LH|M MONETARY POLICY ANALYTICS

Policy Focus

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Jackson Hole Preview: Yellen to Speak on Financial Stability

Chair Yellen will deliver a speech titled "Financial Stability" Friday morning at the Jackson Hole conference. This is not a particularly interesting subject for near-term monetary policy, which perhaps is why she chose it! Nevertheless, in light of Congress considering rolling back some parts of Dodd-Frank, this talk provides a timely opportunity to reinforce her and her colleagues' views of the successes of financial regulatory reform and especially to focus on aspects that are most likely to draw fire from Republicans, while also putting the Fed on the side of reforms that reduce the regulatory burden on smaller banks. Perhaps the speech is also an opportunity to get out in front on the discussion of this topic, inside and outside the Fed, before the nominee for Vice Chair of Supervision, Randal Quarles, is confirmed and begins his term—though he will likely be in sync with the direction of her remarks, or at least not push in a different direction.

The market, of course, will be looking for any sign that financial stability concerns are a meaningful consideration with respect to the pace of hikes, and specifically on the December rate-hike decision. Any interpretation that this is an issue that will weigh on that decision would be interpreted as hawkish. In any case, while some participants have commented on financial stability concerns, *these concerns will not weigh on the December decision*.

What about the Important Decisions the FOMC Will Make in the Remainder of This Year?

Financial stability concerns will not be an issue in either the announcement of the phasing out of reinvestment or the decision about whether to raise rates. No need to discuss either of these decisions. Certainly Yellen will give no meaningful signal about December, which is far away at this point.[1] Markets fully expect a September announcement of the phasing out of reinvestment. The only surprise would be no move. There is very little economic conditionality at this point surrounding this announcement.

The big question is what it would take for the FOMC to hike rates in December (See What Will It Take to Raise Rates in December?) We see the decision as all about core inflation, specifically about how to judge the underlying rate of inflation, and which measure or time horizons to focus on. The dominant view remains that the recent slowing in inflation reflects, at least partly, the effect of a price level shock in March, a shock that will remain in the 12-month rate until it passes out of the 12-month window. The 12-month inflation rate will likely still be 1.5% at the December meeting, given the data in hand. And we already have several months of

[1] Even if the FOMC does see a need to send a signal at some point before December, consider that the FOMC was able to prepare markets for a rate hike shortly before the March FOMC meeting through several (likely coordinated) public remarks by key policymakers. Plus, Yellen has shown that she doesn't like making important announcements or signals in her speeches. In particular, she has already ended the post-crisis "tradition" of the Fed Chair foreshadowing upcoming policy moves at Jackson Hole.

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data since that shock, and they do not show a pick up. There is anxiety about this and therefore a uniform wait-and-see posture.

Still, FOMC participants often offer, as a prelude to the speech's central topic, a brief consideration of the state of the macro economy and even implications for monetary policy. If she were to venture into this territory, she would prefer not to make news, but it's possible she'll provide an update of her views on the recent inflation data. Quoting from the minutes is a way to repeat what has been said without adding anything.

The Banking System, Systemic Risk, and Macroprudential Policy

The view within the FOMC is that financial stability is principally about systemic risk. Hence, the resiliency of the banking system is of overwhelming importance. The July 2017 FOMC minutes state:

> Participants agreed that the regulatory and supervisory tools developed since the financial crisis had played an important role in fostering financial stability. Changes in regulation had likely helped in making the banking system more resilient to major shocks, in promoting more prudent balance sheet management strategies on the part of nonbank financial institutions, and in reducing the degree to which variations in lending to the private sector intensify cycles in output and in asset prices. Participants agreed that it would not be desirable for the current regulatory framework to be changed in ways that allowed a reemergence of the types of risky practices that contributed to the crisis.

We already know what Yellen will say about guarding against systemic risk: Emphasize the role of macroprudential policy and cite the success in this respect of financial regulatory reforms, while supporting revisions that would reduce the burden on smaller banks. She will focus in particular on maintaining higher capital standards, something that Republicans may target in legislation. Also, she will highlight the importance of stress tests, though perhaps not for smaller banks, and the need to keep in place a procedure for the orderly liquidation of systemically important financial institutions.

The Party Line: Two Problems, Two Instruments

The party line under Bernanke, and now under Yellen, has been that monetary policy should focus on the dual mandate and macroprudential policy should focus on financial stability concerns. Financial stability is not a third mandate that should be balanced against price stability and full employment. Monetary policy is only a second line of defense with respect to financial stability. Given confidence in macroprudential policy, monetary policy rarely would respond to financial stability risks.[2]

> Going forward, the Fed needs to think about financial stability and monetary economic stability as being, in some sense, the two key pillars of what the central bank tries to do. And so, we will obviously be working very hard in financial stability. We'll be using our regulatory and supervisory powers. We'll be trying to strengthen the financial system, and if necessary, we'll adjust monetary policy as well. But I don't think that's the first line of defense. (Bernanke, January 14, 2013.)

[2] But, given there are questions about the effectiveness of macroprudential policy, one cannot completely take monetary policy off the table.

The one question in the regard is the one sentence in the July 2017 minutes about the views of "one participant," who perhaps was Yellen:

> One participant stressed that the risks both to the Committee's inflation objective and to financial stability would require careful monitoring. This participant expressed the view that a gradual approach to removing policy accommodation would likely strike the appropriate balance between promoting the Committee's inflation and full employment objectives and mitigating financial stability concerns.

That talks about balancing promoting the dual mandate and mitigating financial stability concerns. That seems to be different than the hierarchy Bernanke suggested and that Yellen has seemed to also believe: that monetary policy is concerned primarily with promoting the dual mandate, and macroprudential policy is the main line of defense for financial stability concerns, with monetary policy only the last line of defense. This framework still seems to best describe the consensus on the Committee.

The Kitchen Sink

But if that is the case, why do so many participants appear to talk about a role for monetary policy in response to emerging financial stability concerns?

> Rosengren, June 20, 2017: "I believe monetary policymakers must factor in financial stability concerns...They are important for exit strategies from very low rates...They have implications for monetary policy responsiveness to negative shocks."

> Kashkari, February 21, 2017: "Really we have a third mandate and the third mandate is financial stability."

> Rosengren, August 31, 2016: "Current cap rates the United States indicate that a long period of very low interest rates can add to potential downside risks, and in my view this suggests that financial stability concerns could be a consideration in how long policymakers wait before resuming the gradual removal of monetary accommodation."

In our view, more-hawkish members who favored a quicker start and a faster pace of rate hikes throw all the arguments they can find on the scale, whether or not each is a decisive or even weighty issue for them. Kashkari is an obvious exception, but this may reflect his experience in the Bush administration during the financial crisis.

Asset Valuations and Financial Stability

Concerns about financial stability today are not about systemic risk in the banking system. Rather, they relate to "rich" asset valuations in a number of markets.[3] Yellen will comment on asset valuations, but we know what she will say in this regard:

> So in looking at asset prices and valuations, we try not to opine on whether they are correct or they're not correct. But...as you asked what the potential spillovers or impacts on financial stability could be of asset price revaluations, my assessment of that is that, as asset prices have moved up, we have not seen a substantial increase in borrowing based on those asset price movements. We have a financial system, a banking system that's well-capitalized and strong, and I believe it's resilient.[4]

So, she first deflects a question about whether assets are overvalued. Second, she turns the focus to whether there is increased borrowing (leverage) based on the higher asset values. The answer is no. And finally, she concludes with the resilience of the banking system.

Still, she does talk about the how the Fed's supervision responsibilities play into their monetary policy deliberations. The former informs the latter:

> So, I would say, especially in the aftermath of the financial crisis, we've found that our understanding of the economy of the financial system and of appropriate monetary policy has been greatly informed by the role we play in supervision. It's helped us understand risks to financial stability, pressures in particular portions of credit markets and there's been a close integration between what we learned in bank supervision, financial stability and monetary policy.

Financial Conditions and Monetary Policy

On the other hand, while asset valuations today are not a consideration with respect to concerns about financial stability and in any case would not call for a monetary policy response, asset valuations are part of financial conditions and, in this way, do affect monetary policy. This is a point Yellen could make. Specifically, when financial conditions change for reasons other than monetary policy, it can feedback to monetary policy decisions. This is a point that Dudley has repeated, and which is appreciated by all on the Committee:

> For example, when financial conditions tighten sharply, this may mean that monetary policy may need to be tightened by less or even loosened. On the other hand, when financial conditions ease -- as has been the case recently -- this can provide additional impetus for the decision to continue to remove monetary policy accommodation.

Today the issue is that, as the FOMC has been tightening monetary policy through rate hikes, financial conditions have nevertheless eased. The July 2017 FOMC minutes described FOMC participants discussing this phenomenon. The failure of financial conditions to become less accommodative as the FOMC has been trying to withdraw monetary accommodation is a concern, and, other things being equal, would call for a sharper response of monetary policy.

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[3] Governor Stein left the Fed in 2014 and, without him, there has been less focus on financial instability arising from market pricing. In any case, Yellen will likely characterize the vulnerabilities of the U.S financial system as "moderate on balance," consistent with the Fed staff's assessment reported in the most recent FOMC meeting minutes.

[4] Janet Yellen's testimony before the House Financial Services Committee on July 12, 2017.

Bottom Line

Yellen's objective is to give a talk which is uneventful: no signaling something we don't already know and nothing that would move markets. But while that is her objective, her remarks on financial stability could be interpreted incorrectly as an intentional hawkish signal.

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