bank capital requirements. Bank capital is higher now than in the years preceding the crisis, in large part due to post-2008 regulation. However, participants noted that this regulation could be constricting in a downturn when recapitalization may be slow, so that even small losses could cause banks to contract lending significantly. FAR members suggested that sufficiently high capital would allow the system to better absorb shocks without triggering runs. Participants further discussed more dynamic capital requirements, which would increase in good times and decrease in bad times. FAR members highlighted that, while the Federal Reserve has so far not raised the counter-cyclical capital buffer above zero, scenario-based stress tests can also dynamically affect capital to a certain extent.

FAR members next discussed whether the credit cycle is a natural feature of the economy and whether the Federal Reserve can and should manage it. Some participants noted that monetary policy is a short-term tool, which may only tangentially affect the long-run credit cycle. Members also discussed a tradeoff between pursuing long-term and short term objectives. In particular, members raised the issue that easy financial conditions can provide stimulus today but also worsen a downturn in the future. Participants discussed whether issues of credibility and commitment make long-term targets unattainable, especially if these are associated with short-term costs.

FAR members went on to discuss that, even if policy instruments were completely effective at both the long- and short-term horizons, it is difficult to ascertain where the US economy is currently in the credit-cycle timeline.

Financial Indicators and Changing Market Structure

Next, FAR members discussed the relationship between financial conditions and the state of the economy. Some measures of financial condition, such as credit spreads, have been particularly good predictors of recessions and, thus, FAR members discussed ways in which financial conditions could inform the conduct of monetary policy. However, FAR members also discussed certain complications at length. Financial condition signals can be noisy, volatile, and mean-reverting over time horizons that are short for the real economy. The FOMC cycle and the subsequent transmission of monetary policy is relatively slow. As a consequence, the initial financial conditions that prompt a policy reaction may dissipate before the policy comes into effect.

Moreover, since, in the past, monetary policy has quickly been reflected in financial conditions, there may be reverse feedback loops between financial markets and monetary policy. Meeting participants highlighted that policy actions or the communication of potential action can impact the information content of market variables, as market prices are forward-looking and reflect expectations of monetary policy. Hence, policy makers should take care in relying solely on market-based signals, as prices are less informative about a market's health when they incorporate policy expectations.

Following in this vein, members next discussed the fact that market participants are changing, leading to the question of whether the right type of signals are even still available to policy makers. Many lenders do not have the same disclosure requirements as traditional banks. This applies in particular to private equity firms, which may be extremely leveraged and have a fundamentally different relationship with borrowers than traditional banks.

In delving into the changing structure of market participants, FAR members raised the concern that, in many ways, private equity firms undertake the role of mid-market lenders without being bound to the same standards. Similarly, loan ETFs and loan funds hold long-term investments as assets but make use of short-term funding (daily redeemable shares). Recent research suggests that there may be a first-mover advantage among investors in such funds, which makes them susceptible to runs, like banks, while not being regulated as such. Finally, members discussed that it is still not perfectly understood why the level of the short-term nominal rate should matter for financial intermediaries' risk-taking.

FAR members concluded the meeting by revisiting the discussion of which indicators are most suited to managing the credit cycle and broader financial conditions. Members agreed that the next crisis will not be like the last and that there may be risks driven by factors that are as yet poorly understood. Cyber security, the fact that the US economy has spent a long time at or around the zero lower bound (as have many others worldwide), volatility in short-term funding markets, and legacy contracts predating the LIBOR-SOFR transition were all noted as sources of concern.