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Transcript: Hyun Song Shin on the New Financial Stability Risks

Where are the dangers now?

By Tracy Alloway and Joe Weisenthal

(Bloomberg) -- **At Jackson Hole, the Kansas City Fed's annual gathering for economists and central bankers, there's a lot of focus on the short-term path of monetary policy. But, of course, the Economic Symposium is supposed to be about long-term policy frameworks. And central bankers aren't just responsible for changing benchmark interest rates – they are also financial regulators. On this episode, we speak with Hyun Song Shin, economic advisor and head of research at the Bank for International Settlements, about where he sees risks lurking in the financial system now. We discuss the shift from bank lending to bond-based borrowing, and what it means for inflation now. We talk about how even safe assets like US Treasuries can become sources of stress, such as in March 2020, the gilt crisis of last year, and most recently, the collapse of Silicon Valley Bank. We also talk about how higher interest rates are supposed to bring down inflation, but might not be doing that much currently, as well as the limits of central banking. This transcript has been lightly edited for clarity.**

Omny Studio: Hyun Song Shin on the New Financial S...

Key insights from the pod:

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Tracy Alloway: (00:10)

Hello and welcome to another episode of the *Odd Lots* podcast. I'm Tracy Alloway.

Joe Weisenthal: (00:14)

And I'm Joe Weisenthal.

Tracy: (00:15)

Joe, we are still here at Jackson Hole. We are coming to the end of our sort of discussion series, however, and I think one of the themes that has emerged from a lot of the people that we've been talking to at this event is this idea of living with high levels of public debt and high inflation, all while having basically a global financial system that is built on bonds. Things that are supposed to be boring, they're not supposed to see their yields kind of swing wildly. And yet that's been what's happening.

Joe: (00:49)

Okay. Two things. One is to your point on yields, I mean, it's the story of the last year, but it's really also like the story of the last month, right? Which is that we, you know, you think things have mellowed out and suddenly you get a new spike. Mortgage rates at the highest since 2010, or 30-year yields highest at least since like 2007.

The other thing is, can I just say one fun thing about Jackson Hole is running into possible *Odd Lots* guests on a hiking trail.

Tracy: (01:14)

Yes!

Joe: (01:15)

Which is a really fun aspect of here. You know, it's like when we're back in New York, we have to do all this work to try to find guests. You know, here you're just like 'Oh, hey, it's you. You want to come on the show?'

Tracy: (01:23)

You just pick them off in the wilderness, like predators. Alright. Well one person we did actually run into, while hiking is one of our favorite *Odd Lots* guests, we're going to be speaking to Hyun Song Shin. He is of course economic advisor and head of research at the Bank for International Settlements. And we're going to try to synthesize a lot of the discussion points we've been having for the past day or so.

Joe: (01:47)

Right. And to your point, you know, I do think that, and this was sort of part of the interesting thing we talked about with Darrell Duffie, which is that we came out of 2008 very focused, or 2008/2009, very focused on credit risk, right? Like downside risk, etc. And I think by and large policy makers, we would [say] probably did a good job of de-risking the system from the perspective of credit, right? Then we got this rate spike, we got the highest inflation in at least four decades, we got Silicon Valley Bank. And suddenly they're like, 'Oh, there's other risks out [there]. It's not just credit risk.'

Tracy: (02:20)

Well, we reduced credit risk at the expense of interest rate risk, it feels like, and we sort of by design made bonds really fundamental to the way that, again, the financial system works. So we need to dig into these financial stability risks as they are now. So without further ado, let's bring in Hyun. Hyun, thank you so much for coming back on! I think this must be your fourth or fifth *Odd Lots* appearance.

Hyun Song Shin: (02:43)

Yeah. Something like that,

Joe: (02:44)

But our first in person, which is really exciting.

Hyun: (02:46)

Yeah, absolutely. I mean, I was going to say, it's such a pleasure to do this in person, Tracy. And it's a great topic, of course, and I think you've had other people on during the day that have explored bits of this.

But maybe the thing to the point to start with is just to take her a step back and have an overview of the way that the structure of intermediation has changed. Since the GFC, as you say, Joe, the GFC very much was around the banking sector and in particular credit risk. The idea is that you need capital there to absorb losses on the assets because they're risky assets. And that's the way that you protect the depositors and other claim holders.

I think what we saw in March, 2020 with the stress episode in the Treasury market is that even safe securities can be at the center of a financial stress event. I think the UK gilt episode last year, again, these are safe assets, but they were very much at the center of financial stress. And I think what that does point to is the shifting nature of risks, the different propagation mechanisms and you know, the different set of players out there.

So we're going from banks to non-bank players -- in the jargon they're called NBFIs, it's non-bank financial intermediaries. But it's not just the intermediaries. I mean, it's also the way that infrastructure, you know, CCPs, exchanges, they've also become very important as well. So this is, I think, a very, very important topic for us to touch on.

Tracy: (04:18)

Well talk to us more about who those non-bank financial intermediaries are, because I think people often hear the term, the more colloquial term, 'shadow banking.' And it sounds kind of nefarious, but there are all these different flavors of non-bank investors. So talk to us about who they are and what's happened to them in the years since 2008?

Hyun: (04:40)

Well, you can draw a kind of flow chart here. You've seen those New York Fed charts where you have ultimate creditors on one side and ultimate borrowers on the other side, and money flows from right to left following the balance sheet direction. We can think of something like that in this case as well.

We have fewer of these bank-based intermediaries, although we of course still have them, but they've shrunk in size and heft, if you like, within the system. Instead, what we have are many non-leveraged players, you know, asset managers of various stripes, life insurance companies, pension funds, but I think a very, very important class of players are the other hedge funds as well.

There are non-regulated market intermediaries there. And a very important part of the infrastructure here would be the new central counterparties, other exchanges where, rather than having intermediation go through a dealer balance sheet, you have clearing, you have the central counterparties that actually act as creditors and debtors to a wide range of participants.

Joe: (05:45)

So you mentioned March, 2020, you mentioned the gilt episode. There's also, of course March, 2023 with Silicon Valley Bank. I guess we have had this run up in yields over the last month again, but I don't think, you know, nothing has floated to the surface. Nothing's broken yet. Nothing's broken just yet, but it feels like we might be in for multiple years of a very different direction. Whereas the 2010s were all about, you think rates are going to go up and they go back down, you think finally you're breaking out, they go back down. Maybe we'll be in the other direction where we think rates and inflation are settling down, but it turns out they gather steam. We don't know. But maybe that is. How do you think about that in terms of systemic risk, financial risk? How is it different than a period of credit risk and slow growth?

Hyun: (06:29)

It's worth thinking about the journey that we've been on for the last 10 years or so. Well, maybe 10, 12 years. You know, we've had a very long period of low for long interest rates and of course central bank asset purchases that has really compressed the yield curve.

And what that's meant is that borrowers have taken advantage of that and they've turned out, you know, their borrowing and we see it in the corporate sector, they've really turned out their bond issuance. We see it in the household sector as well.

But I think especially important would be the government bond market. There's been an increased duration of the bonds outstanding, not surprising really, because government debt managers would also be taking advantage of the low long-term rate.

So just to give you a number in the bi-annual economic report this summer, we had a small discussion on this. If you look at the duration in aggregate of advanced economic government bonds, it was around seven years at the end of 2010, that's now nine plus years. So we've had a tremendous lengthening of duration.

And so as central banks have raised rates in response to inflation, what that's meant is that the price impact has been that much larger. So if you are not marking-to-market, if you are using ultimate maturity accounting, we call that interest rate risk on the banking book. And this is what happened with SVB. You don't mark to market until you have to, if you're marking to market, then it's duration risk. So as long-term rates go up, the price of your assets will go down accordingly. And the longer the duration, the bigger the impact.

And I think in that sense, there is a broad continuum here between what we saw in SVB, the UK gilt episode, but also I think just in terms of emerging market bonds that I think we'll also talk about during the course of this conference. So I think that's, if you like, looking through the sector to the underlying exposures. And if we do that, I mean that's what's out there. What's different of course is that inflation is high, and so monetary policy has to respond and after a very, very long period of low for long, we are seeing, if you like, the consequences of raising rates once the exposure has lengthened.

Tracy: (08:55)

So I mentioned this in the intro and you just gave a very good outline of duration risk and this idea of additional sensitivity to interest rate moves. But I mentioned in the intro that a lot of this is by design. We have actively encouraged a lot of investors to buy more bonds. And maybe that wasn't an issue in the lower for longer era, as you just pointed out, but it seems to be problematic in an era of high inflation if not bonds. What do you use as the sort of safety net for a lot of these entities?

Hyun: (09:30)

Well, I think, you know, before we go there, Tracy, I think we have to point out that lengthening duration has also a lot of advantages. One thing that is very good with very long duration exposures is that with very long duration liabilities, is that you're not facing the rollover risk that you used to if you were borrowing short, right?

So, you know, for example, if you go back to the Asian financial crisis, there you have the combination of a currency mismatch as well as a maturity mismatch. And if your liability is very short term and your creditors want their money back, then that's actually going to lead to a much sharper episode of

stress. So lengthening duration has also a lot of advantages for financial stability, for mitigating financial stability risks.

Tracy: (10:20)

This would be one reason why we perhaps haven't seen as many bankruptcies as were expected as the Fed raises rates? Because everyone spent the past two years terming out their debt.

Hyun: (10:29)

Absolutely. And that's especially true for those homeowners who actually refinanced their mortgage. I think that's a very, very good example. And what we also see is that in the household sector, mortgage duration has also lengthened as well, not just in the US, I mean the US is special because of its institution of a 30-year fixed-rate [mortgage], but it's also true in other economies that there's been this shifting out.

I think on balance, I would say that the lengthening of the liabilities is a good thing on balance, but every, you know, silver lining has a cloud, and here, you know, we have exactly this problem that it's not a free lunch. You have to pay for the additional risk that comes from rated duration.

Tracy: (11:12)

And what about the 'If not bonds, what?' question? Because this is what I struggle with. What is the next safe asset basically?

Hyun: (11:20)

Well, I think the safest asset is just money. And I think this is where the money in the sense of the high-powered money that is issued by the central bank. So when a central bank conducts QE, what happens is the central bank takes out duration by purchasing the bonds, but then pays for it by creating reserves that are held by the sellers of those bonds, typically commercial banks who then would pass that on to the sellers, you know, their customers.

What that means though is that as interest rates rise, the assets that the central banks will also be subject to losses. And this is why we're seeing the spate of losses on central bank balance sheets. The important thing about central bank liabilities though is that they're not subject to redemption. The central bank doesn't have to repay the dollar with another dollar because that is the ultimate liability.

And as we argued in a BIS bulletin recently, we should not be so concerned about central bank losses in the same way that we are concerned about losses suffered by a private sector entity who are subject to those redemptions. But it doesn't mean that there are no limits. I mean, clearly there are limits and we see those limits, especially in very fragile emerging and developing economies that don't have the same credibility in the value of money as with the Fed or with an advanced economy.

Joe: (13:04)

Actually, this is a good time to ask you a question. And I also posed this to Barry Eichengreen in earlier conversation. Balance sheet policy, I mean, I think we typically associate Fed, QE, etc. EM central banks are building out that capacity. And it seems like in the post, in the sort of [post] Covid era, we are seeing more central EM central banks having some credibility or capacity enough to be a buyer of last resort for their own government bond markets in a way that we didn't have in the past. Is that fair? Is that an accurate characterization?

Hyun: (13:36)

I think, Joe, what I would say is if we look at the events of last year, if anything, it's been the emerging markets that have done better in some respects than the advanced economies. And let me explain what I mean by that. So, you know, a good comparison is between the events of last year with the earlier stress episode for emerging markets in 2015, 2016.

So back then what we saw was a very strong dollar coupled with very low commodity prices, capital outflows for emerging markets. We saw a sharp steepening of yield curves. That combination of stresses are very typical of emerging market stress episodes that we're familiar [with] from the textbooks.

What we saw last year was actually quite different. What we saw was the nature of the shocks were different. We had a war and a pandemic. And what that meant was when commodity prices rose, emerging markets that were commodity exporters actually did very well relative to historical experience.

If you look at the Mexican peso or the Brazilian real, it actually appreciated last year. And that's very different from let's say the euro, the yen, even all the other advanced economy currencies, we see quite a resilient picture. And so they didn't even need to enter the market like that.

Now, Joe, your question raises a very important issue, which is when can a central bank come into the market intervene and play the role of a buyer of last resort? I think this is a very, very important policy, issue. Maybe we can get back to some of the discussions that's happening in the official world, but when we look at emerging markets, in particular emerging market central banks, policy makers generally are very reluctant to wade into markets in those stressed circumstances. And for good reason. Because when you, when you go into the market, you have to buy the bonds and you're creating reserves as the byproduct of that, that's going to be held by some of the domestic participants.

You're creating money. So liquidity injection -- that has many, many good aspects, but what it means is you are also going to put pressure on the exchange rate. So if you are pushing a lot of liquidity into the system and you're a central bank that doesn't have the credibility of a central bank like the Fed, then that's going to lead to a very sharp depreciation of the exchange rate and that could in fact do more harm than good.

So I think the short answer to your question, Joe, is that last year we saw a very different set of circumstances. Emerging markets actually did pretty well. I would say the major emerging markets did very, very well. I mean, there are clearly more stressed developing economies that still have to borrow in dollars and so on. But emerging markets did particularly well. But I think there is a very important lesson here on what are the circumstances that mean that you can enter the market with impunity? And, and you know, when can you enter the market and get away with it?

Tracy: (16:39)

Well, why don't we go back to central banks that can create reserves without putting necessarily downward pressure on their own currencies. I wanted to talk to you about leverage and bonds because I think we're used to talking about leverage in the context of credit and everyone remembers credit derivatives from their starring role in the 2008 financial crisis.

But I guess what's perhaps underappreciated, although it feels like more people are becoming aware of it now, is that there's also a lot of leverage attached to the bond market. And we've seen sort of flashes of it emerge -- most notably in the March, 2020 Treasury event. But how are you thinking about that issue and how do you see leverage emerging in the world of bonds?

Hyun: (17:23)

I think that's a very important question, Tracy, and I think it goes to the point made at the outset. I mean, how is it possible that a safe asset can still be at the center of a stress event? And I think here we have to think about the possible reasons for perverse demand responses. And I will sort of make it more concrete shortly.

By a perverse demand response, what I mean is when a price falls, we typically would think, well, that means that it's more attractive to buy. And so people would come into the market. So when the price falls, you expect people to come in and pick up the cheap assets. But in these stress episodes, what you typically find is that a price decline actually generates more sales. And that actually of course leads to further price decline. And you can have this loop.

Now, why would you have this perverse demand response? Well, leverage is one way that you can have that. So if you're leveraged, if you're levered and the price of your assets fall, well your creditors want their money back. You need to, you know, meet margin calls and you have to sell.

Tracy: (18:29)

Right. This is something we spoke with Darrell Duffie about, that typically the thing you sell first is your safest, most liquid asset, which would usually be a bond, probably a US Treasury of some sort.

Hyun: (18:39)

Absolutely. And so this is how a safe asset can still be at the center of a stress event, but it doesn't have to be leverage as such. It could be leverage-like behavior. And what I mean by that is what other ways can you have where a price decline would beget more sales?

I think a typical, and a very, very classical example, and it's in the mortgage market, actually, a well-known historical episode is what happened in 1994 when you had this, you know, rapid steepening of the yield curve. The way that the embedded option in the mortgage market in mortgages means, is

that we know when you hedge, so when rates go up, the duration increases actually because people stop refinancing.

Tracy: (19:18)

This was the big convexity event?

Hyun: (19:20)

This was the, you know, convexity issue. Now there's something similar also, I mean, something similar can happen even in very boring sectors like, you know, pension funds or life insurance. So if you are trying to match duration and you know, you have liabilities to your policy holders, which are let's say, you know, 30 years, but you have assets that are 10 years, liabilities are much longer duration than your assets.

Now when rates rise, the duration comes in both on your assets and your liabilities, but because your liabilities a much longer duration than your assets, liability duration comes in much faster. So what ends up happening is that you find that you've got too much duration on the asset side. And so you have to sell. So what's just happened? You know, rates rose, but you are ending up selling. That's another example of leverage.

Joe: (20:10)

And this is the UK story, right? I mean this is similar. This is what happened...

Hyun: (20:13)

The UK, it's a combination of both leverage and this story because there was the LDI fund aspect, which actually gave it a further amplification boost. But the underlying exposures I think are, you know, really all the same, depending on exactly how it will play out. Depends on, you know, who are the main players, but the principles are very similar. So even very conventional, very supposedly boring sectors can still be the source of these kinds of, you know, perverse dynamics.

Tracy: (20:41)

That's a fun thought.

Joe: (20:43)

Well, forgive me if like this is like too big picture or too meta of a question, but for a sort of market capitalist system, someone's got to hold the risk. People need income. You know, it seems to me, I don't know, maybe there's not even a question here, but it seems to me it's like, you know, 2008, okay, there's too much credit risk and too much bad lending to households and German banks somehow financed, you know, construction in the Sunbelt in some way.

And then now we're talking about pretty boring bonds, Treasuries going up, boring sort of simple life insurance companies, pension companies, not particularly exotic. Is this our fate that for the rest of our careers it's just every 10 years we just have to like pinpoint a new area? I mean, because it's not like risk can never go away. Someone's got to hold the asset, someone's got to make the income to pay the savers.

Hyun: (21:29)

I think the key here is that we have a diversity of investors. So whatever we do, we have to make sure that when someone is selling, someone is actually willing to come in and buy. And the diversity of the market participants is absolutely key for this. And this is all about finding the right price. And finding the right price means that, you know, we have buyers as well as sellers.

The reason why these financial stability channels of propagation can be so corrosive is because sometimes one part of the market just becomes too big. They grew without our knowing it, without our really noticing it. And then when something happens, this is when all these dynamics take hold. I don't think we need to worry, you know, every 10 years that something big will happen. It's just a case of making sure that we have a diversity of buyers and sellers of participants in the market.

And there are some rules of thumb that we should use both in the regulation, but also for the private sector institutions themselves and the risk management. So what are some of the potential kind of decision rules that might be baked in given the kinds of leverage and other exposures out there?

Relative value hedge funds I think were very important in March, 2020, that was very much about leverage using futures and the cash bonds futures implied yields a little bit lower because it doesn't take up balance sheet. And so you are selling the futures and buying the bonds, but then if margins go up, you know, you have to either come up with additional equity from somewhere. That's very difficult

in stressed episodes. So you typically end up selling. And so this is another case where a safe asset can still be at the center of this kind of episode.

So as market observers, as observers from the official sector, we just have to be very careful to be on the lookout for where these stress episodes might arise. I mean, there are some rules of thumb we can use. And I think one of the interesting things is that for the relative value hedge funds, we're seeing again, the short positions in futures growing -- not in the 30-year horizon that we saw into 2020, but more in the five-year horizon. More in the belly of the curve this time. But it seems that that's something that has come back. It's much smaller than it was before the March, 2020 episode. But these are the things that, you know, it's not a precise science, but these are the things that we can look out for.

Tracy: (24:16)

So maybe we could talk a little bit about potential solutions to some of these issues. And again, we touched on this with Darrell Duffie, and he was advocating for possibly all-to-all trading where you would allow investors to trade bonds with each other so that you would have, to your point here, a more vibrant, diverse body of participants in times of crisis.

And the other thing he was talking about is central clearing. The idea being that you create a central entity that can then net positions and sort of offset the risk. But a classic critique of central clearing is that you are in effect concentrating the risk in one big entity. And I'm curious, you were in the room with all the policymakers at Jackson Hole. What were some of the debates around these proposals and what are your own views?

Hyun: (25:06)

Well, actually I was sitting next to Darrell. And so we had a great discussion on this. I mean, and we've had some very good discussions on this over the years. I think the plumbing is important. I think whenever the plumbing can be improved to improve, if you like, the day-to-day functioning of markets, that's something that we should seize. And in fact, the analysis in Darrell's paper is really excellent.

I think on the policy prescription that comes from that, I think there can be some diversity views, should we say. I mean, you mentioned the diversity of the market participants, but that's a necessary condition, if you like, for the all-to-all trading or for central clearing itself to bring, to channel that diversity into the market. But that is a necessary condition. We have to be quite sure that there will be a large enough body of buyers out there who will actually come into the market.

Now, if we don't have that diversity sufficiently, and we still have this, you know, one-way type of markets, then simply changing the infrastructure is not going to do that. I think the way that the policy debate, that policy discussion has gone is to look for, if you like, a happy mean, some kind of balance between how much should we make sure that the leverage and other perverse type of demand behavior that could arise can be mitigated from the outset. How much do we need the central bank or other authorities to play a kind of backstop role?

And in this connection, you know, I would just point your listeners to a very important BIS markets committee report that we put out earlier this year. It was actually from a working group that was chaired by Lorie Logan when she was at the New York Fed and Andrew Hauser at the Bank of England.

It was very much motivated by the March, 2020 episode. And it turned out that it was also, you know, very well-timed for the gilt stress episode as well.

To cut a long story short, the story there is we have to strike a balance. In the end, the central bank has to be a backstop. So if no one else is there to really pick up the pieces, the central bank has to be there to cushion that shock, because otherwise, the consequences of not doing so would be very, very large.

But it should not be a first resort to the extent possible. So whenever possible, it should be a market-determined outcome. The central bank shouldn't wade in at the drop of a hat. And if you like, influence market outcomes that way.

The other important point is that there's a very important issue here of incentives. If it becomes generally known that the central bank's threshold for pain is here and therefore they will enter, what that could do is to shift, if you like, the incentives in the portfolio decision of the private sector market participants. What you're doing by doing that, by having a kind of, you know, a rule to enter the market would be to lop off the left tail of the outcome distribution. [It] means that it becomes less risky to one layer of leverage.

And so I think if you're looking for a simple answer, there isn't one. And I think this is where we are. The central bank has a very important role to play as a backstop, but it should be a backstop rather than an intervener of the first resort.

Joe: (28:26)

Let me ask this question, but from a very non-plumbing standpoint: How much would it be beneficial for financial stability if fiscal authorities were to play, you know, right now we've sort of tasked the central banks with fighting ... there's a lot of spending and there's a lot of stimulus, particularly in the US and it's sort of the central bank's job maybe to counteract that and figure out a way to get back to 2% inflation. Would it be good for financial stability if the central bank didn't have to row cross purposes with fiscal authorities as much and weren't facing so much pressure from that side?

Hyun: (29:02)

Well actually, Joe, in our annual economic report this year, our chapter two, it's great that you asked this question. You know, we have a whole chapter on this point. What we argue is fiscal policy has to row in the same direction as monetary policy, not only for Phillips Curve reasoning or aggregate demand, but for the kinds of arguments that we raised earlier about if the central bank has to enter the market intervene in a way, and you're going to inject liquidity in a situation that might actually undermine financial stability through a very sharp depreciation of the exchange rate, you could actually end up doing more harm than good. What we call is we need to be at the region of stability. So we need to make sure that monetary policy and fiscal policy are working in concert rather than at cross purposes.

Tracy: (29:51)

So how do you actually do that? Because, you know, we were speaking with Adam Posen earlier and he was talking about how there's a lot of uncertainty around how central bankers should react to fiscal. A lot of them are completely separated from fiscal for very obvious reasons, and it can be awkward for them to even start to talk or consider this issue at least publicly. So how do you actually get there?

Hyun: (30:18)

I think this is why talking about fiscal policy is actually a very important function of the central bank. And now it's true that when central banks talk about fiscal policy, it can sort of raise eyebrows. But I think we have to make it very clear that monetary policy and fiscal policy are not separate policy functions.

They're actually very closely-interrelated. And so in order to perform monetary policy, well, fiscal policy also has to play its part. Now there is the whole issue of the Phillips Curve reasoning. What is aggregate demand when monetary policy is tightening? Should fiscal policy play more of a role if the economy is depressed, even with very low rates? Should fiscal policy take up the slack and stimulate the economy more? Those are very, very important debates. And you know, I think that's something that is more, more conducive to these formal economic modeling.

But when monetary policy, fiscal policy are joined up because of the balance sheet interconnections, then I think it's much more difficult. And I think this, you know, these kinds of issues are more or less second nature in emerging markets because in emerging markets and developing economies that have really a painful history of financial crises, the debate is on much firmer footing. There's a lot more consensus. I would say the difficulty, I think, is more when that recognition is not so strong, it's a bit of an uphill struggle to put that on the agenda. But I think that's really why we at the BIS are here. I mean, we, this is one of our jobs to actually put these things on the table.

Joe: (31:54)

Just to take it back to I think maybe the first part of this conversation, how much has the terming out or the fixed nature of debt in the US and maybe elsewhere contributed to the fact that we've had this extraordinary rapid rate of nominal rate hikes, particularly the short end, without a ton of evidence that it's done a whole lot. I mean, inflation is down, but there is some question about why there hasn't been much economic slowing. How much would you attribute it to that simple fact that there is not a lot of floating rate debt here?

Hyun: (32:24)

This is actually a very important part of the debate right now, discussion and research at central banks, and it goes to the channel of monetary policy. So when the central bank raises rates, what are the levers that it's pulling to actually slow the economy down?

You know, one channel is the classic credit channel where, you know, when you raise rates and there's plenty of evidence both from... So let me just finish the sentence and then explain. So when you raise rates, banks tend to lend less and the lending standards tend to become higher. And that channel I think is very well established.

It is less strong in the data this time around. And I think there is an interesting set of questions as to why not? You are pointing to another interesting channel, which is if the debt has been termed out, right, how much does raising the short rate due to slow spending when liabilities are so long term, if homeowners have refinanced their mortgage at very low rates, then they're sitting on very big gains and raising short rates will have limited impact.

I think empirically these things still need to be worked out. I mentioned earlier that this terming out is not just a US phenomenon, it's pretty global. I would say countries like the UK used to be more or less completely floating rate. Now we have mortgages that are actually between two and five years. That's quite typical. And I think the debate is what has been the impact of that terming out?

But I think there is a bigger puzzle, that we're all wrestling with, which is why did we have the inflation in the first place and how have we managed to get the disinflation without triggering a recession? And I think that's a good puzzle to have. What's the answer

Speaker 5: (34:13)

What's the answer Hyun? You're the BIS, you're here to tell us!

Hyun: (34:15)

I mean, if you look at the standard textbook models for how the Phillips Curve would work, I mean, we should not have had that inflation outbreak. At least not the persistent inflation or clearly there were supply chains, the flare up with used car prices and so on, that you've covered extremely extensively on this podcast.

But we should not have had the persistent inflation cropping up because I think the excess demand, if you like, was, I mean, it was clearly there. It had a very important role to play, but it wasn't way off the charts. And yet we still have this very persistent inflation taking hold. And by the same score, we are very happy to see the disinflation and the disinflation has come and it's confounded some of the, you know, pessimists who've said that, look, we have to have a very deep recession in order to bring the inflation down.

And that logic is completely watertight if you look at a Phillips Curve, right? If you look at a Phillips Curve, you do need activity to slow very substantially to bring inflation down. But we are very happy to see that inflation has come down.

So there are still many things that we don't understand fully. I think having gone through the pandemic and the shocks, especially the Russian invasion of Ukraine, shocks to commodity prices, food and energy, these were very unusual shocks that subjected the global economy to a really unprecedented combination of shocks.

And so I think we have to be modest here, but I think one thing is for sure, which is that if we knew exactly what the channels of monetary policy transmission were, then probably we were a little bit too overconfident. We were overconfident there. And in that respect, I think one of the candidates that we have to look at is to what extent has the terming out of debt meant that short-term rates are having less purchase on the real economy?

Tracy: (36:17)

So to sum it all up, the risks are safe assets can be the locus for instability, there's still hidden leverage in the system, monetary policy might not be as effective as we think because of the shift from banks to bonds and the terming out of debt. And finally, we're not clear how any of this works. These are sobering thoughts.

Hyun: (36:42)

You know, I wouldn't put it in those terms. And I think you've probably overplayed some of these points, but it's definitely, I mean, it's true of economics more generally and policymaking especially, we just have to be very humble. We're always learning. And I think what, you know, the last three years has taught us is that we need to be extremely open-minded on what the channels are. And it's very, very fortunate that it seems that we are now, we've opened the door to a soft landing, it seems, where we haven't had the very deep recession to bring inflation down.

Tracy: (37:20)

Alright, well, I think that's a great place to leave our Jackson Hole series of *Odd Lots* discussions with the note of very reasonable humility that you just described, Hyun. Thank you so much for coming back on *Odd Lots* and walking through these issues with us.

Joe: (37:35)

Yeah, that was great. Thank you so much. And so great to do it in person.

Tracy: (37:37)

Yeah, finally!

Hyun: (37:38)

Finally do this in person. It was great. Thanks for the invitation.

Joe: (37:41)

Thank you so much.

Tracy: (37:54)

So Joe, always a treat to catch up with Hyun and I'm so glad that we, we caught him while he was out hiking and managed to drag him back for a podcast recording.

Joe: (38:04)

I feel like, it's a good thing. Humility is sort of maybe the watch word.

Tracy: (38:10)

Humility should be the theme of the conference.

Joe: (38:12)

I feel like humility has been the theme and it's come up over and over again. And I don't think anybody could look at the last three years and come away with anything but... Some people, you know, maybe have better intuitions than others or whatever. But with it, like everyone needs a dose of humility.

Tracy: (38:28)

Absolutely. And I did think his point about how you want to avoid the central bank becoming the first lender of last resort, or the lender of first resort, makes a lot of sense. I remember after the Fed announced the corporate bond buying program, there were some analysts that came out with notes and basically said, the Fed has changed the corporate bond market forever, because now we know that this backstop will come out if things get bad enough. So you did see that moral hazard sort of creeping into the market.

Joe: (38:58)

You know, Hyun made the point, he was talking about in the ideal world, which never happens, you know, the central bank and the fiscal authorities work together on some level. And we saw it, we saw the breakdown in the 2010s -- I'm always going back to this idea of how 2020 is like the bizarre 2010s. In the 2010s fiscal was probably too tight. And we expected central banks to do everything to get the economy back going. And it was a long, slow process, and many people were disappointed by the pace of the recovery.

It feels like in the 2020s we're once again, the entire burden of the inflation adjustment this time is being put on the central banks. And A) they do seem to be working at cross purposes with fiscal authorities. And B) it does seem like that contributes to financial stability risks when the only move really is higher and higher rates. And then you get SVB-like its situations.

Tracy: (39:49)

Very well put, Joe. You basically just summed up, what? Five hours of *Odd Lots* episodes?

Joe: (39:54)

There we go. All right. Shall we leave it there?

Joe: (39:55)

Let's leave it there.

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