

“The Long-Run Imperatives of Monetary Policy and Macro-Prudential Supervision” -- Remarks of FDIC Vice Chairman Thomas M. Hoenig to the Cato Institute’s 34th Annual Monetary Conference: Central Banks and Financial Turmoil

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Introduction

As central banks have come to dominate financial markets, the debate over their ability to deliver strong, long-run economic growth has become increasingly intense. “Central Banks and Financial Turmoil” is the theme of this conference, and given the dramatic expansion of central bank balance sheets and their influence over economies, it is a topic well worth our attention. I congratulate the conference organizers for their foresight in selecting it.

I will focus my remarks this morning on two areas on which central bank performance is judged: monetary policy and macro-prudential supervision. While a host of factors determine an economy’s strength, these two policy instruments have come to play a dominant role in our economy, and their role going forward is a major subject of attention. I will suggest that monetary and regulatory policies have for some time been overly focused on short-run effects at the expense of long-run goals, which has unintentionally served to increase uncertainty and economic fragility. Future success requires that policy move deliberately toward a more balanced long-run objective.

Monetary Policy

The dual mandate for U.S. monetary policy, established by Congress, is to “maintain long-run growth of the money and credit aggregates commensurate with the economy’s long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.”¹ In reading this mandate, you might note the emphasis on long-run effects. As a colleague once described it, “central bankers should take care of the long-run so that the short-run can take care of itself.”

In a world of discretionary policy, when the moment comes to choose between long-run goals and short-term effects, policymakers experience enormous pressure to choose the more expedient short-run solution, deferring to another time concern with long-run implications.

This tendency can be seen in the long-run trends of short-term interest rates. Chart 1, for example, shows the real fed funds rate from 1960 to August 2016. For comparison, the chart also shows the average real GDP growth rate of near 3 percent for that period. It is noteworthy that the real fed funds rate was below the average real GDP growth rate for nearly 80 percent of the time, and it was negative for over 30 percent of the time. Also noteworthy, the real fed funds rate averaged only 0.9 percent from 1991 to 1995, 0.2 percent from 2001 to 2005, and minus 1 percent or lower from 2008 through 2015. Regardless of what one deems the appropriate U.S.

¹ Federal Reserve Act of 1913, as amended

monetary policy to be, it was -- except in the early 1980s -- decidedly directed toward lower interest rates.

Regulatory Policy and Macro-Prudential Supervision

Turning to macro-prudential supervision, its objective might best be described as that of assuring the integrity of financial institutions, sound markets, and a reliable payments and intermediation framework. Carrying out this mandate involves an extensive program of rules and supervisory oversight designed to achieve long-run financial stability, credit availability, and stable economic growth.

As with monetary policy, authorities have discretion as to how they carry out the supervision mandate, which has led to different degrees of oversight over time. For much of the quarter century prior to 2008, for example, there was a systematic easing of constraints on bank activity and, most notably, an extension of the public safety net to an increasing number of non-bank financial activities conducted by both banks and shadow banks. Commercial banks were given authority to engage in investment banking, trading, and broker-dealer activities, while investment banks and other financial firms were permitted to engage in a host of bank-like activities.²

While the safety net was broadened over this period, capital requirements were allowed to weaken, exacerbating the downward effects on stability.³ Chart 2 shows that from 2001 through 2008, equity capital supporting the industry's balance sheet – defined as the ratio of tangible equity-to-tangible assets – declined to less than 4 percent. This trend of lower capital continued a century-long shift in which market and public confidence in banks relied less on bank capital levels and more on the growing presence of government safety nets.⁴

Leveraging the Economic System

Chart 3 shows the longer-run effects of accommodative monetary and supervisory policies. Total U.S. debt relative to nominal GDP rose from 265 percent in 2000 to 365 percent in 2008, and it has improved only slightly since then. Behind this broad trend, debt within sectors also has substantially increased. For example, gross federal debt increased from 39 percent to 51 percent of GDP, consumer debt increased from about 70 percent to almost 100 percent of GDP, non-financial debt increased from 63 percent to 74 percent, and U.S. debt extended to the rest of the world increased from about 8 percent to 11 percent of GDP.

² Laws such as the Glass-Steagall Act were repealed, which ended the separation of commercial banking from investment banking, broker-dealer activities and, in some cases, non-financial commercial firms. Bankruptcy law changed to allow short-term liabilities to be secured with mortgages instead of short-term U.S. government securities. The SEC eased capital restraints for investment banks in 2004.

³ Between 1993 and 2007, financial regulators allowed leverage at regulated firms to increase to unprecedented levels. The average leverage – measured as total assets to tangible equity capital – of the 20 largest, most systemically important U.S. financial institutions increased from 18 dollars of assets being funded by one dollar of equity, to a high of 31 dollars of assets being funded by that same dollar. This represents almost a doubling of debt used to fund assets.

⁴ FDIC calculations based on data from the FDIC and Cambridge University Press.

These trends in debt have been described by some as a consequence of a global savings glut. However, it is no coincidence that the trends followed nearly a decade of systematic and sometimes dramatic accommodative U.S. monetary policy and capital standards that encouraged higher bank and financial leverage.

Finally, Chart 4 shows that despite these ever-more accommodative monetary and regulatory policies, and despite the increase in financial and economic leverage, the growth rate of the U.S. economy has not increased. Indeed, real GDP growth during expansionary periods has declined steadily from more than 4 percent annually in the 1980s to just over 2 percent today.

Financial Crisis

These trends suggest that the financial and economic shock experienced in 2008 did not just happen randomly. It followed an extended period of accommodative policies in which long-run considerations were most often discounted against the perception of immediate needs. Extended periods in which monetary policy catered to short-term growth objectives and regulatory policies encouraging ever-declining capital levels among financial firms made the system increasingly vulnerable to shocks.

As 2007 and 2008 unfolded, the effects of these policies erupted and losses quickly overwhelmed the financial industry. Chart 5 shows that cumulative losses and TARP capital injections in 2008 approached nearly 6 percent of total industry assets. Several of the largest financial firms failed, requiring unprecedented government support to prevent collapse, while many others appeared ripe for failure. The public and the market did the rational thing; they ran for the exits. The crisis was on.

Central banks, using unprecedented facilities, injected enormous amounts of liquidity into the economy. In an important sense, their actions represented a decisive execution of the lender and liquidity provider of last resort, which calmed fears and staunched the crisis. While it was the appropriate short-run response, its extended duration comes with a substantial public cost.

Post Crisis: Monetary Policy and Discretion

By the third quarter of 2009, an economic recovery was underway. Then, as now, the month-to-month data were mixed⁵ but the overall trend suggesting a sustained recovery was compelling. For example, average GDP growth during the first year of recovery was 2.7 percent, which compares favorably to the 2.9 percent growth rate in the first year following the 1991 recession and 2.3 percent growth following the 2001 recession.

Nevertheless, most policymakers were uncertain of the recovery's durability and were loath to normalize monetary policy regardless of the emerging favorable evidence. Long-run

⁵ For example, industrial production ranged between a negative 0.4 percent in June to plus 1.1 percent in August, and durable goods orders varied from a strong 7.1 percent in July from a minus 3.2 percent in June. Private job growth continued to decline, but at a slower pace.

considerations took a back seat to short-run concerns.⁶ In November of 2010, under the title QE2, the Federal Reserve voted to purchase \$600 billion of Treasuries at a rate of \$75 billion per month. Again between 2012 and October 2014 the Federal Reserve, under QE3, purchased \$40 billion of MBS securities per month. Monetary policy throughout 2010 and beyond remained not only accommodative, but also represented an unprecedented policy easing into a recovering economy.

As a result, a fragile equilibrium dependent on low interest rates has settled so deeply into the economy and financial markets that the difficulty of moving rates higher represents an unsettling force within the United States and global economies.

Post Crisis: Macro-Prudential Supervision

As monetary policy was steadily eased, concern arose regarding its negative long-term effects on financial firms and the broader economy. To offset these concerns, macro-prudential supervision was touted in financial policy circles as a powerful force to balance any negative effects of monetary policy.

Enhanced macro-prudential financial rules and standards are tools that serve the goal of greater financial stability, but as a complement to monetary policy they raise their own set of issues. If monetary policy is set to stimulate credit expansion and wealth effects, it is highly unlikely that bank supervisors would take actions that impede those policies.

Chart 6 shows the trend line for tangible capital-to-tangible assets for the largest U.S. banks since 2012. This ratio increased from 3.66 percent in the second quarter of 2012 to 5.75 in the second quarter of 2016.⁷ Before 2008 it was argued that requiring increased capital would slow economic growth. These arguments tended to win the day in policy circles, but do not hold up as data and experience show⁸. Referring back to Chart 5, cumulative losses plus TARP capital injections for the 26 largest U.S. banks in 2008 were nearly 6 percent of total assets. Thus, should the largest firms experience losses in the future similar to those of 2008, those losses would absorb nearly all of their reported tangible equity capital and would, again, place enormous stress on the financial system.

⁶ In justifying the highly accommodative policies of 2010, the arguments echoed those used in the 2003 easing period, when the federal funds rate was lowered to 1 percent, and where it remained until 2004. For example, during this earlier period, there were constant references among FOMC members to a risk of deflation and constant reminders of Japan's deflation. And although in the third quarter of 2003 real GDP in the U.S. expanded at an annual rate of nearly 7 percent, the policy rate still remained at 1 percent for nearly a year. The insistence on keeping rates low set the stage for the speculative binge that contributed to the 2008 financial crisis. Policymakers accepted the risk of greater long-run financial instability for short-run gains.

⁷ Global Capital Index of capitalization ratios for global systemically important banks, second quarter 2016. <https://www.fdic.gov/about/learn/board/hoenig/capitalizationratio2q16.pdf>

⁸ Gambacorta, Leonardo; Shin, Hyun Song; BIS Working Papers No. 558: Why Bank Capital Matters for Monetary Policy, April 2016, <https://www.bis.org/publ/work558.pdf>
Pogach, Jonathan, "Literature Review on the Macroeconomic Impacts of Capital Requirements," FDIC Division of Insurance and Research, <https://www.fdic.gov/about/learn/board/hoenig/2016-05-12-lr.pdf>

While strengthening bank capital would serve the industry and the economy well, an effort is underway to back away from this macro-prudential policy goal.⁹ The argument continues now, as it did pre-crisis, that increasing capital from current levels will hurt economic growth. To the extent that these arguments are successful, the industry and economy will be very poorly served. Macro-prudential supervision and monetary policy are not tools for fine-tuning the economy, but are blunt instruments generally managed toward the same policy goals. The mandate for these policies is long-term stability, but too often the immediacy of the short term has taken precedence. And the cost has been great.

Changing the Approach

After nearly a decade of highly accommodative monetary policy and uneven supervision, the U.S. economy is growing more slowly than policymakers had hoped for or expected when this policy cycle began. While it prevented a financial collapse in 2008, subsequent easing failed to deliver the expected economic growth and has left the system fragile. And allowing financial firms to operate at minimum capital levels fails to accelerate economic growth and leaves the system more vulnerable to shock.

This accommodative policy loop must change. To normalize monetary policy, interest rates must increase, which will temporarily put downward pressure on financial industry asset values and earnings. It is also understood, but less acknowledged, that if capital levels of the world's largest banks remain at current levels, these firms will continue to be vulnerable to losses that flow from higher rates and macro-economic adjustments. Such consequences could weaken bank balance sheets significantly and undermine their ability to support the economy through the adjustment period.

The challenge is to find a path that enables central banks to rebalance monetary policy without shock overwhelming the financial system and undermining long-run economic growth. One such path to consider is for interest rates to be increased in a clear, deliberate manner toward an announced long-run target rate or range. The time line, adjustment path, and target range would be influenced by a host of factors, including, for example, fiscal policy, demographics, and international events. However, once chosen and announced, the policy must not be abandoned at the first – or even second – sign of stress. It took a decade to get to this point, and it will take time to return to “normal”.

Importantly, there should be no backing away from insisting on strong equity capital standards. Capital should be set to levels that ensure the industry can absorb future losses and reduce concerns about its resilience. This requires building tangible equity capital beyond current levels.

While challenging, there is clearly room to strengthen capital through retained earnings. For example, since 2009, the largest eight US banks have paid out \$243 billion of the \$431 billion

⁹ Governors and Heads of Supervision (GHOS) statement “The GHOS endorsed the broad direction of the Committee's reforms. The GHOS discussed the Basel Committee's ongoing cumulative impact assessment and reaffirmed that, as a result of this assessment, the Committee should focus on not significantly increasing overall capital requirements.” Bank for International Settlements, Press Release, September 11, 2016.
<http://www.bis.org/press/p160911.htm>

earned. The industry, therefore, has the capacity to systematically strengthen capital and build industry resiliency through retained earnings.

Importantly also, retained earnings would not be stale reserves, as is sometimes suggested. Retained earnings are working capital that facilitates bank lending, enhances bank earnings, promotes financial stability, and supports long-term economic growth. While concern has been expressed in some quarters that requiring increased equity would lower returns to investors and raise the cost of capital, there is ample evidence that well-capitalized banks trade at higher premiums than less well-capitalized banks and have a lower cost of capital over time. History also shows that without the government safety net, the market would insist on banks having tangible capital levels – in other words, owner equity -- higher than currently maintained. And, as a matter of public policy, we should not allow the benefits of the government safety net, which are meant to protect the public, to flow as a subsidy to private investors.

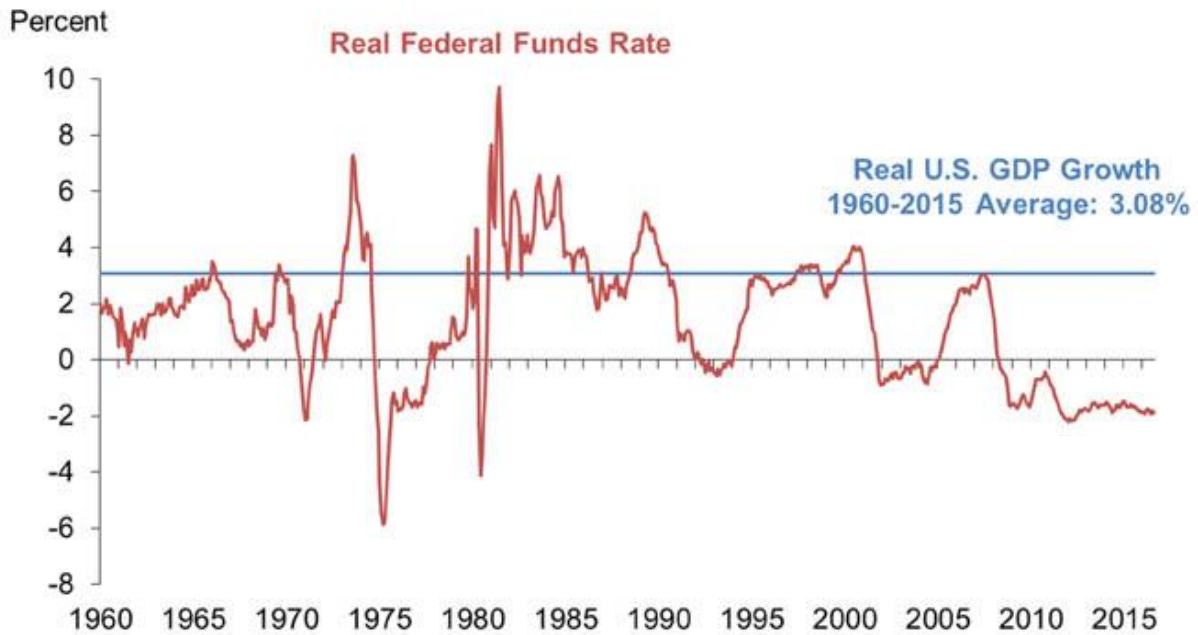
In summary, I am suggesting that both monetary and macro-prudential policies need to focus independently on the long run. Interest rates need to normalize, and bank capital needs to be strengthened. Policy cannot stay on its current path of low-for-long rates and return-to-lower capital without undermining the resilience of the financial system and the economy, and without inviting harsher future adjustments, as occurred in past episodes when policy was highly accommodative. We have an opportunity to strengthen banks, the financial system, and the economy to achieve real long-run growth goals, if the view of policymakers shifts from short-run effect to long-term sustainability.

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The views expressed are those of the author and not necessarily those of the FDIC.

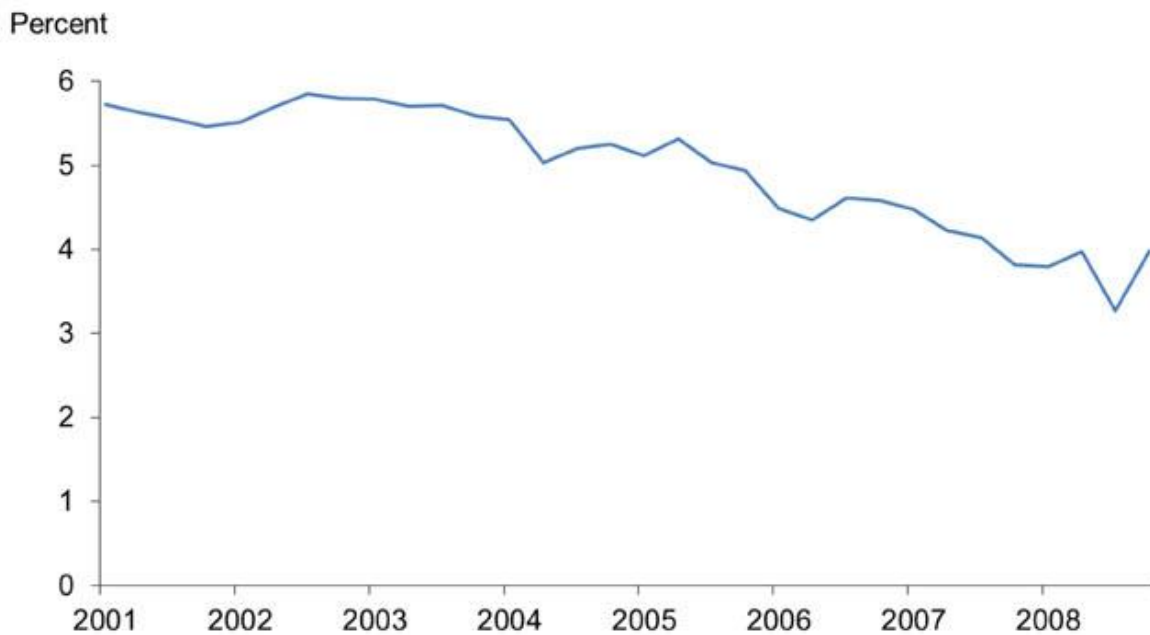
Thomas M. Hoenig is the Vice Chairman of the FDIC and the former President of the Federal Reserve Bank of Kansas City. His material can be found at <http://www.fdic.gov/about/learn/board/hoenig/>

Chart 1: Real Federal Funds Rate and U.S. GDP Growth



Sources: Federal Reserve / Bureau of Labor Statistics / Bureau of Economic Analysis (Haver Analytics).

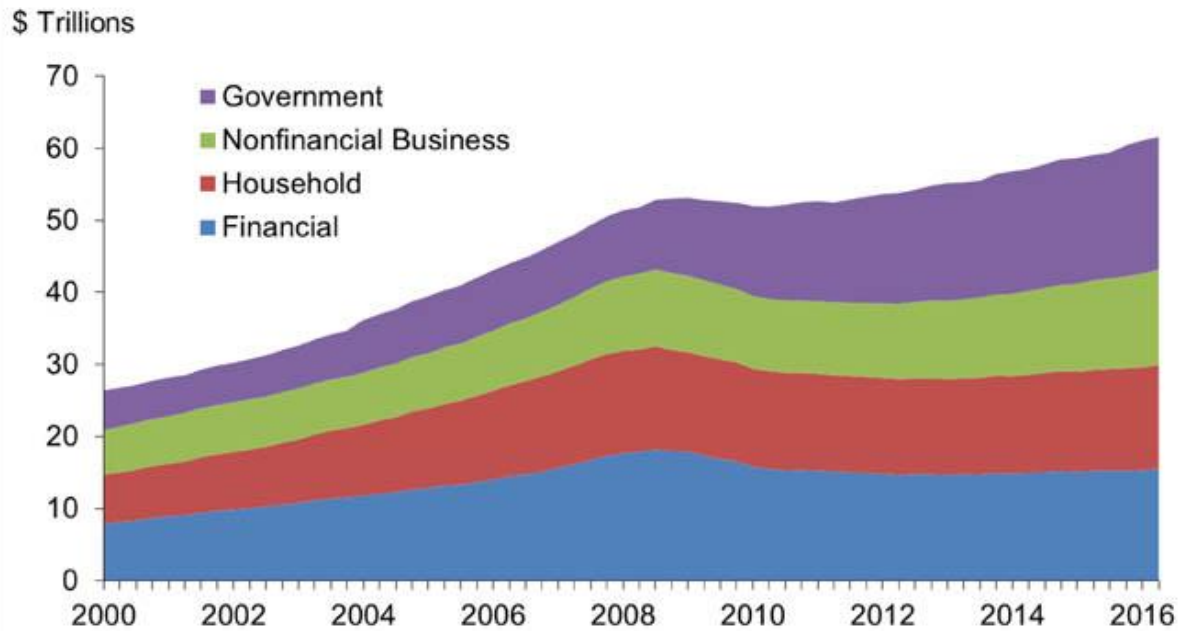
Chart 2: Tangible Leverage Ratio for U.S. Bank Holding Companies



Source: Federal Reserve Y-9C.

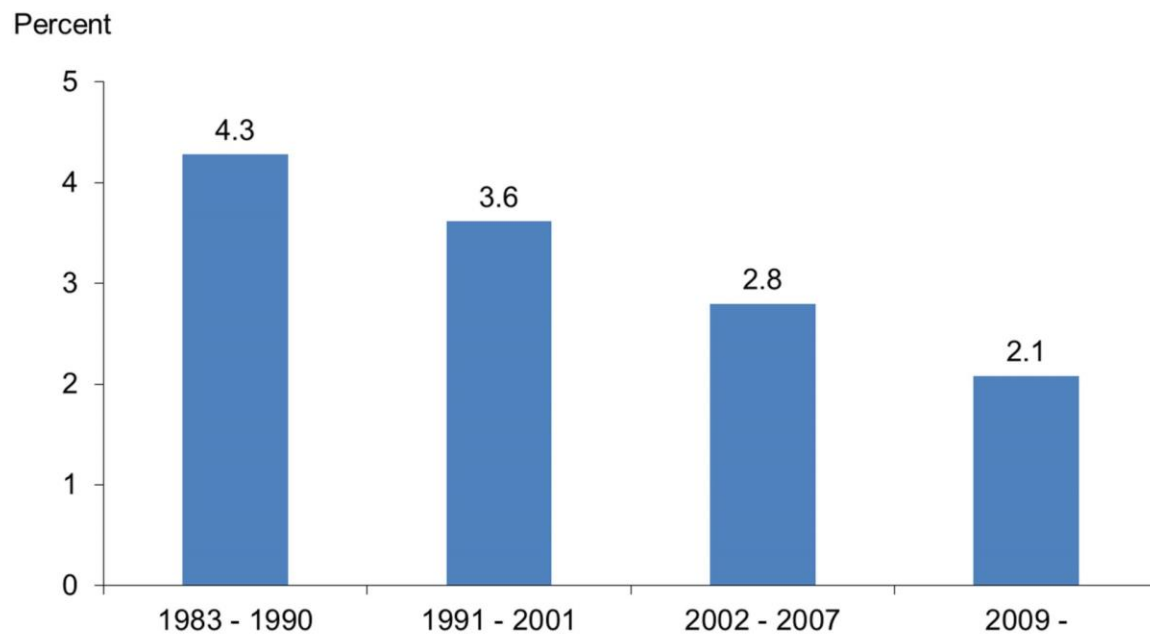
Note: Quarterly weighted average ratio of tangible equity less deferred tax assets (DTAs) to tangible assets less DTAs.

Chart 3: Debt Securities and Loans Outstanding in the United States



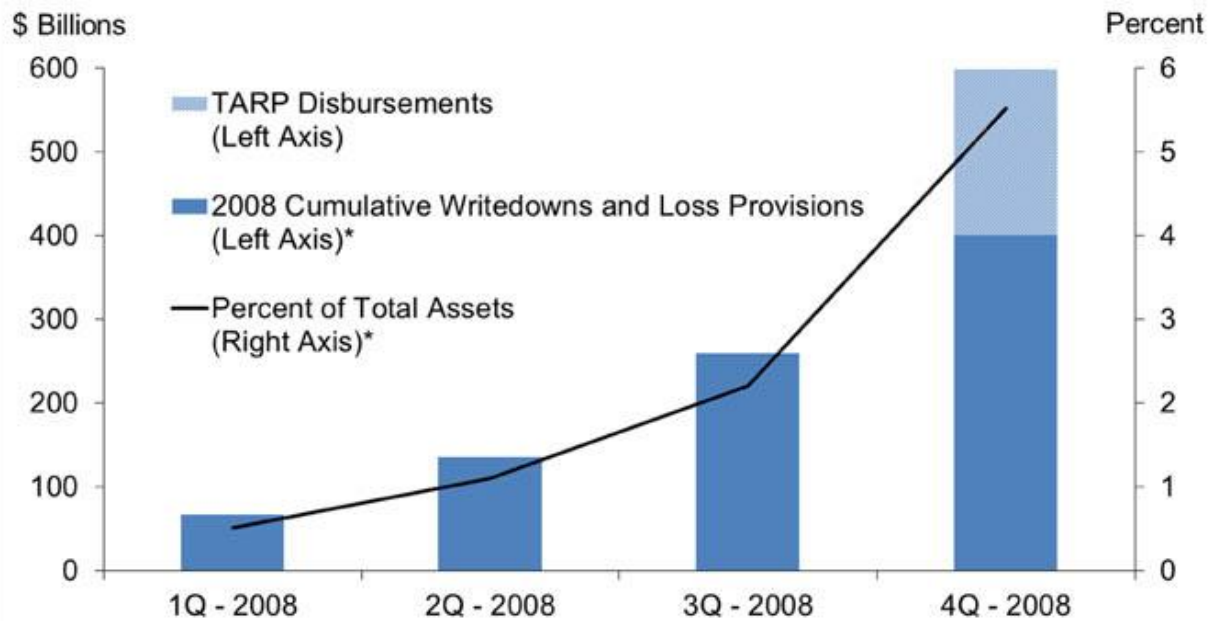
Source: Federal Reserve Flow of Funds (Haver Analytics).

Chart 4: Annual Real U.S. GDP Growth During Expansions



Sources: Bureau of Economic Analysis / National Bureau of Economic Research (Haver Analytics).

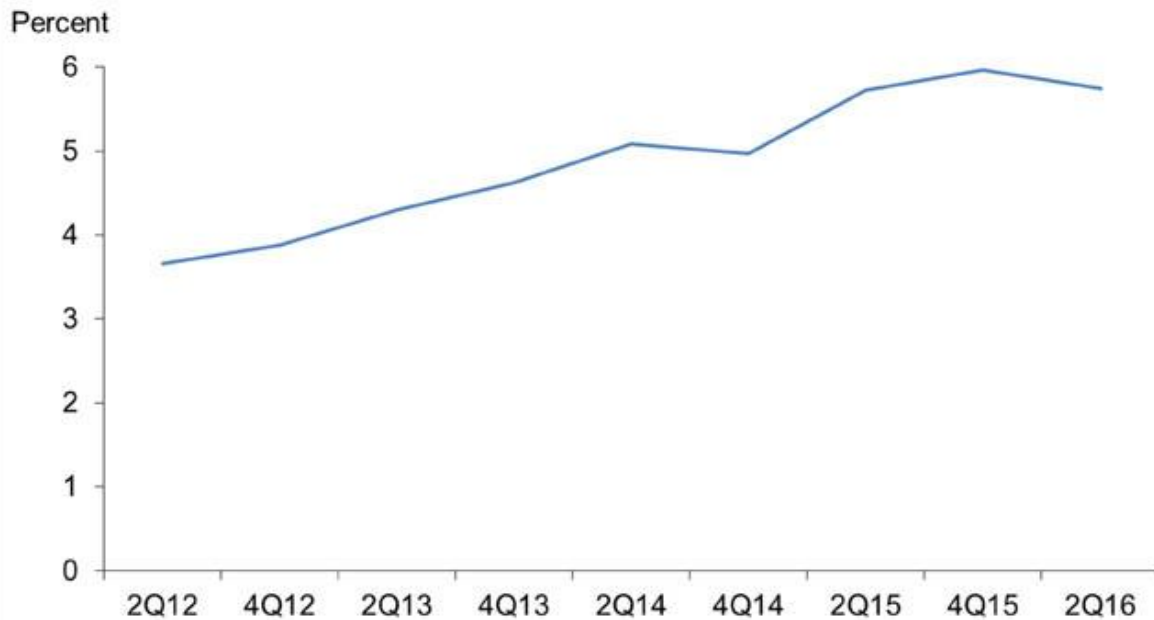
Chart 5: Cumulative Writedowns and TARP Disbursements for U.S. Banks in 2008



Sources: Bloomberg / U.S. Treasury.

*Data for 26 large U.S. bank holding companies from the Bloomberg WDCI command.

Chart 6: IFRS* Tangible Leverage Ratio for U.S. Global Systemically Important Banks



Sources: Federal Reserve Y-9C / SEC 10-K and 10-Q Forms.

*International Financial Reporting Standards