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Financial Stability and the Hemianopsia of Monetary Policy

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Financial stability concerns cannot be separated from macroeconomic objectives of monetary policy. Stimulative monetary policy works by creating financial conditions that could lead to instability in markets that could, in turn, engender deflationary pressures. Although the Federal Reserve Act does not explicitly mention financial stability as an FOMC objective, it is fundamentally bound together with the achievement of the explicit goals of maximum employment and price stability.

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The idea that financial stability is distinct from, and secondary to, the objectives of monetary policy puts both financial stability and price stability at risk.

Easy monetary policy stimulates demand. But the same conditions that stimulate demand can also, in excess, cause financial instability and the deflation dynamics that should be our greatest concern.

Financial instability and debt deflation are different symptoms of the same malady: the stressed, levered balance sheets that are the product of unsustainably elevated asset prices and seemingly cheap liabilities. Because of the presumed primacy of monetary policy, however, the connection between financial instability and deflation has been obscured.

It is a mystery to me how a thing called "financial stability" came to be separated from a thing called "monetary policy". This was not the case when I joined the New York Federal Reserve in 1985.

Perhaps the schism had its origins during the 1990s, in our naïve, twin hopes that risk-based capital alone would solve the riddle of bank safety and soundness and that inflation targeting would be a sufficient guide for monetary policy.

By the start of this century, however, the separation was complete and the primacy of monetary policy established. How else can we understand the narrative that, starting in 2001, "monetary policy" successfully stimulated the interest-rate sensitive sectors of housing and autos to revive the U.S. economy but it was a failure of "financial stability" when house prices and auto sales subsequently collapsed in the financial crisis and the great recession?

Can we really accept the story that "monetary policy" is going to target a set of financial conditions to produce good macroeconomic outcomes but if we end up with a set of bad financial conditions, that put us at risk of bad economic outcomes, it will be the fault of "financial stability" and not "monetary policy"?

What are the "good" financial conditions that monetary policy fosters to stimulate demand and what are the "bad" financial conditions that we fear when we invoke financial stability? They are the same.

There are only three channels—three financial conditions—that central banks can foster to stimulate demand. By accommodative policy and lower rates, we can weaken our exchange rate and take demand from our trading partners. We can take demand from the future by inducing more borrowing against future income and also by a wealth effect created when declining interest rates increase the present value of future cash flows.

When we think about financial instability, what financial conditions do we fear? We fear an impaired financial system, incapable of intermediating between borrowers and lenders. But what conditions give rise to this? Do we simply fear the volatility of financial assets?

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If we are candid we will admit that we fear falling prices more than rising ones. Although behavioral preferences, no doubt, play a part, falling asset prices —and the rising value of liabilities expressed in diminished asset values—put leveraged balance sheets in particular jeopardy, creating the risk of fire sales, too-rapid a deleveraging, panics, bank runs, and systemic risk.

So what financial conditions are likely to give rise to excessive leverage and the risk of sharply falling asset prices? Consider each of the three channels.

If we borrow demand across our exchange rate we also create the risk that our trading partners will borrow in our currency and eventually face the risk that their unhedged, foreign currency liabilities will increase in value relative to their assets. We can see exactly this balance sheet dynamic at present in emerging market firms and sovereigns.

In a domestic context, if we borrow too much compared with our likely future income, incurring debt greater than our ability to repay, we will undermine the value of the financial assets based on our credit. We may also constrain our future ability to invest and to consume, weakening demand.

Borrowing from the future via a wealth effect is a trick that can work only once, which must push us closer to uncertainty about the sustainable level of asset prices.

Putting the credit and wealth channels together, if we incur liabilities beyond our probable income, against elevated asset values that then decline, we risk creating exactly the stressed balance sheets that threaten the solvency and strain the liquidity of borrowers and lenders alike. This painful balance sheet combination—of fixed liabilities and variable, declining asset values—would be familiar to both the underwater homeowner of 2007 and the oil producer of 2016.

So the same financial conditions that can stimulate aggregate demand can also, in excess, give rise to financial instability and falling prices.

Do not take my word for it. Listen, instead, to Irving Fisher (no relation of mine) in his 1933 essay "The debt-deflation theory of great depressions" [Fisher 1933], as he parses the causes of "great disequilibrium":

> 20.... over-investment and over-speculation are often important; but they would have far less serious results were they not conducted with borrowed money....
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> 30.... when a deflation occurs from other than debt causes and without any great volume of debt, the resulting evils are much less. It is the combination of both—the debt disease coming first, then precipitating the dollar [deflation] disease—which works the greatest havoc....
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> 31.... Just as a bad cold leads to pneumonia, so over-indebtedness leads to deflation.
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> 32. And, vice versa, deflation caused by debt reacts on the debt. Each dollar of debt still unpaid becomes a bigger dollar, and if the over-indebtedness with which we started was great enough, the liquidation of debts cannot keep up with the fall in prices which it causes. In that case, the liquidation defeats itself....
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> 33. But if the over-indebtedness is not sufficiently great to make liquidation thus defeat itself, the situation is different and simpler. It is then more analogous to a stable equilibrium; …

In the vocabulary of today, Irving Fisher is describing fire sales, too-rapid deleveraging and systemic risk and, in these dynamics, he sees over-indebtedness as triggering the conditions most likely to lead to a worrisome deflation.

Irving Fisher also provides solace for the would-be quantitative easier. In dismissing the idea that a "*general* over-production" could cause a great disequilibrium and deflation, he strikingly observes that [Fisher 1933]:

> The reason, or a reason, for the common notion of over-production is mistaking too little money for too much goods.

But he is equally clear that over-borrowing and elevated asset prices are the principal cause of a worrisome deflation and that "[e]asy money is the great cause of over-borrowing." So he leaves us in the uncomfortable position of seeing easy money as both a cure and a cause of deflation.

Of course, in the medical sciences it is elementary that the same treatment in small doses might be a cure but in larger quantities might be harmful or even lethal.

Today's central bankers do not see both possibilities. They do not see how financial instability is the acute symptom and debt deflation the chronic symptom of the same exposed, levered balance sheets. They do not see how financial conditions can cause deflation. They do not see what was apparent to Irving Fisher in 1933.

Hemianopsia is a partial blindness in which half the visual field simply does not register with the brain.

Therefore, "the hemianopsia of monetary policy" is the condition afflicting central bankers who cannot recognize the full spectrum of consequences of the

financial conditions that they create, who have lost sight of the connection between financial instability and deflation, and who, as a consequence of their impaired vision, make the extreme claim that—to avoid deflation—there are no limits to what accommodative monetary policy can do.

But what of the dual mandate? What of the imperative, for the Federal Reserve at least, to consider the tradeoff between full employment and price stability?

First, if debt-deflation dynamics are a foreseeable consequence of *easy* monetary policy, then in pursuit of price stability (however defined) the risk of *inflation* is not the only constraint on low interest rates. In a world where we can anticipate the deflationary consequences of easy financial conditions, central banks worried about *deflation* need a more thorough explanation of the intertemporal tradeoffs they seek with *easy* monetary policy.

Second, have you noticed that in reiterating the so-called dual mandate in its statements, the Open Market Committee repeats the phrase "Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability" [Federal Open Market Committee 2016]? Why repeat the phrase "consistent with its statutory mandate" if it is, in fact, consistent?

Section 2A of the Federal Reserve Act (12 USC 225a) reads in full:

> The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary 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.

Note that the actual statutory *mandate*, the "shall" provision, the imperative, the thing the Federal Reserve must do, is to grow money and credit no faster and no slower than potential growth.

Note also that this mandate is to be pursued so as to promote three, not two goals: maximum employment, stable prices, *and* moderate long-term interest rates. Thus, the "dual mandate" and a Phillip's Curve trade off are not consistent with the three goals of the single mandate the Federal Reserve actually has.

Some of you may cringe at the idea of a goal of moderate long-term rates. But is it really irrational of Congress to suggest, having stipulated a goal of price stability, that the Fed should also aim for real interest rates and credit spreads that tend toward a moderate mean, and to avoid having them too low or too high for too long?

I draw your attention to the statutory language not out of a legalistic hope that policymakers will actually be constrained by it—although that would be nice. Rather, I do this because I think Section 2A so eloquently expresses the nexus between money and credit and the idea that we should not grow either one faster or slower than the growth in our real income—and the statute does this without drawing a dichotomy between financial stability and monetary policy.

Last spring, at the Hoover Institution, when I expressed these views about the Federal Reserve's mandate, my friend Paul Tucker asked me whether I thought one could find a financial stability objective inside the terms of Section 2A and I too quickly responded no. Upon reflection, I should have responded: "no, you can't find a financial stability objective distinct from a monetary policy objective because the two are so thoroughly bound together in a single mandate—which is as it should be."

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