Understanding the Interplay between Financial Markets and Monetary Policy

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Key Points

- Atlanta Fed president Raphael Bostic gives the opening remarks at the Day Ahead Conference on Financial Markets and Institutions on Thursday, January 5.
- Bostic notes that inflation is much too high here in the United States, as it is in other countries. Recent reports show signs of moderating price pressures, but there is still much work to do.
- Bostic points out that the focus of the conference is on the interplay between the financial markets and monetary policy, and he reviews the conference papers.
- One paper that particularly caught his attention finds that mortgage borrowers can get confused by a plethora of mortgage contract terms on offer in the marketplace, which means a borrower's choice can be more profitable to the lender but unambiguously more expensive to the borrower.

Good morning. Welcome to the New Orleans Branch of the Federal Reserve Bank of Atlanta for the Day Ahead conference. Thank you all for joining us for what promises to be a stimulating day.

I would like to offer a special welcome to my colleagues from throughout the Federal Reserve System and from the Bank of England, the Riksbank, and the Banque de France, as well as other domestic and international guests. It's good to have you here, as I feel like we are kindred spirits fighting against the same economic headwinds.

The biggest headwind, of course, is inflation. It's way too high here in the United States, as it is in your countries, and I and the Federal Open Market Committee remain determined to use our policy tools to bring inflation back toward our objective of 2 percent as measured by the Personal Consumption Expenditures price index. I appreciate recent reports that include signs of moderating price pressures, but there is still much work to do. I'm sure my central bank colleagues from around the world agree with me on this.

Now I realize that inflation is not the primary concern of today's event. That said, the interplay between financial markets and monetary policy—which *is* our focus today—helps determine the ultimate effectiveness of that policy. So, the research that will be discussed here is critical to our understanding of factors important in the efforts to bring down underlying inflation.

I'm thrilled that we can resume in-person ASSA—or Allied Social Science Associations—meetings, and excited about the opportunity to host the Day Ahead conference. Before I go further, let me add the standard disclaimer. The thoughts I will share today are my own and do not necessarily reflect the views of my colleagues at the Federal Open Market Committee or the Atlanta Fed.

I will preview our agenda shortly. First, though, I wanted to offer a lagniappe, as they say here to refer to a little something extra. Some of you who follow Fed history may know that New Orleans was nearly chosen as a Federal Reserve headquarters city when the districts were drawn in the early 20th century. At that time, New Orleans was among the nation's leading seaports and financial centers and today remains an important commercial and cultural hub.

When New Orleans was not chosen to host a Reserve Bank headquarters, locals were not pleased. An outcry issued from local media and civic leaders. In fact, don't be too surprised if you still hear a New Orleanian refer to this building as the "New Orleans Fed."

While they missed out initially, Crescent City advocates made a persuasive enough case that New Orleans was selected for the very first Reserve Bank branch office. It opened here in 1915, just a year after the Federal Reserve began operations.

I figured you might find that bit of history interesting as you enjoy the city over the next few days. You might also take a moment to tour our Museum of Trade, Finance, and the Fed downstairs for more local economic history.

Now, our focus today is on the more recent past, which provides valuable context for better understanding a very complex and uncertain present and future. The papers we'll hear presented necessarily examine historical data, particularly from the period between the global financial crisis of 2007 to 2009 and the coronavirus pandemic.

Clearly, the economic and financial environment has changed dramatically over the past couple of years—we've experienced a sharp economic downturn, a rapid rebound, supply chain disruptions, surging inflation, an imbalance of supply and demand in the labor market, monetary policy tightening, and a war in Europe. These developments create numerous new challenges for policymakers. Economic conditions are extraordinary, so we have to manage through a lot of uncertainty.

While much has changed, we need to appreciate how we got here to best navigate the uncertainty ahead. I believe research focused on the period between the financial crisis and the pandemic can help us better understand how financial markets operate under stress and how policy affects markets as they emerge from severe financial pressure.

Our agenda today includes discussions of 11 papers. I won't go into detail about all of them, but let me give you a flavor of the day to come before I highlight one particular paper. A sampling of what we will explore includes papers on:

- how investor demand for dollars early in the pandemic widened spreads on US dollar-denominated bonds more than spreads on bonds issued in other currencies;
- the role banks played in lending to so-called zombie firms;
- repo market activity amid the financial crisis and the implications for liquidity in the Treasury market; and
- the way bond purchases through quantitative-easing programs generated significant and persistent increases in producer price inflation.

One paper that particularly caught my attention, which we'll hear about later this morning, is work by Jamie Coen, Anil Kashyap, and May Rostom. Their paper, titled "Price Discrimination and Mortgage Choice," is intriguing because it interrogates an underlying assumption of economic theory—that is, that full information leads to optimal outcomes and that departures from full information lead to bad outcomes.

Preliminary results of this research show that mortgage borrowers can get confused by a plethora of mortgage contract terms on offer in the marketplace. That means in some instances a borrower's choice is more profitable to the lender but unambiguously more expensive to the borrower.

As a quick aside, I can sympathize. Even though my own research has focused on residential real estate finance, the last time I purchased a home, I still found it difficult to select the best mortgage loan from so many choices!

The authors also find that younger and first-time home buyers are most likely to be financially hurt by the bewildering array of mortgage choices. On a more positive note, the analysis concludes that most borrowers overall manage to find a mortgage that is close to optimal, though I would note that a not-insignificant share fail to find such a mortgage.

These findings concern me, as they suggest that confusion stemming from myriad mortgage options is likely to impose the largest costs on those least able to withstand the burden, including, disproportionately, minority borrowers. It will be interesting to hear what the discussant has to say, both from a theoretical and empirical perspective.

A caveat here is that this work is based on data from the United Kingdom, so we lack solid evidence that it would apply directly to the US mortgage market and borrowers. Nevertheless, I strongly suspect we would find similar results here, especially given the even wider variety of mortgage contracts available in the United States compared to the United Kingdom. I think this would be a good topic for a follow-up paper.

I hope that whets your appetite for the day ahead. Thank you for your attention. I think we all stand to learn a great deal from our distinguished presenters, discussants, and fellow attendees.

At the end of the conference sessions over the next three days, let the good times roll—or, as they say around here, laissez les bons temp rouler!