

Monetary Tools, Financial Reforms, and the Next Financial Crisis

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The Questions Posted to Me for this Presentation

- *How will central banks and governments use monetary tools in the next financial crisis?*
- *What are your thoughts on the state of global financial reforms and/or global responses to US financial reforms?*
- *What do you see as the future of international monetary policy cooperation?*

The First Question Starts From the Wrong Premise

- *How will central banks and governments use monetary tools in the next financial crisis?*
- There is not going to be a “next financial crisis”
- My starting point: to convince you to stop worrying about the next crisis
- Change of topic: adequacy of monetary tools for the next recession
- When are we going to have the next recession?

Why We're Not Going to Have Another Financial Crisis

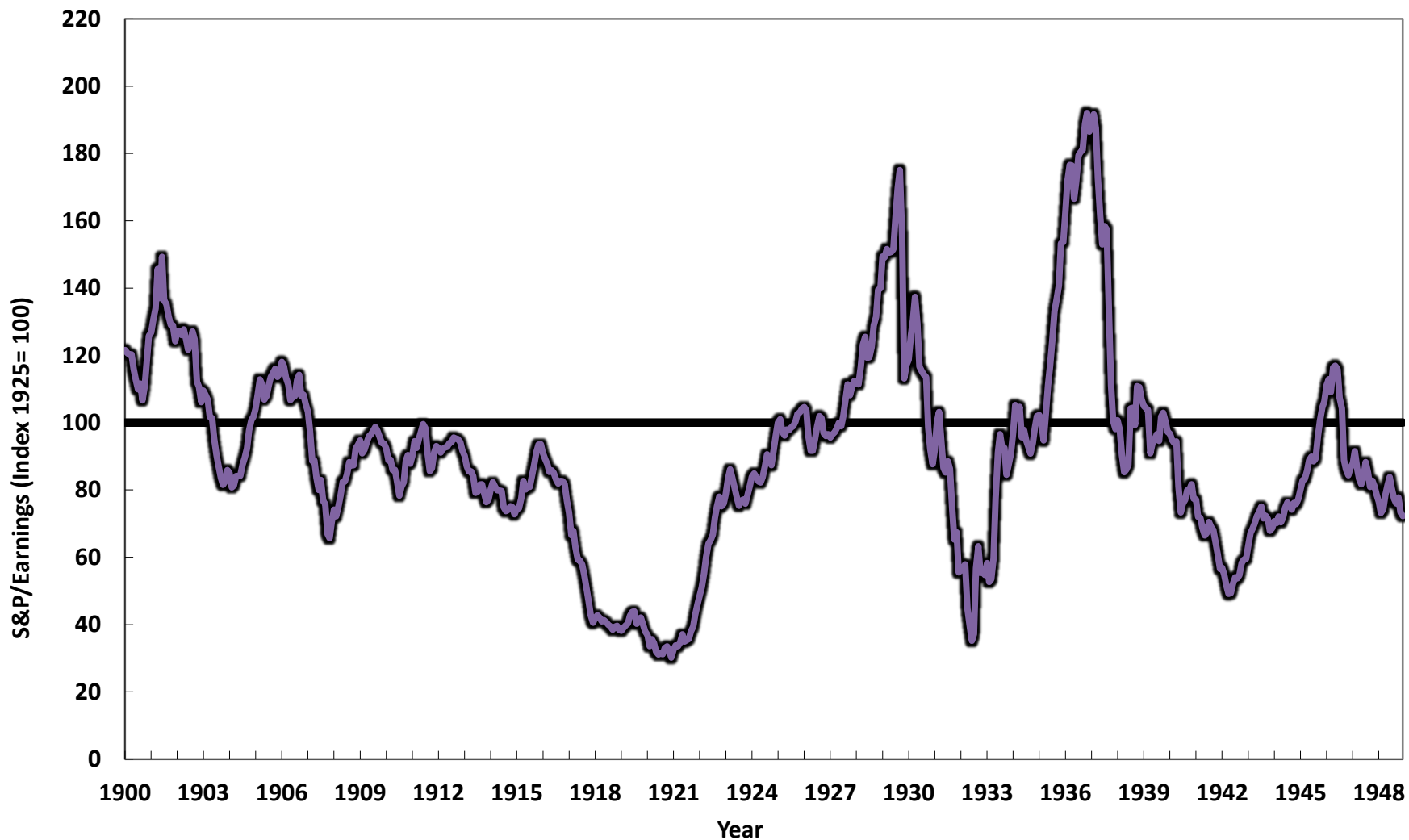
- **There can't be a global financial crisis without a crisis in the U.S., and there won't be a crisis in the U. S.**
- **Previous foreign financial crises that had no impact on the U. S.**
 - **Mexico 1994**
 - **East Asia 1997-98**
- **Instability in major nations that did not affect U.S.**
 - **Gyrations in Chinese stock market**
 - **2013 Euro crisis, second wave of high unemployment in Europe**

U. S. Crisis History:

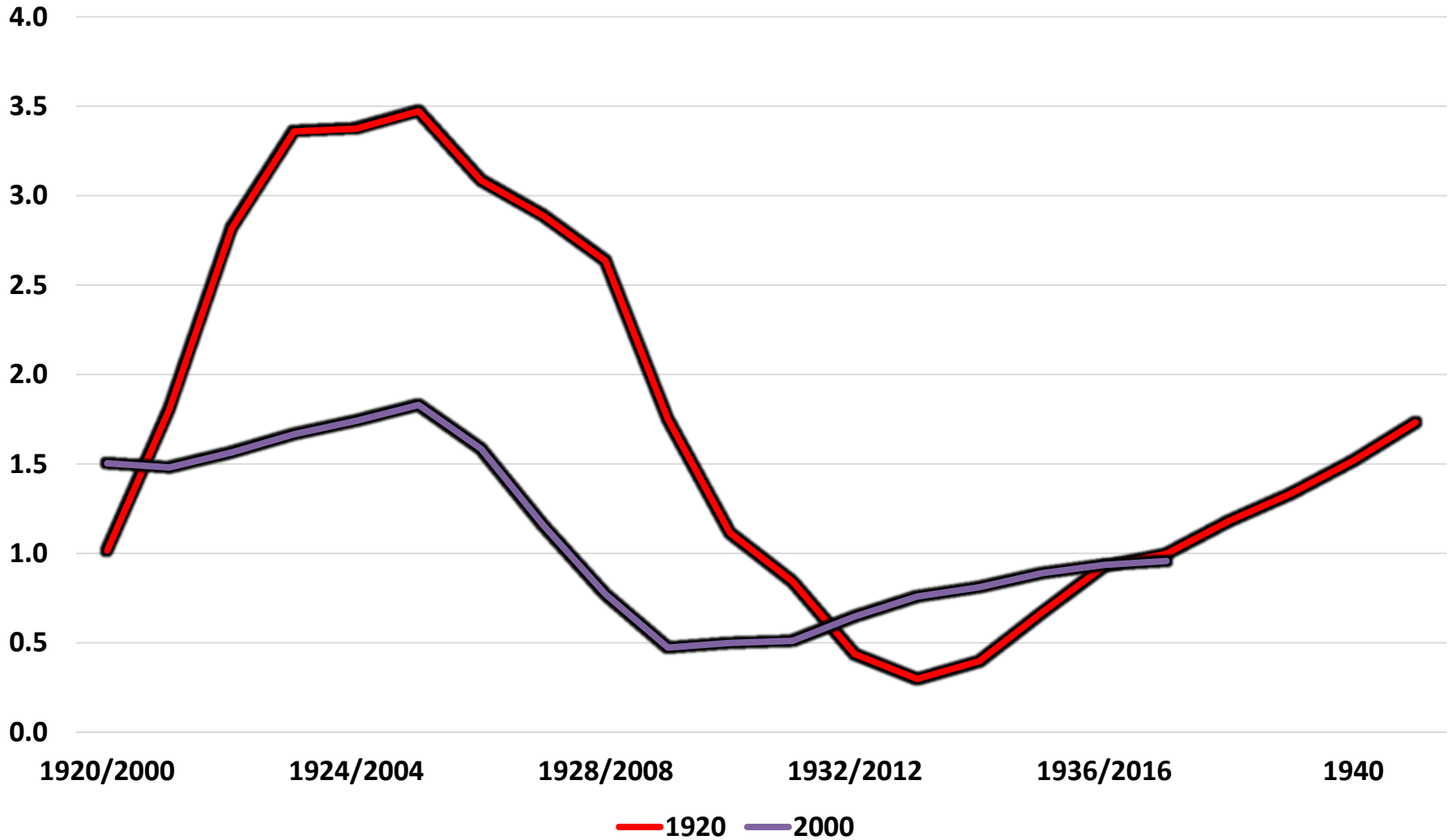
Only Two U.S. Crises Since 1907

- **1929: Stock market fell by half in one month, but this isn't enough to explain Great Depression**
 - Monetary ineptness, money supply declined by 1/3
 - 25,000 banks failed
 - Overbuilding in 1920s sapped demand for investment in 1930s, especially for housing
- **2008: What were the ingredients?**
 - Housing price bubble
 - Sub-prime mortgages bundled into mortgage-backed securities
 - Overlevered shadow banks which became insolvent when MBS were marked to market
- **2000-2001? Stock market fell by half but no crisis**

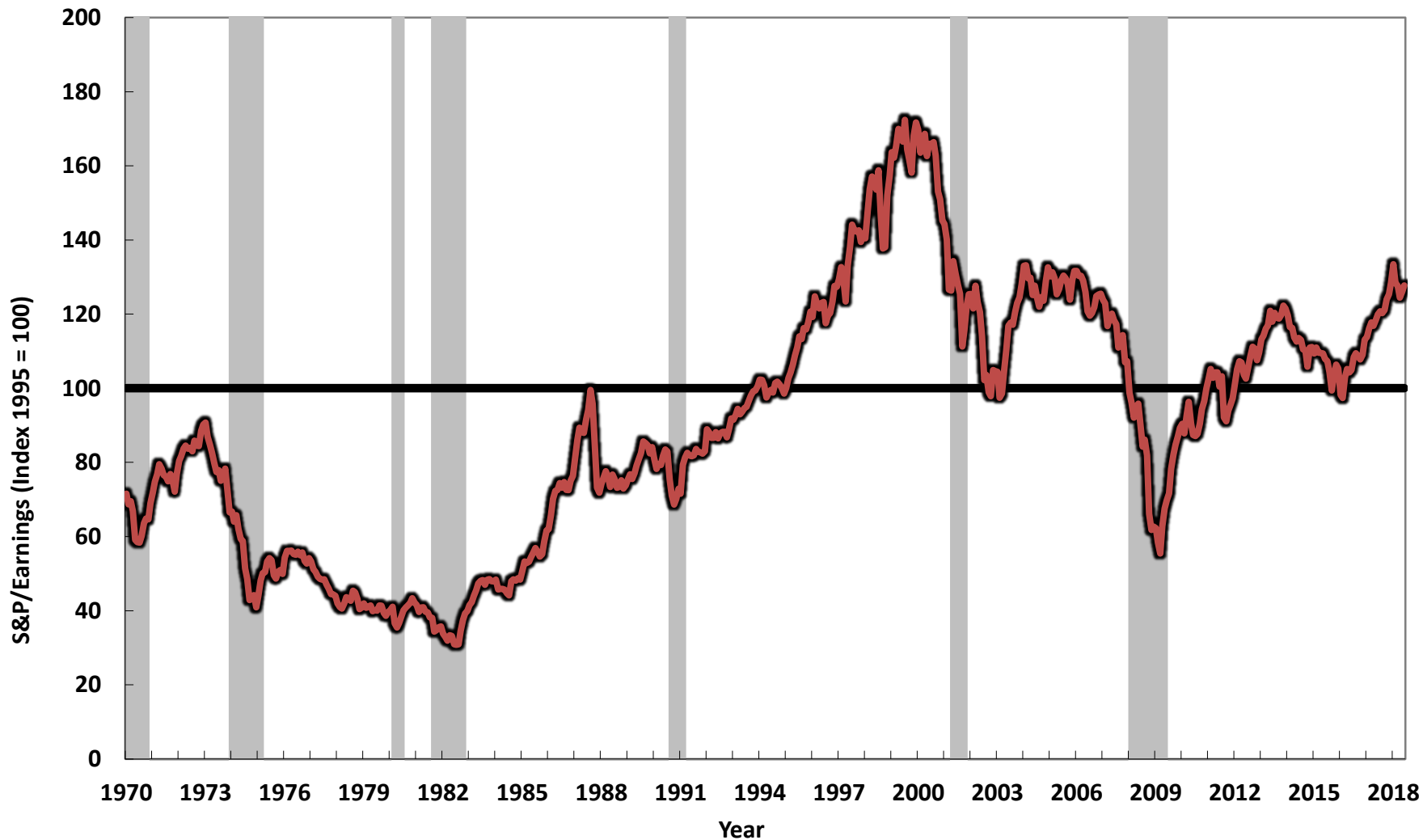
S&P Price Earnings Ratio, 1900-1948



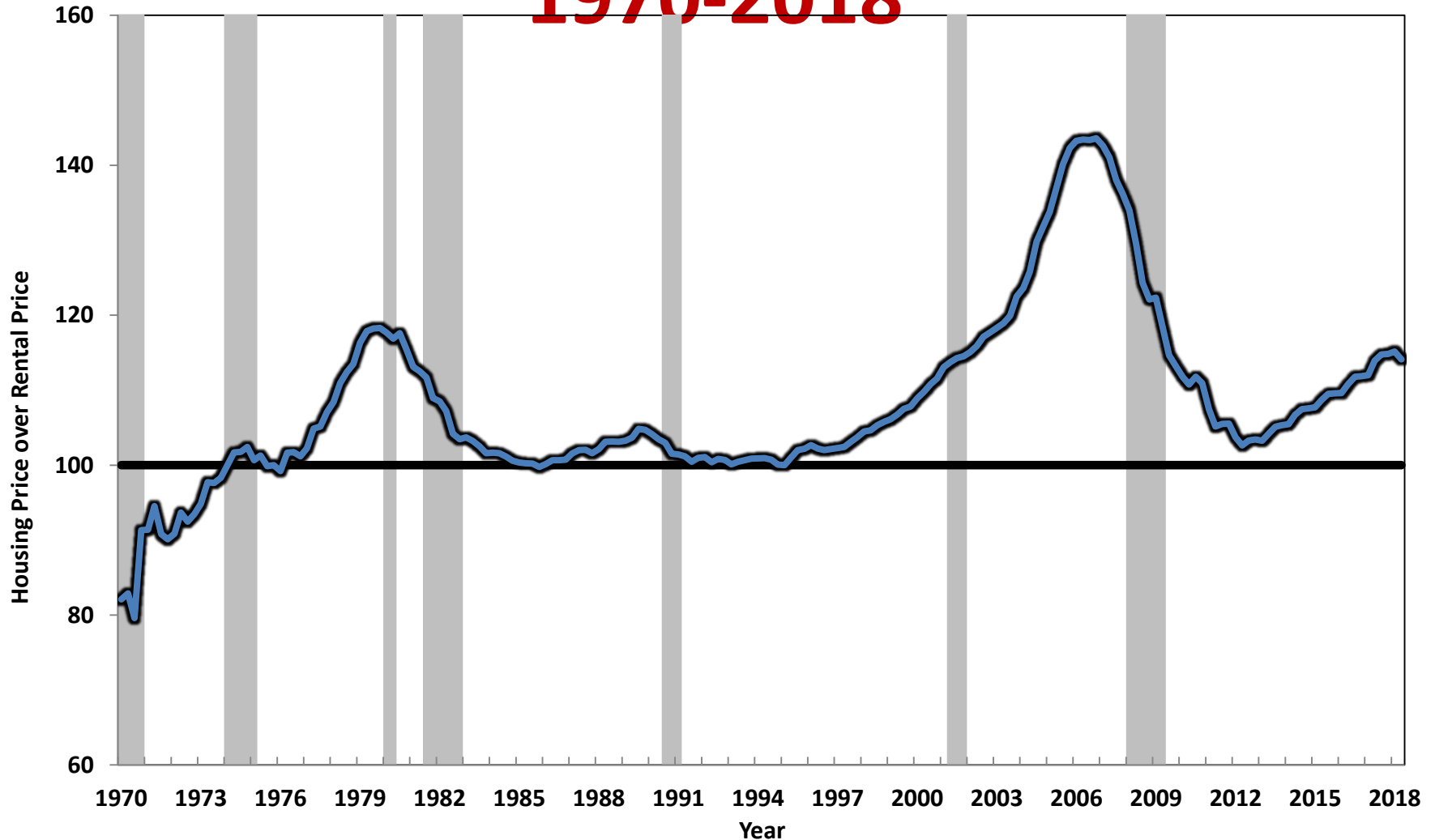
Housing Starts Relative to Households, 1920-41 vs. 2000-2018



S&P Price-Earnings Ratio, 1970-2018



The 2003-06 Housing Bubble Stands Out: House Price/Rent Ratio 1970-2018

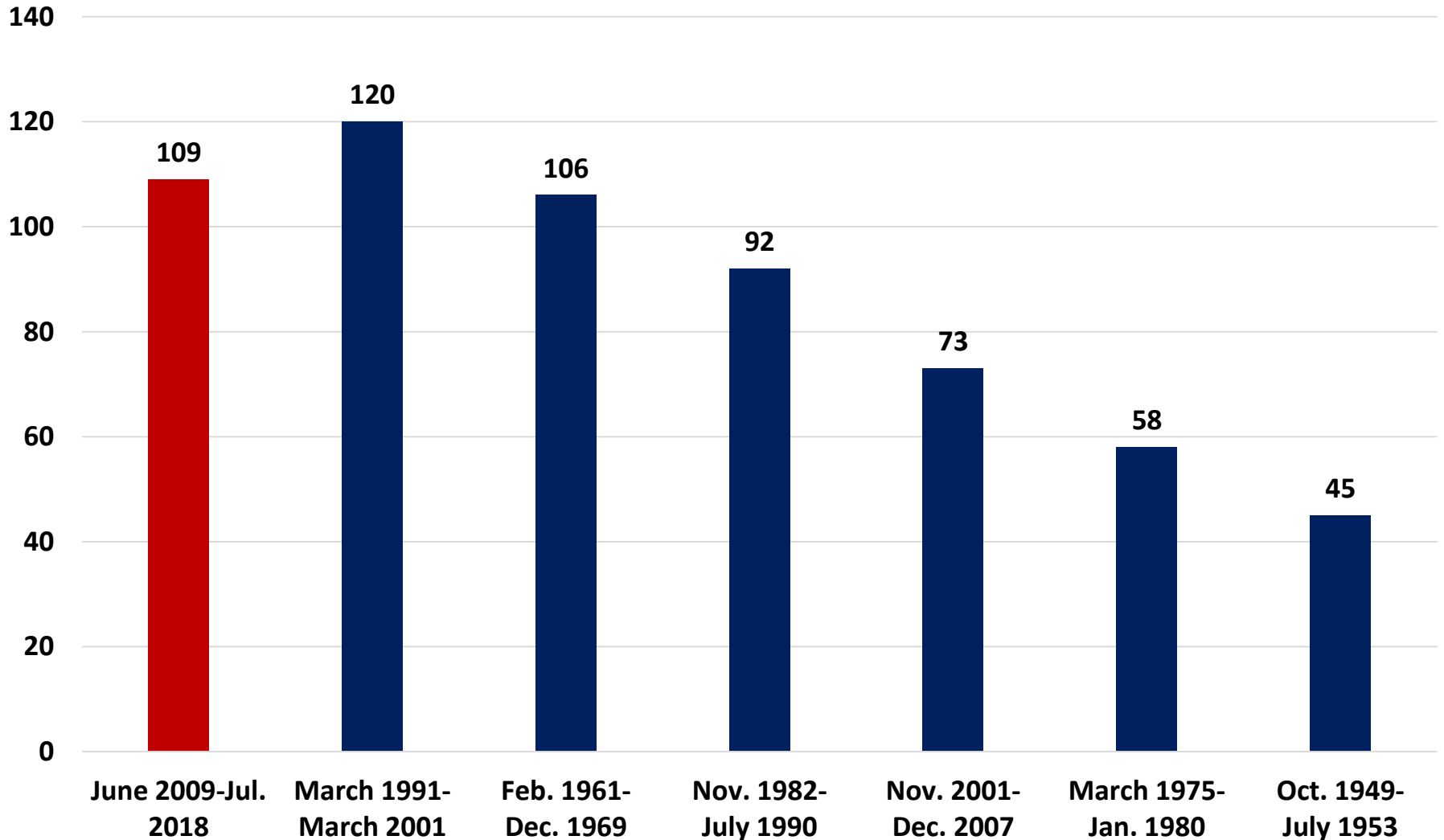


When Will the Next Recession Come?

Factors to Consider

- **Monetary Policy: How Restrictive?**
- **Tax Cuts and Reform: How Stimulative?**
- **Added Stimulus from Government Spending**
- **How Long Will Growth Rise to 3% from its 2% average during the expansion?**
- **Can the Supply Side Support the Demand Expansion?**

The Longest Expansions in U.S. History



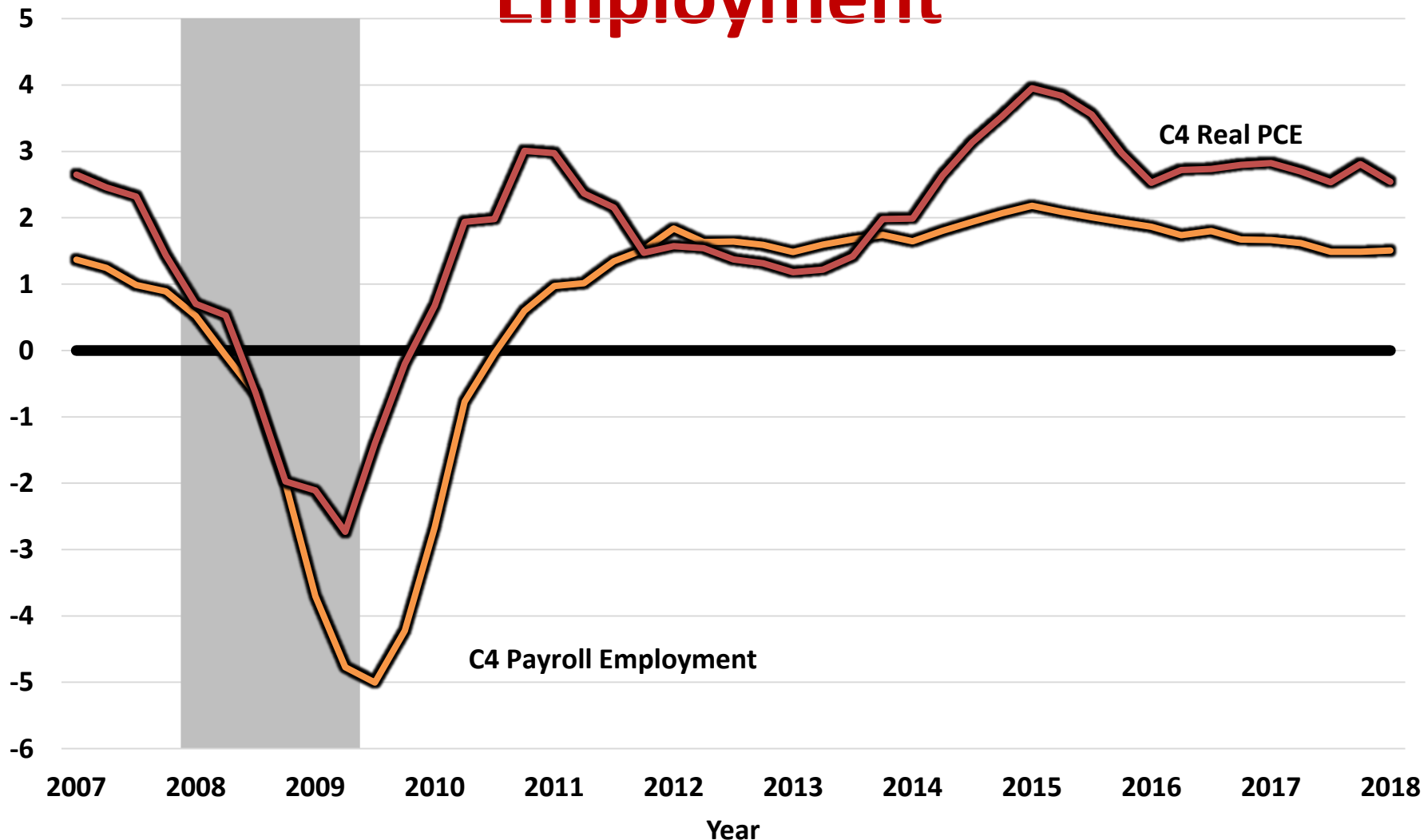
The Current Economy: A Golden Era

- **“Golden” with low inflation and GDP growth of 2.9 percent over the year ending in 2018:Q2**
 - Another year of 3 percent growth now to mid-2019
- **Unemployment rate has fallen from 10 percent in October 2009 to 4.0 in June 2018**
 - Below Most Estimates of Full Employment
- **But Inflation is not accelerating as in past expansions. Why? Discussion in second talk today.**
- **How Low Can Unemployment Go?**
 - 3.8% April 2000, 3.4% Fall-Winter 1968-69
 - 19 U.S. states have U rates at 3.5% or below
 - WI-MN-CO 3.0%
- **Conditional on inflation remaining at 2.0% or slightly above**

What Has Propelled the Expansion Over the Past 9 Years?

- **“Virtuous Circle” of job growth feeding income growth feeding consumption growth feeding more job growth.**
- **That can go on forever, or until we run out of workers**
- **Even as the U rate goes below 4.0 percent, there remain many discouraged workers and those working part-time who still lack full-time jobs**

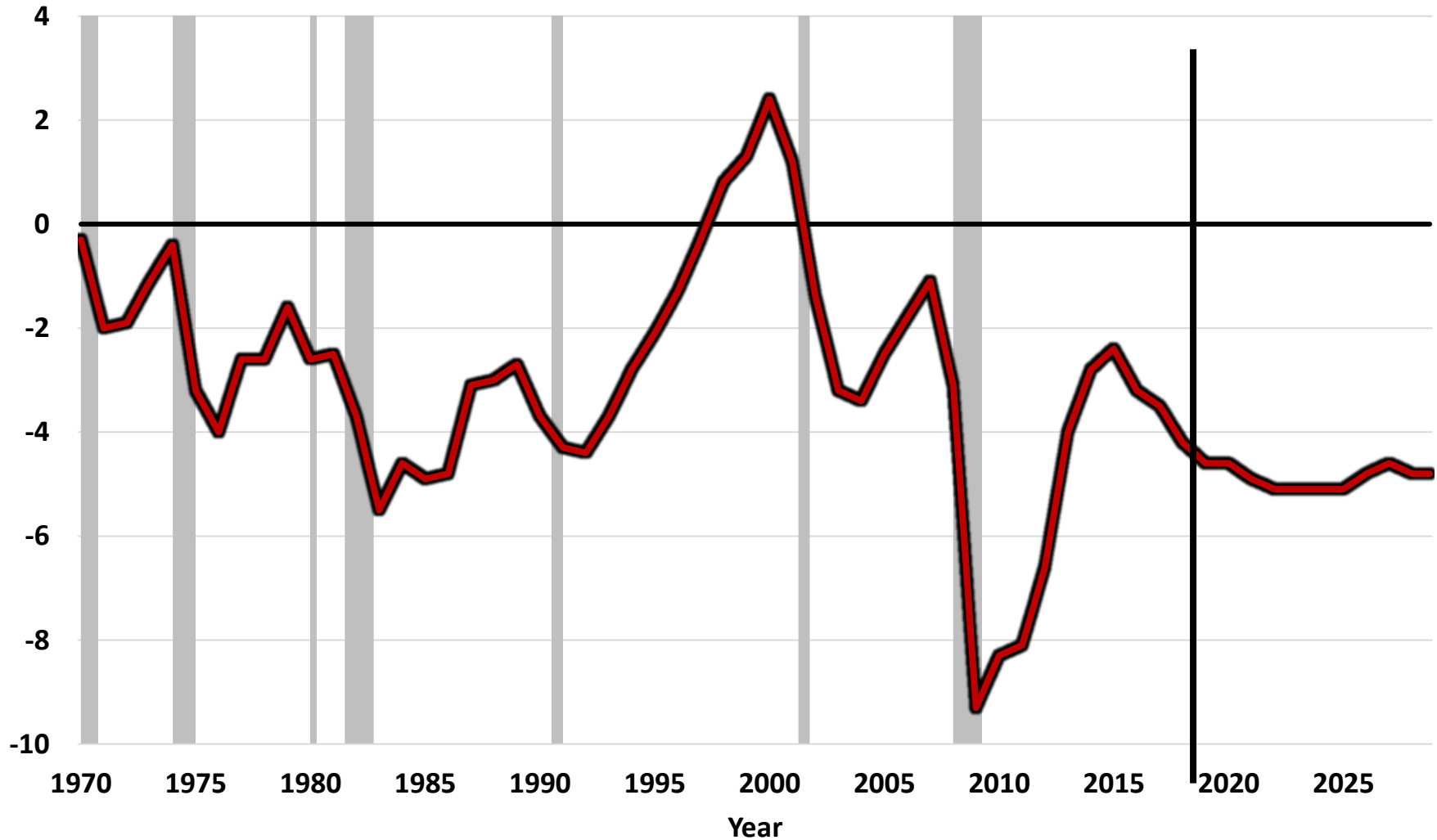
The Virtuous Circle – Employment Feeds Consumption Feeds Employment



Why Is GDP Growth Speeding Up from its 2% Path to 3%?

- Normal expansion deficit shrinks as rising incomes pull up Federal revenues**
- Now the corporate and individual tax cuts provide 0.3% growth stimulus in 2018**
- Bipartisan two-year \$300 billion increase in government spending 2018-19 provides 0.8% growth stimulus each year**

Government Deficit Should Decline in Expansions, But Not Now



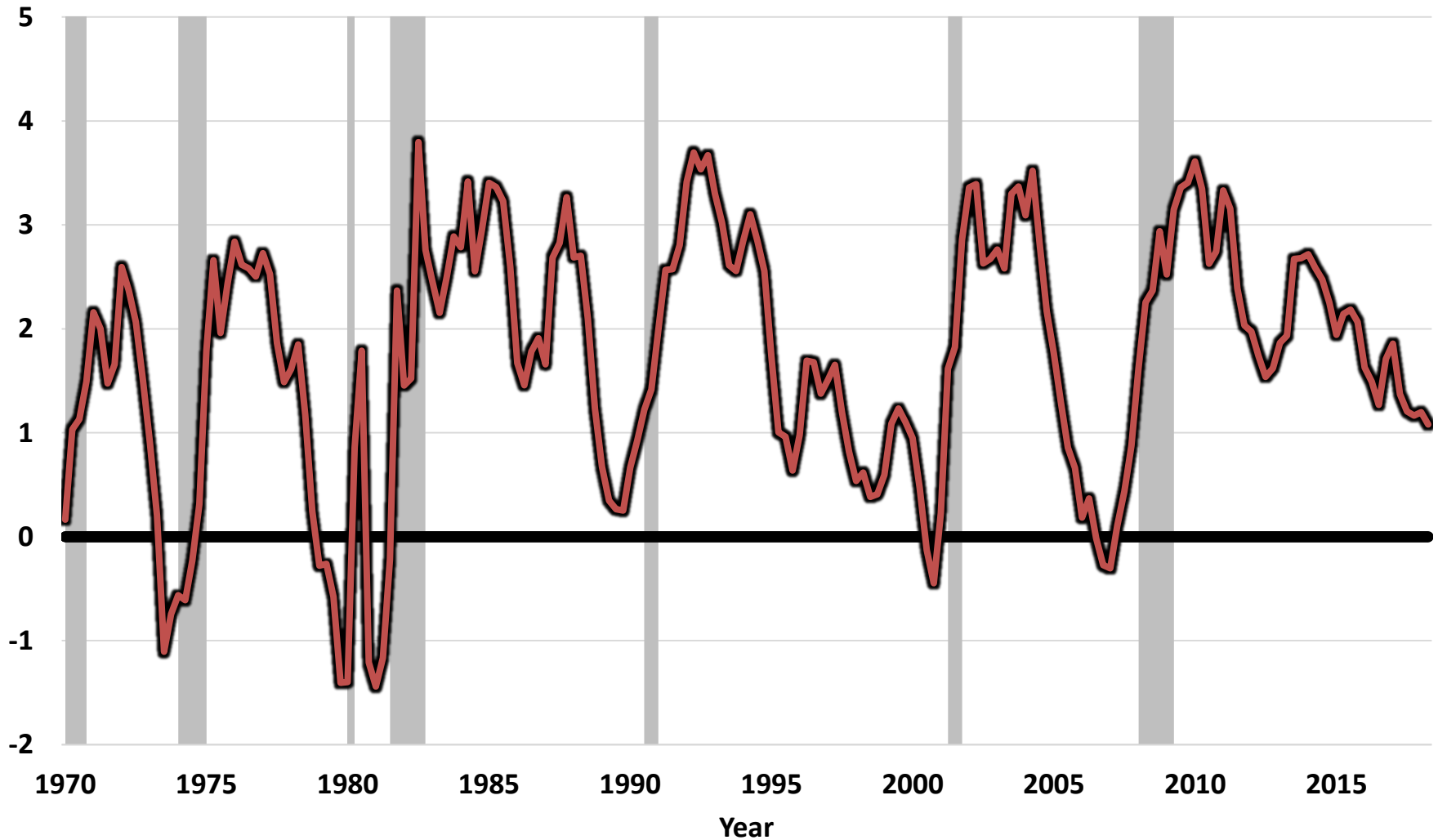
Stock Market Wealth Effect

- S&P 500 has increased 30% since Oct 31, 2016
- This represents about +\$6 trillion in wealth
- How much of this wealth would have to raise consumption to boost GDP by half a percent?
- Answer: 1.5 cents spending per dollar of extra wealth
- Together with tax cuts and govt spending, , that's more than enough to boost GDP growth from 2.0 to 3.0

What Will Bring the Expansion Finally to an End?

- **End of bipartisan government spending increase? It could be extended in 2020, an election year**
- **Trump's trade war? Even a 10% tariff on \$400 billion of Chinese imports only impacts 3% of personal consumption expenditures. Raises inflation by 0.3% for a year.**
- **Traditional answer? Monetary tightness, measured by the inverted yield curve**

The Yield Curve Inverted Before Recessions: 1970-2018



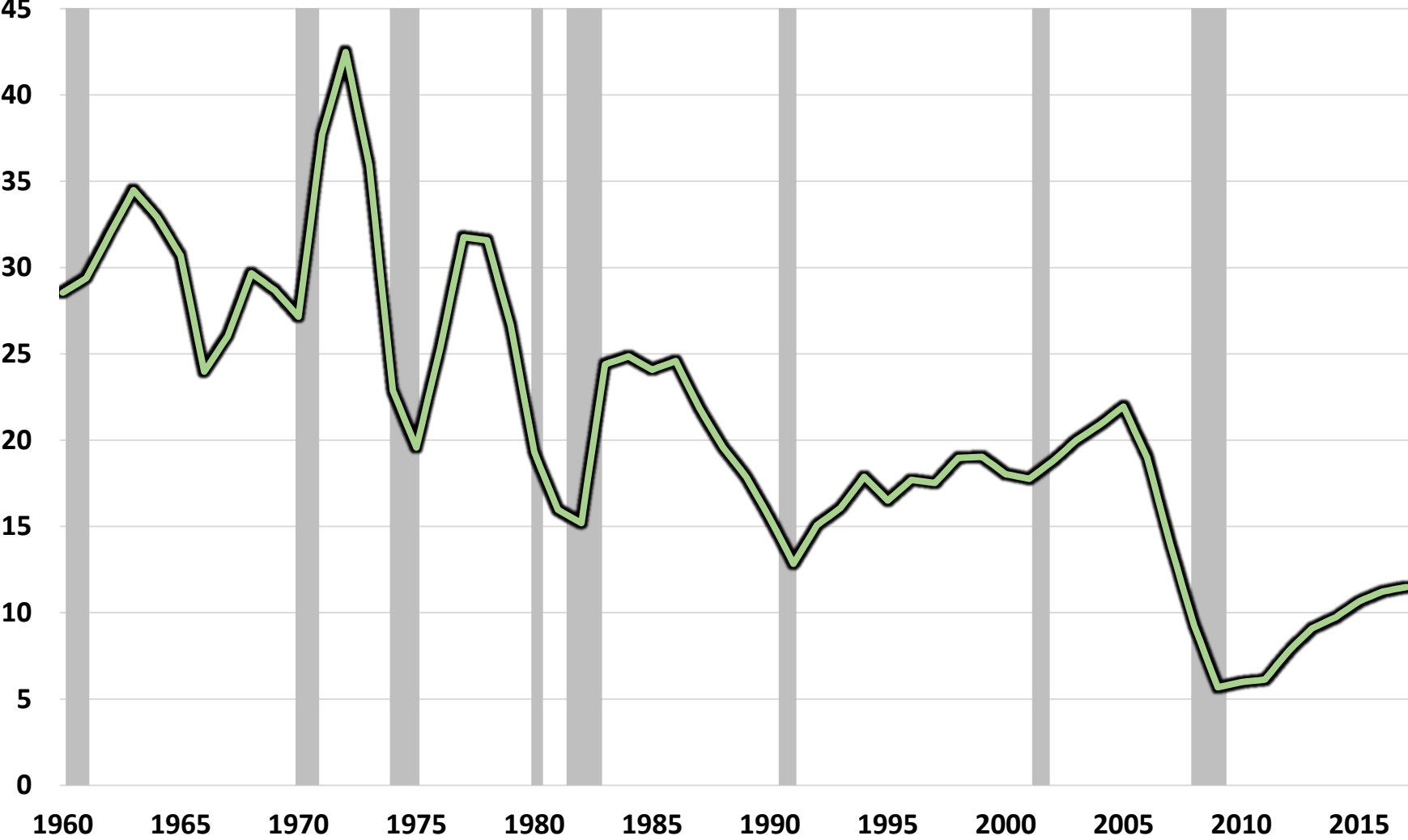
When Will the Yield Curve Invert?

- Fed is on track to raise Fed Funds rate to 3% by end of 2019
- But by then 10-year rate, now 3%, likely to be 3.5 to 4%, so no inverted yield curve
- What could change the forecast FF path?
 - Rise of inflation faster than Fed's overly optimistic forecast
 - Impact of Trump's tariffs on inflation rate
 - Overheating of economy in response to tax cuts and extra government spending

Adequacy of Monetary Tools to Deal with the Next Recession

- **Widespread concern that Fed “doesn’t have enough room to drop rates.”**
 - Fed Funds rate has typically declined 5% in response to a recession
 - Now barely 2% and can’t fall below zero
- **Potency of rate declines greatly exaggerated, legacy of old Regulation Q era pre-1980**
 - Then S&Ls had a monopoly of mortgage lending
 - Fed rate policy controlled flow of S&L lending

Monetary Weakness: Housing Starts Were Much More Sensitive in 1970s



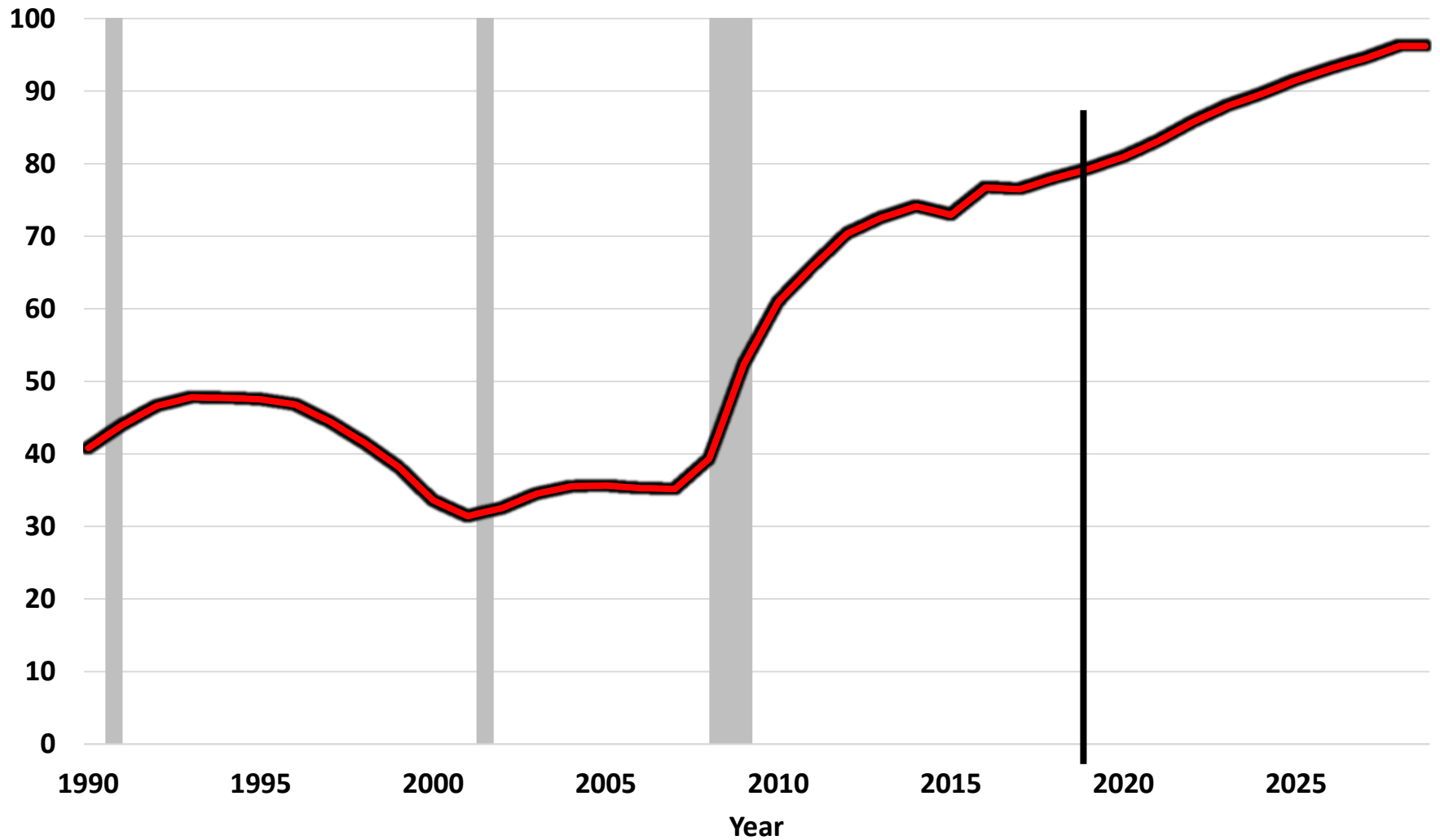
Verdict on Monetary Potency to Fight the Next Recession

- **Residential housing is the most sensitive spending component to interest rates**
 - **Business investment depends on confidence, tax policy, and capacity utilization, not interest rates**
- **Rate cuts have little impact on residential housing**
- **What about Quantitative Easing (QE)?**
- **Huge increase in Fed's balance sheet from \$0.8 trillion to \$4.5 trillion decreased the 10-year rate at most 50 basis points**
- **Conclusion – Fed has little power to blunt the next recession**

Is Government Helpless to Fight the Next Recession?

- **If monetary ease has little impact, what about fiscal?**
- **2009-2010 Obama stimulus was \$800 billion (5% of GDP) spread over two years**
- **Stopped the collapse but didn't stimulate a brisk recovery**
 - **GDP grew at only 2% per year 2010-2017**
- **Impact of Obama stimulus followed by sequester-driven fiscal austerity from 2012 to 2015**
- **Big obstacles to another stimulus**
 - **Rising debt-GDP ratio under current policy**
 - **2018-19 Tax cuts and spending increases just when we don't need it**
- **Current fiscal stimulus should have been saved for next recession**

Public Debt % GDP



Second Topic

- *What are your thoughts on the state of global financial reforms and/or global responses to US financial reforms?*
- U.S. Dodd-Frank and stress tests leave us with a well-capitalized banking system
- Sub-prime mortgages and over-levered shadow banks could become a problem again but not now nor in sight

Global Reform?

Look at Euro-zone

- **Not prepared for next recession**
 - Interest rates still near zero, negative some countries
 - Quantitative easing still happening, unlike Fed's normalization of balance sheet
- **Slow recovery caused by**
 - Lack of bank bailouts, slow start on monetary stimulus, fiscal austerity
- **Fiscal coordination impossible because of divide between Germany and S. Europe**
- **GDP still hasn't recovered to 2007 in Greece, Italy**
- **Lack of serious structural reforms except in France**

Conclusion

- **No financial crisis in U.S.**
- **Next recession not in sight**
- **Fed has little power to stabilize economy**
- **Fiscal stimulus in next recession hampered by high debt-GDP ratio**
- **2018-19 fiscal stimulus exactly the wrong timing, should have been saved for next recession**
- **Wild card? More inflation than Fed forecasts, stay tuned for my second presentation**