Time To Return To the Regular Rulebook – Economic Uncertainty Is Not Extraordinarily Elevated

Bill Nelson | Feb. 26, 2021

In June 2020, the Federal Reserve Board took the extraordinary action of limiting dividend payments and banning share repurchases of all banks that are subject to annual stress tests regardless of their performance on the tests. It extended restrictions in September and eased but still maintained restrictions in December.

In the wake of the Global Financial Crisis, the Fed constructed a complex framework of capital and liquidity requirements, with capital informed by stress tests, precisely to determine when banks' capital distributions to their owners should be limited. But the Fed then abandoned its framework when it encountered its first serious test and instead imposed blanket restrictions that were independent of bank capitalization or projected capitalization or loan loss reserves. Such blanket restrictions and the uncertainty they convey to investors will raise banks' costs of funds and so reduce the supply of bank credit for the foreseeable future.

According to the Fed's announcements, it was restricting banks' capital distributions because the outlook was uncertain:

June 2020 Federal Reserve Board - Statement by Vice Chair for Supervision Quarles

> Today's actions by the Board to preserve the high levels of capital in the U.S. banking system are an acknowledgement of both the strength of our largest banks as well as the high degree of uncertainty we face.

September 2020 Federal Reserve Board Publication

> Due to uncertainty about future economic conditions and the ultimate path of the current recovery, the Board is extending the time period to notify firms whether their stress capital buffer requirements will be recalculated until March 31, 2021.

December 2020 Press Release

> In light of the ongoing economic uncertainty and to preserve the strength of the banking sector, the Board is extending the current restrictions on distributions, with modifications.

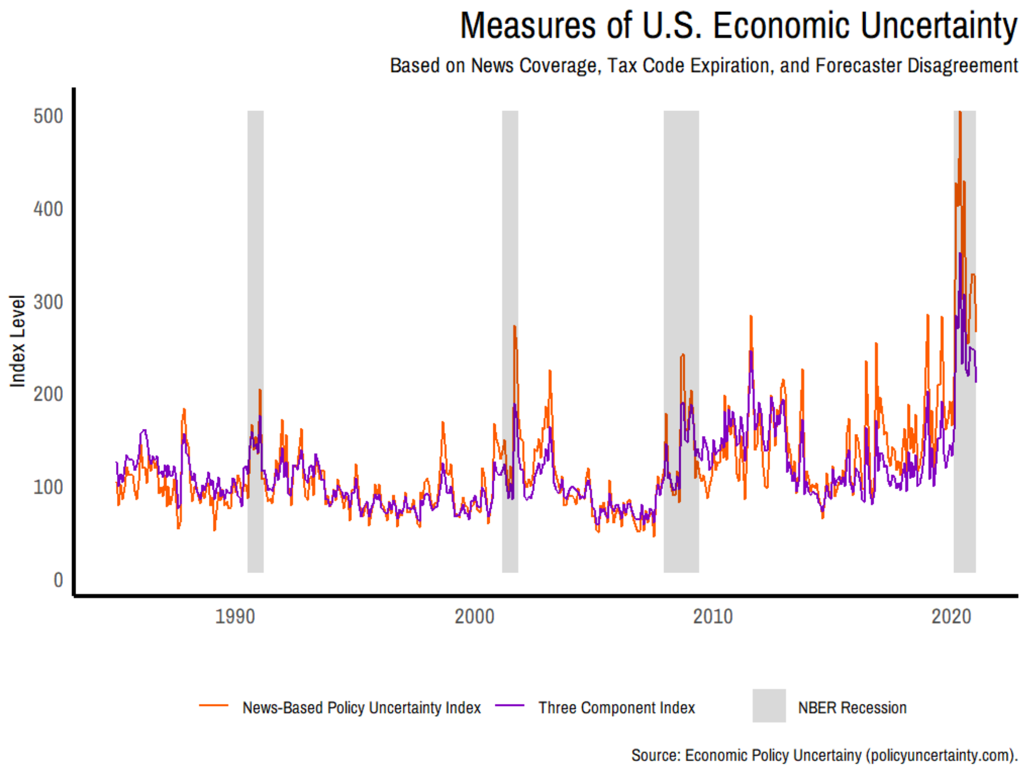
The economic outlook is, of course, always uncertain, sometimes very uncertain, and there are always potential scenarios where the economic situation worsens. Of course, capital is held precisely to guard against unexpected losses, and a new accounting standard (CECL) was adopted in 2020 precisely to require banks to reserve against loan losses over their unpredictable lives.

Presumably, then, to justify suspending the post-crisis regulatory framework, the outlook must be extraordinarily uncertain. The outlook was definitely extraordinarily uncertain in the initial months after the pandemic struck. The outlook was bimodal – the economy could have recovered quickly, or we could have experienced another Great Depression. Moreover, as the pandemic situation worsened sharply in the fall, uncertainty about the economic impact remained high.

The discussion of the Fed staff's forecast in the [minutes of the April 2020 FOMC] meeting captures the uncertainty well:

> The staff noted that, importantly, the future performance of the economy would depend on the evolution of the coronavirus outbreak and the measures undertaken to contain it. Under the staff's baseline assumptions that the current restrictions on social interactions and business operations would ease gradually this year, real GDP was forecast to rise appreciably and the unemployment rate to decline considerably in the second half of the year, although a complete recovery was not expected by year-end. …
>
> In light of the significant uncertainty and downside risks associated with the evolution of the coronavirus outbreak, how much the economy would weaken, and how long it would take to recover, the staff judged that a more pessimistic projection was no less plausible than the baseline forecast. In this scenario, a second wave of the coronavirus outbreak, with another round of strict restrictions on social interactions and business operations, was assumed to begin around year-end, inducing a decrease in real GDP, a jump in the unemployment rate, and renewed downward pressure on inflation next year. Compared with the baseline, the disruption to economic activity was more severe and protracted in this scenario, ….

By most measures, however, uncertainty is no longer exceptionally high. For example, as shown in the exhibit, two popular indexes of economic uncertainty based on news coverage, forecaster disagreement and other data (available here, see also Baker and colleagues (2016)), have dropped to the top of their normal range:



Some Federal Reserve officials also judge the outlook to have brightened and uncertainty to have fallen. For example, on [Feb. 24, 2021](), Vice Chair Richard Clarida stated:

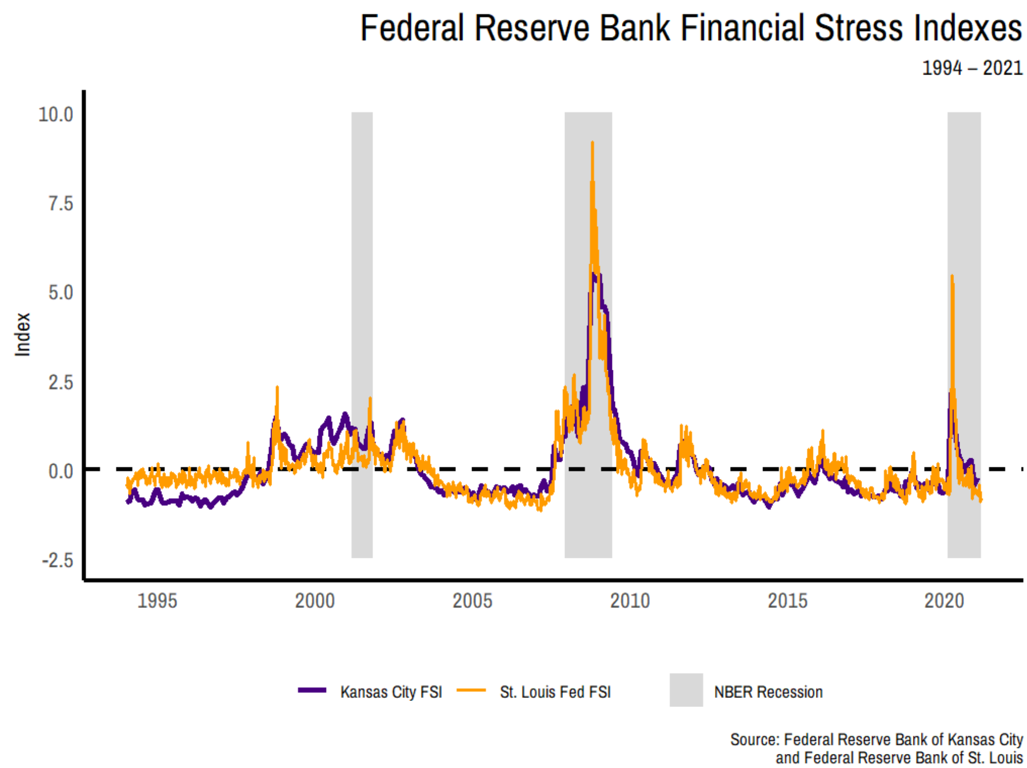
> While the winter surge in new COVID cases and the spread of new variants of the virus are cause for concern as well as a source of downside risk to the very near-term outlook, the welcome news on the development of several effective vaccines and the passage by the Congress in late December of a package of fiscal relief measures indicate to me that the prospects for the economy in 2021 and beyond have brightened and the downside risk to the outlook has diminished.

While in his testimony before Congress Chair Powell stated that the outlook is "highly uncertain," he also stated

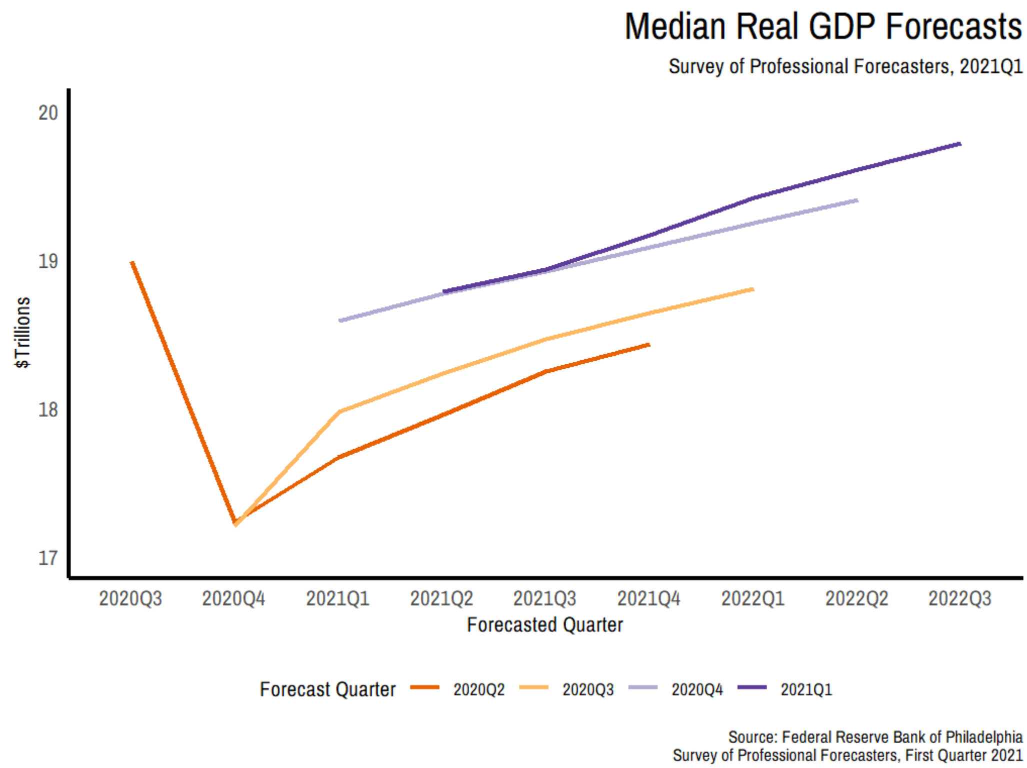
> While we should not underestimate the challenges we currently face, developments point to an improved outlook for later this year. In particular, ongoing progress in vaccinations should help speed the return to normal activities.

And in response to questions, he stated that the Fed projected GDP in 2021 to grow "six or seven percent" and for the economy to return to its pre-pandemic level by the first half of the year. Similarly, John Williams, President of the New York Fed, stated that growth in 2021 could be "the strongest we've seen in decades."

The Fed's various financial stress indexes now report that financial stress is low, not high. See, for example, the Kansas City and St. Louis Fed indexes report that stress is below average:



The median projections from the survey of economic forecasters have brightened considerably. As can be seen in the exhibit, the outlook for GDP improved notably in the fourth quarter of last year and rose again in the January survey. The median forecaster expects GDP to grow 4.5 percent in and 3.7 percent in 2022. The median survey participant expects GDP to reach its pre-COVID level by the middle of this year.



An important barometer of how the Fed views uncertainty about the outlook will be available on March 17 when the Committee releases its quarterly forecast. Participants are asked to assess the level of economic uncertainty, and in the December release, 16 of the 17 participants stated that uncertainty was higher than normal. A material decline in that number would be a strong indication that the Fed no longer viewed uncertainty as extraordinarily elevated.

A drop in the Fed's own assessment of uncertainty in combination with other indicators that the outlook has improved and uncertainty has returned to its normal historical range would call into serious question the Fed's justification for continuing to depart from its own rulebook for banks' capital distributions. There is a risk that, having abandoned its rulebook, the Fed requires a compelling case to return to it. That, however, is not how a rules-based organization is supposed to operate. If the extraordinary conditions that justified a departure from the rules no longer exist, the Fed should return to its normal procedures.