Market Tantrums and Monetary Policy

Michael Feroli
J.P. Morgan Chase & Co.

Anil K. Kashyap
University of Chicago - Booth School of Business; National Bureau of Economic Research (NBER)

Kermit L. Schoenholtz
New York University - Stern School of Business - Department of Economics

Hyun Song Shin
Princeton University - Department of Economics

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Abstract:
Assessments of the risks to financial stability often focus on the degree of leverage in the system. In this report, however, we question whether subdued leverage of financial intermediaries is sufficient grounds to rule out stability concerns. In particular, we highlight unlevered investors as the locus of potential financial instability and consider the monetary policy implications.

Our focus is on market “tantrums” (such as that seen during the summer of 2013) in which risk premiums inherent in market interest rates fluctuate widely. Large jumps in risk premiums may arise if non-bank market participants are motivated, in part, by their relative performance ranking. Redemptions by ultimate investors strengthen such a channel. We sketch an example and examine three empirical implications. First, as a product of the performance race, flows into an investment opportunity drive up asset prices so that there is momentum in returns. Second, the model predicts that return chasing can reverse sharply. And third, changes in the stance of monetary policy can trigger heavy fund inflows and outflows.

Using inflows and outflows for different types of open-end mutual funds, we find some support for the proposition that market tantrums can arise without any leverage or actions taken by leveraged intermediaries. We also uncover connections between the destabilizing flows and shocks to monetary policy.

We draw five principal conclusions from our analysis. First, in contrast with the common presumption, the absence of leverage may not be sufficient to ensure that monetary policy can disregard concerns for financial stability. Second, the usual macroprudential toolkit does not address instability driven by non-leveraged investors. Third, forward guidance encourages risk taking that can lead to risk reversals. In fact, our example suggests that when investors infer that monetary policy will tighten, the instability seen in summer of 2013 is likely to reappear. Fourth, financial instability need not be associated with the insolvency of financial institutions. Fifth, the tradeoffs for monetary policy are more difficult than is sometimes portrayed. The tradeoff is not the contemporaneous one between more versus less policy stimulus today, but is better understood as an intertemporal tradeoff between more stimulus today at the expense of a more challenging and disruptive policy exit in the future.

Of course, our analysis neither invalidates nor validates the policy course the Federal Reserve has actually taken. Any such conclusion depends on an assessment of the balance of risks given the particular circumstances, which lies beyond the scope of our paper. Instead, our paper is intended as a contribution to developing the analytical framework for making policy judgments. But our analysis does suggest that unconventional monetary policies (including QE and forward guidance) can build future hazards by encouraging certain types of risk-taking that are not easily reversed in a controlled manner.

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Contact Information

Michael Feroli

J.P. Morgan Chase & Co. (email)
60 Wall St.
New York, NY 10260
United States

Anil K. Kashyap (Contact Author)

University of Chicago - Booth School of Business (email)
5807 S. Woodlawn Avenue
Chicago, IL 60637
United States
773-702-7260 (Phone)
773 702-0458 (Fax)

National Bureau of Economic Research (NBER) (email)
1050 Massachusetts Avenue
Cambridge, MA 02138
United States
773-702-7260 (Phone)
773-702-0458 (Fax)

Kermit L. Schoenholtz

New York University - Stern School of Business - Department of Economics (email)
44 W. 4th Street
Suite 7-89
New York, NY 10012
United States
212-998-0868 (Phone)
HOME PAGE: http://w4.stern.nyu.edu/faculty/bio/kim-schoenholtz

Hyun Song Shin

Princeton University - Department of Economics (email)
Princeton, NJ 08544-1021
United States

PRINCETON UNIVERSITY