EconoFact Chats: The Financial Sector and Rescuing the Economy

Jeremy Stein, Harvard University

Published 12th October, 2020

Michael Klein:

I'm Michael Klein, executive editor of EconoFact, a non-partisan, web-based publication of the Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies publishing work from leading economists across the country. You can learn more about us and see our work at www.EconoFact.org

Michael Klein:

Main street versus wall street. The Global Financial Crisis began in 2008 with the collapse of Lehman Brothers and the seizing up of the financial system. Efforts to avert another Great Depression focused on saving the financial system, saving wall street, the then chairman of the federal reserve, Ben Bernanke, made a compelling case that it was necessary to save Wall Street in order to save main street because a functioning financial system is needed for a functioning economy.

Michael Klein:

The current economic crisis due to the effects of COVID-19 is not as directly tied to the financial system as was the 2008 crisis, but there are concerns that the financial knock-on effects of this crisis can hamper the recovery.

Michael Klein:

To talk about these issues, I'm very pleased to be speaking today with Jeremy Stein. Jeremy is the Chairman of the Department of Economics at Harvard. He was a member of the Board of Governors of the Federal Reserve from 2012 to 2014. And during the Global Financial Crisis, Jeremy served as a senior advisor to the Treasury Secretary and on the staff of the National Economic Council. Jeremy, welcome to EconoFact Chats.

Jeremy Stein:

Thanks, Michael. It's nice to be with you.

Michael Klein:

Jeremy, how does the current economic crisis compare to the Global Financial Crisis or the Great Depression in terms of the linkages between the economic downturn in the financial system?

Jeremy Stein:

Well, I point to two relevant differences. One is that we now have enormous macro economic uncertainty, but it's not coming from sort of within the economy or from things that are amenable to policy maker action. In particular, it has to do with health outcomes, with progress on the vaccine, all of that sort of thing, which is again, out of the reach of economic policy. And second, there is a sort of striking disconnect between the fortunes of companies over this year or over the time during which we're really in the heart of the pandemic and their ultimate long run viability.

Jeremy Stein:

Normally, if you see a company having its revenues decline by 75%, you might say, wow, that's a company that really is just not a viable enterprise. And if you see the government stepping in to help it, they might be thought of as helping a zombie firm. Here in many cases, what determines whether you're hard hit has more to do with the type of business you do. So for example, dentists have been pretty hard hit because nobody wanted to get their teeth cleaned for the first three months. But for all of our sakes, I would hope that that doesn't say much about the long run viability of dentistry as an industry.

Michael Klein:

Yeah. I don't want to think of my dentist, Keith, as a zombie, as a walking dead, but I know for him, it was a very difficult period. So Jeremy, what does this mean for the way policy should respond to the crisis? Is it different from what the playbook looked like in 2009 when you were a Senior Advisor to Treasury Secretary Geithner?

Jeremy Stein:

I certainly think it should. I mean, if you've seen some of the policies that have been rolled out, they do in many ways resemble or are built on policies that were used last time around, but a fundamental difference is that at least in hindsight, and with a good bit of luck, you can think about what we had in 2008, 2009 as being a significant part of what economists would call a liquidity crisis. That is to say you had fundamentally solvent companies and banks that just ran out of short-term money. And thus to the extent that the Fed could step in and provide them some of that money, they had a good chance of survival and hence they had a good chance of paying back their loans.

Michael Klein:

So these are not zombies as you called it before, but rather they're just sort of under a difficult period for hopefully a short period of time.

Jeremy Stein:

Right. Again I don't want to underplay the role of luck, but if you look at what happened, the government put a lot of money in, for example, to the banking system, but ultimately it all got paid back with interest. And that was because at the end of the day in the banks and parts of the policies, the companies and the banks that were financing them were basically not zombies. Exactly as you say. Whereas in the current environment, I think no matter how good the policies are, because you've got this disease in the background, there's just going to be a level of risk. And I don't think it's a reasonable expectation that the government can, as it did last time around, hope to get its money back. And in other words, if you make loans only in those cases where you're confident that you can get your money back this time around, I don't think you'll be addressing the most pressing parts of the crisis or helping those companies that need the help.

Michael Klein:

So, a key risk in the recession that began in 2008 was that of a vicious cycle, the financial meltdown for the economy that imperiled financial firms, so they cut lending. This hurt the economy further, which made the financial firms even more fragile, and so on. Do we face a similar kind of risk of what we call financial amplification of a downturn now?

Jeremy Stein:

Well, we certainly did. If you'll recall in early March, markets were experiencing really quite pronounced turmoil, both the stock market and the corporate bond market, where there were very large outflows from bond funds. Unprecedentedly, large outflows, credit spreads rose very sharply and dramatically, what's often a real harbinger of problems in financial markets. Now fortunately, the Fed stepped in very aggressively, and I think appropriately so, with new programs and I'd point in particular to what are called the primary and secondary market credit facilities, where they announced that they stood ready to buy for the first time corporate bonds, if need be. That had a relatively dramatic stabilizing effect on the economy. And I think at least for the time being has taken that particular channel of amplification out of play. So I think absent defense action, we could have had an economic shock turned into a very, very damaging financial spiral. So far, it looks like we've avoided that piece of it.

Michael Klein:

The fed going in and purchasing these bonds, the price of the bonds didn't have to fall, that is interest rates didn't have to shoot up, so it was more reasonable interest rates that the firms had to pay in order to borrow. And then as you say, it seems like there's been a recovery in the stock market since then, in bond markets since then, and the market seemed to have calmed down. But a lot of companies don't float bonds or they don't have stock, instead they have to borrow from banks. What's going on with the bank sector right now?

Jeremy Stein:

Well, I think that's a very good, good question. And I think the concern I certainly have is that we've seen something of a divergence, and a somewhat unusual divergence between the fortunes of the larger corporate bond market and the banks. So again, corporate bond market, if you're a big enough company that you can borrow in the corporate bond market, there's been a tremendous wave of issuance of those bonds. Costs are relatively cheap for those companies, and they've been able to stockpile large amounts of cash to help see them through.

Jeremy Stein:

By contrast, surveys of lending conditions in the banking sector, suggest credit is quite a bit tighter for smaller companies. And I think that's in no small part due to the fact that the banks are starting to experience and are likely to experience fairly significant loan losses going forward, which depletes their capital and makes it harder for them to make new loans.

Michael Klein:

So, Jeremy, I know you've done a lot of research on this. Can you just quickly describe the role of bank capital and why it's important?

Jeremy Stein:

Yeah. So what bank capital is, it's essentially the extent to which banks finance themselves, finance their assets with equity, as opposed to with borrowing. And when they do so, when they have more equity in their capital structure, they're more resilient to losses, to downturns because they don't have to keep paying interest. They're less likely to basically go broke or to go and become insolvent. And in the worst case experience a run. So having more capital makes them safer and allows them to continue to lend when they experience losses.

Michael Klein:

But then bank capital is depleted when banks pay out dividends to their shareholders. And I know you and your friend and colleague David Sharpstein wrote about this back in 2009 when banks were being bailed out, but then they were also at the same time paying out dividends. Do we see anything like that now?

Jeremy Stein:

Well, it's a good question again. I think one of the lessons, I thought one of the really most clear-cut lessons we learned last time around, is that as you pointed out banks from 2007, when we started really seeing problems in the financial markets through Lehman brothers in late 2008, banks collectively paid out over a hundred billion dollars in share repurchases and dividends to their shareholders while raising relatively little new equity. In retrospect, that looks like a mistake. That we could have done a lot better and we could have mitigated the crisis earlier had we kept the banks from paying out all that cash and thereby conserving some capital. And the good news is this time we started with higher levels of capital. The banks had substantially more capital to begin with. Nevertheless, it's being depleted and will continue to be depleted by the significant losses that the pandemic is creating. And I think the mistake and a missed opportunity for policymakers in the United States is that they've continued to allow banks to pay dividends to their shareholders.

Jeremy Stein:

This stands in contrast to regulators in many other countries that have stopped not only share repurchases, but dividend payouts, again, in an effort to conserve capital and to preserve bank's ability to keep lending through the recession and on the other side of it.

Michael Klein:

So the role of banks as you were noting is very important. Isn't it that it's especially important for the kinds of firms that were most hard-hit? If you think of, like you mentioned dentists, but also restaurants, or small retail stores, places that don't have access to the capital market or can't float stock. So it's kind of a double whammy for them and they're most hard hit because they by the pandemic and operate, but then also their source of funding is drying up more so than other kinds of funding.

Jeremy Stein:

Yeah. Again, that's precisely right. And I think one thing that has been a little bit different about this episode, because the Fed's intervention has been much more so successful in the bond market, this is a case where the crisis is actually driving or may drive a wedge between the fortunes of the bigger companies, and for exactly the reasons you described, the fortunes of smaller companies. So I think it has issues of sort of fairness that are important. And to the extent that economists have expressed concerns about some industries becoming more concentrated, more dominated by the sort of bigger winner take all firms, I think, at the margin that kind of plays into that concern as well.

Michael Klein:

So Jeremy, you were a member of the Board of Governors of the Fed. How would you grade the Fed's response to the economic crisis so far?

Jeremy Stein:

Well, I would say overall, I give them very high grades, particularly as I said, I think the speed and forcefulness with which they responded in March to the turmoil in markets, A plus. And this is to the primary market and the secondary market credit facilities, which again, really stabilized markets, not only in the U.S. but abroad. And I think for the time being has taken what could have been an extremely damaging downward spiral, where an economic crisis turned into a financial crisis, has taken that off the table. So that I think is very, very good.

Jeremy Stein:

They also have rolled out, to your point about smaller and medium-sized firms, they've also rolled out a so-called main street lending program, which aims to make loans to smaller firms. That has so far done essentially much, much, much less business. It has not really had much take-up. So I think that's a concern. I don't necessarily fault the Fed entirely for that. I think the Treasury Department deserves some of the blame there because they're the junior partner. In other words, they're going to take the first set of losses if the main street loans go bad. And they have been quite conservative in their design.

Jeremy Stein:

Back to your first question, they appear to be thinking about it a little bit more like 2008, 2009, and thinking, well, we should only make loans where we can expect to be fully paid back. But for the problems that we're facing today, we need a willingness, I think, of the government to take some credit risk and to be willing to make loans that they can't assume will be entirely paid back. And I think that's part of the reason the terms on main street are just too restrictive. And I think, therefore we're, again, back to your other point, we're doing a better job of helping large firms than small and medium-size.

Jeremy Stein:

And then final, last point I'll make, is again, I think the really kind of glaring failure here has been to allow banks to continue to pay dividends. Again, that weakens bank capital, and ultimately, I think it's not that we're going to see banks failing or toppling over, but I do worry about a constriction of credit. And particularly as you noted to the smaller firms in the economy.

Michael Klein:

So we've talked about how financial markets have responded positively to the Fed's actions. Have they responded too positively?

Jeremy Stein:

I think that may be the case. In other words, it's been very striking if you look at the stock market, that in the middle of a pretty frightening recession, it's essentially regained its pre-pandemic highs. Also, from my perspective, what's been very interesting has the credit markets where the so-called credit spreads on junk bonds on riskier bonds, and in fact, even on the very riskiest, the lowest rated triple C bonds have also largely recovered to the point where these spreads are now at levels that are close to their unconditional averages and nowhere near where they normally stand in recessions. And even if this recession turns out to just be an average recession in terms of the losses experienced and the defaults experienced on these bonds, it's pretty hard to understand why they're trading at the levels that they are, unless investors have an extremely optimistic view of exactly what the Fed will do ff things go South.

Jeremy Stein:

In other words, it's one thing to expect the fed to stabilize the trading prices of some of these bonds. It's another thing entirely to think that they're going to make investors whole if the bonds default, and yet the traded prices seem to suggest at least some belief in the latter direction. And so that's one sense in which too high might concrete the notion of prices being too high.

Michael Klein:

So what happens if the markets are wrong about the Fed's willingness to provide a full backstop?

Jeremy Stein:

Well, it depends very importantly on the course of the economy and that the virus takes. So if we get lucky, and the vaccine comes relatively soon, we may just sort of skate through and that will be great. And again, I applaud everything that the Fed has done to make it easier for us to skate through. If on the other hand, things drag out and the economy sort of doesn't recover as quickly and we have a wave of downgrades and defaults, then the worry would be that not only is there the direct bad news associated with the downgrades and defaults, but investors will learn that unfortunately, the fed can't backstop that maybe as fully as they had hoped, and that will cause a further lag down in markets. So I think that's a risk. Again, it does not mean that the original policy was not a good policy. I think it was appropriately aggressive, but it comes with a risk. And I think that's the scenario that I'd be concerned about.

Michael Klein:

So we can imagine a situation where the Fed is put between a rock and a hard place. If things, as you say, continue to go south, and then there'd be political pressure brought to bear on the Fed. Economists think a lot about the importance of central bank independence. Could you talk about that a little bit?

Jeremy Stein:

Sure. I think it is important. The word central bank independence gets thrown around a lot. I think it's important to kind of narrow it a bit. In other words, central bank does a lot of things. It does monetary policy, it does regulation, it serves as a lender of last resort. I don't think it should be. I don't think it's appropriate for it to be fully independent in all aspects.

Jeremy Stein:

So for example, when it sets regulation, that is done in an interactive way. There's a process of putting out the regs for comment and all of that, and that's appropriate in that context. Similarly, in some of the lender of last resort programs that we've seen, the credit market programs, where the Fed is taking fiscal risk, it's doing that together. It's essentially joining hands with Congress and with the treasury department. Now, where I think independence has typically been thought of as important is in the setting of traditional monetary policy with the idea being that you don't want the Fed to shy away from say raising interest rates to combat inflation when we're close to an election, or when there are other political pressures not to raise interest rates.

Jeremy Stein:

So I think that sort of independence is certainly worth preserving and protecting, but sometimes that means being careful not to overstep or to over-serve independence in other aspects of what a central bank does.

Michael Klein:

So Jeremy, I'd like to close by asking you a bit about your experience as a member of the Board of Governors. You were there for a few years, you came out of academia, you returned to academia, you and I were at the Board of Governors as interns, way back in the mid eighties. How did you find that experience?

Jeremy Stein:

Well, it was one of the really great and rewarding experiences of my professional life and it was really, honestly a privilege to work with not only the other governors and the chair or both of the chairs that I served under, but the staff there. And I guess as a personal thing, one of the things that I most appreciated about it is you've got these enormously talented and public oriented folks. And I've worked closely with dozens, if not hundreds of people there. And one of the things that I sort of appreciated the most is of all these people that I work with, and in many cases on issues that were quite fraught, I couldn't have told you based on our interactions, anything about their political affiliations. Whether they're Democrats, Republicans, they saw themselves as civil servants, as public servants, and as technocrats in the very best sense of the word. I guess given my own background, I again, found that enormously satisfying and admirable.

Michael Klein:

Well, Jeremy, thank you very much for speaking to me today. As always, I find our conversations illuminating and interesting.

Jeremy Stein:

Great. Thanks for having me, Michael, it was a pleasure.

Michael Klein:

This has been EconoFact Chats. To learn more about EconoFact, and to see the work on our site, you can log into www.EconoFact.org. EconoFact is a publication of the Fletcher School at Tufts University. Thanks for listening.