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The Fed's Systemic-Risk Balancing Act

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The Federal Reserve Board of Governors recently warned of the possibility of excesses in asset markets but concluded that, at least for now, if there is a need to act it will not be done by raising interest rates but by relying on "macroprudential" policy tools to reduce systemic risk.

We are not expressing a view on whether there are current financial excesses that are potentially destabilizing—that is always hard to judge—or whether the Fed should raise rates now to deal with such possible risks. But we do think it imperative that Fed policy makers have a realistic view of the breadth of the possible systemic risks and of the tools that are available to deal with such risks.

The macroprudential tools that the Fed has discussed relate primarily to making banks more resilient, and that is obviously very important. But the possible systemic risks extend to a vast number of other institutions and asset markets, and there the issues around macroprudential regulation become much more complicated.

The Financial Stability Oversight Council, established in 2010 by Dodd-Frank, can give the Fed authority over certain non-banks, and can recommend policy changes to regulators like the Securities and Exchange Commission and the Commodity Futures Trading Commission. But so far the FSOC has taken very limited actions. The Fed's banking regulatory powers may also give the Fed the ability to indirectly affect some other areas of risk, such as hedge-fund positioning, but how much is unclear. Neither the Fed nor any other regulatory body has laid out a comprehensive description of the potential macroprudential tools.

Thus, we see three important issues with respect to relying on macroprudential tools. First, since a wide range of assets and asset holders are involved, current tools are not nearly as broad and comprehensive as the existing range of systemic risks. Second, the situations are complex, making the design of an appropriate regime complicated and time consuming. Third, it might take considerable time for the FSOC and the relevant agencies to reach a decision to act.

There is debate about how much the extremely low yield on 10-year U.S. Treasury bonds has been affected by the Fed's "unconventional monetary policies," including both the quantitative easing and the long-term guidance of short rates. In addition to Fed policy, the low yields on Treasury bonds reflect weak investment demand by businesses, the slow pace of the recovery, and the dollar's role as a safe haven in a troubled world.

Whatever the reason, the low yields on Treasury bonds have led to reaching for yield in many ways and in very large magnitudes. Again this needn't mean that the asset prices are excessive, but the combination of their dramatic increase in price, the low volatility and the reaching for yield by investors and lenders suggest that the risk of excesses and the consequent instability have increased substantially. And if there are excesses, they represent wide-ranging systemic risks that go beyond the banking system.

There are many potential examples of heightened risks. For one, if hedge funds hold excessively priced assets that at some point start to adjust, there could be contagion and a snowballing effect, especially given the crowded trades that are common among hedge funds. That could affect broader markets and the economy more generally.

The yield spreads on low-quality "junk" bonds have fallen dramatically. The volume of high-risk "leveraged loans" (i.e., loans that require interest rates of Libor, the London Interbank Offered Rate, plus 200 basis points or more) have increased from $200 billion in 2010 to $600 billion last year. Covenant-light loans have grown from $10 billion in 2010 to more than $250 billion last year. The S&P 500 is near record highs. Volatility across asset classes is very low and volatility instruments like the Vix index of equity volatility are trading at low prices to reflect this. European sovereign-debt yields have come way down, with the Spanish 10-year bond, for example, recently trading at the lowest rate since 1789. And the list goes on.

The buyers of these instruments and securities include insurance companies, endowments, money managers, hedge funds, individuals, pensions, special funds created for their acquisition, and others.

In the short run, markets tend to be psychological and in the longer run tend to reflect fundamentals. Whether and how much markets are mispriced relative to fundamentals is always uncertain. But when markets have moved across the board as much as they now have, that should be a warning of the possibility of excesses.

Our conclusion is not that the Fed should respond to those risks by raising interest rates now. Weak labor markets are and should be a deep concern and a pressing issue. But the Fed should also take into consideration the possibility of excesses brought on by low interest rates that could create financial crises. In making interest-rate decisions, the Fed should have a realistic view of the broad range of the existing systemic risks and of the limits of the government's currently extant macroprudential tools.

The stress in these interest-rate decisions is heightened by the political system's failure to act on our nation's broader policy challenges, increasing the pressure on monetary policy, despite the limits on what it can do and the risks its expanded use can pose.

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