The Farmer and the Seed Corn: Why Lowering the CCyB and Imposing Dividend Restrictions Are Opposites

Bill Nelson| Nov. 18, 2020

When two full years had passed, Pharaoh had a dream: He was standing by the Nile, when out of the river there came up seven cows, sleek and fat, and they grazed among the reeds. After them, seven other cows, ugly and gaunt, came up out of the Nile and stood beside those on the riverbank. And the cows that were ugly and gaunt ate up the seven sleek, fat cows. Then Pharaoh woke up.

- Genesis 41: 1-4

Even while enjoying the abundance of the years of plenty, Egypt must experience in its imagination the reality of the upcoming famine, and each and every day store away food for it. The seven lean cows ought to be very much present and alive in people's minds and in their behavior during the era of the seven fat cows.

- Rabbi Yosef Y. Jacobson's interpretation of the story of Joseph and the Pharaoh's dream.

Each fall, a farmer harvests his corn and decides how much to eat now and how much to put away for planting in the spring. He prefers eating now to eating later, and eating more to eating less, but feasting gives him less pleasure than starving does pain.

When he has a bumper crop, he eats some of the abundance, but he also puts more aside for planting, thereby eating a bit more the following year as well when the crops ripen, smoothing out the bounty. Similarly, when he has a lean year, he cuts back some on his consumption, but he also cuts back on the amount he sets aside for planting; as a result, he eats a little less the following year too but the intensity of the famine is reduced. Replanting his corn harvest rather than eating it is a form of saving because it sacrifices consumption now for consumption later. Saving is cheap when food is plentiful and dear when food is scarce, so he saves more when food is plentiful and less when it is scarce.

For whatever reason, though, suppose he makes bad decisions about saving. Suppose he eats too much of the corn in good years and cuts back on his consumption too much in lean years. Perhaps he is providing for an elderly parent who is less tolerant of swings in diet, but he doesn't take his dependent's well-being into account.

In that case, his ruler can make him and his dependent better off by requiring him to save more in good times and save less in bad times. The ruler, perhaps, is better able to take into account the low costs of saving in good times and high cost in bad.

This story, in a nutshell, provides the logic for the countercyclical capital buffer (CCyB) requirement. Because, the story goes, the Fed better appreciates that good times don't last and that banks' troubles hurt others as well as themselves, the Fed makes banks save more (reinvesting earnings in their own capital or even raising more capital from others) in good times and allows them to save less (paying out more of their earnings to their owners) in bad times. The Fed is, in effect, forcing banks to raise capital when it is cheap to do so and allowing them to deplete their capital when capital is expensive. The Fed forces the banks to make hay while the sun shines.

But suppose, instead, the farmer was ruled by a king who imposed a policy of forcing him to replant more rather than less of his corn harvest of corn in lean times. Bad times come with fear and uncertainty, and the king might reason that a time of uncertainty is the worst time to be eating up valuable grain. Or the king could worry that a bad harvest could be a harbinger of an even worse harvest next year, requiring more seeds to be planted to offset the anticipated low yield.

The king's policy to set aside more for replanting when there is a bad harvest is the exact opposite of the benevolent policy of encouraging savings in good times and dissaving in bad times. Rather than smoothing the impact of a famine over several years, the policy would make famines even more intense because the amount of the poor harvest available to eat is cut back even more by the insistence that the farmer replant a higher-than-normal fraction of it.

How will the farmer respond? Knowing that lean years are going to be even worse, he might switch to a more reliable crop, one he had avoided before because it has a lower average yield. He would end up poorer on average but subject to less intensive famines. There might also end up being more farming outside the perimeter of the king's control.

The king's policy is the agricultural equivalent of curtailing banks' capital distributions—dividends and share repurchases—in bad times. Rather than acting on the insight that drove the CCyB – make banks raise capital when the sun shines – the dividend ban makes banks raise capital when it is most expensive to do so, when it is raining cats and dogs, as it were. That high price of capital in bad times is the signal in a market-based economy that more current consumption, not more future consumption, is what is needed.

The policy of imposing a dividend ban on banks in bad times misses two important pieces of the big picture. First, like any mature industry, banks provide a relatively steady stream of income and the investors that buy bank stock and hold it do so in expectation of that dividend income. Perhaps, like the farmer's dependent, they aren't well able to withstand swings in income. If the Fed makes banks cease dividends in bad times, those investors will choose other stocks. Banks will have to find the illusive investor interested in a mature industry without reliable dividends – a utility stock with unpredictable dividends. Banks' cost of capital will rise, and the supply of bank credit will fall.

Second, the demand for credit falls in bad times. Society needs more current consumption, not more investment. That's why it is more expensive to raise capital (or equivalently, cease capital distributions) in bad times. Forcing banks to reinvest more of their income in bad times will almost surely result in the banks building up their stockpiles of government debt. Exactly the medicine the doctor didn't order.

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