EconoFact Chats: The U.S. Economy: Financial Stability, Longer-Term Risks and Reasons for Optimism
Eric Rosengren, Federal Reserve Bank of Boston
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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:

The federal reserve system includes the board of governors in Washington, DC and 12 regional banks that are located in cities such as New York, Cleveland, St. Louis, San Francisco, Kansas City, Dallas, and Boston. The presidents of these regional banks contribute to monetary policy decisions and also monitor economic conditions in their regions. And some of these presidents, like my guest today, have also looked beyond traditional concerns of monetary policy to look at issues like climate change and the economic consequences of racism.

Michael Klein:

My guest today is Eric Rosengren, the president of the Federal Reserve Bank of Boston. Eric is the longest-serving federal reserve regional president having been appointed to this position in July 2007. Before that, he was in the research department at the Boston Fed, where he published a series of very influential scholarly articles on the effects of credit crunches, times when banks are constrained in their ability to lend, and this affects the overall economy. In the interest of full disclosure, I was a co-author on one of those articles, and I've known Eric since we were both starting out in the profession in the late 1980s.

Michael Klein:

Eric, great to have you on EconoFact Chats. Thanks for joining me today.

Eric Rosengren:

Great to be with you, Michael.

Michael Klein:

Eric, you've now served as the president of the Boston Fed during the two largest crises in the post-World War II era, the 2008 financial crisis and the current COVID crisis. I know it was all hands on deck in 2008 and you didn't get home much in the evenings. I imagine you're not getting a lot of vacation time now either.

Eric Rosengren:

Unfortunately, that's true, but hopefully we're getting towards the light [at the end] of the tunnel.

Michael Klein:

You're the longest-serving president in the federal reserve system, and you've also been in this position longer than any of the current members of the board of governors. You're only one of two current presidents of a regional federal reserve bank who was in that position when the 2008 crisis began, and none of the members of the board of governors was serving at that time.

Michael Klein:

A central part of the 2008 crisis was the near meltdown of the financial system and the consequences of the seizing up of credit markets. As I mentioned, a lot of the research you did before becoming president of the Boston Fed was on credit crunches. How did this research inform your policy decisions at that time?

Eric Rosengren:

The research was really useful. I'd say as well as having a research background, I also have been head of bank supervision, so I had some real hands on experience with how we supervised and regulated banks. One of the things that my research had highlighted, including my research with you, was to highlight that when banks take significant losses, they tend to pull back on their balance sheet, and that has the effect of tightening up on credit to borrowers. Even if you're a good borrower, you may be [facing] very different lending conditions because of the conditions of the bank, not because of the conditions of the borrower.

Eric Rosengren:

Understanding some of the mechanisms in which credit went through the economy was very important, not only in the banking system, but also in the part of the banking system or the financial system that's not controlled by banks. I would say it was also useful in setting up emergency lending facilities and thinking about the stress testing of banks, which we instituted in the middle of that crisis.

Michael Klein:

We seem to have dodged the bullet in terms of a financial meltdown this time, although things looked pretty dicey a year ago in March 2020. I had Jeremy Stein as a guest on EconoFact Chats and he gave the fed an A for its response to the challenges that arose last spring. Congratulations on such a good grade from a Harvard professor.

Eric Rosengren:

Jeremy can be a tough grader, so pleased with that grade.

Michael Klein:

Yeah, no, it's well-deserved. A big lesson from the 2008 crisis is that financial stability matters, and the fed responded to that, but are there still dark clouds on the horizon in terms of financial stability? I'm thinking in particular of two potential weaknesses, student loans and commercial real estate. What's your view of these potential vulnerabilities? Could they prove to be systemic threats?

Eric Rosengren:

Yeah, so I'd say there are three immediate things that came up during the crisis, particularly as we were in March and April when the pandemic was rolled out. One was money market funds. In both 2008 and in this most recent pandemic, money market funds actually had significant problems. Investors started running on them and it badly disrupted short-term credit markets. I would say money market fund reform, which was not done well after the financial crisis, still is an issue that hasn't been addressed.

Michael Klein:

The money markets are important for commercial paper, for very short-term lending by firms. For example, in 2008, there was an issue of GM being even able to make its payroll. Is that correct?

Eric Rosengren:

That's correct. They hold bank CDs. They hold a short-term paper issued by high quality corporations. And most periods, those money market funds don't have a problem, but unfortunately, because of some of the way the accounting is done, as soon as they get into financial stress, investors tend to pull their money. That's particularly true for a particular type of money market fund, the prime funds, that do hold some credit risk. The government funds actually continue to have a flow in, not a flow out of funds, but when they get badly disrupted, the prime funds, it means that spreads on borrowing by banks and businesses become much more difficult, and so that's a real problem and that's a regulation that we need to adjust.

Eric Rosengren:

A second area that I'd say is critically important is the treasury securities market became badly disrupted. Even though treasury securities market is normally highly liquid, easy to sell and buy securities, when everybody tries to sell at the same time, it goes through banks' balance sheets, and that didn't work particularly effective, so we need a better way of clearing.

Michael Klein:

We have a nice EconoFact memo on that showing how the spread spiked so high last March and last April, and then the fed stepped in and helped resolve that problem.

Eric Rosengren:

Yeah. The fed stepped in by purchasing a very significant amount of treasury and MBS securities. But what we didn't do is fix the underlying problem, and that is that broker dealers, which are in banks, the people that are buying and selling the securities, have limited balance sheets, a lot like what we were discussing with the credit crunch, that they don't want to keep buying securities if everybody's selling. That resulted in that bad disruption, and so having a different way to clear treasury securities would improve that situation.

Eric Rosengren:

A third area that we had to make dramatic changes in was bank supervision. We had to give forbearance for borrowers. We reduced capital requirements. We made a number of adjustments to our bank regulations, all of which I think was very appropriate, but actually, we could have used a counter-cyclical capital buffer. It would be much better if we had a way to more naturally increase capital during good times and decrease capital during bad times without having to use ad hoc procedures. To me, those are the most immediate of the financial stability issues.

Eric Rosengren:

Now, you highlighted two that I think are longer term, maybe not as immediate. Student loans is obviously a concern and it's certainly a concern given what we've just seen through the pandemic. A lot of people lost their jobs. A lot of people lost wealth. If you have a lot of debt, that can be a significant issue. And on the commercial real estate, commercial real estate is going through significant changes. It's still unclear what kind of office setting we're going to have. If you walk around downtown Boston right now, it's pretty empty. It's really important whether people get back to offices and how they do for how those assets get priced, and many of those assets are held in banks. It's still a lingering problem. Many of the banks are smaller banks. They're not the biggest banks, but nonetheless, I agree with you. It is a significant financial stability issue.

Michael Klein:

All of these are not just issues for finance, but ultimately they're issues for Main Street as well as Wall Street. And you've been involved in the Main Street lending programs by the fed. Can you discuss these programs a little bit and speak to what you think of as their successes?

Eric Rosengren:

Yeah. There were two facilities that were run out of the Boston Fed. One was the money market liquidity facility, which in effect provided immediate emergency funds to money markets during their run. And that was highly successful. We made roughly $58 billion in loans to banks that then took paper off the balance sheets of money market funds, and we currently have no loans on our books from that program. They were all paid off. We took no losses and they actually stopped the outflow from money market funds.

Eric Rosengren:

The Main Street lending program was to deal with issues of troubled borrowers not having access to credit. And so in that facility, we participated with banks in order to make sure that troubled borrowers actually got funding. We did $16.5 billion dollars in loans, roughly 1800 firms. I think it was successful. I think it could have been more successful if congress had been clear about what kind of losses they were experiencing. This is a facility that was negotiated with the treasury, and treasury and the federal reserve both had to agree on the conditions. And in my own view, it would have been better if we'd had somewhat easier conditions.

Eric Rosengren:

I would also say that that Main Street facility was ended in December when we did 70% of our lending. It probably could have gone on for another quarter or two, but it was the treasury's view that we needed to close up that facility at that time.

Michael Klein:

Yeah. Jeremy had a similar view about there should have been easier terms and there should have been more of a willingness to actually lose money because of how fraught things were at that time.

Michael Klein:

Eric, most of our listeners will want to know what you think will be happening to the economy over the rest of the spring, during the summer and into the fall. We've had others on our podcasts, such as Greg Mankiw, who said that the economy cannot fully recover until the virus is under control. Would you agree with that assessment?

Eric Rosengren:

I certainly agree that the outlook for the economy over the last year has been intertwined with the outlook for the pandemic. The good news is in the United States, the rollout of the vaccine is going much better than people anticipated. And as a result, the economy's opening up more quickly than most forecasters expected. If you look at what the FLMC participants are expecting for growth for this year, we're expecting six and a half percent growth in real GDP. That's really strong growth in the economy and indicative that things are going quite well with the mitigation of the virus.

Eric Rosengren:

Now, things could change if we have co-variants that become more problematic, but assuming that we continue to have success against the virus, I'm very confident that we're going to grow pretty rapidly. We've had a lot of fiscal stimulus. We also have a lot of monetary policy stimulus. Many consumers ended up saving. If you were fortunate enough to have a job and keep your job during the pandemic, you probably did a lot more savings because you couldn't take vacations, couldn't travel, couldn't eat out at restaurants. As a result, there's a lot of pent up savings that probably will encourage people to consume more.

Eric Rosengren:

I'm optimistic about what the economy is going to be this year, and I'm quite hopeful that over the next two years, we get to an unemployment rate in the fours, which is a very significant rebound and much faster than what we saw coming out of the financial crisis.

Michael Klein:

Your mouth to God's ear, as they say. But also, the experience over the past year could very well cast a long shadow. For example, Jesse Rothstein and I discussed in an EconoFact Chats podcast the idea of labor market scarring. That is, people who are first entering such a weak labor market, their entire career is affected by that. What do you think will be the longer-term economic consequences of the pandemic?

Eric Rosengren:

I think it's not certain yet. There are a variety of ways that scarring can occur. One straightforward example is labor force participation rate dropped very significantly. Both for male and female, it's about two percentage points lower than it was February before the pandemic started. But I would highlight that for women, particularly of childbearing age, you see a very substantial age and gender cohort reflecting the fact that when schools weren't open or when they were only open for a hybrid approach, many women, some men, but predominantly women, pulled out of the labor force in order to be able to take care of their family. It's a real question about how quickly or whether they come back. That has long-run implications for what growth in the economy is.

Eric Rosengren:

A second area of scarring is a lot of restaurants. Again, going downtown Boston, a lot of the restaurants have closed permanently. Over time, I expect a lot of that space will fill up, but it is going to take time. People that have lost their wealth, it takes time to find other entrepreneurs willing to take a risk of opening a restaurant, paying for a lease, and I would say that many households have lost a lot of income and wealth and when you're in that situation, you make different decisions. I agree that labor market scarring, but even broader scarring as a result of what we've experienced with the pandemic is likely to occur.

Michael Klein:

I also interviewed Jeff Fuhrer in another EconoFact Chats episode. Jeff worked with you at the Boston Fed for actually decades. And he talked about the fed's new framework that recognizes the benefits to the job market of running a hot economy, especially for those with a marginal attachment to the labor force. Can you talk about that a little bit, Eric?

Eric Rosengren:

Sure. One of the issues coming out of previous recessions is we tended to tighten monetary policy as soon as we started forecasting that inflation would get up in the range that we wanted it to be in. We were pretty preemptive and that was partly a reflection of trying to avoid having inflation go out of control. But if you go back to the financial crisis, we started tightening after a few years and we never really got to our 2% inflation goal on a sustained basis over the entire decade of that recovery period. We changed our framework, in other words, to be more patient and to focus much more on outcomes and not on forecasts. The implication of that is that we keep interest rates lower for much longer and wait until we actually see the economic outcomes we want to see before we start raising rates.

Michael Klein:

As I alluded to in my introductory remarks, you and the Federal Reserve Bank of Boston have been innovative leaders within the federal reserve system for addressing a range of issues not typically associated with monetary policy. For example, racial discrimination and the recovery of cities that are struggling, like in Massachusetts, Lawrence and Fall River. The Boston Fed has also taken an important role in looking at red lining and mortgage discrimination in the 1990s and the racial and ethnic disparities of wealth in 2015. What do you see, Eric, as the evolving role of the federal reserve for issues beyond standard monetary policy?

Eric Rosengren:

Well, I would say all these issues are actually tied to monetary policies. For example, our Working Cities Initiative, which is focused on post-industrial cities that have not fared so well over the last 50 years, it's really important when we talk about getting to maximum employment that we understand what the impediments to getting to maximum employment are. And many of these cities are the cities where we have pockets of unemployment that stay persistently high, even as the economy recovers. It's important for us to understand the mechanisms that monetary policy can transmit to those areas much better.

Eric Rosengren:

Race in the Economy, which is a series that the fed has been putting on and I'd recommend as another podcast -- we frequently get six to 7,000 people watching that series -- has really focused on how race affects the economy in a variety of different ways, including in the labor markets, and again, labor markets are something that the federal reserve has a lot of attention to. I think these issues, while they're not the mainstream kind of interest rate and monetary policy that people frequently think about, have direct connections to what monetary policy is trying to achieve with the outcome for the economy.

Michael Klein:

Well, Eric, thank you very much for joining me today. It was great to have you on this podcast. And also, Eric, thank you very much for your service to the country and the very important role that you've been filling.

Eric Rosengren:

Pleasure to be with you, Michael.

Michael Klein:

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