Minutes of the Financial Advisory Roundtable (FAR) Meeting
May 6, 2022

Present:

FAR Members: Viral Acharya, Hayley Boesky, Keishi Hotsuki, Robin Greenwood, Ralph Koijen, Til Schuermann, Jeremy Stein, Joanna Welsh, and Toni Whited.

FRBNY: **Chair**: John Williams, Jaison Abel, Gara Afonso, Mary Amiti, Pablo Azar, Nina Boyarchenko, Nicola Cetorelli, Hunter Clark, John Clark, Rita Csejtey, Jeff Dawson, Marco Del Negro, Keshav Dogra, Thomas Eisenbach, Leonardo Elias, Michael Fleming, Linda Goldberg, Jan Groen, Beverly Hirtle, Darau Johnson, Anna Kovner, Frank Keane, Donggyu Lee, Deborah Leonard, Eric Le Sueur, Stephan Luck, Jim Mahoney, Jonathan McCarthy, Rebecca McCaughrin, Susan McLaughlin, Michelle Neal, Jordan Pollinger, Matthew Plosser, Paolo Pesenti, Matthew Raskin, Julie Remache, Joshua Rosenberg, Jaap Ritzen, Asani Sarkar, Argia Sbordone, Or Shachar, Lee Seltzer, Kevin Stiroh, Giorgio Topa, Jennifer Wogelmuth, and Patricia Zobel.

Agenda

The Financial Advisory Roundtable considered the implications of monetary policy tightening. The meeting included two presentations from roundtable members. These presentations were followed by a discussion focusing on the topics listed in the meeting agenda:

1. What are the channels through which quantitative easing and quantitative tightening may affect financial stability? Are the effects of quantitative tightening asymmetric to those of quantitative easing?

2. Has the pass-through of monetary policy tightening to real rates changed in recent periods?

3. What are the medium run risks to the economy and financial stability if real rates rise substantially?

Differences and similarities between quantitative easing and quantitative tightening

The discussion began with a comparison between the implementation of quantitative easing (QE) and quantitative tightening (QT). The FAR members agreed that in many ways QE and QT are quite similar. In particular, they affect financial stability through the same channels. For instance, both may affect risk-taking, with QE potentially increasing risk-taking and QT potentially decreasing risk-taking. Moreover, both affect liquidity and volatility through this channel.

However, the FAR members did note important asymmetries between the two. The most substantial source of asymmetry between QE and QT is that the impact on rates is limited in QE. Specifically, a reduction in interest rates can be limited by the zero lower bound; whereas an increase in rates is unbounded – it is unknown how high the central bank may increase interest rates. Hence, from an investor's perspective, there is greater uncertainty involved in the implementation of QT. Greater uncertainty can be associated with increased volatility, which provides incentives for more active risk and liquidity risk management by financial market participants. Some FAR members mentioned the possibility that this increased uncertainty could lead investors to react more strongly to QT than QE.

A FAR member also pointed out that a benefit of QE is the reduced need for banks to compete for deposits. QT would reverse this benefit at the same time as deposit rates would rise. While the increase in deposit rates will be offset by increases in loan rates, bank loan maturity has been increasing, meaning it will take longer for banks to receive that benefit.

Productivity and household financial health

Much of the discussion focused on how resilient the economy will be to increases in interest rates. FAR members pointed to several optimistic trends. Most FAR members shared a view that household balance sheets are quite strong relative to where they were prior to the pandemic. For instance, it was noted that households with $1,000 or more of savings before the pandemic now have 130% more savings. Members also observed that while house prices had risen the quality of the mortgages was higher than in the run-up to the Great Financial Crisis. At the same time, it was noted that households are now spending more on cars and gas, indicating that inflation poses a significant risk to these households' abilities to consume.

FAR members mentioned signs of higher levels of investment by corporates, and overall strong economic performance. Some FAR members took this as a sign that productivity and long-term real rates had increased in the economy. Other FAR members mentioned that it is possible that we are just observing the consequences of several unusual shocks and expressed a belief that the distribution of nominal rates suggests a high probability of hitting the lower bound in the future, which would be consistent with a lower productivity and lower long-term rates.

Monetary tightening in the context of an oil shock

An important consideration in evaluating the resiliency of the economy to monetary policy tightening is the broader economic context. Historical experience suggests previous oil shocks have affected fuel prices and preceded recessions. In this context, FAR members discussed that monetary policy's ability to engineer a soft landing will depend on how pessimistic consumer expectations are, highlighting the importance of anchoring household expectations of inflation and consumption.

FAR members then discussed what a soft landing might look like. FAR members also discussed what different market participants mean when they discuss the probability of stagflation.

FAR members then identified two important trends that might add inflationary pressure: deglobalization and the transition to green technologies. With respect to deglobalization, FAR members discussed that their corporate clients report to be thinking about changing their global platforms in ways that might affect supply chain management and put inflationary pressure on US consumers. With respect to the transition to green technologies, FAR members discussed that as global corporations invest in green technologies, the transition is likely to be accompanied by higher costs and hence, more inflationary pressure.

Financial market volatility in the context of high corporate debt levels

Another recent trend that participants noted is the vast expansion in corporate debt levels in recent years and its potential implications. One aspect of the recent expansion is that over 50% of issuance in 2020 was rated BBB or lower. A FAR member discussed how these "prospective fallen angels" are at risk of being downgraded and this has potential financial stability implications as many institutional investors cannot invest in junk bonds.

However, other FAR members pointed out that there are multiple reasons not to be concerned about corporate debt levels. Some FAR members pointed to the current strength of corporate balance sheets and that cashflows have increased. Other FAR members discussed the fact that corporate spreads have increased very little. FAR members also pointed out that there has been a dramatic decline in issuance this year by high yield investors and that there is very little refinancing needs until 2024. It was also mentioned that credit ratings do not always correctly reflect probability of default.

Implications for government bond markets

The discussion then moved from conditions in the corporate bond market to the government bond market. In this context, participants noted the recent co-movement between stocks and bonds' prices. For instance, during the month of April, a decline of over 5% in the stock market was accompanied by a greater than 2% decline in Treasuries. FAR members pointed out that if this correlation stays positive, it would be a troubling development as it would mean that investors suffer losses in both the risky and the safe component of their portfolios. This could potentially lead to a "dash-for-cash" and a drawing dawn of bank credit lines, with potential implications for financial stability.

FAR members discussed how this might affect the Fed's plans to normalize the size of its balance-sheet as any sales of Treasuries can further add to losses in the government bond market.

Other comments

FAR members noted that high deposit and reserve levels can result in a binding leverage requirement which may reduce banks' willingness to provide liquidity in key markets. This has been somewhat alleviated by the competitiveness of the overnight reverse repurchase (ON RRP) facility which reduces demand for deposits and bank reserves. A FAR member proposed that the Federal Reserve should maintain the attractiveness of the ON RRP facility so that it remains competitive with the interest on reserves which could decrease the risk that the leverage ratio binds for banks.

It was also noted that one effect of reducing policy rates is reduction in interest revenue for banks, which incentivizes them to take more risk. Raising rates can thereby lead to reductions in incentives for risk-taking by banks.