
**Financial Stability and Monetary Policy: Multiple Goals,
Multiple Tools**

**Charles L. Evans
President and Chief Executive Officer
Federal Reserve Bank of Chicago**

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Those of the Federal Reserve System or the FOMC.

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Introduction

Thank you Franklin for that kind introduction. It is a great honor to be the recipient of the Financial Management Association's (FMA) Outstanding Financial Executive Award and join distinguished past recipients, such as my Fed colleague and our new Chair-designate, Janet Yellen. It is also a great pleasure to welcome the FMA back to Chicago.

It has been six years since the onset of the financial crisis that painfully illustrated how excessive risk-taking in financial markets can have persistent negative spillovers to the macroeconomy. More than four years into the recovery, the unemployment rate is much higher than the economy's normal long-run rate and there is still a substantial output gap. The crisis's lasting negative effects on the economy highlight the complex web of interactions between financial markets and real economic activity. As a result, financial stability issues now play a more prominent role in monetary policy deliberations around the world than they did prior to the crisis.

Today, I would like to share with you my approach as a policymaker to the juxtaposition of monetary policy and financial stability objectives. Let me note that these are my own views and not necessarily the views of my colleagues on the Federal Open Market Committee (FOMC) or within the Federal Reserve System.

Targets and Tools of Monetary Policy

The monetary policy mandates of the Federal Reserve are clear: to foster monetary and financial conditions that support maximum employment and price stability. During normal times, the two objectives of monetary policy are generally complementary while the relationship between maximum employment, inflation and our traditional policy tool — the target federal funds rate — is well understood and time-tested.

Clearly, the economy has been far from normal in recent years. The country has struggled through a serious financial crisis, a deep recession and what, so far, has been an unsatisfactory recovery. The Federal Reserve's monetary policy mission has been put to the test.

In response, the FOMC has acted decisively to provide extraordinary monetary policy accommodation to help the economy regain its footing. The target fed funds rate has been near zero for nearly five years. Nonetheless, massive shortfalls in aggregate demand have left the unemployment rate persistently above the 5 to 6 percent range that characterizes a well-functioning labor market. At the same time, inflation has been well below our 2 percent long-run target.

With the fed funds rate pinned down at its zero lower bound, the FOMC has turned to nontraditional tools — namely, forward guidance on short-term interest rates and large-scale asset purchases (LSAPs). Our strategy is to promote a faster recovery by lowering long-term interest rates. A classic textbook decomposition of long-term rates is to view them as the sum of expected future short-term rates and a premium that compensates for interest rate risk. The new tools are aimed at influencing both of these components of long-term rates. Forward guidance reduces expected future short-term rates by ensuring that the fed funds rate will remain low until we reach specific thresholds with respect to the dual mandate goals. The LSAPs are intended to reduce term premiums by removing duration risk from private portfolios. This combination of unconventional tools demonstrated our willingness to take extraordinary measures to restore the economy to full employment.

While these policy tools lower interest rates in an unconventional way, their transmission to real economic activity is quite conventional. Through arbitrage and portfolio rebalancing, lower rates in one market — whether it's the fed funds market or the Treasury and the agency mortgage-backed securities markets — are transmitted to other rates faced by investors, nonfinancial firms and consumers, as well as across the asset and maturity spectrum. There is significant evidence that the FOMC's policies have been helpful in lowering rates paid by firms and consumers and, more generally, in supporting aggregate demand in the face of substantial economic headwinds over the past six years.

Financial Stability and Monetary Policy

The Federal Reserve Act is clear in giving the Federal Reserve a dual mandate to support price stability and maximum employment. Where does financial stability fit in monetary policy? There is clearly an interdependent relationship between the two. A strong and robust economy with low inflation provides a key stabilizing force for financial markets. At the same time, stable and well-functioning financial markets are essential to achieving the goals of monetary policy. The past six years reinforce this critical interplay between monetary and financial conditions.

However, beyond these basic tenets, what is the appropriate policy stance for achieving both financial stability and the dual mandate?

These are particularly important issues in the current environment of low interest rates. A bedrock principle of modern central banking is that low and stable inflation provides the best outcomes for society. Typically, this principle also implies low and stable nominal interest rates that reflect the underlying inflation rate and a relatively stable equilibrium real interest rate. Of course, this real rate is the one that matches the supply of savings to the demand for investment. Today, however, the forces of demand and supply have pushed down equilibrium real interest rates to very low levels. The supply of savings is high as households work down their debt overhang and repair their balance sheets. The demand for such savings is low as long-term, real-money investors face an already abundant supply of housing, substantial unused productive capacity and uncertainty over the path of the economy going forward. As a result, equilibrium

real interest rates are currently quite low. Low equilibrium real interest rates, combined with a low inflation rate, mean equilibrium nominal interest rates also are quite low — indeed, they are likely negative at shorter maturities. (This, of course, is another way of describing the policy dilemma posed by the zero lower bound on interest rates.)

When faced with shortfalls in aggregate demand, large resource gaps and low equilibrium interest rates, highly accommodative monetary policies are needed to stimulate demand. One way this works is by encouraging households and entrepreneurs to take on some additional risk in their borrowing and spending decisions. This may sound odd at first. But during a period of economic weakness, overall risk-taking is often reduced well below normal levels. That appears to be the case today. The Fed's accommodative policies are meant to help restore a more normal level of real risk-taking — a level more naturally associated with typical spending and investment behavior in a vibrant economy.

With inflation running below our 2 percent long-run target and the unemployment rate still unacceptably high, appropriate monetary policy dictates that low real interest rates should prevail until the economy is further along on a sustainable path to its potential level. This assertion is made from a mainstream macroeconomic perspective. Nonetheless, it is common to hear the argument that these highly accommodative monetary policies might sow the seeds of financial instability. How should we evaluate this argument?

Without adequate safeguards, excessive and persistently low interest rates could lead to excessive risk-taking by some investors. For instance, some firms, such as life insurance companies and pension funds, are under pressure to meet a stream of fixed liabilities incurred when interest rates were higher. (And perhaps these liabilities were offered at somewhat generous terms to begin with.) To meet commitments like these in the current low interest rate environment, the incentive exists to reach for yield by investing in excessively risky assets. Furthermore, with the costs of borrowing at historically low levels, other investors might simply decide that this is a good time to cheaply amplify the risk and return in their portfolios by taking on more leverage.

So, one could reach the conclusion that historically low and stable interest rates pose a threat to financial stability. This creates a seeming paradox for policymakers. The existing large shortfalls in aggregate demand call for highly accommodative monetary policies and historically low interest rates. Yet, such policies have the potential to raise the likelihood of financial instability in the future. How should regulators and the Fed mitigate this potential financial risk? Should the FOMC step away from what we thought was the best monetary policy with respect to our dual mandate? Should we discard our nonconventional tools and raise the fed funds rate in order to reduce the possibility of undesirable financial imbalances in the future?

I don't believe that is the right approach. I think the inference that persistently low interest rates pose a danger to financial stability is based on a partial equilibrium analysis and is unlikely to survive a general equilibrium approach. If more restrictive

monetary policies were pursued to generate higher interest rates, they would likely result in higher unemployment and a sharp decline in asset prices, choking the moderate recovery. Such an adverse economic outcome is unlikely to set a favorable foundation for financial stability. Moreover, our short-term interest rate tools are too blunt to have a significant effect on those pockets of the financial system prone to inappropriate risk-taking without, at the same time, significantly damaging other markets, as well as the growth prospects for the economy as a whole. Therefore, stepping away from otherwise appropriate monetary policy to address potential financial stability risks would degrade progress towards maximum employment and price stability. This approach would be a poor choice if other tools are available, at lower social costs, to address financial stability risks.

Let me be clear. I am not saying that financial stability concerns are not relevant for the economy or that policymakers should not take decisive action against developments that threaten financial stability. Rather, I am saying that the macroprudential tools available to policymakers are better suited to addressing financial risks directly. These macroprudential actions can be dialed up or down given the appropriate setting of monetary policy tools, so undesirable macroeconomic outcomes are less likely than if we were to resort to premature monetary tightening. After all, any decision to rely on more-restrictive interest rate policies to achieve financial stability at the expense of poorer macroeconomic outcomes must pass a cost–benefit test. Such a test should clearly illustrate that the economic outcomes from more-restrictive interest rate policies — which could include much higher unemployment and even lower inflation than at present — would be better and more acceptable to society than the outcomes that can be achieved by using enhanced supervisory tools alone to address financial instability risks.

Macroprudential Tools

Even before the recent financial crisis, central bankers were well aware of the key role played by stable financial markets in economic activity. The FOMC has always followed financial market developments closely. Since the crisis, however, the analysis of financial stability issues has been greatly expanded and given a more prominent role in the FOMC's deliberations.

In addition, the Federal Reserve has revamped its supervisory approach substantially to focus on financial risks. Today, traditional bank supervisory tools are being used more intensively, and new tools have been developed. The Fed also has increased its involvement outside its traditional role as a banking regulator. Let me give you a few examples.

One of the lessons learned from the financial crisis was that the extensive interconnectedness of the financial system can generate important systemic risks. Traditionally, the Federal Reserve's supervisory efforts were focused on analyzing an individual institution's activities to understand the strengths and challenges of that particular company. This microprudential approach continues to provide supervisors a sound working knowledge of the institutions. However, it lacks what Chairman Bernanke

has described as a macroprudential “field of vision.”¹ Accordingly, since the crisis, the Fed has taken a broader, cross-firm approach. Taking such a wide-angle view of the industry helps identify common trends and emerging concentrations of risks that might pose systemic threats to the broad financial system. It also allows supervisors to better identify sound practices among firms and incorporate them into supervisory reviews and the feedback provided in them.

This broader view is also reflected in the changes made to the Federal Reserve System’s supervisory infrastructure in recent years. For instance, the Large Institution Supervision Coordinating Committee (LISCC) was formed in 2010 to incorporate an integrated, macroprudential approach to the supervision of the largest financial firms in the nation. Through better data collection and quantitative analysis, the LISCC seeks to identify concentrations of risk not only at the firm level, but also in the industry as a whole. When needed, these efforts also provide input into developing the broader supervisory approach for these complex organizations.

The Federal Reserve has also greatly expanded its surveillance efforts to financial markets outside of the traditional banking sector, such as the insurance industry. Insurance companies hold 20 percent of all corporate and foreign bonds, as well as approximately 12 percent of all municipal debt in the market.² Clearly, disruptions at these companies could have ramifications to broader markets and institutions — just think AIG (American International Group Inc.). The Federal Reserve now serves as the supervisor of savings and loan holding companies that have significant insurance businesses. It also has a role in the oversight of organizations deemed systemically important by the Financial Stability Oversight Council (FSOC), which currently include the insurers Prudential Financial and AIG. Here at the Chicago Fed, we have set up an initiative to better understand the role of the insurance industry in the financial sector and the economy as a whole. For example, our staff is studying how the life insurance industry is responding to the current low interest rate environment. Furthermore, the Chicago Fed’s insurance surveillance efforts support the Federal Reserve System’s supervisory roles and help to provide insights into special risks inherent to insurance companies.

Another insight from the financial crisis was the importance of financial market utilities, or FMUs. These are institutions that function in the background of the financial markets and include clearinghouses, securities depositories and payments and settlement systems. FMUs generally functioned well during the crisis, and it is critical for these utilities to function well under stress. Otherwise, financial instabilities could be magnified.

¹ Bernanke (2008).

² Federal Reserve Bank of Chicago staff calculations from the Flow of Funds. For more information on the assets and liabilities of life insurance companies, see Berends, McMenamain, Plestis and Rosen (2013).

The Financial Stability Oversight Council has designated eight FMUs as systemically important.³ Three are in Chicago: the Chicago Mercantile Exchange, ICE Clear Credit and the Options Clearing Corporation. All three are central counterparties that clear derivative contracts. Our Chicago-based supervisory team and staff members at the Board of Governors have actively engaged in the FMU supervisory efforts, which are led by the FMUs' primary regulators, the Commodity Futures Trading Commission and the Securities and Exchange Commission.

As a result, regulators have developed a deeper understanding of the central clearing mechanisms for derivatives contracts, including inherent credit and liquidity risks associated with banks' off-balance-sheet activities.

An example of such FMU analysis includes recent outreach performed by our Chicago team, in conjunction with our New York supervisory colleagues, in assessing the impact of mandatory swap clearing rules on banks.

Another set of financial stability issues involves the role of high-frequency computerized trading in securities and derivatives markets. Technological advances have allowed trading to become faster, with trades completed in time frames measured in milliseconds. High-frequency trading can enhance market liquidity, provide automated audit trails and narrow bid–offer spreads. However, given the speed with which these transactions are executed, errors such as unintended accumulation of large positions, out-of-control algorithms and trades at incorrect prices can rapidly spread through and across markets.

Staff from the Chicago Fed is actively engaged in assessing the high-speed trading environment and issues that arise within it. We continue to work with the industry and other regulators to identify risks, address policy concerns and suggest best practices for error controls at all levels of the trade life cycle, from order submission through trade matching, clearing and settlement.

Most of what I have highlighted thus far covers the ways the Federal Reserve has reoriented its supervisory efforts to control potential financial risks and increase the resiliency of financial markets. I think it's also important to talk about new tools put in place at the firm level to foster stability in the financial markets. Capital stress tests are one example. The first testing exercise in 2009 resulted in roughly \$75 billion in equity capital being raised at ten of the 19 largest bank holding companies and helped to calm financial markets at a crucial period during the crisis. In each successive year, the tests have been refined, and capital stress testing is now a mainstay in supervision for large firms. In addition, U.S. banks will soon be subject to Basel III rules that increase both the quantity and quality of capital they hold. Upon full implementation, banks will be required to hold capital conservation buffers and, if these buffers are deemed insufficient, will have their dividends, stock buybacks and discretionary bonuses restricted. In addition, if the evidence points to an overheating in credit markets, regulators will be able to require the largest companies to hold countercyclical capital

³ U.S. Department of the Treasury, Financial Services Oversight Committee (2013).

buffers — which would dial up the capital requirements for these firms during good times as a buffer against shocks during bad times.

These are just a few examples of regulatory tools available to monitor and promote financial stability. There are a host of additional instruments in our toolkit, such as resolution plans, liquidity requirements and single counterparty credit limits. All are examples of improvements in supervisory practices aimed at reducing the likelihood of systemic disruptions and containing the impact should such disruptions occur.

Conclusion

Some have questioned the ability of these supervisory and regulatory tools to adequately address potential financial stability risks, arguing that a broad interest-rate policy might be more effective in catching incipient risks that might fall through the cracks. It is certainly true that higher interest rates would permeate the entire financial system. But this is just another way of saying that raising interest rates is a blunt tool. Higher interest rates would reduce risk-taking where it is excessive; but they also would result in a pullback in economic activity in sectors where risk-taking might already be overly restrained. That's how a blunt tool works.

If you believe that financial stability can only be achieved through higher interest rates — interest rates that would do immediate damage to meeting our dual mandate goals at a time when unemployment is still unacceptably high — then we ought to at least ask ourselves if the financial system has become too big and too complex. This conclusion is particularly vexing if supervisory, macroprudential and market-discipline tools are inadequate. If the only way we can achieve financial stability is to raise interest rates above where the forces of demand and supply in the real economy put them, then the cost-benefit calculus of our policy choices becomes much more complex. The possible benefit of such a restrictive rate move would be to reduce risks that might potentially be forming in the nooks and crannies of a highly complex financial system. But the cost would be higher unemployment; a risk of choking off the economic recovery; even lower inflation below our objective; and, somewhat paradoxically, the introduction of new financial risks by reducing asset values and credit quality. When weighing the costs and benefits of alternative policy actions under these circumstances, I would have to question whether the financial system has become too complex — perhaps complex enough to generate negative marginal social value. Rather than degrading our macroeconomic performance through suboptimal monetary policies, I also would have to consider whether we should contemplate big changes to the financial system — a lot more rules, substantially higher capital requirements for all institutions and maybe even fewer financial products.

However, I have a more favorable view of the social value of our financial system and the efficacy of supervision and regulation. Since the financial crisis, the Federal Reserve has expanded its macroprudential toolkit and enhanced its microprudential tools. We have also reoriented our approach to supervision to take full advantage of Federal Reserve System staff's wide-ranging expertise on macroeconomic and financial developments and risks. I believe that these regulatory efforts can effectively minimize

the risks of another crisis and increase the resiliency of the financial system. We can achieve these objectives without having to resort to wholesale changes to the financial system and without degrading our monetary policy goals. Maintaining the effectiveness of the financial system for generating stronger and more robust economic growth continues to be a crucial objective for public policy.

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