The Fed’s Longer-Term Challenges

After the Pandemic

Bill Dudley
Senior Research Scholar
Princeton University
Four Longer-Term Issues for the Fed

• The Fed’s Balance Sheet Risks
  It’s exploding in size, should we be concerned?

• Independence of Monetary Policy
  Fed and Treasury are working closely together—is this a feature or a bug?

• Inflation/Deflation: What’s the Greater Risk?

• Moral Hazard and Financial Stability
  Do the interventions reward bad behavior?
  If so, what should we do about it?
The Fed’s Balance Sheet

• Ballooning
  Currently exceeds $7 trillion, has doubled in 3 months

• Huge increase in excess reserves
  Currently $3.3 trillion

• Implications
  Locked into IOER monetary policy floor framework for the foreseeable future
  Credit risk very low
  Interest rate risk more significant
  Relaxation of leverage ratio capital requirements for banks likely to persist
Independence of Monetary Policy

• What does this mean?

• Does working closely with the UST undermine it?

• Fed independence is a political question

• Fiscal outlook: The bigger risk
  Debt service costs closely tied to monetary policy
  Extraordinarily low now despite big rise in debt
The Longer Run Macro Implications

Inflation vs. Deflation: What’s the Bigger Risk?

• The cyclical outlook—deflationary
  Excess capacity increases sharply
  Unemployment rate to remain elevated for a considerable time
  Downward pressure on commodity prices

• The secular outlook—inflationary
  Supply chain disruption
  Need to reallocate capital and labor resources
  Loss of productivity gains from global specialization
  Fiscal position
The Moral Hazard Problem

• Fed is taking away the tail risk
  In speculating in Treasury securities
  In decisions about optimal capital structure for corporations
  Liquidity support for money market mutual funds and mortgage reits

• How does this influence future behavior?
  Likely to increase incentives for risk taking in the future
  Creating the need for future interventions
  More moral hazard, repeat
Moral Hazard (cont.)

• How do you break the cycle?
  Conflict between short run and long run
  Political bias is to the short run, same for Fed chairs

• The case for greater regulation
  If it’s potentially systemic, regulate it
  Require the purchase of liquidity insurance
  Pay for tail insurance ex ante, not in the middle of the crisis
Other Lessons of the Crisis

• Fix problems during peacetime
  • Money market mutual funds
  • Eliminate same day liquidity for mutual funds investing in illiquid assets

• Confidence is Important
  • Fed backstop facilities effective even before they were operational
  • But this only works if programs that are implemented have a track record of being effective
Webinar: The Fed's longer-term challenges after the pandemic

WITH BILL DUDLEY
FORMER PRESIDENT, NY FEDERAL RESERVE BANK

Monday, June 1, 12:30 PM ET

Intro: MARKUS BRUNNERMEIER

Twitter: @MarkusEconomist
Markus’ Zoominar intro

- Previous/future webinars
  - Larry Summers: Vaccine acceleration, US-China, Resilience...
  - Bill Dudley: The Fed’s longer-term challenges

- Speakers
Primitive Funnel Basket Trap Design
Inflation/Deflation pressures

- Output loss, productivity loss (permanent)
- Issuance of money + government bonds
- Involuntary (dis)savings (temporary)
- More idiosyncratic risk
  - Esp. if crisis drags on
- Wealth inequality
- Physical capital misallocation
- Future government policy

“The I theory of money”

- Banks’ reduce risk bearing capacity
  - Can’t diversify idiosyncratic risk away \(\Rightarrow\) money demand \(\uparrow\) 

Brunnermeier, Merkel, Payne & Sannikov (2020)
Institutional Design: 2nd Game of Chicken

- **Monetary dominance**
  - Fiscal authority is forced to adjust budget deficits

- **Fiscal dominance**
  - Inability or unwillingness of fiscal authorities to control long-run expenditure/GDP ratio
  - Limits monetary authority to raise interest rates

- **Financial dominance**
  - Inability or unwillingness of financial sector to absorb losses
    - Refusal to issue no equity – pay out dividends in early phase of crisis
Global Symmetry to Asymmetry

- Global Symmetric shock ➔ Asymmetric – worse for EMDE?
  - How to reduce asymmetric amplification for EMDE?
Poll 01:

1. EMDE (grants vs. liquidity support)
   a. EMDEs need grants not liquidity due to debt overhang problem
   b. Liquidity support is essential since liquidity problems morph into solvency issues

2. EMDE should
   a. Should defend their currency and safe asset status (using their reserves/IMF liquidity life lines)
   b. Let currency go and make foreign investor take the hit?

3. Debt to EMDEs should be
   a. Bailed out
   b. Restructured
End of MARKUS’ INTRODUCTORY REMARKS

Now

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