The Income Statement Channel of Monetary Policy

Binz, Joos, and Kubic

Discussion by:
Dushyant Vyas, University of Toronto

UNIVERSITY OF TORONTO

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Important and Timely!

Federal Reserve Chairman Jerome Powell said Wednesday the central bank approved a half-percentage-point interest-rate increase in an effort to reduce inflation that is running at a four-decade high. Photo: Win McNamee/Getty Images

US makes biggest interest rate rise in 22 years

By Natalie Sherman
Business reporter, New York

4 May

Wall Street Journal

Fed Rate Hikes Are Good for Banks— Unless They End in a Recession

Higher rates are usually good news for bank shares, but not this year, with investors worrying that rate increases that are t...

Forbes

How Windfall Profits Have Supercharged Food Inflation

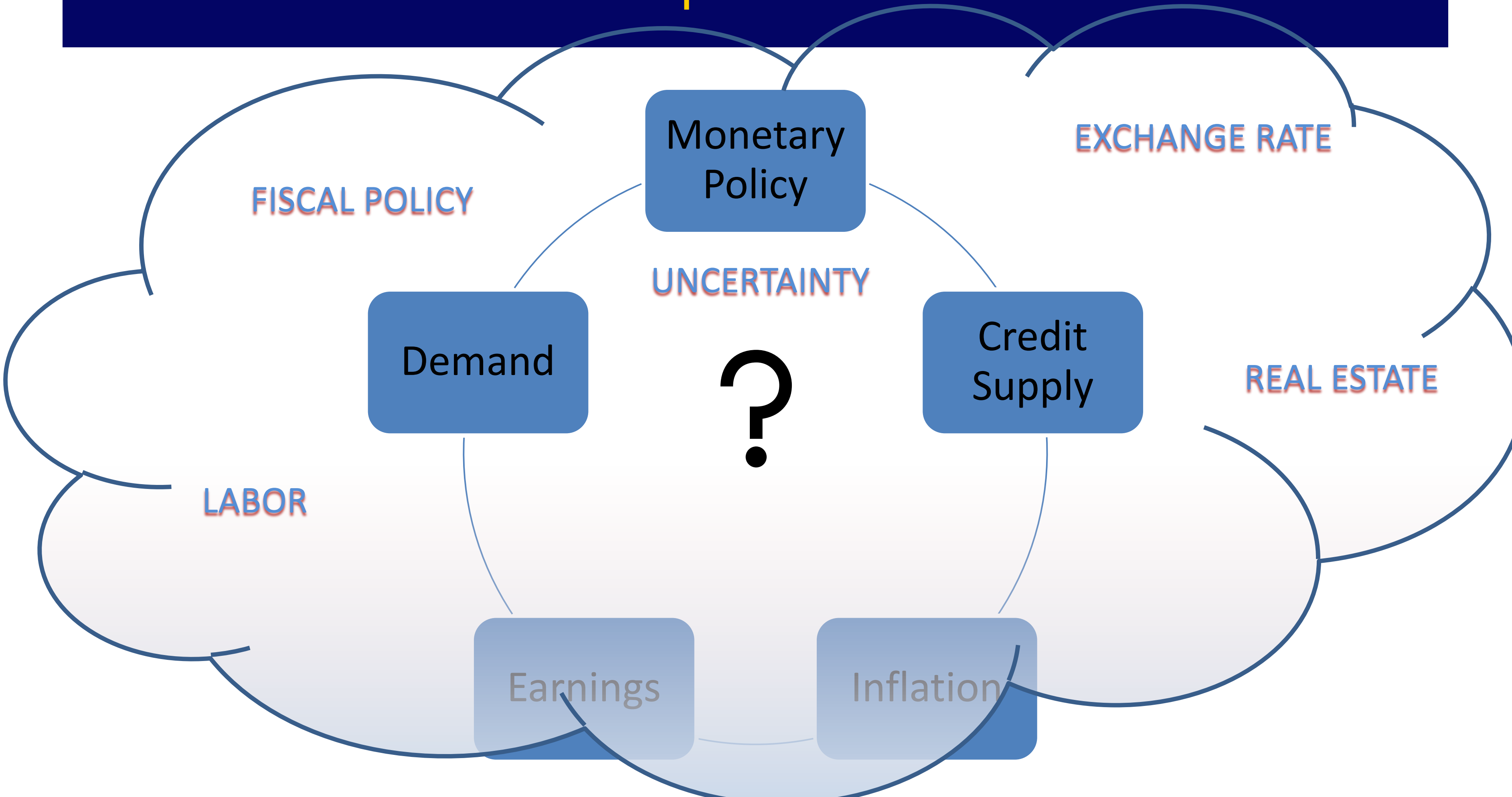
The Federal Reserve Board has voted to increase interest rates by 50 ... of price increases in the last two years have ...

CNBC

Oil slips on fears recession may hit demand

Oil prices dropped on Thursday in a volatile week as recession fears ... bigger interest rate hikes, and their impact on economi...

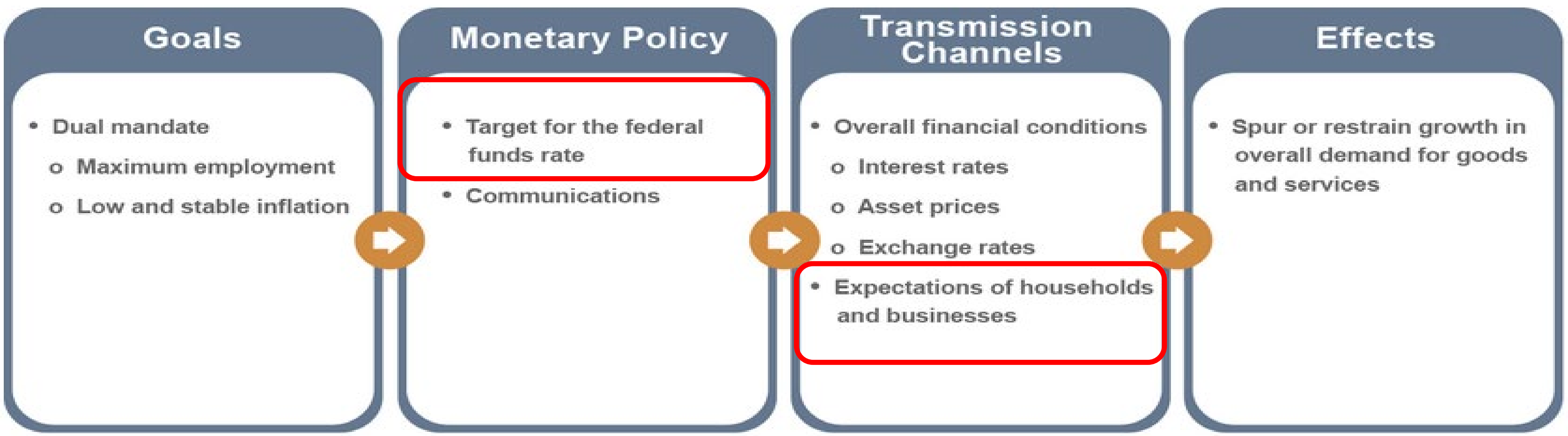
A Complex Web...



Can we cleanly separate one from another?

Policy Impact – Macro to Micro

Directly speaks to the Fed's intended objectives



https://www.federalreserve.gov/monetarypolicy/monetary-policy-what-are-its-goals-how-does-it-work.htm

Key Findings

- Monetary policy shocks (unexpected FFR delta) are transmitted through corporate income statements
- Short run (quarter t and t+1)
  - Negative association with revenues (substitution effect; lower consumer spending)
  - Negative association with expenses (cost of capital effect; lower investments)
  - Positive association with profits (expense effect > revenue effect)
- Longer term (quarter t+2 onwards)
  - Reversal of revenue and expense effects
  - No further effect on profits
- Heterogeneity in response -> larger effects for
  - Periods when consumers are financially constrained (revenues); B to C firms (revenues); financially stable firms (expenses); Tech firms (expenses)

Contribution / Strengths

- Regulatory, academic, and practitioner interest in monetary policy impact - Economically important and timely research
- Examining “macro to micro” essential for understanding “macro to macro”
- Important initial steps towards developing a comprehensive understanding of effects on corporate financial statements (Gallo et al. 2016; Armstrong et al. 2019)
- Granular accounting data can help in better identifying the mechanism
- Yellen’s call: From representative agents to heterogeneity

“At the firm level, there is evidence that financial constraints had a particularly large adverse effect on employment at small firms and the start-up of new firms, factors that may be part of the explanation for the Great Recession's long duration and the subsequent slow recovery. More generally, if larger firms seeking to expand have better access to credit than smaller ones, overall growth in investment and employment could depend in part on the distribution of sales across different types of businesses”

Contribution / Strengths

- Accounting researchers are well positioned to understand the heterogenous impact of policy shocks at a granular account level (instead of overall earnings)
- Theoretically well motivated (analytical model)

Comments / Suggestions

Motivation

- We are currently witnessing an inflationary environment that is unique in recent history
- All eyes are on the Fed as it uses monetary policy tools to manage a superheated economy
- Impact on consumer spending and corporate investment at the center of debate
- **Suggestion: Discuss implications for the current environment. Potentially base discussion on fine-tuned tests**

Motivation

- One of the strengths of the paper – model in sec. 2
- Paper motivated in part by need to study heterogenous response (Yellen)
- Most of the paper does not focus on such heterogeneity (comes in later as cross-sections)
- Model in sec. 2 – representative consumer, firm and central bank
- **Suggestion: Embrace heterogeneity throughout the study. Perhaps focus on a few importance sources of heterogeneity (e.g., cost structure, financing constraints)**

Motivation

- Establishing channels for policy transmission is important, but..is the paper showing us a distinct transmission channel?
- Is showing an association with I/S elements evidence of a transmission channel?
- Close the loop -- transmission at the macro level
- Linkages with other parts of the economy: E.g., Financial firms – ability to supply credit
- **Suggestion: Examine subsequent linkages with macro outcomes (e.g., GDP growth and unemployment rate) and relation with other sectors of the economy**

Asymmetry

- Most of the paper..
  - Does not distinguish between unexpected increases and decreases in interest rate
- One paragraph in the end: Rate decreases drive the results. Why?
  - Differential stickiness in prices and costs that limits response in one direction?
- **Suggestion: Further probe the reasons behind asymmetric response to rate changes (+ve vs. –ve)**

Non-linearity

- Are fed funds futures a reasonable proxy for consumer and business expectations?
- What are consumers and corporates responding to - Unexpected rate changes or magnitudes of rate changes? Over a period of time, is response to an "expected" 75 bps hike the same as an unexpected but smaller 25 bps hike?
- Quarters vs. policy episodes that may last multiple quarters (e.g., multiple periods of positive or negative or conflicting)
- **Suggestion: Incorporate non-linearity in rate change magnitudes**
- **Suggestion: Analyze cumulative rate changes over adjoining quarters**

Types of Expenses

- Further develop conceptual distinction between types of expenses
  - Interest rate: Fixed vs. floating proportion (Ippolito et al. 2019)
  - Balance sheet channel (change in collateral values): Asset impairments
  - COGS: Response to consumer spending (revenues)?
  - All investment-related expenses, esp. depreciation: Are three quarters enough to see a response?

- **Suggestion: Move beyond blanket characterization of expenses as investments; bring up the last part of the paper**

Monetary Policy Uncertainty

- Monetary Policy Uncertainty
  - New measures: Baker, Bloom, and David (2016); Husted, Rogers, and Sun (2017)
  - Do shocks follow or coincide with periods of macro policy uncertainty?
  - Does ex ante policy uncertainty moderate/exacerbate the response to policy shocks?
  - Do firm-level attributes moderate the response to uncertainty? (e.g., financial constraints, information environment, cost structure..)
- **Suggestion: Consider moderating role of policy uncertainty and firm-level heterogeneity**

Miscellaneous Empirical

- Impact of sectoral trends in growth in revenues and expenses; time-varying industry controls (e.g., industry x qtr or year)
- Lagged revenues and expenses. For example,
  - Past investments may lead to future revenue growth
  - Advertising budgets may be set based on past sales

Overall

- Important and timely
- Very ambitious in scope (+); too many moving parts (-)
- Going forward – focus
  - One /few sources of heterogeneity
  - Part of the income statement
  - How accounting methods for certain items might affect observed association with monetary policy shocks
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Best of Luck!