Monetary Reform: Looking in the Wrong Places

Central bankers met in Wyoming last week as they do every August to contemplate monetary issues. This year the challenges seem to be particularly daunting. After three decades of battling inflation, central bankers are faced with two equally pernicious macroeconomic problems, namely a massive debt overhang and slow nominal GDP growth that may require an entirely new mindset. The symposium is entitled "Designing Resilient Monetary Policy Frameworks for the Future", but the focus seems to be on what else could be done to stabilize the economy in the event of another recession, whenever that might happen. The concern, of course, is that central banks are running out of ammunition. The evidence is clear that monetary policy has become surprisingly impotent since the Great Financial Crisis (GFC) as policy rates have fallen to the zero bound despite increasingly aggressive measures to stimulate demand. Worse yet, these unconventional measures, especially when pursued to extremes as both the ECB and BOJ seem intent to do, undermine future financial stability by mispricing credit risk and asset prices in general while promulgating more leverage and wasteful investments through the lure of super low interest rates. Adding more debt is not the answer for a world in which debt burdens already sap cash flow and weigh on global demand. In short, central banks now are feeding the beast rather than taming it.

Many Federal Reserve officials are beginning to acknowledge this conundrum and realize that they might need to rethink their policy framework. So far suggestions have centered on the new bells and whistles that central banks have added to their toolboxes – asset purchases, forward guidance and negative policy rates. All these policy levers are used to promote 'macroeconomic stability' nowadays, that is, to add stimulus to demand when the economy is lagging and to cool conditions when they get overheated. The ultimate objective of this countercyclical monetary policy with its new unconventional tools is to meet the Fed's legislated goals of full employment and price stability. One often forgets that 'macroeconomic stability' is only half of the Fed's remit; the other half is to ensure safety and soundness of the financial system as is set forth in the Federal Reserve Act of 1913. Banking crises were frequent and destructive. A central bank was needed not only to maintain order and to establish a safety net but also to impose more prudent lending practices that were the cause of booms and busts. Wasteful lending during good times still is the root cause of financial instability when recessions hit. In this new world of debt overhangs and anemic growth, the Fed should be looking to rediscover its role as overseer of sound lending practices with an eye toward curtailing wasteful and unproductive lending. Relying on macro-prudential guidelines and risk models will not preclude the next financial crisis. There seem to be few signs that all the Dodd-Frank rules have changed the fatal flaws of bank lending, namely, using too much short-term debt to finance lengthy development projects and lending to ever-sketchier borrowers as the business cycle matures. Indeed, deteriorating credit quality will be the cause of the next financial crisis.

The Fed's Policy Framework

In practice, the Fed's policymaking framework has four priorities, not just the two mainstays of full employment and price stability as set forth by the Humphrey-Hawkins Full Employment Act of 1978. The pecking order is 1) safety and soundness of the financial system; 2) price stability; 3) full employment; and 4) external considerations. The first priority was established by the Federal Reserve Act of 1913 and is distinct from the others in that the dangers of a meltdown in the financial system are far greater than those of a business cycle downturn, as has become clear

ever since the Great Financial Crisis (GFC) of 2008-9. Financial crises can transform mere recessions into depressions or secular stagnation and hence warrant extraordinary measures. When the Fed feels the financial system has become unglued for whatever reason, the gloves are off; the Fed is free to do whatever it takes to restore stability including acting as lender of last resort to both domestic and foreign banks, other systemically-important financial institutions, other central banks and even foreign governments. The bottom line is to restore liquidity and trust in the financial system as quickly as possible.

As such, this priority has been **conditional** on the Fed's assessment of the health of the financial system. It is a judgment call that often is not as clear as it was during the GFC. For example, the collapse of many US Savings and Loan institutions during the early 1990s had all the trappings of a nascent financial crisis. S&Ls originated about 80% of mortgages at the time and the Fed decided to err on the side of a generous monetary easing to the point where the real policy rate was negative. By 1993 it had become clear that the rest of the economy was booming, inflation was rising and the Fed was forced quite suddenly to change course. There are other examples when the Fed **reacted** to legitimate concerns about the stability of financial markets such as when the Fed eased policy after Russia's default and Long Term Capital's collapse in 1998 which it was feared would render the high yield market dysfunctional and undermine the economic expansion in turn. The operative word, though, is that the Fed 'reacted' to potential financial instability. This priority has not been formulated as a proactive means of limiting excessive leverage, wasteful lending and other ill-advised lending practices in a proactive way. They should do so in order to nip financial instability in the bud.

Priorities #2 and 3 (and even #4) have to do with managing 'macroeconomic' stability. They have a decided domestic focus as is mandated by the Humphrey-Hawkins Full employment Act of 1978. At the time, both inflation and unemployment were headed to clearly unacceptable rates of 10%, and the Fed had to finesse the tradeoffs between these two mandates in gauging the appropriate stimulus. The first step, of course, was to define terms. Chairman Volcker asked the key operative question: "What **measured** inflation rate is consistent with price stability?" He shrewdly understood that all price measures have upward biases because of quality changes, shifting spending patterns and measurement issues. The staff asked the Bureau of Labor Statistics (BLS) to estimate those biases in the Fed's favorite price measures, i.e. those that worked best in our models. The BLS response was almost identical to the current targets – namely, 1.5% for the GDP deflator, 1.75% for the PCE fixed weight index and 2% for core CPI (excluding volatile food and energy items). Indeed, these estimates became implicit inflation targets for Fed policy as early as the mid-1980s and later were formalized as explicit targets by Chairman Bernanke in 2004. During the Volcker years, the staff also in essence jettisoned old concepts of the 'natural rate of unemployment" and the NAIRU (non-accelerating inflation rate of unemployment) in favor of the concept of 'output gap' – the difference between actual and potential GDP – as a measure of full resource utilization in large part because it could be estimated with greater certainty.

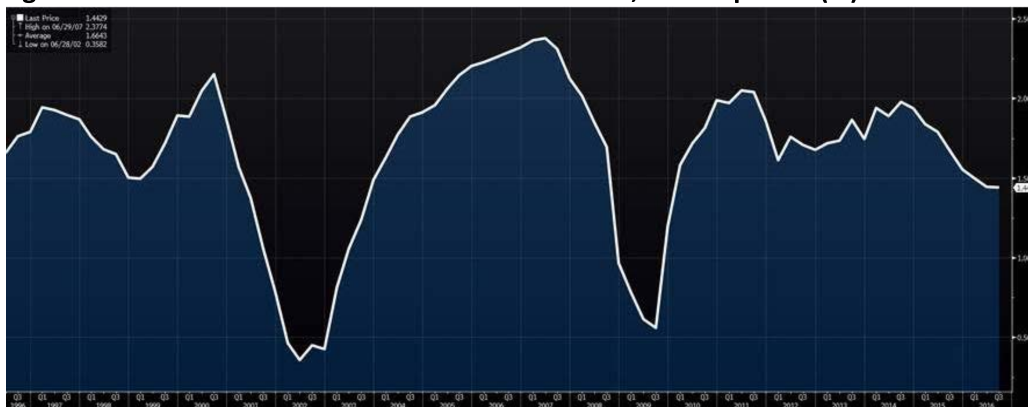
The dual mandate in my opinion proved to be an ideal framework for dis-inflating a world in which inflation had gotten the upper hand. Not only did it give the Fed much greater flexibility than central banks with a single price mandate but also allowed the FOMC to stay the course in eradicating inflation while making difficult choices along the way. Times have changed, however. Prices no longer are rising, except those for real estate and investment assets. Central banks and governments no longer can count on a gentle increase in the overall price level to generate

interest income for retirees and to ease the pain for debtors. The lethal combination of a debt overhang and slow nominal GDP are not amenable to a one-dimensional emphasis on macroeconomic stability. Under the current framework, central banks supposedly should try harder to stimulate demand and reach their targets. That strategy has involved either creating more credit or intervening in capital markets with the intent to lower borrowing costs. These 'unconventional' policies including direct asset purchases by the central bank were supposed to supplement any waning stimulus from low short-term rates as is inevitable as rates approach the zero lower bound.

Unlike other central bankers, however, Fed officials seemed to understand that these unconventional tactics are not limitless in scope and may not be sustainable indefinitely, which was one reason why FOMC members voted to 'taper' purchases in May 2013. Fed purchases of government securities topped out at less than 25% of outstanding debt. How many asset purchases are too many is somewhat subjective. A BOJ board member recently stated that the only limit for Japan would be the entire stock of outstanding JGBs. That view seems extremely dangerous. At some point, the BOJ will be perceived simply as the enabler of government deficits and, as sole financier of that largesse, will lose all credibility as an independent central bank.

Neither tweaking the targets nor pressing harder on existing monetary levels seem adequate to deal with the formidable nexus of a massive debt overhang and low nominal GDP growth. Indeed, low interest rates actually may be exacerbating the world's oversupply problem by encouraging investment in uneconomic capacity. Obvious examples abound in Chinese manufacturing, resource industries, real estate and finance. Figures 1 and 2 suggest that the

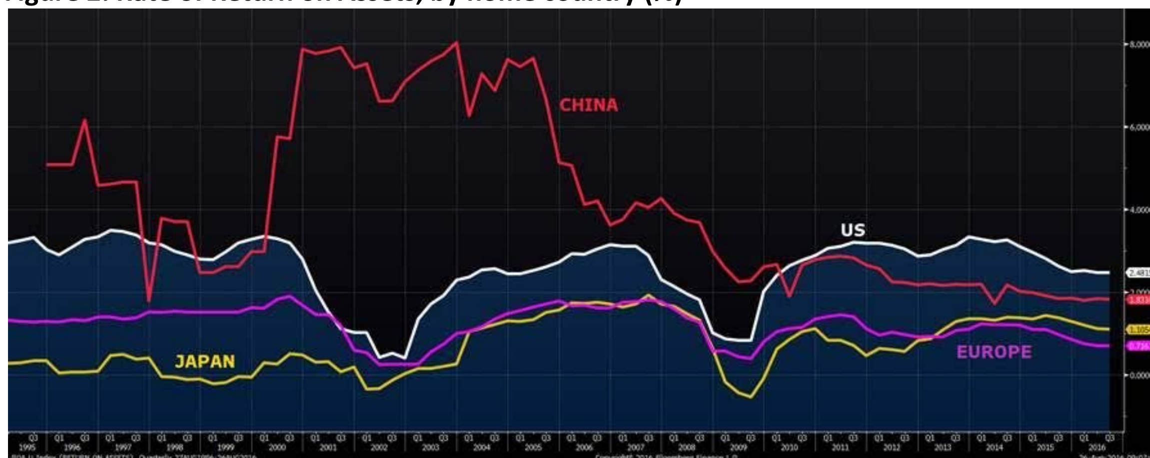
Figure 1: Rate of Return on Assets from MSCI World, all companies (%)



Source: Bloomberg

phenomenon may be pervasive. Rates of return on assets have fallen to abysmal levels, less than 1-1/2% on average across the globe. In Japan and Europe those low returns have persisted for decades; China has joined the club in recent years and the US is not much better. At first, the notion that low interest costs are linked to uneconomic capacity seems nonsensical because business fixed investment has been anemic. However, consider the less obvious notion that companies are not pruning uneconomic capacity because sunk costs and low debt service have obviated the need to do so. By keeping marginal capacity afloat, central banks actually are contributing to the very deflationary pressures that they are trying so hard to overcome! In short, zero, and especially negative, nominal interest rates are a fool's game.

Figure 2: Rate of Return on Assets, by home country (%)



Source: Bloomberg

In that context, Chair Yellen and her like-minded colleagues on the FOMC have good reasons to persist in normalizing policy rates, especially if the US economy is close to satisfying the targets of full employment and price stability. Moving the goal posts or tweaking the toolbox simply postpones the pruning of capacity and misallocation of credit. Besides, the Fed's endgame is very timid – a nominal rate of 2% and a real rate of zero. That 'New Neutral' at least might introduce some semblance of discipline into credit pricing and lending decisions. And the Fed has plenty of time to reach the new neutral.

Looking in the Wrong Places

That still leaves the more vexing dilemma of how to reformulate monetary policy to cope with the debt overhang. I fear that not much attention is being given to this issue. Indeed, it is not even clear that FOMC members think credit practices and wasteful lending are within their purview. Neoclassical mumbo-jumbo would claim that those decisions should be left to markets, or worse yet bankers, to decide. Nothing could be further from the truth if we are to overcome secular stagnation. We are awash in wasteful lending and surely financial markets will drown in it when the next recession ensues.

The sequence of events leading to a financial meltdown follows a fairly predictably course. At first, things seem rosy. Growth perks up somewhat, as already appears to be happening in the US economy. (Remember that the hurdle for 'acceptable' growth is very low – probably about 2% which coincides with the economy's potential growth rate.) The Fed is forced to respond at least with a few timid rate hikes because, as Chair Yellen explained in her Jackson Hole presentation, the US economy already is at or close to its targets. Even though those hikes will be meaningless in terms of their impact on the economy, their symbolism will not be lost on financial markets, for better or worse depending on whether the Fed is seen as acting ahead or behind the inflation curve. Some improvement in growth seems likely in the months ahead. Banks have yet not curtailed lending on either mortgages or credit cards and it appears that residential housing will lead the way.

Even so, those developments, notably rising interest rates, are NOT what germinates the next recession. Rather, developers of projects with long gestation will rush to begin new projects

while times are still good, even though it is late in the game .Meanwhile, bank lending officers will find some of their weaker clients are struggling the pay their overextended loans on time. Delinquencies and bad loans begin to rise. Banks eventually decide to tighten standards not only to the offending companies but more generally to protect their balance sheets. Credit availability, which has fueled the expansion, suddenly becomes a major problem for companies with insufficient cash flow. When too many loans are not rolled over, the music stops and financial asset prices collapse. Figure 3 shows this pattern from the past several cycles. Banks already have begun tightening standards for large firms, notably oil related firms and commercial real estate developers, which began in late 2015.We have not reached a tipping point yet but are headed in that direction.

Figure 3: US Bank Lending Standards, Commercial and Industrial Loans (large and medium firms)

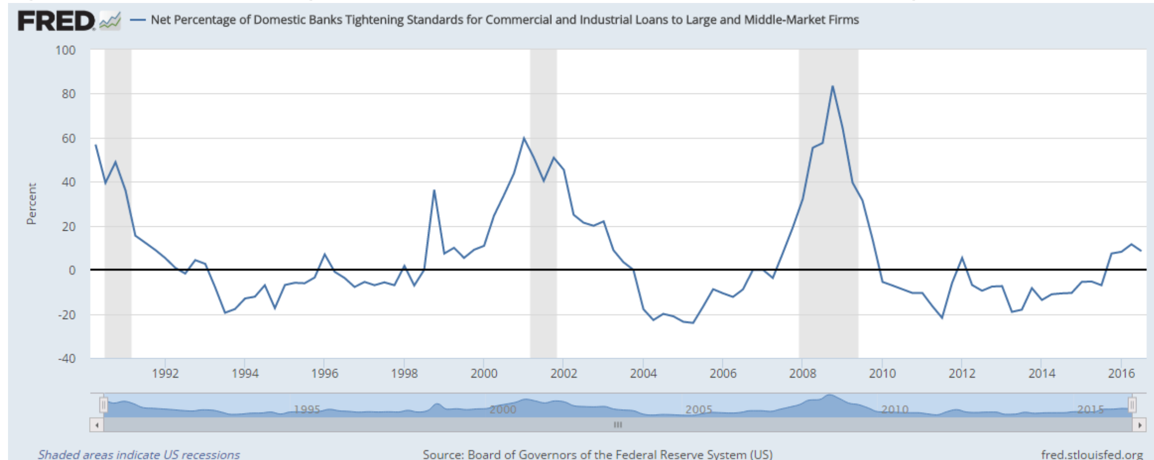
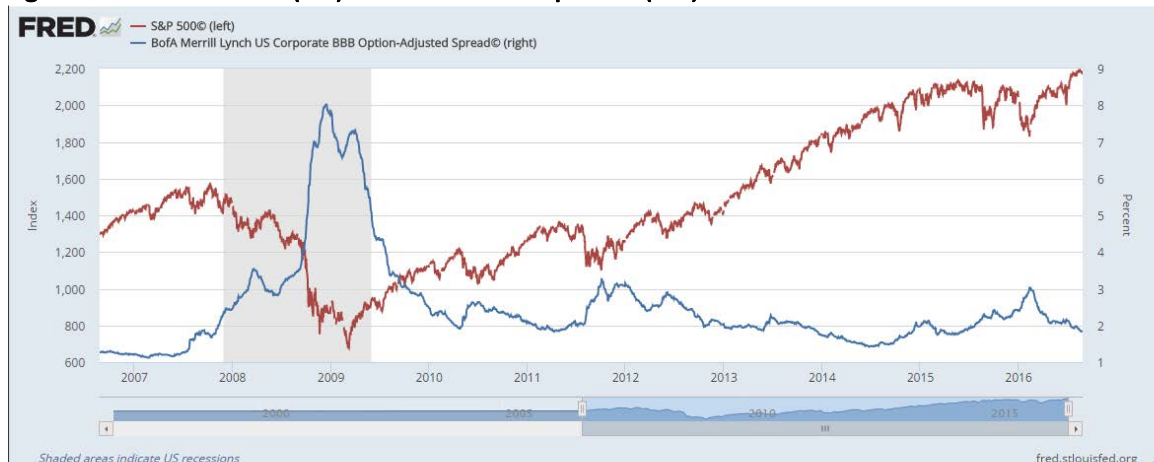


Figure 4 shows what happens to asset prices when loans finally are not rolled over. Credit spreads blow out, even those for many investment grade rated companies, and of course equities collapse. The next flare-up is not likely to be any different from previous ones, except debt burdens around the world are much higher today than they were prior to the GFC and potentially more dangerous. Forget that the balance sheets of US firms in general are in better

Figure 4: S&P500 Index (lhs) and BBB Credit Spreads (rhs)



shape than those elsewhere. It won't make any difference. Financial crises begin when some major borrower somewhere cannot pay. The spread of that trouble is inevitable thanks to the massive global financialization of the past two decades.

Banks, overloaded with long-term assets and short-term liabilities still are the Achilles Heel of markets and the primary source of instability. Until central banks come to grips with that vulnerability, we will not escape financial crises. And the only way to ameliorate that fatal flaw is for central banks to become more intimately involved in the credit decisions of their member banks. Such intervention is not a fanciful idea. To give an example for recent US history, the State of Texas completely avoided the property boom and bust of the 2000s along with the bankruptcies and foreclosures that trailed in its wake. The reason is that state bank regulators adopted a strict maximum of 80% on the **combined** value of all loans relative to property valuations (LTV ratio). There was no wiggle room to avoid the limit on LTV. It could be argued that this quantitative limit on leverage also instilled disciple in mortgage brokers who were unable to embrace the deceptive lending practices and outright fraud that plagued many other sunshine states.

For western central banks, the obvious place to begin is with a review of lending to commercial real estate. Lending to real estate in general has risen almost 10 times as fast as nominal GDP in many western societies over the past two decades, whereas lending to other businesses both large and small has increased in line the nominal GDP. Moreover, real estate has a long history of boom and bust because developers chronically overbuild during expansions and especially during the late phases. It is a mystery why banks continue to lend into excess capacity but they do. In the US, Eric Rosengren, President of the Boston Fed, has highlighted the rapid rise in rents and lending for multifamily dwellings as a sign of a brewing bubble. Other observers see real estate bubbles coming to an end in London, Sydney, Hong Kong and elsewhere. In my opinion, though, the next spate of defaults will be developers of office space and resort properties; new construction leveraged with cheap debt is cannibalizing old buildings and properties whose solvency will become increasingly tenuous. The loosest cannon, though, may be the People Bank of China whose usual discipline has been cast aside in a vain effort to forestall bankruptcies and plant closures in mining, steel and numerous other industries with huge excess capacity. The strategy of Chinese banks of 'extend and pretend' on loans is destined to haunt the PBOC for years if not decades to come.

We are entering the late phase of an aging expansion when asset price bubbles and poor credit decisions sow the seeds of the next crisis. Despite the lofty and open-ended title of this year's Jackson Hole Symposium, I fear that the Fed is missing an opportunity to raise the issue of how to deal with the credit bogeyman and hence to incorporate some preemptive safeguards into its policy framework. Presuming that stress tests and risk models will inspire bankers to do the right thing is a dangerous illusion.

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