Minutes of the May 31, 2024, Financial Advisory Roundtable

Attendance (Physical and Virtual):

FAR Members: Viral Acharya, Takis Georgakopolous, Keishi Hotsuki, Yie-Hsin Hung, Maureen O'Hara, Thomas Philippon, Jeremy Stein, Joanna Welsh,

New York Fed Staff: Chair: John Williams, Kartik Athreya, Argia Sbordone, Marco Del Negro, Nina Boyarchenko, Kinda Hachem, Fulvia Fringuellotti, Linda Goldberg, Giorgio Topa, Joshua Younger, Julie Remache, Anna Kovner, Matthew Plosser, John Clark, Leonardo Elias, Caren Cox, Thomas Eisenbach, Tom Klitgaard, Rita Csejtey, Eric Lewin, Jaison Abel, Ozge Akinci, Pablo Azar, Hunter Clark, Stephanie D'Amico, Jeff Dawson, Keshav Dogra, Michael Fleming, Jonathan McCarthy, Michelle Neal, Michaela Nistor, Rick Ostrander, Roberto Perli, Or Shachar, Katharine Tilghman Hill

Summary: The Financial Advisory Roundtable (FAR) meeting discussed the potential financial stability implications of divergent monetary policies for advanced economies. Specifically, FAR members provided their views on the following questions:

1. What are the implications of policy rate differentials across advanced economies?
    a. How do they impact transmission to financial markets and policy efficacy?
    b. Are there financial stability risks from rate differentials? For banks? Non-bank financial intermediaries? Firms?
    c. How might these policies help/hinder monetary policy objectives?
2. How do asynchronous policies impact global liquidity? Credit growth?
3. What impact might de-globalization have on these considerations in the future

The meeting began with a reminder from New York Fed staff that FAR meetings are subject to the Antitrust Guidelines for Members of the New York Fed's Advisory and Sponsored Groups, which were included in the meeting invitation with instructions for members to review and become familiar with them. The meeting then included introductory remarks by Jeremy Stein and Yie-Hsin Hung. First, Yie-Hsin Hung noted that rate differentials tend to reflect relative growth across economies and in and of themselves are not a significant source of concern. However, prolonged elevated rates in the US can result in a strong dollar that can pose challenges for emerging market economies.

Then, Jeremy Stein focused his discussion on the implications of rate differentials in the specific context of Japan given the starkness of the policy rate differential between the U.S. and Japan. He explained that, historically, higher rates in the US have incentivized carry trades (long dollar and short yen) and more broadly a flow of investment from Japan to the US. This behavior can pose stability risks if the positions must be unwound quickly, particularly if investors haven't hedged their exposure to currency risk. Such an episode could be triggered if Japanese interest rates were to rise quickly.

Sources of risk

FAR members began with a discussion of which rate differentials may pose the greatest risks. There was a general agreement that inflation and rates are roughly similar between the Western economies. While the European central banks were expected to cut rates before the US, the resulting differentials were not considered to be significant. Nevertheless, there are persistent rate differences between the US and several Asian economies, in particular South Korea and Japan.

FAR members noted that the US economy is not especially exposed to trade (e.g., relatively closed) and therefore less sensitive to currency fluctuations than its trade partners. Therefore, rate differentials tend to create challenges for other countries exposed to the relative value of the dollar. This has been evidenced by a higher sensitivity of foreign markets to news relating to the US economy (and by extension dollar exchange rates). FAR members identified emerging/frontier markets as most exposed to the dollar's value due to their reliance on dollar-denominated trade and dollar-based credit.

One FAR member noted that differential economic growth can pose challenges for areas that cannot lower their policy rates. For instance, in the Euro-area, Southern countries may prefer a faster reduction in rates which can create credit risks and reduce economic growth.

Monetary transmission

FAR members noted that high rates in the US attract foreign investment. For instance, there is demand for US CLOs from lower rate countries in Asia and there has been substantial growth in US private credit. Some members noted that the foreign demand for credit has outstripped supply. This increase in foreign investment can run counter to monetary policy that is seeking to moderate investment and growth. Similarly, once rates decline and differentials close, the process may reverse, reducing supply of funds. Middle market leverage and lending may be particularly exposed to a turn in the credit cycle.

FAR members further discussed potential developments in Japan. The Japanese central bank recently exited a long period of loose monetary policy by raising interest rates and loosening yield curve control. FAR members noted that this is still "the first inning" for normalization of Japan's monetary policy. Japanese inflation expectations remain low, but sovereign debt levels are high and of short maturity --- if inflation spikes there is a risk of sharply higher interest rates, which could lead to sharp changes in the demand for dollars and higher US rates.

Deglobalization

With respect to deglobalization, there were several themes discussed related to trade, data, and the role of the dollar. Some FAR members noted that deglobalization of trade can be good for reducing systematic risk of some country differentials or relations. For instance, there is a strong trend of global players reallocating investments and production within Asia to reduce exposure to China. FAR members noted that protectionism and "on-shoring" sentiment remains ascendant, as evidenced by recent efforts to impose data location requirements.

There was also a discussion of countries looking to reduce reliance on the dollar for trade and finance. Consistent with this, China's central bank has reduced its exposure to US debt which may pose risks in the future. Cross-border flows remain dollar denominated, suggesting that a substantive alternative had not emerged. In addition, FAR members noted that there have been benefits from the creation of redundant payment and settlement systems.