Exchanges at Goldman Sachs

Central bank tightening: what could break?

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Allison Nathan: Since the 2008 global financial crisis, the financial system has gotten used to a low interest rate environment. But that's now changed as policymakers in the US and Europe have aggressively increased interest rates to fight high inflation. So, what could break in the global financial system amid this rapid tightening? I'm Allison Nathan and this is Exchanges at Goldman Sachs.

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Allison Nathan: On this special episode, we're breaking down our most recent Top of Mind report now available on GS.com. We dig into what vulnerabilities the current higher rate environment could expose, whether policymakers have the tools to address these vulnerabilities, and if they could be worrisome enough to prompt central banks to slow or even pause tightening ahead.

We first speak with Jeremy Stein, former member of the Federal Reserve Board of Governors. During his tenure at the Fed, he argued that monetary policy should be implemented with financial stability in mind. Nowadays though, he thinks the Fed's only option is to continue to focus on taming inflation.

Jeremy Stein: Inflation is a very serious problem. So, given where it is now and the very real risk of it getting embedded into expectations and becoming something of a self-fulfilling problem, I think the Fed's only option for now is to continue to make inflation the number one policy priority. I don't think you can preemptively pull back on fighting inflation because of the risk of an unknown possible financial breakage that hasn't yet manifested.

That's not to say that I discount the risk. There are plenty of risks out there. But for the time being, until something changes, I think the absolute unwavering focus has to be on inflation.

And, of course, some tightening in financial conditions is a big part of the mechanism that is going to slow the economy. And ideally, that's what the Fed is trying to accomplish. And just to give you a better example of when financial stability comes to the fore, think of where we were in late, say, 2019 shortly before the pandemic. So, then we were, like, unemployment around 3.5. Inflation 1.7. And the first-class problem we had back then was people thought inflation was at 1.7. We wish it was at 2. There was a debate about how aggressively should monetary policy be easing to get inflation from 1.7 to 2.

At that point, I would have said it's very different. We're very close to mandate. We were very close to a bliss point. So, at that point, I would not have been willing to burn a lot of furniture and to overheat financial markets just to get from 1.7 to 2. When you're close to mandate, I think the financial stability, inner temporal considerations weigh more. But when you're very far, the importance of just making progress becomes the dominant consideration. Again, at least for the time being.

I think if you were going to make an argument for stopping or slowing down, to me, the more compelling one is lags in the process. So, this is not so much about financial stability. But there's a lot of tightening already, potentially, in the pipeline. We don't know how much. But we know it's going to take some time to show up. So, at some point that might be a reason to pause even aside from financial stability kinds of issues.

Allison Nathan: However, former vice president of the European Central Bank Vitor Constancio has always been opposed to the idea that monetary policy should respond to financial stability concerns. He still stands by that view.

Vitor Constancio: In 2018, proposals were in the air that we should increase interest rates in order to contain the buoyancy of the asset prices. And I was against that. And in ideal terms, I still firmly believe that interest rates cannot be used to serve several different objectives like the economy, inflation, and then also financial stability. And that the central banks need two types of instruments. First, positional monetary policy instruments [PH]. And then the macroprudential instruments which were born after the 2007/2009 crisis.

And in the way we developed our concept at the ECB about macroprudential policy, that should include not only regulatory measures, general ones, to increase the robustness of the financial system. But also, a second type of instrument that should deal with the objective of trying to smooth out the financial cycle, which is different from the business cycle because it has a longer duration than the business cycle.

The problem is that in many countries, these second type of instruments do not exist. And so, to separate the two goals and the two policies, we need those instruments to be available. When they are not available, then monetary policy, reluctantly, in my view, and as a last resort, may have to consider financial stability issue. But again, as I say, very reluctantly.

However, in 2021, the ECB in its new monetary policy strategy for the first time, and against my view, by the way, but I was not there, of course, but they introduced financial stability considerations into monetary policy decisions.

The irony of things is that now we have the opposite situation, potentially. That, indeed, instead of increasing rates to tackle financial stability issues, it should be perhaps the opposite. Now that financial stability considerations are included in monetary policy decisions.

And the other crucial point is that there was recently no time for the existing macroprudential instruments to build up buffers that could be released or eliminated so as to help the financial system in a downturn.

So, as I say, monetary policy, particularly in the ECB after what they decided may have to do that.

Allison Nathan: That said, Constancio expects the current hiking cycle to end before material financial instability concerns arise.

Vitor Constancio: I think that the central banks will stop hiking rates before the tensions with financial stability come to an extreme situation where monetary policy could have to really consider that other objective.

Allison Nathan: But why is that?

Vitor Constancio: So far, we have seen that there have been no signs of real financial instability. And central banks are close to the peak that is foreseen in this cycle. The markets are now foreseeing that the peak rates of the Fed and the ECB will be respective around 5 percent and 3 percent. And I think it's enough because, in particular, in the West, all the signs are now quite visible that inflation is going to decelerate next year quite sharply. And that's also what, more and more, the markets are considering there.

In Europe, it's more complicated because we still have the energy problem, which is much more serious and weighs much more than in the West. And so, it will be, perhaps, slower.

If you calculate the core inflation contribution in percentage, that contribution is 62 percent in the West. In Europe, it's 34. Which means that energy and food, which have a much higher import content and are subject to these external price shocks, in Europe contribute 69 percent to the total inflation, right? And in the US, contribute only 38 percent. But the declaration of inflation will happen.

This is predicated on the notion which historically is true, by the way, that supply shocks don't last forever. To be the source of sustained inflation, they would have to be repeated as jumps, as shocks every year. That is not, indeed, foreseen by anyone. That does not seem possible. And that's what is behind my consideration that the cycle of the hikes will not now trigger episodes of significant financial instability.

But if rates should continue to increase well beyond the expected peaks, then I would have a different view.

Allison Nathan: But Constancio is worried about the potential effects of quantitative tightening or QT policies which shrink the size of central banks' balance sheets, particularly in the Euro area.

Vitor Constancio: I really am concerned about QT, particularly in Europe because in a monetary union of many heterogeneous sovereign countries, there is the problem of financial fragmentation that may happen. And that can impair the transmission of monetary policy. We had that in the crisis of 2010. And that's always there as a concern. And so, on top of the increases in rates and yields for all European countries, to then start the QT may, indeed, have some potential financial stability situations.

QT, it's an equivalent to an increase in interest rates by the way. Lail Brainard, the recently vice president of the Fed, said that if the Fed does the full program of the QT, that's equivalent to an increase in rates of 200 to 300 basis points, which is very significant. But then there are the other considerations.

In Europe, there is now an episode which is relevant in this respect which is related to long-term central bank liquidity that has been supplied to [UNINTEL] banks, so called TLTROs. So, the really long-term program of long duration lending to banks. The conditions of those three to four years borrowings by the banks from the central bank were improved during the pandemic. It became very generous in terms of the profits that now the banks could have as a result of paying very little for those credits from the ECB, and then even continuing to leave the reserves in the central bank and earning, now, which is the remuneration of those reserves.

So, the ECB decided, somewhat controversially, to change the conditions of those long-term loans to the banks which creates the very reasonable expectation that the banks will early repay those borrowings from the central bank. There are 1.2 trillion of those things that mature in June of next year. And it may be very well that the banks will repay those much earlier now that the conditions have changed. And that would be already a very sizable reduction of the balance sheet of the ECB without having to embark formally into QT.

So, my hope is that the Central Bank really waits and if and when it introduces QT, it must go about it very gradually.

Allison Nathan: And beyond this concern around QT, Constancio sees several things that could potentially break in the financial system during this policy tightening cycle.

Vitor Constancio: There are several potential events or triggers of such instability. The first one that comes to mind is liquidity problems in sovereign bonds. That includes the US. The most extraordinary thing that happened in the week of the IMF meetings was Secretary Yellen saying in public that she was concerned with the liquidity in the treasuries market. And that admission reminds us that there are such problems in the treasury's markets in the US, particularly the insufficient size of broker dealers to really manage the market the way they did in the past now that the market is much bigger. So, that is my first point in the list, not just in the US, but in general.

In emerging markets in Europe, potentially, liquidity problems in sovereign bonds is a potential source of instability.

And although nowadays the Euro area has all the instruments that can avoid the sort of liquidity crises that we had back around 2010, the second one has to do with high yield bonds and also leveraged loans because the increases in interest rates and recession may create problems of default in firms that have those types of borrowings.

Then there is the possibility of liquidity problems in investment funds or mutual funds and the possibility of some fire sales or securities.

In Europe, the mismatch between the asset side and the liability side of investment funds that are most open-end funds has increased in more recent years. And so, there is, indeed, a potential problem there if some turmoil starts. And there are lots of redemptions and then liquidity problems that would require that the funds would have to sell some securities in order to have the liquidity. So, that's another concern.

Then there is China. And not only the growth declaration, which is disturbing in itself, but also the possibility of a collapse in the housing markets in China because the bubble keeps growing. And one day it cannot be sustained. So, that's another potential problem coming from China, perhaps of a different nature of what happened by the end of 2018, for instance, where China was also a source of financial instability.

And finally, there are the emerging countries where some defaults are expected. Perhaps that will not be significant enough to have global impact. But it's a sign of what may happen in these environments.

Allison Nathan: Stein is also concerned about potential risks to financial stability. Here he is again.

Jeremy Stein: I have been very surprised at how all things considered orderly this has been. So, if you had asked me a year ago, the Fed is going to have this dramatic change in its policy stance, I would have thought, for example, that credit, you know, we had told ourselves the story that credit spreads were so low because of easing monetary policy. Now, if you look at the high-yield credit spreads, they've backed up a bit. Not nearly as much as I would have thought.

Now what do you draw from that? I don't draw reassurance, necessarily. I think it just doesn't happen in a nice, linear fashion. So, I do worry that there's another leg to go in some of these things.

We know if you put a lot of pressure in the pipe, something is going to crack somewhere. But it's always not what you expect and not what cracked the last time. So, I think it's hard to say. But so far this has all been the easy part of it. Right? Not a drop of blood has yet been spilled.

Unemployment rate is still around 3.5 percent. It's come up a little bit. But still, the blood hasn't gotten spilled. I think it's going to get much tougher when the policy starts to work. So, it's hard to make a prediction. But I'll tell you some things that I think are worth worrying about. Treasury markets, obviously. We've seen some of the potential vulnerabilities, both in March of 2020 and recently in the UK. Here's where, actually, I think there's some relatively low hanging fruit in terms of things we could do, not to completely fix, but to partially address.

So, for example, I think it's pretty clear that in March 2020, the supplementary leverage ratio that the banks faced. Not helpful. This [UNINTEL] risk weighted capital requirement discourages the banks and the dealers from taking positions from being market makers, effectively, and treasury securities. It would be easy enough for the Fed to essentially make that what it was originally intended to be, more of a backstop as opposed to a primary binding constraint. And they could do that without weakening overall capital in the banking system by both dialing back in one way or another the leverage ratio. But making a compensating adjustment in the risk base so that overall capital in the system stays the same.

The Fed has a standing repo facility. They've made, what I think, is a mistake in that it can only be accused by banks and dealer firms. If it were my preference, and I was involved in a G30 report on this, we argued that it should be more broadly accessible. That, basically, anybody who brings treasury securities to the Fed as collateral, ought to be able to borrow against those.

The idea there being we saw a lot of selling, for example, in March 2020 by hedge funds, by mutual funds. If they knew ahead of time that they could always bring their treasuries to the Fed and get cash on a moments notice, maybe that sort of stays their hand and they don't feel like they're in such a rush to sell. And people will sometimes talk about moral hazard. But you've got to ask yourself the question of which is the better moral hazard? Lending against treasury collateral? Or as the UK was, getting cornered into having to buy a lot of treasuries at a time when you're supposedly tightening monetary policy? I think that is a bad box to be in.

So, I think treasury's an area of concern. I continue to be worried about the open-end bond fund complex. We saw real serious tremors there, again, in March of 2020. Big outflows. Big liquidations by these funds. Basically, bailed out by the Fed coming up with these credit facilities which had a very powerful effect. It was absolutely the right thing to do for the Fed. I mean, I think the financial system is very lucky the Fed did it.

I think, unfortunately, they spoiled the empirical experiment. We would have learned a bit more about, really, the fragility associated with some of these funds. But we didn't. So, I think there's a bit of a moral hazard there. Credit spreads really tightened afterwards and business went on as usual.

A third place is the very tight policy here has led the dollar to appreciate quite sharply. That puts a fair bit of stress on a variety of things in the system. One of them being a bunch of emerging market and lower income countries have corporate sectors that borrow in dollars. Looks like a cheap thing to do in good times. Of course, if the dollar appreciates, that puts a lot of pressure on those economies.

Many of them are relatively small. So, on a valuated basis, trade spill over is maybe not that big. But again, this is where cracks in the financial system, who knows when a bunch of these loans go bad which bank is over exposed and which larger bank is over exposed to which smaller bank? So, things can go wrong there.

And then the last thing to keep an eye on, again, with the strength of the dollar in mind, is Japan. They're running with more than 200 percent debt to GDP. Because of the enormous QE that they've been doing, essentially if you consolidate the monetary authority with the financial ministry, it's as if that 200 percent debt is mostly on an overnight basis because the debt has been taken out and replaced with interest-bearing reserves. 200 percent debt to GDP and most of it rolling.

Now, of course, it's fine if you always have zero interest rates. But if, because of inflation globally, the strength of the dollar, if they start to import some inflation, and they have to start fighting inflation, now all of the sudden you've got a different fiscal picture for them. And I think a bunch of countries have that same issue. But Japan is, in some sense, an extreme case.

Allison Nathan: And Stein argues that the Fed's ability to address some of these risks is more limited compared with prior episodes of market stress and more constrained than the market expects.

Do you think that the Fed has the tools to be able, essentially, to separate the conduct of monetary policy from intermediation of financial stability risk?

Jeremy Stein: I think some of the tools that they've had before, some of the most dramatic tools like the credit facilities won't be there. Right? I think you shouldn't count on them being there. Even though some market participants may be assuming if things start to get hairy in that space again, I don't think we can assume the Fed can ride to the rescue this time.

Last time they were able to do it because they had fiscal backing from the treasury. The Fed is not allowed to directly buy corporate bonds. They had to do it with a special purpose vehicle that had treasury fiscal backing from the Cares Act. I don't think you can assume that will be there again. So, I mean, I think that's another place where there's some vulnerability.

The one tool that they always have is the ability to buy treasury bonds. But that is way more complicated than it was in March 2020. So, in March 2020, they did it initially for market function reasons. But as they started doing it, it became a little bit murky whether it was just market functions. And then I think eventually one of the reasons that they were a little slow to turn the ship around with monetary policy is that this bled into QE and then they needed a long runway to stop QE without sending the wrong signals on monetary policy.

Now, think about what you've got now. Now you've got inflation. How do you communicate that you're doing QE, this is not monetary policy QE, this is market function QE? That's a pretty trick bit of communication. The Bank of England faced this. I think they were a little helped institutionally because they have a separate monetary policy committee and financial policy committee. And they were at pains to have the financial policy committee be the one that did the bond buying in this case. So, that's something we could see again.

Okay, part of the reason I'm very keen for the Fed to broaden the access to their repo facility is to the extent the treasury [UNINTEL] needs help, I would much rather see it come from repo lending where I think this sort of problem is not nearly as severe.

More broadly, in a world where the problem is insufficient demand, the Fed can always step in and try to do more to reassure markets. There can always be a Fed put in a demand shortage world. In an inflation world, you really can't do that much of it because it trips over your monetary policy objectives so much.

And so, one of the things I worry about is has the market fully understood that the Fed is just going to be much more limited? I think even with the treasury market, but certainly more so with credit. And I worry that when things start to get a little shaky, you know, we haven't really had defaults yet. But once we start having defaults, it's not only going to be the direct effect of the defaults, it's going to be, in some sense, a realization that the Fed put is no longer there. And that would be another potential shoe that can drop.

Allison Nathan: With questions about how much central banks can tighten before things start to break sure to remain in focus, we'll continue to keep a close eye on risks to financial stability from here.

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