WHAT IS CENTRAL ABOUT CENTRAL BANKING?: A STUDY OF INTERNATIONAL MODELS

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WHAT IS CENTRAL ABOUT CENTRAL BANKING?: A STUDY OF INTERNATIONAL MODELS

Wednesday, November 13, 2013

U.S. House of Representatives,
Subcommittee on Monetary
Policy and Trade,
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:27 p.m., in room 2128, Rayburn House Office Building, Hon. Bill Huizenga [vice chairman of the subcommittee] presiding.

Members present: Representatives Huizenga, Pearce, Posey, Fincher, Stutzman, Mulvaney, Pittenger, Cotton; Clay, Perlmutter, Carney, and Kildee.

Ex officio present: Representative Hensarling.

Mr. Huizenga [presiding]. The subcommittee will come to order. And without objection, the Chair is authorized to declare a recess of the subcommittee at any time. It appears that we will be having votes somewhere around 4:15 or 4:30, is the indication that we have.

So with that, we are going to get moving, because we have a lot of very interesting stuff ahead of us as a committee today. And the Chair is going to recognize himself for 5 minutes for the purpose of an opening statement.

So we have to ask ourselves, what is central about central banking? What works? What doesn't? What thinking went into forming the European Central Bank 80 years after the formation of our own Federal Reserve and how has it lived up to expectations so far? Did it perform better or worse among its peer institutions in the wake of the financial crisis?

It is these questions and others that our committee is interested in exploring as we consider potential reforms of our own Federal Reserve System, which is posting its 100th anniversary this year.

This afternoon, we welcome our witnesses: Dr. Desmond Lachman from the American Enterprise Institute; Dr. Athanasios Orphanides from the Massachusetts Institute of Technology; Dr. John Makin from the American Enterprise Institute as well; and Dr. Adam Posen from the Peterson Institute for International Economics.

Gentlemen, thank you very much for being here today. We appreciate your time.

Today's hearing will examine the central banks of the other advanced economies around the world, focusing on their governance and policy tools, as well as their successes and failures in implementing monetary policy.

The Federal Reserve prides itself on being an independent central bank here in the United States. However, independence is hard to measure and even more difficult to demonstrate. The appointment process of policymakers, reporting requirements, and policy review processes all play a role in defining the relationship that central banks have with their own national governments. Even still, the most independent central banks are ones where there is very little coordination or interference by fiscal policy decisions.

In 2009, the Bank of International Settlements (BIS) surveyed 41 central banks and reported on both the broad commonalities in the structures and roles of these institutions as well as the differences among them. The BIS reported that all the central banks it surveyed have full or partial responsibility for monetary policy. Over half are given policy objectives, usually specified in domestic law or international treaty, but some policy objectives come by published statements that do not have the force of law. Many have either a "single mandate" of pricing stability or a primary goal of price stability with secondary macroeconomic objectives. The United States and Canada are the only two countries identified as having a price stability mandate equally weighted with other macroeconomic objectives. I think this dual mandate is what we will be discussing quite a bit. Nearly all central banks have full responsibility for formulating and implementing monetary policy.

Specifically, we will explore today international models of central banking. Some central bank models, like our own U.S. Federal Reserve System, have a "dual mandate" of enacting monetary policy with a goal of maximizing employment while simultaneously minimizing inflation. Other countries' central banks work under a more focused or prioritized mandate or set of mandates. And that is what I am hoping to personally hear today from all of you.

Some, like myself, also believe that the employment component at a minimum has diverted the Fed's attention from the more important issue of inflation, which in my opinion should be the sole focus. In the worst case, an equal price stability and employment mandate has the potential of a moral hazard, with the Fed playing off its regulatory role against its monetary role.

I look forward to hearing from our witnesses today as we compare and contrast with other international banking models. What we will learn today should not only inform our own understanding of the increasingly global and complex macroeconomy, but should also contribute to our efforts to enact reforms on our own Federal Reserve System as it hits its 100th anniversary milestone.

And with that, the Chair is going to yield back the rest of his time.

The Chair now recognizes the distinguished ranking member of the subcommittee, Mr. Clay of Missouri, for 5 minutes.

Mr. CLAY. Thank you, Mr. Chairman, and thank you for holding this hearing regarding central banks of other advanced economies and focusing on their governance.

In the United States, the Full Employment and Balanced Growth Act of 1978, better known as the Humphrey-Hawkins Act, set four benchmarks for the economy: full employment; growth in production; price stability; and balance of trade and budget. Also, Humphrey-Hawkins charges the Federal Reserve with a dual mandate: maintaining stable prices; and full employment.

The Bank of International Settlements report found that many nations have either a single mandate of price stability or a primary goal of price stability with a secondary macroeconomic objective like full employment. The United States and Canada are the countries identified as having a price stability mandate equally weighted with other macroeconomic objectives. Many central banks have sole inflation targets, sole exchange rate targets, and others have price stability targets. Also, asset portfolios of central banks vary considerably. Some hold foreign assets, government debt, and claims on financial institutions. And during the financial crisis, the Federal Reserve purchased commercial paper, made loans, and provided dollar funding through liquidity swaps with foreign central banks.

Due to this action, the Federal Reserve Bank balance sheet has expanded. When you look at the European Central Banks (ECBs), their main objective for the euro system is price stability and safeguarding the value of the euro. During the financial crisis and the euro crisis, the ECB used several policy tools, including long-term liquidity, refinancing liquidity swaps with the Federal Reserve, and purchase of the euro denominating covered bonds and other government bonds on the secondary market. The ECB's balance sheet has expanded.

The Bank of Japan set monetary policy to achieve price stability. During the financial crisis, the Bank of Japan purchased private debt security, offered long-term refinancing operation, and provided dollar funding through liquidity swaps with the Federal Reserve. The Bank of Japan's balance sheet has expanded.

And one more example. The Swiss National Bank's primary goal is to ensure price stability. During the financial crisis, its balance sheet has expanded.

Mr. Chairman, I will conclude there with my opening statement. And I look forward to the witnesses' comments. I don't know if the gentleman from Colorado wants me to yield—I yield the rest of my time to the gentleman from Colorado.

Mr. PERLMUTTER. I thank the gentleman.

Just a couple of points. Listening to the Chair's opening, I personally think that you can't operate in a vacuum, that you have to compare your price stability inflation versus how many people are working and what the economy is doing. And we have enjoyed a very low inflation rate now for a number of years, even with pretty expansionary monetary policy. But we have had very checkered fiscal policy in the process.

And so, I do appreciate the gentlemen for testifying today. I look forward to your testimony. But I, for one, support sort of the Humphrey-Hawkins approach, which is you don't look at just any one thing. And I know certain central banks, that is their sole focus. I appreciate the fact that the Federal Reserve in our country gets to look at more than just one thing and has the responsibility to address more than just one thing.

With that, I yield back.

Mr. HUIZENGA. The gentleman yields back.

With that, the Chair would like to recognize Mr. Stutzman from Indiana for 3 minutes for an opening statement.

Mr. STUTZMAN. Thank you, Mr. Chairman.

And I want to thank each of you for being here, and also thank the chairman and the ranking member for holding this hearing to evaluate various central bank structures throughout the world, many of which look very different than our own U.S. Federal Reserve System.

I want to thank each of you for being here and for bringing your expertise in order to examine the ways we might analyze these different central banking systems. Conducting an honest evaluation here will allow us to better understand how well our own systems function.

I remain particularly interested in those governments without a dual mandate, which is most of the world. As you may know, Mr. Chairman, I have authored a bill, the FFOCUS Act, which eliminates the Fed's dual mandate in order to focus on price stability. I have said before that the American people can ill afford the inflation, debt, and insecurity that this misguided approach threatens. Now is the time to repeal the dual mandate and break this destructive cycle and return to a predictable, rules-based system.

Numerous economists and scholars have come before our committee supporting this position and reiterating that the dual mandate undermines any attempt to fashion predictable monetary policy. I agree with those who say the dual mandate underpins the Fed's rationale for greater discretion when forming monetary policy, creating a troubling lack of accountability and oversight. Today, I look forward to examining other global models and how they seek to strike the right balance of independence and oversight.

Lastly, I remain troubled at the Fed's bloated balance sheet and I remain unconvinced that there is a viable exit strategy from the Fed's policy of quantitative easing. So in this light, I am interested in how other central banks handle the makeup of their balance sheets and what lessons we can take away from them.

Again, thank you for holding this hearing, and I look forward to the testimony of our witnesses. And I yield back, Mr. Chairman.

Mr. HUIZENGA. The gentleman yields back.

And with that, I would like to extend a warm welcome to our panel of distinguished witnesses today. We are going to be starting from our left to right here with Dr. Desmond Lachman. He is a resident fellow at the American Enterprise Institute. He has previously taught at Georgetown and Johns Hopkins Universities. He served as a deputy director of policy development review at the International Monetary Fund and has worked as a managing director and chief emerging market economic strategist at Solomon Smith Barney.

We also have Dr. Athanasios Orphanides, a professor of the practice for global economics and management at MIT Sloan School of Management. He served a 5-year term on the European Central Bank Governing Council as a governor of the Central Bank of Cyprus. He also served as a senior adviser to the Federal Reserve Board of Governors and taught courses at Georgetown and Johns Hopkins Universities as well.

Dr. John Makin is a resident scholar at the American Enterprise Institute. Previously, he worked as the chief economist at Caxton Associates. He has served in capacities at the Bank of Japan, the U.S. Treasury Department, the International Monetary Fund, and the Federal Reserve Banks of both San Francisco and Chicago. He has also taught courses at the University of Wisconsin, Milwaukee, the University of Virginia, and the University of British Columbia.

Finally, last but not least, Dr. Adam Posen is president of the Peterson Institute for International Economics. Previously, he has served as a member of the Bank of England's Monetary Policy Committee and also worked as an economist at the U.S. Treasury Department.

Gentleman, you will be recognized for 5 minutes each to give your oral presentation of your testimony. And, without objection, your written statements will also be made a part of the record.

On your table right in front of you, you see lights. It will start out green. When it turns yellow, you have 1 minute to sum up. And when it turns red, you will be hearing my gavel shortly after that. So we would like you to wrap that up and pay attention to that timing. And once each of you has finished presenting, each member of the committee will have up to 5 minutes within which to ask any or all of you questions.

And with that, Dr. Lachman, you are recognized now for 5 minutes. And welcome.

STATEMENT OF DESMOND LACHMAN, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. LACHMAN. Thank you, Mr. Chairman, Ranking Member Clay, and members of the subcommittee for affording me the honor of testifying before you today. I am going to talk about the four major central banks of the world: the United States; Japan; Europe; and the Bank of England.

Over the past 5 years, all of those banks have pursued unorthodox monetary policies on an unprecedented scale. This has led to massive expansion in these central banks' balance sheets and it has taken monetary policy into entirely uncharted waters.

Since September 2008, with the Lehman crisis, the motivation for the pursuit of unorthodox monetary policies in all of the major industrialized economies has broadly been similar. All of these countries' central banks needed to intervene aggressively in financial markets to repair the damage wrought by the Lehman crisis. In addition, with policy interest rates having reached their zero lower bound, and with unusually weak economic recoveries and very low inflation, these central banks have all felt obliged to resort to policies aimed at reducing long-term interest rates, increasing asset prices, and encouraging risk-taking.

While unorthodox monetary policies have led to a dramatic expansion in all four major central banks' balance sheets to a range of between 20 and 30 percent of the respective countries' GDPs, there has been a marked difference in the manner in which these central banks have implemented their policies. Underlying these differences have been basic differences in the structure of these countries' financial systems, as well as in the specific problems that these individual central banks have been trying to address.

Assessing the relative success of unorthodox monetary policy pursued by the major industrialized countries is rendered difficult and subject to debate for two basic reasons. The first is that we cannot know what the counterfactual would have been had these policies not been pursued. The second is that it is still far too early to know what the longer run consequences of these policies will be since we do not yet know what will happen once these policies are unwound.

Having said that, there would seem to be little room for debate about the success of these policies in restoring the proper functioning of the global financial system in the immediate aftermath of the Lehman crisis. There also seems to be little room for doubt that the world's major central banks have succeeded in lowering long-term interest rates and in boosting asset prices.

In addition, it would seem that the ECB's Outright Monetary Transaction program, announced in August 2012, was highly successful in substantially reducing sovereign borrowing costs in Europe's troubled economic periphery, while the Bank of Japan's more aggressive round of quantitative easing, announced in 2012, has succeeded in substantially weakening the Japanese yen, thereby increasing Japanese inflationary expectations.

Now, critics of qualitative easing observe that despite the large decline in long-term borrowing rates and the strong increasing local asset prices, the economic recovery in industrialized countries is the weakest of the post-war period. While true, this criticism would not seem to be a serious indictment of recent quantitative easing policies. It overlooks the fact that absent forceful central bank action, it is highly probable that the industrialized countries would have again leapt into serious recession.

A more serious line of criticism of the unorthodox monetary policies being pursued by the world's major central banks is that too little regard is being paid to the unintended longer run consequences flowing from these policies. These consequences could materially compromise the longer run global economic outlook.

Among these unintended consequences are, first, the risk that these policies might be giving rise to excessive risk-taking and to bubbles in asset and credit markets. In this context, one has to wonder whether historically low yields on junk bonds in industrialized countries now understate the risk of owning those bonds and whether yields on sovereign bonds in European periphery have not become disassociated from those countries' economic fundamentals.

The second unintended consequence is that there have been large spillovers to other economies through capital flows and exchange rate movements that have given rise to the charge of currency war. This is of particular concern to the dynamic emerging markets' economies, whose growth prospects have been compromised.

The third drawback of these policies is the moral hazard to which they give rise by reducing the urgency of governments to undertake necessary but painful economic reforms. This would seem to be particularly apparent in both Europe and Japan.

Since the Lehman crisis, the U.S. economy has performed relatively well in relation to those of the eurozone, Japan, and the

United Kingdom. Nevertheless, it would seem at least two lessons for the Federal Reserve can be drawn from the experience of the central banks in those countries. First, Europe's particularly poor economic performance in the aftermath of the Lehman crisis would suggest that a single inflation objective mandate and a high degree of central bank independence do not guarantee meaningful economic recovery.

Second—

Mr. HUIZENGA. I'm sorry, Dr. Lachman, but your time has expired. So I will let you wrap up with one quick sentence, and then we are going to have to move on. We can explore that further in questions.

Mr. LACHMAN. All right. The final point I would make is that aside from the experience of other central banks, I think that the United States' own experience would also caution it against the danger of running up very large assets and credit market bubbles, and that in the conduct of this policy, one really has to be mindful not simply of the short run effects of policy, but also of the longer run costs that we might yet find that we are going to pay.

Mr. HUIZENGA. Thank you. With that, the gentleman's time has expired.

[The prepared statement of Dr. Lachman can be found on page 36 of the appendix.]

Mr. HUIZENGA. Dr. Orphanides, you are recognized for 5 minutes.

STATEMENT OF ATHANASIOS ORPHANIDES, PROFESSOR, PRACTICE OF GLOBAL ECONOMICS AND MANAGEMENT, SLOAN SCHOOL OF MANAGEMENT, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. ORPHANIDES. Thank you, Mr. Chairman. I appreciate the opportunity to testify at this hearing. As requested, my testimony will focus on differences and similarities between the Fed and the ECB. I think the 100-year anniversary of the Fed is an apt occasion for reflecting on the structure of the institution. Historical experience suggests that a well-functioning monetary system is a prerequisite for the greatness of any nation, and this is what has been achieved since the creation of the Federal Reserve 100 years ago.

Since its founding, the Fed has evolved into a very powerful central bank and serves a leading role in global central banking. As a public institution, the Federal Reserve is unparalleled in the professional integrity, technical expertise, dedication to public service, and collegiality that has characterized its staff and leadership.

Over its first 100 years, the Fed has contributed, I believe, to the welfare of the Nation, but has not always managed to avoid major errors. The Great Depression of the 1930s and the great inflation of the 1970s are the most noticeable examples. I am certain that historians will reflect on the most recent crisis over the next many years. In my view, the Fed's actions in late 2008 and 2009 were decisive for averting what could have become an economic collapse of Great Depression dimensions.

However, the easy money policies that have been pursued do create additional challenges. And right now we do see that the central bank's balance sheet and associated continued easing are unprecedented.

What I would like to draw attention to is three elements between the Fed and euro system. One is in the decentralized nature of the institutions. This is a common characteristic that is quite important in that the inclusiveness and incorporation of regional perspectives ensures that monetary policy better reflects the needs of a broad economy, which we have in both cases.

The second element is the independence of both institutions. Both the Federal Reserve and the ECB are very independent central banks, but the ECB is more independent than the Federal Reserve in that its operations are governed by treaty and not by law, and as a result it cannot be changed very easily by modifying a piece of legislation.

There is another difference that has to do with the appointment process of Board Members. Both in the United States and in Europe, once appointed, the Board Members are independent; however, the reappointment process and turnover in the United States arguably makes that aspect of independence less in the United States relative to Europe.

I believe that the independence of the Federal Reserve could be strengthened, and that would be an improvement, if its Board Members were appointed similarly to the ECB Executive Board Members for just one nonrenewable 8-year term.

The third element I would like to draw attention to is the difference in the mandates of the two institutions where, as has been pointed out already in the introductory remarks, the Federal Reserve is governed by a dual mandate that emphasizes, in addition to price stability, full employment. Whereas, in the case of the ECB, price stability is the primary focus of the institution. There I believe that the ECB's mandate better reflects the accumulated knowledge we have had in central banking experience over the 20th Century. It is generally accepted that better results, both in terms of economic stability and in terms of price stability, can be delivered by a central bank that can focus its attention better and be held accountable for what it can do, and that is price stability.

So in this sense, I would share concerns that have been expressed, for instance, recently by Chairman Volcker, who pointed out that if the Federal Reserve is trying to pursue multiple objectives, it runs the risk of losing sight of its basic responsibility for price stability that would end up delivering worse results in all of its objectives together. I believe that these risks could be mitigated by Congress with a clarification that explicitly recognizes the primacy of price stability as an operational goal for the FOMC. And I believe that subject to that objective, the Fed would be in a better position to attain additional objectives such as full employment for the Nation.

Thank you.

[The prepared statement of Dr. Orphanides can be found on page 62 of the appendix.]

Mr. HUIZENGA. Thank you, Dr. Orphanides.

With that, we have Dr. John Makin for 5 minutes.

STATEMENT OF JOHN H. MAKIN, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

Mr. MAKIN. Thank you, Mr. Chairman.

I want to briefly review the experience of the Fed and the experience of other central banks since the financial crisis. Given that time is somewhat limited, I have tried to lay out some of the approaches that central banks have taken to the crisis. I would remind the committee that the Fed was originally formed after a series of financial crises, the last of which was the crisis of 1907, which underscored the need for some kind of an institution to provide adequate liquidity in order to avoid the negative effects of financial crises, such as those that followed from the numerous crises that occurred in the 30 to 40 years before the Fed was formed.

The Lehman crisis was unique. I bring to it the perspective both of an academic and a think tanker, but also someone who was in the middle of the crisis, working at a hedge fund at the time. And I can assure you that the role of the central bank as an institution designed to avoid a total financial meltdown was one of the primary activities that emerged. The typical goals of the Fed, that is price stability and full employment, were subsumed beneath or among the more primary objective of the Fed to try to staunch the severe bleeding that had emerged in the financial sector.

In order to follow up and try to restore the growth of employment and to maintain stable prices, the Fed extemporized, using the zero interest rate policy, the quantitative easing, forward guidance. All of these measures were pioneered by the Fed in response to the crisis that was facing them. Other central banks to some degree followed the example of the Fed. You may remember that initially the European Central Bank felt that they had avoided the financial crisis and its fallout. And that outlook was changed in 2009 when it was revealed that the Greek Government was concealing the amount of fiscal deficits that it was undertaking.

So basically, central banks have tended to stylize their responses to the crisis, again, as measures designed to try to avoid financial meltdowns. The Bank of Japan this year, as most of you know, initiated measures that were quite similar to what the Fed had undertaken, that is they set a goal for 2 percent inflation and they undertook aggressive additions to their balance sheet in order to try to effect that goal.

The outcomes have varied, and I have tried to actually summarize them in my testimony in terms of evaluating what central bank has performed best. In the first figure, I look at the path of gross domestic product from 2008 to the present, and the winner is the United States. Although growth has been slow to somewhat lagging—it is on page 7 of the testimony—the United States has seen a total increase, cumulative increase in output of about 8 percent since 2008. The biggest loser is Spain in this picture because Spain is part of a monetary union in which it does not belong; that is the ECB sets monetary policy for Germany, the rest of Europe has to struggle, and the result is a rapid drop in output.

Inflation has not been a big problem so far. In fact, disinflation is emerging as a big problem in Europe and the United States. Figure 2 looks at price levels. The cumulative increase in the price level in the United States, in spite of heavy quantitative easing since 2008, is something on the order of, again, 8 percent. In Switzerland and Japan, prices have actually fallen. And one of their big problems has been to intervene heavily to avoid currency appreciation intensifying their deflation problem.

The second wing of the mandate, that is employment, is looked at in terms of figure 3. Central banks have not been terribly successful at engendering growth of employment. And here again, in terms of what the committee is considering, I, too, share the idea that it is probably best to have the central bank target a stable price level. And by that, I mean that inflation should not be above 2 percent, but it should not be below 1 percent. And in an environment where you can get deflation, it is important to put a floor on that range. But in general, the behavior of employment suggests that the central banks have not been terribly successful in pursuing that goal.

I see my time is up, so I will stop.

[The prepared statement of Dr. Makin can be found on page 49 of the appendix.]

Mr. HUIZENGA. Thank you, Dr. Makin.

Dr. Posen, you are also recognized for 5 minutes.

STATEMENT OF ADAM S. POSEN, PRESIDENT, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. POSEN. Thank you, Mr. Chairman. Since my colleagues, Athanasios, Desmond, and especially John, have taken you through the basics comparisons, I am going to make slightly more pointed remarks. I am going to talk about the operational structure of central banks and what the Fed is doing right and wrong in two major areas, The first issue is of governance and how its goals are set, which goes to the mandate issues and Humphrey-Hawkins issues that people have raised, and the second is about the tools that are available for policy implementation.

I would argue that the differences between central banks are going to actually become more important in the next couple of years. In the midst of a crisis, whatever a country's mandate, whatever a central bank's mandate, everybody is going in the same direction, pretty much. And if they don't go in the same direction, they realize very quickly that they have to catch up, and you throw everything you have at the problem.

And if you look back, particularly at John, but also at the other testimony, you will see that the central banks did largely the same thing. All this talk about the difference in mandate and uncertainty caused by the Fed's dual mandate is absolute nonsense. There is no evidence econometrically that it makes a difference either to the perceived uncertainty in financial markets or to the levels of inflation you see.

So what does matter? Let's talk a bit about goals. The central banks, as Stanley Fischer has pointed out, should not have goal independence, but should have instrument independence. In other words, all of you here as the elected officials should be setting what the central bank's goals are, debating them, resetting them as necessary, but then leaving the central bank alone to get on with the job and not worry too much about how they get on with it, only checking for competence and results after the fact.

Perhaps this sounds evident, but this distinction matters greatly. Athanasios mentioned that the ECB has an extreme form of independence and insulation from political oversight. Back in 1993, I predicted that this would be the case and would lead to excessively rule-based behavior. And that is exactly what we saw with the ECB running the European economy partway into the ground.

We know that in the Bank of England, and then more recently in the Bank of Japan, we have seen resetting of the policy goals by elected officials in an explicit, transparent manner, taking advantage of the crisis and saying, what have we learned? And this has suffered no shock to inflation, nor stability; it is the way it should work.

So does the Fed have it right? I think largely we can say yes. But I think there are three points I would make. First, an atmosphere of extreme distrust from Congress towards the Fed is harmful and unnecessary. We have the whole notion of auditing the Fed, which is looking as though the Fed isn't totally transparent about its balance sheet, which it is. We have the idea of minutes having to be very explicit and tell you everything that was said exactly, which has the effect of making people ashamed to really debate in the FOMC because they are worried about being caught up. We have the fact that capital in the central bank is not guaranteed and therefore the Fed restricts itself from engaging in policies it should, such as potentially selling off assets, because they don't want to have to come to you and explain an on-paper loss. You could indemnify the Fed against losses incurred in the operation of its duties, as Her Majesty's Treasury does for the Bank of England.

Most importantly and harmfully, Congress has put increasing restrictions on what the Fed can purchase. This is a terrible step backwards in policy. Every central bank in the world except the Fed can purchase a broader range of assets than the Fed currently does. Every central bank in the world for centuries has purchased private assets and a wide range of assets. It was only this brief interlude from the late 1970s to the early 2000s when central banks made the mistake of thinking they could affect the whole economy by playing at the short end of the yield curve in the government bond market. That has been demonstrated to be completely wrong by the experience of the last few years. Look at the fact that in Europe right now, you have a total crushing of small business credit in southern Europe because the ECB chooses only to purchase certain things at the international level.

Let's talk for 1 minute left on tools. Building on this point about where the central bank—Congress has fruitlessly and destructively restricted the Fed's purchases. We have the fact that we get this demonization of purchases and large balance sheets and so-called unconventional monetary policy. Now, the fact is, unless you buy the right things, your policies will be ineffective. The Bank of Japan proved this with its quantitative easing in the mid-2000s when it only bought short duration debt and had no effect on the economy. Once they shifted to buying private and longer term debt, they have managed to reverse deflation.

It is wrong in the United States to think that there has been any mistake here. If the United States hadn't been lucky in the fact that Congress has allowed the Fed to buy guaranteed mortgage-backed securities, we would not have had an effective policy response. Had we not had that effective policy response, we would not have the housing-led recovery, such as it is that we have today. And that was sheer luck that Congress happened to have approved of MBS purchases.

To repeat, no other major central bank is constrained the way Congress has constrained the Fed in its purchases. This is taking the Fed in exactly the wrong direction.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Posen can be found on page 68 of the appendix.]

Mr. HUIZENGA. I appreciate that input.

And I need to make sure that I get my notes here for a moment. Because of the shutdown that had occurred, we had a well-known expert on the subject who we invited to the original scheduled October hearing, but he is unable to attend today. And without objection, I would like to put Dr. Larry Lindsey's prepared testimony into the record. So without objection, we will do so.

And with that, the Chair is going to recognize himself for 5 minutes.

Mr. Posen, you are on a bit of a roll against Congress here, and I would add that you are not unique in that in many ways lately.

Mr. POSEN. My complaints are more narrow, sir.

Mr. HUIZENGA. Yes, yes. I understand your complaints are more narrow. Come to a town hall meeting sometime, and you will have your world broadened.

But I just wanted to make sure that you had a chance to express that fully about the limits on the purchases and those kinds of things. And then I would like the rest of the panel to maybe touch on that and whether they would agree with that.

Mr. POSEN. Very kind of you, Mr. Chairman. And again, obviously, I am working in shorthand; there is no one entity of Congress, and there are obviously people like you and this committee who want to thoughtfully try to do the best possible job. And that is why I am grateful that we are having this hearing.

Mr. HUIZENGA. Duly noted, the buttering up. I appreciate it, though. So I thank you.

Mr. POSEN. Transparency. The issue is pretty straightforward in my eyes. Central banks literally did most of their operations on private loans and private securities throughout the 19th Century and throughout much of the 20th Century. They did so in an environment with many different things going on, but rarely resulting in inflation, rarely resulting in hyperinflation, rarely resulting in instability. And they did this because it had two advantages. First, it directly went after issues in the markets where there were blockages in the markets. And second, this helped to make markets and create more liquid conditions more broadly that you could intervene.

Now, there are costs to doing this because it does of course benefit specific holders of given assets at a given time, which you don't want to do. And there are costs because if it is a narrow market you happen to buy into, it is not that easy to get in and out and the Fed can have too large, or whatever central bank, can have too large an effect on the asset prices. So it is not costless, but it is a tool.

Mr. HUIZENGA. Would anybody else on the panel care to comment on that quickly? Dr. Lachman?

Mr. LACHMAN. I would just make the point that the size of the asset purchases by central banks is without any precedent. It is on a scale that is humongous. So I think not to have congressional oversight on the particular assets that are being made when you are getting distributional effects, I am not sure that I would go along fully with Mr. Posen's point.

Mr. HUIZENGA. Okay. And I would like to just quickly, I am going to take a moment. I would like to submit this into the record, without objection.

This is from yesterday's Wall Street Journal, "Confessions of a Quantitative Easer." This was Andrew Huszar, who is a senior fellow at Rutgers Business School, and a former Morgan Stanley managing director. In 2009 and 2010, he managed the Federal Reserve's $1.25 trillion agency mortgage-backed securities purchase program. And I don't know if anybody else has read this. If so, I would love to get a comment on it. But basically, a little headline: "We went on a bond-buying spree that was supposed to help Main Street. Instead, it was a feast for Wall Street."

Dr. Makin?

Mr. MAKIN. The "feast for Wall Street" rhetoric is popular, but I think it obscures a problem that the Fed faces. And that is, on the one hand, they want to make sure that they keep the recovery going. And so, they are buying assets. I agree that they should be able to buy a wider range of assets. But given the constraints they are facing, they have to buy the assets in order to keep the recovery going. On the other hand, they are supposed to avoid affecting asset prices, which of course is impossible.

And the dilemma they face was highlighted last May when Fed Chairman Bernanke suggested that perhaps they should taper or they should reduce the rate at which they are purchasing securities. The result was a 1.5 percentage point increase in mortgage borrowing rates. So I think perhaps the author of the Journal piece, it is easy to criticize, but, on the other hand, if you withdraw what the Fed is doing, you risk some serious problems in the financial markets. And so in summary, what the central bank, especially the Fed is trying to do is to find a way out of providing a large amount of support for financial markets without disrupting the behavior of the economy and causing a sharp rise in interest rates. It is very difficult to do.

Mr. HUIZENGA. Dr. Orphanides, for the last 30 seconds.

Mr. ORPHANIDES. Thank you, Mr. Chairman. I would also agree that it is an unfair criticism both for the Federal Reserve and for other major central banks to claim that they have been trying to help the banking system and not Main Street. In order to best help Main Street, central bank policies often have to focus on the financial sector. This is what we have seen both in this country and in other countries.

With regard to the purchases of securities, I would agree with Dr. Posen that it would be useful for the Federal Reserve to have the authority to make purchases of other instruments. This is exceptionally important in times of crisis when even very small interventions by the central bank could unclog markets.

In the case of Europe, this proved very important. For example, in 2008, 2009, the ECB made small purchases in the covered bond markets just for a short while, and that helped stabilize the market and restore stability. So you don't need many purchases, you need it as a crisis management tool. That said—

Mr. HUIZENGA. I'm sorry. Unfortunately, my time has expired. So we are going to have to allow one of my colleagues to explore that.

The last thing I would like to do, without objection, is also put into the record an article entitled, "ECB's Praet: All Options on Table, Central Bank Could Adopt Negative Deposit Rate, Asset Purchases If Needed." So without objection, it is so ordered.

With that, I would like to recognize Mr. Clay for 5 minutes.

Mr. CLAY. Thank you, Mr. Chairman.

Today, it is widely acknowledged that over the past few decades the United States experienced a sharp rise in income inequality, levels of inequality not seen since the late 1920s. Moreover, a recent study out of Berkeley has shown that most of the benefits of growth experienced during the recent recovery have accrued to the wealthiest in society.

And when you talk about Fed policies having important distributional impacts on society, do you believe these policies in any way contribute to the problem of growing inequality? Can you give us some examples of Fed decisions that have impacted different segments of society differently and how? I want to start with Dr. Posen.

Mr. POSEN. Thank you, Mr. Clay.

The ongoing rise in income inequality, and particularly wealth inequality in the United States, is largely driven by the U.S. Tax Code, which you are well familiar with, obviously. It is secondarily driven by a global trend that low-skilled Americans and low-skilled workers are getting less and less ability to bargain for wages, while people at the high end of the scale in terms of perceived skill or opportunity get to bargain at superstar status. Those are the two main drivers, and those continued through the crisis.

The crisis made things worse in the United States and elsewhere because of course the most vulnerable become unemployed and you see fiscal cutbacks on the provisions that go out to them. Particularly in the United States we saw at the State and local government level, that it was a big cutback and cutback opportunities through the community college and other such systems. Again, this committee is well familiar with that.

Where does the Fed come into this? The Fed basically is contributing to inequality. But similar to what Athanasios, Dr. Orphanides just said, it is contributing to inequality in a minor way to prevent a very concentrated blow to inequality in a major way.

Let me spell that out. The way the Fed policy is working is it is benefiting stockholders and relatively middle-income householders, people with mortgages, disproportionately. And then you hope that by benefiting those, that will lead to growth in the rest of the economy. And that isn't going for equality.

Had the Fed not taken the course it did, you would have seen a much higher increase in small business failures and in unemployment. And so the overall inequality picture might not have been that different, but the concentration of very bad outcomes would have been very high.

Mr. CLAY. I see.

Dr. Makin?

Mr. MAKIN. I agree that the tax system is a much more effective way to address problems of inequality than the Fed. The Fed's goals are already perhaps more than instruments they have to achieve them with, that is to maintain inflation at a low and stable level and to try to minimize unemployment. To that extent, they are trying to deal with all sectors of the economy. But for the Fed to be charged in any specific way, I don't know what instrument the Fed would use to affect income distribution. So I would turn to the Tax Code to effect that outcome, and suggest that perhaps a flatter schedule of tax rates would be a good idea.

Mr. CLAY. Thank you.

Dr. Orphanides, would you have any comment on the income inequality?

Mr. ORPHANIDES. Thank you. I would like to emphasize that central banks do not have the tools to achieve all that society might wish that government institutions might be able to contribute to. The best way central banks can contribute to even an element such as the reduction of inequality is by ensuring stability in the economy, the preconditions for economic growth that can then allow households and corporations and businesses to prosper and allow the Congress with fiscal policy to select distributional policies it would have with high income.

We cannot expect central banks to deal with this problem. I believe that in the last few years, we have been overburdening central banks already. We expect them to keep interest rates low and help fiscal policy as well. We expect them to contribute much more than they can to full employment. We expect them to fix all the problems of the financial system. We cannot have all of these expectations simultaneously.

Mr. CLAY. Dr. Lachman?

Mr. LACHMAN. Yes, I would basically agree—

Mr. HUIZENGA. The Chair is going to take a prerogative here. My time went a little long, so without objection, I will grant just this answer.

Mr. CLAY. Thank you.

Mr. LACHMAN. I will keep it really brief. I would certainly agree that you don't want to overburden the central bank with too many things to do, that price stability is a big enough task that will do a lot of good. So I would think that other policies, fiscal policies, stuff of that sort, is a more appropriate way to deal with the distribution issue.

Mr. CLAY. Thank you, Mr. Chairman.

Mr. HUIZENGA. No problem. Thank you.

With that, the Chair is going to recognize Mr. Pearce of New Mexico for 5 minutes.

Mr. PEARCE. Thank you, Mr. Chairman.

Mr. Makin, you had made a comment there in response to the gentleman from St. Louis' question about income inequality. Would you state that again? I am just not sure that I heard the whole thing.

Mr. MAKIN. Very briefly, as the other panel members have suggested, the central bank is really not equipped to address issues of income distribution. And the tax system is a better way to do that.

Mr. PEARCE. And would you have any ideas, understanding it is not the Federal Reserve or central bank's job, but what would you recommend on the tax policy if you were going to make a recommendation?

Mr. MAKIN. I would prefer a kind of textbook approach, which was followed in the 1986 tax reform, which was to have the lowest possible rate on the broadest possible base. So that would partly involve financing lower marginal tax rates by closing loopholes, among other things.

Mr. PEARCE. Mr. Posen, the Federal Reserve has driven interest rates to almost zero—or to actually zero. Is that a good policy long term for the United States?

Mr. POSEN. Congressman, it was a good policy and it remains a good policy given the economic context in which we find ourselves, and it is a policy that has very little in the way of long-term implications. Despite the comments made by Dr. Lachman earlier, there is no statistically significant evidence across countries that low interest rates lead to bubbles. It is just not there in the data. It requires a combination of regulatory changes and animal spirits to get bubbles. Low interest rates don't cause them. And if it is not about bubbles, it is not clear what it does.

There are second order, meaning existing but not huge distributional effects. My mother, who is a retiree, who has mostly invested all her savings in government bonds has less income now because the Fed did that. Other retirees who happen to have 401(k)s have more income because the stock market went up. The Fed can't fine tune that without getting into deep trouble. And I think on net, it is not a big deal one way or the other. The interest rate only—

Mr. PEARCE. If I could take back my time right there, I would invite you to come to my town halls.

Mr. POSEN. Okay.

Mr. PEARCE. I have seniors, we have a little bit older population in New Mexico, they come there for the hot, dry weather. They say, we lived our life correctly, we paid for our houses, we have cash equivalents. We used to get 4 percent income—this statement was made this past week—on our investments, and now we are getting one quarter of 1 percent. So for every $16 they used to live on, now they have $1. And they are spending into their capital.

And to hear you describe that as not significant, I would like you to use that terminology in front of the hostile people that I get to face at our town halls. Because I will guarantee you, my friend, it is a significant impact on the lives of seniors who have lived correctly, and because of the policies of this government and this Administration, they cannot even live in retirement. And to have that described as nonsignificant statistically just drives people insane when they hear folks in Washington say crap like that. Statistically not important.

Do you have a response?

Mr. POSEN. Yes, indeed.

Mr. PEARCE. Yes?

Mr. POSEN. I have two responses. First, when I was serving at the Bank of England I did those town halls myself, without the protection of some local Congressman or MP. I talked to over 8,000 individual U.K. citizens while I was there. And I held myself accountable to people. And I explained to them that just as you think about the 4 percent you used to have wasn't controlled by you and wasn't set by the government, it was a market effect. In reality, if this economy is not growing, there is no interest rate out there. And it is not for the Federal Reserve to subsidize people just because they happened to have done what you call living correctly. Secondly—

Mr. PEARCE. I have 24 seconds, sir. And the Federal Reserve is subsidizing Wall Street, because zero interest rates are a boon to the big bankers. They get money for free, and they are able to then charge more.

Mr. Chairman, I yield back my time. Thank you.

Mr. HUIZENGA. The gentleman yields back his 5 seconds. All right.

With that, the Chair recognizes—

Mr. PERLMUTTER. The gentleman from Colorado. Ed Perlmutter, the gentleman from Colorado.

Mr. HUIZENGA. Yes, my former neighbor who moved away from me.

Mr. PERLMUTTER. How soon you forget.

Mr. HUIZENGA. Yes. With that, the gentleman has 5 minutes.

Mr. PERLMUTTER. Mr. Posen, I have a bunch of questions. Do you want to finish your second point to Congressman Pearce?

Mr. POSEN. That is very generous. I will be brief. The definition of living correctly is in the eye of the beholder. Most human beings in the United States live correctly. And whether it is the children of the unemployed; they don't deserve to bear the burden of the crisis any more than the people you are meeting with in your town halls. I wouldn't make a moral judgment.

Mr. PERLMUTTER. And I thank the gentleman for that. I thought you might want to say they ought to take a look at the value of their homes, which had dropped like a rock. And because there has been some effort to stabilize and grow the economy again, really only on the backs of monetary policy, that they can look at their house and see some value returned to their house that fell like a rock in 2008 and 2009 and 2010. That is where I thought you might go.

Mr. POSEN. That is better.

Mr. PERLMUTTER. I appreciated a couple of words that were used. Dr. Lachman, you used one, and, Dr. Makin, you used one. One was "humongous." I understand the word humongous. And the other was extemporize. And, through this recession, crash, fall on Wall Street, whatever you want to call it, we saw some constrictions in the stock market and in the financial market that we hadn't seen at least—maybe ever, but certainly not since the Depression or before then. It was a different kind of a constriction.

And I appreciated the comments of all the panelists that some very difficult steps, some new steps were taken by the Federal Reserve, as well as a number of the other central banks, because they are looking at the whole economy crashing. And then it is like, price stability, we saw prices drop in 2008 and 2009, certainly in the real estate market, and in other markets, oil and gas. It went from $4 during the summer of 2008 in Colorado down to about $2 or less.

So I guess I would ask just as a general comment, and I know all of you were focused on this, have we as legislators, where we really have not had much of a fiscal policy over the last 2 years except for a very contractionary fiscal policy, and we put restraints on our Federal Reserve, have we done the right thing? And I will start with you, Dr. Posen, but I definitely want to get to the other gentlemen to get their response.

Mr. POSEN. I should defer to the other people's time. Just quickly, we have basically done the right thing. It doesn't fix everything. It doesn't fix everyone. But putting the restrictions on means when the next crisis hits outside the housing market, we are not going to be able to respond to it, and you are just going to have very indirect means of responding to it.

Mr. PERLMUTTER. Dr. Makin?

Mr. MAKIN. Yes, let me pick up on the word "extemporize." A financial crisis presents policymakers with unprecedented problems. We have seen a combination of measures undertaken by the Fed, as well as fiscal stimulus packages undertaken by the Congress. Putting it all together, the outcome is okay, the best, actually, among the industrial countries.

Mr. PERLMUTTER. And looking at your graphs, I think your graphs verify that or support that.

Mr. MAKIN. Right. We have had about 2 percent growth without a lot of inflation. The employment picture hasn't improved a lot, but that is partly because of some major changes that have occurred in the labor market. But so we have extemporized in a difficult situation and done better than most industrial countries. We certainly do need to do better. And we will eventually need to abandon these extreme policies, as the Congress has already done on the fiscal side. It just takes a very cautious and gradual approach.

But for example, if we were to want to abandon the quantitative easing and the zero interest rate policy, interest rates would shoot up, the stock market would collapse, owners of bonds would get a higher return on their savings, but they might be faced with substantial wealth losses in terms of the value of some of their other assets. So we are in a difficult period now, but so far we have extemporized and done reasonably well.

Mr. PERLMUTTER. Dr. Orphanides?

Mr. ORPHANIDES. Thank you.

Central banks are incredibly powerful institutions, especially during crises when using the balance sheet of a central bank can paper over a lot of problems that you wouldn't have thought about that could be done during the crisis.

I am worried that with the additional restrictions that have been placed on the Federal Reserve in light of the actions that they took in 2008, the Federal Reserve may be overly constrained. And because of the need to coordinate with the Treasury, and in some instances with Congress, the additional delay might actually create problems if we had a crisis such as the one we had in 2008. That is the concern.

Mr. PERLMUTTER. Thank you, Doctor.

And I'am sorry, Dr. Lachman, that I didn't get to you. Maybe one of my colleagues can let you respond. Thanks.

Thanks, Mr. Chairman.

Mr. HUIZENGA. And my apologies to my friend from Colorado for totally being the deer in the headlights and blanking. So, 2 years of being directly next to each other and I am blank.

With that, we are going to go to Mr. Mulvaney for 5 minutes.

Mr. MULVANEY. Thank you, Mr. Chairman.

Gentlemen, I will read you a statement from last year's meeting of the Joint Economic Committee. It says, "With respect to employment, monetary policy as a general rule cannot influence the long run level of employment or unemployment." That is a true statement, isn't it? That is economic orthodoxy, correct? Does anyone disagree with that?

Mr. MAKIN. I will jump in. I essentially agree with that, that what monetary policy can do is to move employment increases forward, but they tend to get lost.

Mr. MULVANEY. I think the general consensus is they can affect short run, but not long run.

Dr. Posen, you had a look on your face like maybe you disagreed with that statement.

Mr. POSEN. I disagree slightly, sir. If you go to the most recent paper issued by the Federal Reserve by Mr. Wilcox and co-authors—

Mr. MULVANEY. I am familiar with it.

Mr. POSEN. —it talks about the idea of hysteresis, that if you have a negative shock it could become self-fulfilling; that people who are out of work for a long time don't get to get back into work at the same rate, say, of a young person. We saw monetary policy have a positive lasting effect on employment in the mid-1990s. We had welfare reform in the United States that increased the incentives for people to go to work. Monetary policy was allowed to run hotter for longer than it normally would have under the leadership of Chairman Greenspan. The unemployment rate dropped much lower than what people thought the limit was because of that. So under certain conditions, I think it can matter.

Mr. MULVANEY. All right. There is another quotation I will read very briefly: "In the longer run, increasing the potential growth of the economy, that is not really the Fed's job. That is the private sector's job and Congress' job in terms of things like the Tax Code, investment, infrastructure, and training." That is Chairman Bernanke. Both of those quotations are from him.

So my question to you is this: Why are we one of the only two countries that has the dual mandate? Is it because it is economic orthodoxy that you cannot impact—the Chairman of the Federal Reserve says that we cannot impact long-term employment with monetary policy. Yet, it is our mandate. And that is what I don't understand. Why are we one of two countries that has the mandate when we know that monetary policy can't influence it in the long run?

Dr. Lachman?

Mr. LACHMAN. I think one really has to be cautious. One really doesn't want to have a single mandate that you pursue with great vigor to the exclusion of what you are doing to the economy. That really gives the incentive for being too vigorous in the pursuit of the inflation. And I would just take a look at the European experience, where the single mandate right now is leading them down a path towards deflation—

Mr. MULVANEY. No, I don't know about that, because I went on to ask Dr. Bernanke on a similar line and what he told me was very clear. It is actually consistent with what Dr. Posen said earlier today, which is that the activities of the Fed over the course of the last several years since the crisis would have been essentially the same, because you could have undertaken the same policies for the last 4 or 5 years in the name of fighting deflation. We happen to be saying we are doing it in pursuit of full employment, or close to full employment, but really without the dual mandate, the Federal Reserve would have undertaken the same couple of steps. So I understand that.

I am just worried about the situation where those two things diverge. And that is what the paper is about, are we going to tolerate higher inflation in the future in order to pursue this lower rate of employment? And I guess my question is, why would we do that if we know that we cannot impact long-term employment.

But I am going to move on to my question, because Dr. Posen said some very interesting things in his testimony, his written testimony about limiting the tools. If I can very quickly recognize, we have a minute to cover two very important things. Limiting the tools. Should we limit some of the tools? If Detroit comes to Congress and asks for us to lend them money and we tell them no, shouldn't we restrict the Federal Reserve from participating in that? Wouldn't that be crossing the line into fiscal policy?

Mr. POSEN. Yes. But I am not sure you need to restrict it in advance. I think you can afford to wait and then call up the chairperson and say you made a bad judgment there, I wish you hadn't done that.

Mr. MULVANEY. Fair enough. I guess the cows are a little bit out of the barn after that, though, aren't they?

Mr. POSEN. No. Because just as happened in Japan, sir, you can make a major change. Obviously, it is like with the military, like with the FDA, at some point you let them do their job, and if they don't do their job right then you hold them accountable. You have to allow for that.

Mr. MULVANEY. Secondly, and I am sorry to cut you off, you recognize the fact we are limited on time, you mentioned indemnifying the Fed against the losses. Your paper says that of course they have made so much money over their lifetime that they would never eat into that surplus. I think it was actually a Bloomberg report recently that projects could lose as much as $537 billion, which would absorb all of the money that they have made. Tell me again how this indemnification would work. I am not familiar with that.

Mr. POSEN. Thank you. I will just be very quick. What has happened in the U.K. and a few other places is they say the balance sheet, any profits belong to the government, the elected government, as it should. And we reckon those at a set term, whether it is once a year, once every 2 years, once every 6 months. There is a fixed, transparent term that doesn't get played with.

If in the operation of your duties, not just benefiting Detroit because you happen to have a Governor of the Fed from Detroit, but in the operation of your general duties you take a loss on the balance sheet, there will be some buffer of the Fed's capital. You don't want to have that go to zero. It doesn't really matter if it does in economic terms, but it is seen as a problem. And so the Treasury or the Congress would say if that capital drops below a certain number, we will replenish it.

Mr. MULVANEY. Thank you, sir.

Mr. HUIZENGA. The gentleman's time has expired.

With that, we go to Mr. Carney of Delaware for 5 minutes.

Mr. CARNEY. Thank you, Mr. Chairman.

And thank you to each of the witnesses for being here today. This is a very interesting conversation. But I think at the end of the day the question is what is the role of Congress, what is the role of elected officials? Dr. Posen, you said that elected officials should set the goals and then check for results. And we have been talking, Mr. Mulvaney has been talking about the dual mandate of price stability and employment. Is there a general agreement among the panelists that ought to be the goals for the Fed?

Mr. MAKIN. Price stability and employment?

Mr. CARNEY. Yes.

Mr. MAKIN. I would disagree. I think I indicated earlier that price stability is something the Fed can achieve. There is not much evidence to indicate that they can achieve either a long-term reduction in the rate of unemployment or a long-term increase in the rate of employment growth.

Mr. CARNEY. How do you answer Dr. Lachman's answer to the last question, where he said if you get overboard like the European central banks have recently, you very negatively affect employment and the economy? Dr. Makin?

Mr. MAKIN. I am not quite sure that I understand Dr. Lachman's point. In other words, what the central bank is responding to in that type of a situation, it seems to me, based on what was happening in 2008, is the situation in the asset markets where you have a threat to the functioning of the financial system. So they are stepping in to try to sustain the financial system.

Mr. CARNEY. Okay. Fair enough.

How about the other two gentlemen and then Dr. Posen?

Mr. ORPHANIDES. If I may provide my response as well to Dr. Lachman's remark earlier on, I think that with regard to the euro area, we should not confuse what is happening, that is quite dramatic and unfortunate, as a failure of monetary policy. Unfortunately, it had nothing do with monetary policy. Monetary policy cannot fix it. We have a governance problem where the States are essentially fighting with each other and do not coordinate in a proper manner, because really they do not have a Federal Government and they do not have the equivalent of the U.S. Congress that can hold things together.

Mr. CARNEY. Okay. Fair enough.

Mr. ORPHANIDES. I would not really attribute to mistakes of monetary policy what we see in Europe. With that said, I would agree with Dr. Makin that in my view as well, price stability should be the primary objective of the central bank, because this is what they can be held accountable for. And then beyond that, I think what is critical for Congress is to watch the appointment process so that the independent officials who are appointed to make the tough decisions are the best possible.

Mr. CARNEY. Okay. Fair enough.

Dr. Lachman, how about you, where do you fall on this?

Mr. LACHMAN. I would just say that Europe has just emerged from its longest post-war recession, that inflation in Europe has gone down to levels that are now threatening deflation, and the central bank has been very slow in either reducing interest rates or taking measures to improve the monetary transmission mechanism in Europe. So to me it looks like the European Central Bank, with its single-minded mandate of getting prices very low, is risking the economy in terms of deflation.

Mr. CARNEY. So if you have a dual mandate, you are keeping your eye on two different things. And what does that require that central bankers do that mitigate against the severe kind of effect?

Mr. LACHMAN. I guess if they have a balanced approach towards meeting their target.

Mr. CARNEY. Thank you.

Dr. Posen, would you like to weigh in?

Mr. POSEN. Yes, really quickly. In an ideal world, it would be a dual mandate of price stability and avoiding excess volatility in the real economy, meaning huge swings in employment and growth, but not a level target for unemployment. I would still rather have Humphrey-Hawkins and the dual mandate as it is than a single mandate. I differ with Athanasios Orphanides on this. I think central banks that have the single mandate, I am echoing Dr. Lachman here, tend to become inflation nutters and not live up to their needed role. We also need to think about financial stability, whether it is said explicitly or not. Central banks have to worry about that.

Mr. MAKIN. Could I add a quick—

Mr. CARNEY. Sure.

Mr. MAKIN. The problem in Europe is not so much the lack of a dual mandate as it is that the European Central Bank is the central bank for over 20 very different countries.

Mr. CARNEY. So they effectively would have a difficult time affecting employment across those boundaries anyway.

Mr. MAKIN. Their policy is fine for Germany; it is terrible for Spain.

Mr. CARNEY. Thank you. Thank you all very much. I wish I had more time to carry on this conversation.

Mr. HUIZENGA. The gentleman yields back.

The Chair now recognizes Mr. Stutzman of Indiana for 5 minutes.

Mr. STUTZMAN. Thank you, Mr. Chairman.

I have really enjoyed this conversation. And I appreciate each of your perspectives.

Dr. Posen, you just made a comment, and I want to see if you could expound on it a little bit. You said price stability and then excessive volatility. Could you expound on that a little bit? Because I agree with you. I think certainty and stability is what is going to help middle income, help folks of lower income get to the next bracket, find the next rung on the ladder. Because right now that is what they don't have. They don't have certainty. Could you expound on that a little bit?

Mr. POSEN. I will try, Congressman. And I know from your past proposals that you are concerned about uncertainty generated by monetary policy, and I respect that concern.

Essentially what the issue is, as Dr. Orphanides on this panel and others have written about, is in the 1970s we made a huge mistake, as you are well aware, because we assumed there was this stable tradeoff between inflation and unemployment and that if we just were willing to accept higher inflation we would get lower unemployment. And that was doubly mistaken. First, we underestimated how costly the higher inflation would be. And second, we didn't get permanent employment gains; we just got temporary ones.

And so since that time there is a lot of academic work and a lot of policy work that has tried to get central bankers to not talk about employment at all. For various reasons that we have discussed, that seems to be something of a mistake. It takes it too far. But there is a truth there that if you target a specific rate of unemployment or you pretend that you can really control the unemployment rate through monetary policy, you probably are going to induce either inflation or uncertainty.

So what I found in practice, and this is something we did at the Bank of England, and which other central banks have done in the past, is to say we may not know precisely what the rate of unemployment is, and we may not be able to push it to where people beg us to push it, but we can see when there is a big swing in the economy, a very rapid change, be it a runup because there is some uncontrolled boom, say, through a housing bubble, or a rundown like we had in 2008 because of a financial crisis, and the real economy, meaning real people, real businesses, real savers are being put through the wringer, we should try and offset that. And doing that in a short-term way should not conflict with price stability.

Mr. STUTZMAN. Thank you. I appreciate that a lot.

I would like to go to Dr. Orphanides. I would like to ask about some of the experiences that have developed under the European Central Bank, which is the most recent central bank that stood up a developed economy or economies. Given your experience on the ECB Governing Council, what did the architects look to when determining how to structure the ECB? And then also, did they look to existing central banks as a model?

Mr. ORPHANIDES. Indeed, they did. And I have to say that I believe that the Federal Reserve did have an influence on the design, institutional design of the European Central Bank in two ways, both directly—the Fed is the closest they could look at in terms of a Federal institution that would bring together Federal Reserves, Federal Reserve banks, and the central banker in the middle, and coordinate this view—and also indirectly—so many of the elements that the ECB drew on were from the Bundesbank that was set up in the 1950s. But the Bundesbank, when it was set up in the 1950s, actually had a structure that also drew on the Federal Reserve.

So the ECB did try, and the founders of the ECB did try to bring the best they could find internationally in their experience. Indeed, this is why they selected to have the lexicographic mandate that places price stability first, because this is what had been recognized as the state of the art when this was done in the late 1980s and early 1990s. And I believe that is still the state of the art.

If I contrast that with the Fed, I think that the reason that the Fed has a dual mandate right now is simply because its own mandate was written in the 1970s, before we developed a consensus that suggests that focusing on price stability and helping central bankers not target real variables is best practice.

Mr. STUTZMAN. If I could quickly, Dr. Makin, if you could comment on Japan's QQE. Will it produce any different results from just the QE program in Japan?

Mr. MAKIN. I believe it will. The Bank of Japan has frequently attempted to get out of their deflationary trap. And until this year, the bank was very conservative when they announced more aggressive asset purchases. They said, we will be very cautious, we are worried about hyperinflation, it probably won't work.

This year, the Bank of Japan, under new leadership, undertook to set an inflation target of 2 percent, which is very important to do when you are trying to end deflation, which is a very different game, and they have suggested that they will follow through until they achieve the goal. The ironic result I think that the Bank of Japan came to realize is that a necessary condition to end deflation is to promise inflation, a sufficient condition as to make it happen, and then have the presence of mind to throttle back when the inflation actually picks up.

Mr. STUTZMAN. Thank you. I yield back, Mr. Chairman.

Mr. HUIZENGA. The gentleman's time has well expired.

I do appreciate everyone's charity as we are getting into some of these very important issues. And without objection, I think if the panel is willing to stay, we can maybe do another slightly quicker, if possible, lightning round of questions. I know I have some. And with that, I would like to recognize myself—and I don't anticipate using the 5 minutes—but I will recognize myself for 5 minutes.

Mr. Makin, I think I got your quote down, and I believe it was extemporaneous, I don't think it was in your written testimony, but eventually we need to abandon these extreme policies—this is the Fed, as you are talking about—just as Congress has done fiscally. There are a number of us who might be concerned that we haven't exactly abandoned our extreme policies on stimulus spending. In fact, we are having this debate right now dealing with unemployment going to be expiring at the end of the year, the extended 2 years instead of the much shorter time of almost a year. We have had that with additional funding that went into nutrition programs, WIC, and others.

And the political lesson that I have been learning out of this is that it is very difficult to extract out of that. And I think what you might have been hearing from Mr. Pearce and some of my other colleagues is it seems like we are taking care of Daddy Warbucks on Wall Street, and with quantitative easing we are, I think as Dr. Posen was pointing out, oftentimes that might be the vehicle you need to make sure you have a strong financial center to let that all trickle down, but there are a lot of us I think who are questioning, can we ever really get out of that cycle? And I am curious how the Fed is going to extract itself out of a QA position when you see markets and Wall Street and maybe markets around the world say, oh, no, no, we can't move off of $85 billion a month because that might mean we are going to have some movement here in a direction we don't like in the short term.

So if you care to answer that, and then Dr. Lachman, I would like you to, really quickly.

Mr. MAKIN. Mr. Chairman, you have certainly hit the nail on the head in terms of the dilemma. When I was thinking of fiscal policy, I was thinking that in spite of many complaints the Congress has managed to reduce the budget deficit by about a third over the past year through a combination of the sequestration cuts and the tax increases. And I was thinking of that progress.

The Fed's problem is perhaps just as difficult. And as I mentioned earlier, it is highlighted by what happens in the marketplace when, as Chairman Bernanke did in May, they hint they might buy less, and interest rates go up and security prices go down, and everybody gets very nervous. So the short answer is I don't know exactly how to do this. But neither does—

Mr. HUIZENGA. I think part of the problem, exactly right, is that neither does the Fed. Now, we are caught in this hamster wheel.

Mr. MAKIN. Nobody does. So I think in terms of being very practical, slowly and cautiously, and having reversibility as you go along, which is what I think the Fed is trying to engineer here. There is no book that tells you how to exit the Fed's current strategy.

Mr. HUIZENGA. Dr. Lachman?

Mr. LACHMAN. Yes, I would agree that we are in uncharted waters. But I think a crucial point is that the longer that we delay the decision, the bigger the chance that we get asset price bubbles, credit bubbles. We are at some point going to have to exit. By delaying it, we just are going to make the exit all the more difficult. We have been to this dance a number of times before.

So my fear is that if you keep printing $85 billion a month, and you have the Japanese printing $70 billion a month, what you are going to do is you are just going to create a very large asset and credit bubble that when you unwind it is going to be all the more difficult. So I think that you really have to be mindful that the benefits you get from the short run you might be getting at the price of large costs in the longer run.

Mr. HUIZENGA. I think I will do this in writing, because, Dr. Posen, we only have a minute left. But I would love to get a reaction from you at some point of how you envision that we are going to pull this liquidity out.

As Dr. Lachman is pointing out, Japan is at $70 billion a month, and we are at $85 billion a month. We don't know what the ECB is going to do. But apparently they are prepared to do something as well. And how do we extract ourselves.

I do want to ask a very specific question, and maybe we can get some answers in writing as well on that. What are those reforms that you would like to see us do as we are approaching this 100th anniversary? I think it was Dr. Posen, I am not sure, but there was some discussion about an 8-year—is this what the European Central Bank—maybe it was Dr. Orphanides—European Central Bank you get an appointment for an 8-year period, and then you are cycled out, correct, you are done? That to me sounds like something that might be a positive. I am curious if anybody has a reaction?

Mr. ORPHANIDES. There are two suggestions I would make. One is on the appointment process, that it would simplify and reduce the political battles we have right now with multiple rounds of potential appointments if you have a one-term, nonrenewable, longer term for all Board Members. Eight years is what is being done at the ECB. I think that would work better in the United States as well.

The most important change, however, I think is to clarify the mandate. I am concerned that the lack of clarity of the mandate will be creating difficulties going forward precisely because we have the uncharted territory and the humongous, I think was the technical term used earlier, size of the balance sheet of the Federal Reserve.

Mr. HUIZENGA. All right. Thank you.

Mr. Carney is recognized for 5 minutes.

Mr. CARNEY. Thank you. I am not sure I will need the whole 5 minutes. But I do want to go back to—

Mr. HUIZENGA. That is what I thought, too.

Mr. CARNEY. —our discussion again.

Not long after our discussion, Dr. Posen, you made an argument against the dual mandate I think when referring to the experience of the 1970s. Was that what that was?

Mr. POSEN. It was an argument, sir, against setting a specific level of unemployment target. So, I am in favor of the dual mandate that there has to be concern for the real economy for growth and employment as well as price stability.

Mr. CARNEY. Because it creates a sense of balance in the thinking of the Members?

Mr. POSEN. Exactly. And it gives you room to respond to very large short-term fluctuations in the economy. And I would still, as I said to you, I would still rather have a dual mandate with an unemployment level than a single mandate.

Mr. CARNEY. Great.

Dr. Lachman, in your testimony you talk about the Lehman crisis and what you considered the effective response of the central banks and the Fed and how it avoided a global meltdown and a lot worse conditions than we saw. And you reference certain programs, including TARP. Have we eliminated tools that the Fed needs to address a crisis in the future?

Mr. LACHMAN. I don't know whether you have eliminated them, but I think that the Dodd-Frank Act might put certain limits on what they can do or that their room for maneuver isn't quite as what it would be prior to the Lehman crisis.

Mr. CARNEY. Notwithstanding some of the rhetoric in this committee, we can't bail out banks in the way that was done in 2008.

There is an orderly liquidation process, as you may know, that banks are required to go through once it is determined that they are dying, I guess. Is that a good thing or a bad thing from the perspective of the broader economy? Forget about the politics of it.

Mr. LACHMAN. My concern is that if we really do build up very large credit and asset bubbles, we have a chance that we are back into the kind of situation that we were at the Lehman crisis, in which case you would want a Federal Reserve that had wide capabilities of dealing with the mess when it occurred.

Mr. CARNEY. Lastly, what should our role be as a subcommittee of Congress? Or what should Congress' role be? Just, in a sentence or two each, each of you.

Dr. Posen?

Mr. POSEN. As I tried to say in my written testimony, which I apologize for delivering so late, I think Congress' role should be very aggressive control of two things. First, what the stated goals of the Federal Reserve are, and changing those every couple of years as needed. Not, obviously, every day. That would be counterproductive. But as needed. And second, as I tried to say to the gentleman—sorry, I don't remember what State you are from, I apologize.

Mr. CARNEY. New Mexico.

Mr. POSEN. Thank you. The gentleman from New Mexico, the Congressman from New Mexico, that you need to have much more retrospective accountability of holding Fed officials, did you do your job well or not? What specifically did you do? And are you accountable for that? But doing it in a holistic, retrospective way, not a starting off and saying there are things we want the Fed to do and not do. It has to be context and results based.

Mr. CARNEY. Dr. Makin?

Mr. MAKIN. Yes, I would like to see a directive for the Fed to pursue price stability, but not to ignore other goals. In other words, to emphasize that the Fed consistently pursues price stability and minimizes uncertainty, and thereby helps to improve the picture for employment and asset prices. In other words, I don't think the Fed should be seen as saying, hey, we don't care what happens. But they should be seen as saying, we want to continue to maintain low and stable inflation. There is a lot of empirical evidence to suggest that the economy performs better under those circumstances and that labor markets perform better as well.

Mr. CARNEY. Dr. Orphanides?

Mr. ORPHANIDES. I am a supporter of the primacy of price stability as an objective. And something we did not discuss sufficiently today, I believe, is that financial stability should be elevated as one of the explicit secondary mandates of the Federal Reserve rather than growth and employment. Those come naturally once you have price stability and financial stability.

Mr. CARNEY. Dr. Lachman, a last word?

Mr. LACHMAN. Yes. I agree with the way Dr. Posen posed the idea that the dual mandate should be working without a specific unemployment target. I am not sure that Congress should limit itself to retroactive review of the purchases that the Fed is doing given the scale of the purchases and given that it does have a distribution effect. I would think that Congress should have some input into those decisions.

Mr. CARNEY. Thank you.

Mr. HUIZENGA. The gentleman's time has expired.

With that, we will go to the gentleman from New Mexico, Mr. Pearce, for 5 minutes.

Mr. PEARCE. Thank you, Mr. Chairman.

So we began this process—and Dr. Lachman, I am probably going to come to you—of quantitative easing, printing money, whatever you are going to call it, and now it looks like we have initiated maybe that kind of an effect worldwide, that if it is good for us, everybody can do it. What are the downside effects of everybody beginning to create money out of thin air?

Mr. LACHMAN. I think the reason that everybody has to do it is it does have impact on their currencies. That cheapens certain currencies, puts countries at a disadvantage. They will find themselves in the same position, so they go ahead with doing it.

My view is that if all of us do this to a very large degree, and we have global financial markets, the risk is that what you get is you get global bubbles, and that when you begin withdrawing from that policy you are going to be paying a heavy price. I am not saying that quantitative easing wasn't the right thing to do at the time that it was initiated. But I am saying that now that the balance sheets are so large and it looks like there is froth in the markets, I think that there has to be pause as to whether you just continue this indefinitely or do you start the process of unwinding.

Mr. PEARCE. But then when we started unwinding we had one Member of the Federal Reserve saying at one point the same day we need to start tapering, and another Member of the Federal Reserve shrieked that we can't start tapering. And so you get this mixed signal, and the markets are a little bit volatile.

What is going to happen, Dr. Orphanides, if we get dropped as the world's reserve currency? What will the effect of the quantitative easing be on the currency inside the United States?

Mr. ORPHANIDES. I would put this in reverse. Of course, it would be catastrophic for the United States if the dollar loses the status of reserve currency.

Mr. PEARCE. And so, it would be catastrophic.

Mr. ORPHANIDES. This is one of the risks of continuously expanding the balance sheet of the Federal Reserve without having—

Mr. PEARCE. If I can reclaim my time, it would be catastrophic. You can look at Argentina. They don't have a currency. They can't export inflation like we do. We get to export to 200 other countries, and so we diminish the effects inside. And so Argentina a couple of years ago had a 1,500 percent inflation rate, and so your statement that it would be catastrophic. So it really got my attention this year, maybe it was late last year, that the BRIC nations said they were going to start trading in other currency—Brazil, Russia, India, and China—and then two of them actually did that.

So we are getting these warning signs from the rest of the world that you are creating some very unstable things with very catastrophic effects. We have started a printing war. And nobody knows the way out. Any hope? So what stops it all? Anyone? Dr.

Makin, I will just come to you next. Dr. Posen, I give you the last shot to wrap it up.

Mr. MAKIN. There would be much more cause for urgent concern if we were seeing all this money printing and observing a big pick-up in inflation. In fact, we are seeing the reverse, that inflation is actually slowing down. It is below 1 percent in Europe. It is about 1.2 percent in the United States. And so, you have a deflationary situation that was kind of akin to what was happening in the early 1930s, and central banks tend to want to export deflation by printing money, causing their currencies to depreciate, which means other currencies appreciate.

So we have to avoid a kind of overt currency war of that type and at the same time try to get past a situation where everybody is using easy money to get a bigger piece of world trade. In other words, avoid a trade war, which is one of the things that made the Depression worse.

Mr. PEARCE. Thank you.

Dr. Posen, I assume that was your saying. You didn't really have a comment to make on this.

I guess the final thing is, what does this look like to the American family? My dad raised 6 of us on $2.62 an hour, the entry level in the oil field. Today, what his dollar would buy it takes $12 to buy. I think that is one of the reasons we are having such great stress in the American economy, that the value of what people make is being diminished radically by policies that the government is setting.

I yield back, Mr. Chairman.

Mr. HUIZENGA. The gentleman yields back.

Seeing none on my over side of the dais here, we will go to Mr. Mulvaney for 5 minutes.

Mr. MULVANEY. Thank you.

Mr. HUIZENGA. And I should also announce we have just gotten notice that we will have votes at about 4:15. So if it is all right with you gentlemen, we will be wrapping up shortly after this round.

Mr. MULVANEY. Thank you, Mr. Chairman. And thank you for the opportunity to do a second round of questions.

Dr. Posen, this gives us an opportunity to spend a little more time on the last topic we had to sort of rush through at the end. I think I misspoke on a couple of numbers. And I want to give you the opportunity to speak at some length as well. We are talking about losses on the Federal Reserve's balance sheet. I asked you previously about the concept of indemnification. I want to point out in your testimony the thing that caught my attention and re-ask my question.

It is on page 10, the last paragraph: "Worries about losses on risky assets are nothing but a distraction. Whether the Fed temporarily loses money on a small portion of its portfolio or temporarily distorts a hypothetical pure market outcome for a particular asset class in service of that greater good should not be a constraint on doing the right thing."

You go on to close by saying, "And of course, the cumulative gains that the Fed has transferred to the U.S. Treasury over the decades outweigh by two orders of magnitude any potential losses on the Fed's balance sheet."

I guess we could have had a long conversation of a day about whether or not losses that the Fed faces now, the potential losses, and the number was actually $547 billion that Bloomberg estimated the Federal Reserve could lose in a higher interest rate environment, whether or not that is a temporary loss on a small part of its portfolio or whether or not we are simply seeing a temporary distortion in the pure market for, say, mortgages, or whether or not there is a larger, more significant distortion.

I want to come to the issue about the cumulative gains and losses. The point that I was making is that I think of the cumulative gains last year, the combined earnings of the Fed, out of the combined earnings they were able to return back to the Treasury about $89 billion, $90 billion. And this is, as you mentioned, the case with other central banks, the policy, which is they take much of their combined earnings, they give it back to the Treasury.

But now we are facing, and I had several Members of the Federal Reserve actually admit that they were facing the likelihood of large losses over a longer period of time. In a higher interest rate environment and a $4 trillion balance sheet, these losses could be substantial. Again, as Bloomberg estimated, on the order of half a trillion dollars.

So I would ask you again to walk me through this process of indemnification. And I am seriously asking a question to which I don't know the answer, which is a dangerous thing to do in Congress, but I have not heard that before. And I would like you to walk me through it. Maybe we can talk about it a little bit.

Mr. POSEN. Thank you, sir. I will try to be responsive.

Just one note on the numbers. I don't remember the particular Bloomberg report you are discussing. You can create, and I don't mean that in a bad way, you can on some reasonable assumptions create loss numbers that big. I would suggest that those loss numbers are pretty much the upper bounds.

Mr. MULVANEY. I will tell you, and I don't mean to cut you off, but I will tell you that we actually had witnesses in another hearing say that 100 basis points would lead to roughly $100 billion in losses.

Mr. POSEN. That sounds about right. But again, you have to spread that over several years probably. But, yes. I think that is fair.

So onto the point of the indemnification. The idea is not that the Congress and therefore the American people are writing a check to the Fed to fill up its balance sheet in total.

Mr. MULVANEY. That is what it sounded like, so I am glad you went there first.

Mr. POSEN. I tried to say, and I apologize for being unclear or too cryptic, there is a core level of the balance sheet, just like with a private business, that is essentially the Fed's capital. It needs a certain amount of equity in order to conduct its operations. That amount is a tiny fraction of the $2 trillion balance sheet we now have. The Fed was able to do its operations back before 2008 with a balance sheet that was a very small portion of what it now is.

Mr. MULVANEY. Balance sheet is $4 trillion, right?

Mr. POSEN. Sorry, $4 trillion.

Mr. MULVANEY. $2 trillion, $4 trillion, pretty soon it is real money. Right. I get it.

Mr. POSEN. The point being that all you would be indemnifying the Fed for is that it wouldn't have to at some point under duress come to Congress or come to the executive and say, we have no money left in the kitty.

Mr. MULVANEY. Can't they just conjure it up?

Mr. POSEN. They can, but that would be inflationary. And then also there would be room for people to say, oh, the Fed is a rogue entity. It is just making up its own policy. It is unconstrained. I think it is legitimate for Congress to have the control of saying we own, in some sense, the Fed. We own the equity. But the amount you need to identify, again, I want to stress this, is a very small amount. I don't know what the exact number is, but it would probably—

Mr. MULVANEY. If the Fed were to lose $100 billion, Dr. Posen, who loses that money? I understand who gains. They make $100 billion, their combined earnings are $100 billion, they remit that to the Fed, the deficit goes down, the taxpayers are better off. When they lose that same $100 billion, who loses?

Mr. POSEN. Unless and until they run out of money for their operations, on paper they lose that asset. Right? So the balance sheet of the Fed shrinks. And that is it. The balance sheet of the Fed shrinks.

Mr. MULVANEY. Thank you. Again, I appreciate the opportunity for the longer discussion. Thank you, Mr. Chairman.

Mr. HUIZENGA. I appreciate that.

And with that, we will recognize Mr. Stutzman for the last 5 minutes.

Mr. STUTZMAN. Thank you, Mr. Chairman.

Dr. Makin, I would like to come back to you about the Japanese policy and quantitative and qualitative easing. How is it that the Japanese Government can be so involved in the Bank of Japan's policy decisions?

Mr. MAKIN. The Bank of Japan is not that independent. And so the Prime Minister—it is a parliamentary government—was very clear when he was elected that he was going to appoint people at the Bank of Japan who would be very aggressive about pursuing an inflation target, and did appoint Mr. Kuroda, who promptly followed that line. So the Bank of Japan is obviously not independent, because we wouldn't see in the United States, for example, a similar directive.

Mr. STUTZMAN. Okay.

Dr. Lachman, how does the Bank of England or the Swiss National Bank remain accountable to their national government if they are an independent entity? There has to be some sort of expectations and accountability between the two at some point, doesn't there?

Mr. LACHMAN. Absolutely. And Dr. Posen can probably talk better to it with the Bank of England. But the government is very much involved in setting what the goals are for the Bank of England in terms of an inflation target. And the Bank of England has to report at regular intervals on how it is doing with respect to the inflation target. So you are granting them what one would call instrument independence, but you are setting for them what the goals are.

Mr. STUTZMAN. And, Dr. Posen, if you would want to comment on this as well, because it just seems to be fascinating, especially even with the European Central Bank, the challenges that they would have within the European Union could be even greater. But, Dr. Posen, if you could maybe talk a little bit about the Bank of England and how their government relates to the different committees that they have structured?

Mr. POSEN. Thank you. My colleague, Dr. Lachman, has it essentially right. There is an explicit inflation target set for the Bank of England. That target is set by the elected government. They can review it at any time, although for practical reasons of not wanting to seem too inflationary or too disruptive to markets, they generally review it every few years.

Mr. STUTZMAN. And you mentioned that earlier. Is that something that appears to work for them?

Mr. POSEN. A colleague of mine, Kenneth Kuttner from Williams College, and I just did a paper in which we showed that there is really no difference in inflation performance between central banks like the Bank of England, but not just the Bank of England, where the target gets reset by Parliament or the executive, versus central banks like the ECB, where you have very little control. It is just a question of legal structure.

And if I may, I had the privilege to co-author with current Fed Chairman Bernanke a book on inflation targeting that came out back in 1999. And one of the main arguments we made for it was not to solely focus on inflation, because that would provide more accountability for the Fed.

Mr. STUTZMAN. So you think that creates not only accountability for the Fed, but you think that by resetting they can refocus on what the environment is for the day. How often would they potentially or have they historically reset, maybe at the Bank of England or some other—

Mr. POSEN. Let me give you just three quick examples. At the Bank of England, they have reset it approximately 4 times in 16 years. One was a purely definitional thing. There was a particular inflation series. They switched the inflation series. Actually, it is only 3 times. And the most recent one was explicitly telling the bank not to worry about fluctuations in output as long as you don't really imperil inflation. So, that was a change in focus.

The Swiss National Bank, which is very independent, had a reset. There is a speech the current Swiss Bank Governor gave at our institute that is available on our Web site, they were facing, as I think Dr. Makin mentioned, huge capital inflows out of Europe that were driving up their currency and causing them deflation. And they explicitly changed their goal to doing with the exchange rate to try to keep a lid on that imported deflation. And that required parliamentary approval.

Mr. STUTZMAN. Thank you. I find it very fascinating.

I yield back, Mr. Chairman.

Mr. HUIZENGA. The gentleman yields back. And I, too, actually sat down with the Swiss Ambassador right about that time. And it was interesting. It was a flight of capital.

Mr. POSEN. Yes.

Mr. HUIZENGA. Flight of capital to something that was solid, the Swiss franc, and that was the reaction that they were having to deal with.

All right. I would like to thank each one of our witnesses again for your testimony today. This was I think very helpful, very illuminating.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

This hearing is now adjourned.

[Whereupon, at 4:13 p.m., the hearing was adjourned.]

A P P E N D I X

November 13, 2013

American Enterprise Institute
for Public Policy Research

Statement before the House Financial Service Committee's Subcommittee
on Monetary Policy and Trade

What is central about central banking? : A Survey of International Models

Desmond Lachman

Resident Fellow
American Enterprise Institute

November 13, 2013

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute

What is central about central banking? : A Survey of International Models

Testimony for the House Financial Service Committee's Subcommittee on Monetary Policy and Trade

Desmond Lachman

Resident Fellow
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November 13, 2013

Thank you Chairman Campbell, Ranking Member Clay, and members of the Subcommittee for affording me the great honor of testifying before you today. My name is Desmond Lachman and I am a Resident Fellow at the American Enterprise Institute. I am here in my personal capacity and I am not here to represent the AEI's view.

Introduction

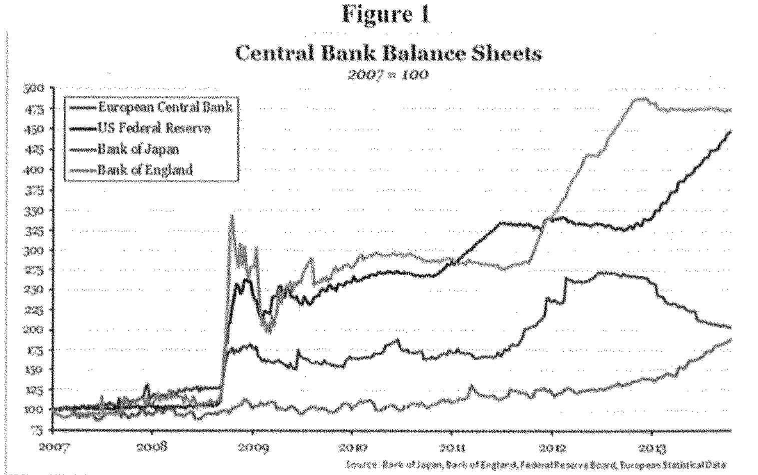
Over the past five years, in the aftermath of the Great Economic Recession, the Federal Reserve, the European Central Bank, the Bank of Japan, and the Bank of England have all pursued unorthodox monetary policies on an unprecedented scale. They have done so in an effort to stabilize their respective countries' financial systems and in an attempt to both support an economic recovery and to avoid deflation. This has led to a massive expansion in these central banks' balance sheets and it has taken monetary policy into entirely uncharted waters.

There can be little question that unorthodox monetary policies were successful in stabilizing the major industrialized economies' respective financial systems in the immediate aftermath of the September 2008 Lehman crisis. It also would seem that they have succeeded in providing welcome support to these economies' recoveries by substantially lowering long-term interest rates and by increasing asset prices. However, these policies have come with a host of unintended consequences, including incipient asset and credit market bubbles, which both cloud the global economy's longer-run economic outlook and which must raise questions as to whether the limits of these policies' usefulness are now being reached. They have also had important spillover effects on other economies in general and on the emerging market economies in particular that now pose a real risk to the global economic outlook.

Similarity and differences in policies

Since September 2008, the motivation for the simultaneous pursuit of unorthodox monetary policies in the major industrialized economies has been broadly similar. All of these countries' central banks needed to intervene aggressively in their financial markets to repair the damage wrought by the Lehman crisis. In addition, with policy interest rates having effectively reached their zero lower bound and with unusually weak economic recoveries and very low inflation, these central banks have all felt obliged to resort to policies aimed at stimulating the recovery. They have attempted to so by reducing long-term interest rates and increasing asset prices by massively expanding their balance sheets (Figure1).

Figure 1



While unorthodox monetary policies have led to a dramatic expansion in all four major central banks' balance sheets, there have been marked differences in the manner in which these central banks have implemented their monetary policies. Underlying these difference have been basic differences in the structure of these countries' financial systems as well as in the specific problems that these individual central banks have been trying to address. Whereas in the United States and the United Kingdom the preponderance of borrowing takes place in the bond market, in Europe most borrowing is intermediated through the banking system. This explains why quantitative easing in the United States and United Kingdom has been effected through large scale bond purchases while in Europe the expansion in the ECB's balance sheet has been implemented mainly through bank lending.

Beyond the common goal of supporting economic recovery, there have been differences in the specific additional problems that the individual central banks have tried to address. In the United States the Federal Reserve has tried to support the US mortgage market through large scale purchases of mortgage-backed securities; in Europe the ECB has taken fundamental measures to support the sovereign debt markets of countries in the European economic periphery; in Japan the primary objective of the Bank of Japan has been to put an end to years of deflation; and in the United Kingdom an important objective of monetary policy has been to encourage corporate borrowing.

Institutional differences between the major economies would also explain why the major central banks have reacted to the crisis with the use of different policy instruments. As an example, although the ECB does enjoy at least as great a degree of policy independence as does the Federal Reserve, the Treaty of Lisbon highly circumscribes its freedom to directly finance member state governments. For this reason, the ECB has resorted to Long Term Refinance Operations rather than government bond purchases to support the economic recovery.

These differences in in institutional structures and in specific objectives are reflected in the present main thrust of the unorthodox monetary policies as between the different central banks, which might be summarized as follows:

- In **the United States**, since September 2012 the Federal Reserve has been engaged in an open-ended third-round of quantitative easing. This has involved the purchase of US Treasury bonds and mortgage-backed securities at a rate of US$85 billion a month. In addition, the Federal Reserve is providing forward guidance to the markets by indicating that it will not raise its policy rate so long as unemployment remains above 6.5 percent and inflation expectations remain well anchored.

- **In Europe,** since December 2011, the ECB has provided massive support to the European banks through its Long Term Refinance Operation (LTRO). This operation provided unlimited three-year financing to European banks against a widened definition of collateral. In addition, since August 2012, the ECB has provided major support to the European sovereign debt market through its Outright Monetary Transaction Program. Under this program, the ECB has offered to buy unlimited amounts of any member country's sovereign bonds with a maturity of up to three years, subject to that country applying to the European Stability Mechanism for an economic adjustment program.

- **In Japan,** in April 2013, the Bank of Japan (BOJ) introduced a quantitative and qualitative easing (QQME) framework to end deflation and to achieve its 2 percent inflation target within two years. Under QQME, the BOJ aims to double its monetary base by 2014 to around 55 percent of GDP. An important part of the QQME program was the broadening of monetary easing to include long-dated government securities and private sector risk assets.

- **In the United Kingdom,** since January 2009, the Bank of England has engaged in quantitative easing that has involved bond purchases in an amount that has totaled around 25 percent of the country's GDP. In addition, in July 2012, the Bank of England, together with the UK Treasury, initiated a Funding for Lending Scheme, which aimed at reducing funding costs for banks and boosting credit supply.

Assessing Unorthodox Policies

Assessing the relative success of the unorthodox monetary policy pursued by the major industrialized countries is rendered difficult and subject to debate for two basic reasons. The first is that we cannot know what the counterfactual would have been had these policies not been pursued. The second is that it is still far too early to know what the longer run consequences of these policies will be since we do not yet know what will happen once these policies are unwound.

Despite these caveats, as will be elaborated upon below, there are good reasons to believe that unorthodox monetary policies have had a salutary short-run impact on both the individual economies concerned as well as upon the global economy. However, it would also seem that these policies have given rise to unintended consequences and to global spillovers, which must raise serious concerns about the longer run global economic outlook and which must pose questions as to whether the limits of these policies have now been reached.

Short-run relative success

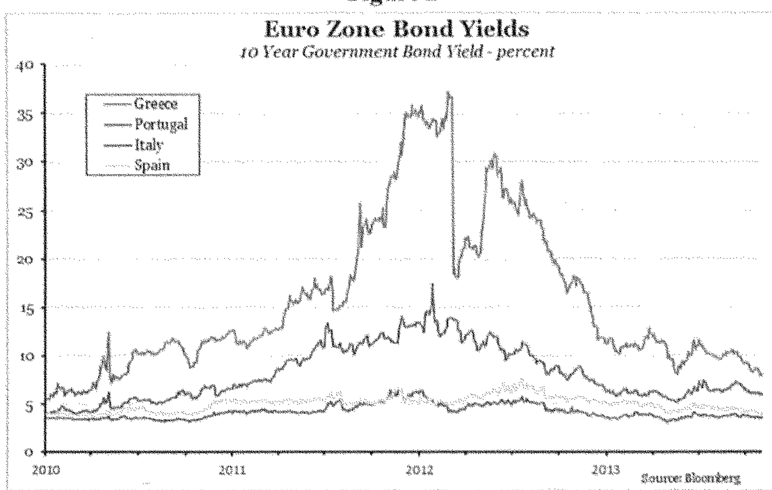
In the immediate aftermath of the September 2008 Lehman crisis, central banks in the industrialized countries resorted to a variety of bold and unorthodox measures with a view to restoring the proper functioning of the financial system. Subsequently, in response to the weakest industrial country recovery in the post-war period as well as to very low inflation rates, they resorted to different variants of very large-scale quantitative easing programs. They did so with a view to restoring aggregate demand by lowering long term interest rates, by encouraging risk taking, by increasing asset prices, and, although they would be the last to admit it, by cheapening their respective currencies.

There is little room for debate about the major central banks' success in restoring the proper functioning of the global financial system. Through innovative programs such as TALF, TAF, TARP, SMP, and LTRO, bank access to liquidity was substantially eased. Further, by lending long-term without asking too many questions of the collateral they received and by buying assets well beyond their usual limits, the world's major central banks restored liquidity to a world financial system that would otherwise have been insolvent based on prevailing market prices.

There would also seem to be little room for doubt that the world's major central banks succeeded in lowering long-term interest rates and in boosting asset prices. Long-term borrowing costs for both the government and the private sector were reduced to post-war lows in the industrialized countries. At the same time, there has been an appreciable recovery in global home prices, while global equity prices have risen sharply from their post-Lehman lows to a six-year high.

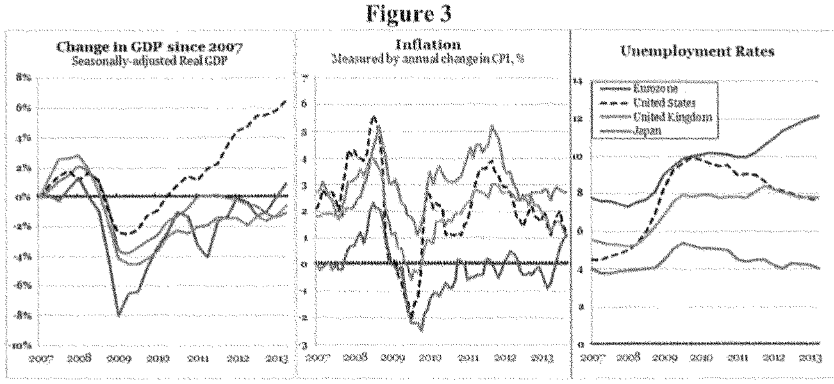
Two particular successes of recent central bank intervention warrant mention. The ECB's Outright Monetary Transaction program announced in August 2012 succeeded in substantially reducing sovereign borrowing costs in Europe's troubled economic periphery (Figure 2). It did so by removing the tail risk of an imminent Euro breakup though offering governments in the periphery with a credible financial backstop. Similarly, the Bank of Japan's more aggressive round of quantitative easing announced at end 2012 succeeded in substantially weakening the Japanese yen thereby increasing Japanese inflationary expectations.

Figure 2



Despite the success of unorthodox monetary policies in reducing long term interest rates and in increasing asset prices, the economic recovery in the industrialized countries has been highly disappointing (Figure 3). While in the United States it is true that the economy has by now significantly surpassed its 2008 peak, the current US economic recovery remains the weakest in the post-war period. Meanwhile, output levels in Europe, the United Kingdom, and Japan are yet to regain their 2008 level. Making matters worse in the United Kingdom is the fact that despite anemic economic growth, inflation has significantly exceeded the Bank of England's inflation target.

Figure 3

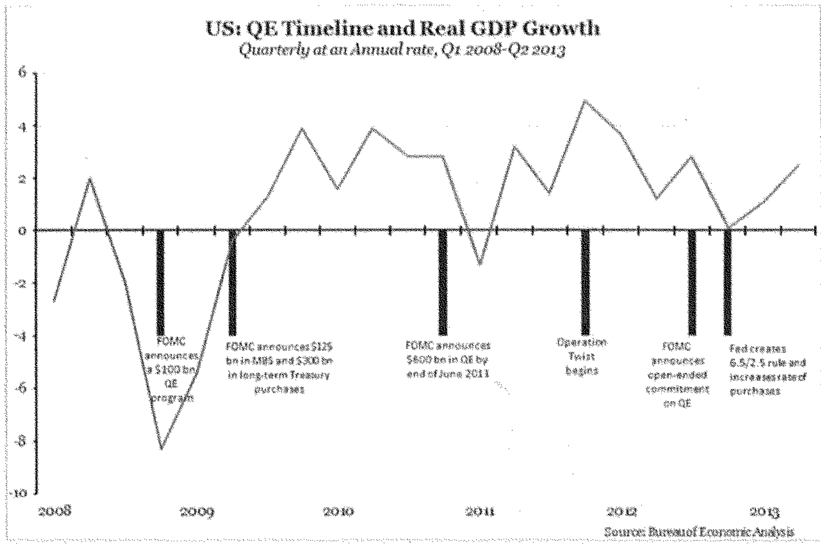


Source: Bloomberg

Among the factors accounting for Europe's weak economic performance and clouding its longer run economic outlook has been the breakdown of the ECB's monetary transmission mechanism and the absence of a banking union that might address the credit crunch hampering a recovery in Europe's economic periphery. While the ECB has now begun an asset evaluation exercise of the major European banks, there is little immediate prospect of either bank recapitalization or of policy action to reduce the gap between borrowing costs in the European economic periphery and those in the European core. This now raises the real specter of deflation especially in the European economic periphery.

Critics of quantitative easing observe that the economic recovery in the industrialized countries is the weakest of the post-war period. While true, this criticism would not seem to be a serious indictment of recent quantitative easing policies. It overlooks the fact that, absent forceful central bank action, it is highly probable that the industrialized countries would have again lapsed into a meaningful economic recession (Figure 4).

Figure 4



Unintended consequences

A more serious line of criticism of the unorthodox monetary policies being pursued by the world's major central banks is that too little regard is being paid to the unintended consequences flowing from these policies. These consequences could materially compromise the longer-run global economic outlook. Among these unintended consequences are (a) the risk that these policies might be giving rise to excessive risk taking and to bubbles in asset and credit markets; (b) the large spillovers to other economies through capital flows and exchange rate movements; (c) the moral hazard that these policies might be causing by reducing the urgency for governments to undertake necessary but painful economic reforms; and (d) the risk that exit from these policies might cause global financial market dislocations.

An important aim of the quantitative easing policies pursued in the United States, the United Kingdom, and Japan has been to encourage risk taking and to raise asset prices as the means to stimulate aggregate demand. The question that now needs to be asked is whether these policies might not have given rise to excessive risk taking, to overleverage, and to bubbles in asset and credit markets.

In this context one has to wonder whether historically low junk bond yields in the industrialized countries now understate the risk of owning those bonds (Figure 5). One also has to wonder whether yields on sovereign bonds in the European periphery have not become disassociated from those countries' underlying economic fundamentals and whether global equity valuations have not become excessively rich.

Figure 5

S&P 500 and High-Yield Corporate Bonds

Source: Bloomberg

Over the past year, the aggressive Federal Reserve and BOJ quantitative easing policies has given rise to large scale capital flows and to significant exchange rate movements. The Japanese yen has depreciated by around 20 percent since the launch of Abenomics in December 2012, which has given rise to complaints about competitive currency depreciation from countries like China and Korea. Meanwhile the Euro has appreciated by around 5 percent, which is hardly helpful to a European economy that is the worst performing of the major industrialized economies.

Recent capital flows and currency movements have been particularly disruptive to the emerging market economies, which have been the main engine of global economic growth. These countries have had the greatest of difficulties in preventing these large capital inflows from causing their currencies to become overvalued and their external current accounts to widen to unsustainable levels. These countries' vulnerability to a change in global liquidity conditions has been all too apparent in the wake of Ben Bernanke's intimation in May 2013 that the Federal Reserve might start tapering its bond purchase program. That intimation caused sharp currency depreciations in Brazil, India, Indonesia, South Africa and Turkey, which prompted the IMF to significantly downgrade its economic growth forecast for the emerging market economies.

Yet another unintended consequence of the unorthodox monetary policies is the moral hazard to which they are giving rise. This is particularly apparent in both Europe and Japan. Europe is not using the breathing space in its sovereign debt market that the ECB's Outright Monetary Transactions program has afforded it to move more expeditiously towards a banking union and a fiscal union that would seem necessary to put the Euro on a firmer footing. Similarly, the very much more expansionary monetary policy by the Bank of Japan seems to be blunting the urgency for the Japanese government to move ahead with structural reform which was supposed to be an important pillar of the Abenomics program.

Lessons for the United States

Since the Lehman crisis in September 2008, the US economy has performed relatively well in relation to those of the Eurozone, Japan, and the United Kingdom in terms of output and employment growth. Nevertheless it would seem that at least two lessons for the Federal Reserve can be drawn from the experience of the central banks in those countries:

a. Europe's particularly poor economic performance in the aftermath of the Lehman crisis would suggest that a single inflation objective mandate and a high degree of central bank independence do not guarantee meaningful economic recovery. It would also suggest that financial market fragmentation imposes a high economic cost and that a single monetary policy not backed by a banking and fiscal union is a bad idea.

b. Japan's prolonged experience with deflation over the past decade would underline the costs of too passive a monetary policy stance in the face of economic weakness. This point would also be supported by Japan's very much better economic performance since the start of this year in response to a very much more aggressive Bank of Japan monetary policy.

Equally pertinent lessons would seem to be on offer from the Federal Reserve's own unfortunate past experience from creating asset and credit market bubbles as well as from its previous experience in fighting inflation:

a. In the period immediately ahead, the Federal Reserve will be confronted with the most difficult of policy choices. A lackluster economic recovery and very low inflation would argue in favor of maintaining the present pace of quantitative easing. Yet doing so would accentuate the longer-run unintended consequences of these policies that are already so much in evidence. One has to hope that the Federal Reserve will strike the right balance between the short run gains to be obtained from further quantitative easing and the longer-run adverse costs of those policies. In particular, one must hope that the Federal Reserve refrains from repeating its past mistake of unduly fueling asset and credit market bubbles as well as of contributing to undue exchange market volatility.

b. From a longer-run perspective one also has to be concerned about the massive expansion of the Federal Reserve's balance sheet. In particular, one has to be concerned that the Federal Reserve will find it politically difficult to normalize interest rates once an economic recovery eventually gathers steam. This has to raise serious concerns about the longer-term inflation outlook, which would argue in favor of ensuring that the Federal Reserve's independence to raise interest rates as needed is not compromised.

c. The Fed's massive asset purchase program has had both important distributional effects amongst wealth owners and it has exposed the US taxpayer to considerable risk. One might reasonably question whether these Fed activities have been subject to sufficient Congressional scrutiny.

Biography of Desmond Lachman

Desmond Lachman is a Resident Fellow at the American Enterprise Institute (AEI). He joined the AEI after serving as a managing director and chief emerging market economic strategist at Salomon Smith Barney. He previously served as deputy director in the International Monetary Fund's (IMF) Policy Development and Review Department and was active in staff formulation of IMF policies. Mr. Lachman has written extensively on the global economic crisis, the U.S. housing market bust, the U.S. dollar, and the strains in the euro area. At AEI, Mr. Lachman is focused on the global macro-economy, global currency issues, and the multilateral lending agencies.

Experience

- Adjunct Professor, Georgetown University, 2010
- Adjunct Professor, Johns Hopkins University, 2009
- Managing Director and Chief Emerging Market Economic Strategist, Salomon Smith Barney, 1996-2003
- Deputy Director, Policy Development and Review Department, International Monetary Fund, 1994-96
- Senior Advisor, European Department, 1990-94; Division Chief, Western Hemisphere Department, 1984-90, International Monetary Fund

Education

Ph.D., economics, Cambridge University
B.A., University of Witwatersrand

American Enterprise Institute for Public Policy Research

Statement before the Committee on Financial Services

Subcommittee on Monetary Policy and Trade

On "What's Central about Central Banking?"

Central Banking since the 2008 Global Financial Crisis

John H. Makin

Resident Scholar

American Enterprise Institute

Wednesday, November 13, 2013

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.[*]

[*] Thanks to Brittany Pineros for her able research assistance.

Chairman Campbell, Ranking member Clay, and members of the committee I am pleased to offer testimony on practices of central banks since the great financial crisis of 2008. While the last 5 years has been a very challenging period for all central banks, a review of practices and outcomes will suggest that the Federal Reserve and the United States have performed very well relative to other countries based on yard sticks measuring economic performance.

I will start with an overview of central bank practices since 2008, then review the practices in some detail, present a summary of economic and financial performance since 2008, and finally, discuss the policy dilemma facing some central banks.

Overview

Among major central banks, the Federal Reserve has been the primary innovator since the 2008 financial crisis presented governments and central banks with serious challenges. Given the global reach of the crisis and the threats of deflation, persistent unemployment and low growth, and potential insolvency of banks and insurance companies, other central banks have, to varying degrees, followed the Fed's lead.

The 2010-11 European banking crises arose after revelations that Greece, along with several other countries in the European Union, had been severely misrepresenting their fiscal problems. The challenges presented to the European Central Bank (ECB) were severe. Unlike the United States, the ECB is responsible for conducting monetary policy for the entire European Union, composed of 28 disparate economies, each with its own separate and independent finance ministry. The right monetary policy for Germany is not the right policy for Greece, Spain, or Italy, to mention only the most prominent examples of countries approaching outright deflation because of a toxic, for them, combination of ECB's stringent monetary policy and fiscal austerity.

Japan and Switzerland have also faced challenges springing from deflation pressures that have required them to employ aggressive monetary measures in order to avoid persistent currency appreciation that would at once symbolize and exacerbate the problems they face. In effect, both have taken measures to avoid importing deflation pressure, a more useful description of the impact of currency appreciation.

The Bank of Japan (BOJ) with a longer standing (15 year) deflation problem has been more innovative than the Swiss National Bank (SNB), relying more, especially since early this year, on a combination of aggressive quantitative easing coupled with forward guidance of the sort engineered by the Fed since 2010.

Both the SNB and the People's Bank of China (PBOC) have instead relied heavily on direct currency intervention, large purchases of foreign exchange (especially dollars in the case of China and Euros in the case of the SNB) to avoid the deflationary impact of substantial home currency appreciation. China's intervention has resulted in its widely-noticed surge in foreign exchange reserves, at $3 trillion and counting, a substantial portion of which has been employed to purchase US treasury securities. That outcome has benefited both China and the US. China's need to store trillions of dollars worth of foreign exchange reserves, to prevent appreciation of its currency, has been accommodated by the US, which in turn has benefited from substantially lower borrowing costs. The surge in US borrowing from China since 2008 has accommodated trillion dollar plus budget deficits, incurred in part to finance programs of fiscal stimulus.

The balance of my testimony, in response to Chairman Campbell's direction, summarizes the post-crisis policy tools of major foreign central banks, benchmarked against the Fed's post-crisis policy innovations and track record. Overall, the Fed's post-crisis performance compares favorably with other central banks in a very difficult economic and financial environment, where no nation has regained pre-crisis financial levels.

Central Bank Tools and Goals

Table 1 summarizes the tools and goals of six major central banks which are actively involved in managing the financial crisis.

Table 1. Central Bank Tools and Goals

	Central Bank					
Instrument	Federal Reserve Board (FRB)	European Central Bank (ECB)	Bank of Japan (BOJ)	Bank of England (BOE)	Swiss National Bank (SNB)	People's Bank of China (PBOC)
1. Zero Interest Rates/Zero Bound	Yes, pushed policy rate to zero in early 2009	Cut rate to 0.25% on Nov 7, 2013	Overnight call rate at 0.5%	Bank rate at 0.5%	Yes	No, current rate at 6%
2. Quantitative Easing (QE)	Yes, in three stages, Aug 2010, Aug 2011, Sep 2012	No	Yes, Apr 2013 to present	Yes, Mar 2009 to present	Yes, to counter currency appreciation	Yes, large 2008-09 credit expansion
3. Large Scale Asset Purchases (LSAP)	Yes, TARP in Q4 2008	Yes, since July 2009	Yes, asset purchase program, Nov 2010 to Mar2013	Yes, asset purchase facility, Jan 2009 to present	No	No
4. Currency Market Intervention	No	"No"	Yes	Yes	Yes, heavy	Yes, heavy
5. Forward Guidance	Yes, date-based in Aug 2011 and state-based since Dec 2012	Yes, Draghi declared would do "whatever it takes" to preserve the euro in July 2013	Yes	Yes, Aug 2013 to present	Yes, aggressive on currency	No
6. Goal Targeting						
a. Inflation	Yes, 2% target	No	Yes, 2% target since Apr 2013	Yes, 2% target	Avoid deflation	Avoid inflation
b. Price level	Flexible inflation target	No	No	Flexible inflation target	No	No
c. Unemployment or economic growth	Yes	No	No	Yes	No	Yes

Sources: Federal Reserve Board, European Central Bank, Bank of Japan, Bank of England, Swiss National Bank, and People's Bank of China websites.

Federal Reserve

Shortly after the Lehman Brothers crisis, the Fed, along with the Treasury, pressed aggressively for a large liquidity injection into the banking system, known as TARP, while following through with a reduction of its policy rate virtually to zero by early in 2009. Thereafter, the Fed undertook large purchases of treasury securities and mortgage-backed securities in three stages beginning in August 2010, with the second round in August 2011, and finally, QE3 beginning in September 2012 which included a specific commitment to purchase securities.

In a sense, quantitative easing and the large-scale asset purchases, employed by other central banks, are quite similar as they both involve the central bank purchasing securities in the open market in an effort to inject liquidity and stimulate the economy.

Currency market intervention has not been employed by the Fed, rather, the US stance on currency has been a passive one, allowing the dollar to reflect intervention and market pressures emanating from the global economy and the efforts of other central banks.

Since August 2011, the Fed has pioneered forward guidance, an effort to underscore and clarify its commitment to achieving its goal of keeping inflation steady while reducing the rate of unemployment. The initial efforts were date-based, indicating that policy would remain highly accommodative for the indicated period. Subsequently, in December 2012, "state-based" policy was introduced, indicating that interest rates would be held at zero until the unemployment rate dropped to at least 6.5 percent.

The Feds goals are, explicitly, 2 percent inflation and minimizing the unemployment rate with an eventual target of reaching a rate consistent with price stability, the so-called natural rate of unemployment. Estimates suggest that the natural rate of unemployment is somewhere between 5 and 5.5 percent, considerably below the current unemployment rate of 7.3 percent.

European Central Bank

Broadly, the ECB was slower to respond to the crisis, for feeling at first that it was largely confined to the US since it had originated with the collapse of a US-based investment bank, Lehman Brothers. However, late in 2009, with revelations that the Greek government had been seriously underreporting its deficits and debt, the European financial crisis began.

The major tool employed by the ECB to combat the financial crisis was, along with actions by the European Finance Ministry, large-scale asset purchases which have been underway since July 2009. Europe endured a very volatile period in 2010 and 2011 as governments struggled with a Greek solvency crisis that became a solvency crisis in much of southern Europe. In July 2012, ECB Chairman Draghi indicated that he and the ECB would do "whatever it takes" to avoid a financial crisis and collapse in Europe. The remarks, underscored by successful efforts in the US and combined governments of Europe, had the effect of calming European financial markets. In April 2013, the ECB added forward guidance to its effort to stabilize and sustain recovery by suggesting that its highly accommodating stance would be maintained for "an extended period".

The ECB has a mandate to maintain price stability above all other goals with no explicit reference to growth or unemployment.

Bank of Japan

The BOJ has struggled with persistent deflation for nearly 15 years. Starting earlier this year with the new Abe government, the BOJ moved aggressively to adopt a program of quantitative easing, even more aggressive than that pursued by the Fed in terms of the pace of increase of the BOJ balance sheet. Prior to that, it had maintained an asset purchase plan designed to support the economy and financial markets through the purchase of a range of assets including government bonds and some equities.

The BOJ has also intervened in the currency market to prevent appreciation that would add to its deflation problem. It has also offered forward guidance insofar as it has committed to reaching a goal of 2 percent inflation over a period of about 2 years. BOJ has no explicit unemployment target but its general goal is to improve economic performance by arresting deflation.

Bank of England

The Bank of England (BOE) dealt with intense solvency issues during and after the financial crisis. Northern Rock, a financial institution, perhaps akin to a savings and loan institution, actually experienced a run on its assets, which was arrested by aggressive liquidity provisions from the BOE. The BOE has pursued substantial asset purchases since March 2009 to help support the UK economy and financial markets. Starting in August of this year, the BOE became more explicit about offering forward guidance with respect to its conduct of monetary policy. The BOE targets inflation and more recently has embraced the UK Treasury's notion of a "balanced approach" to obtaining a flexible inflation target.

Swiss National Bank

The SNB's primary problem has been currency appreciation and its deflationary effect. During the European financial crisis, the pressure to move off the euro and onto the Swiss franc as a safe haven currency was substantial, forcing the SNB to purchase large quantities of euros in order to avoid debilitating currency appreciation and deflation. Judging by the performance of the Swiss economy, to be seen below, the efforts were largely successful.

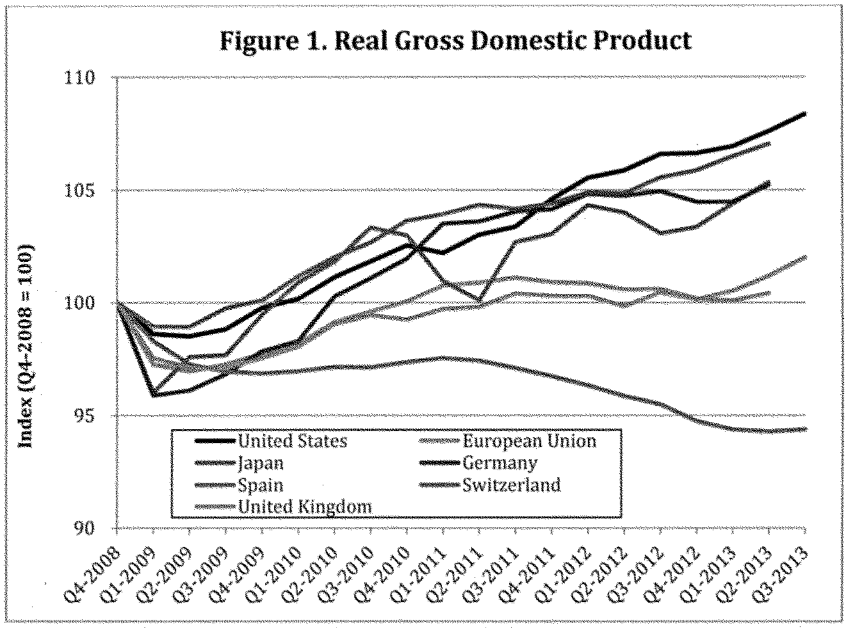
People's Bank of China

The PBOC has largely pursued an intervention policy to prevent currency appreciation. As a result, it has required substantial foreign exchange reserves, over $3 trillion worth, much of which, as indicated above, is invested in US treasury securities. The PBOC has not been particularly innovative with respect to zero interest rates policies, quantitative easing, or forward guidance. It has relied instead on a massive fiscal stimulus program, engineered in late-2008 and early-2009, to avoid a negative feedback from the financial crisis and economic slowdowns occurring elsewhere in the world.

<u>Outcomes</u>

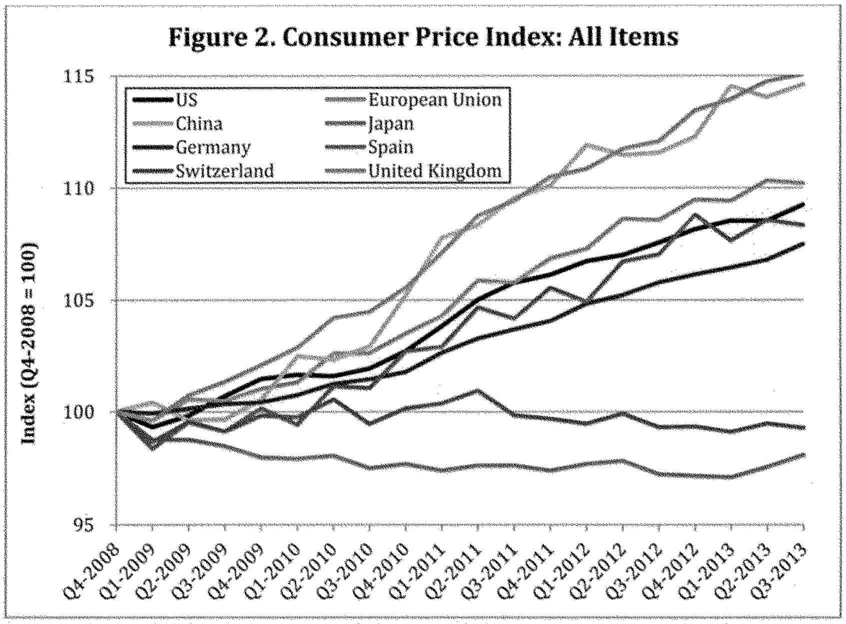
Figures 1 through 4 summarize the performance of most major economies since 2008.

Figure 1 shows the path of real gross domestic product (real GDP) since 2008 for 7 economic regions. After dipping in 2009, most economies, with the exception of Spain, have followed an uneven path of rising output. By the third quarter of this year, the US economy was about 8 percent above its level in 2008, the best performer of the group. Switzerland performed nearly as well, reaching a level of about 7 percent above the 2008 level, while Germany and Japan recovered to levels of about 5 percent above their 2008 benchmark. The UK's recovery has been substantially more modest, and overall, the European Union has been static since 2008. The performance of Spain, indicated on the chart, Italy, Greece, and other southern European economies was dragged down by stringent fiscal austerity and tight monetary policy.



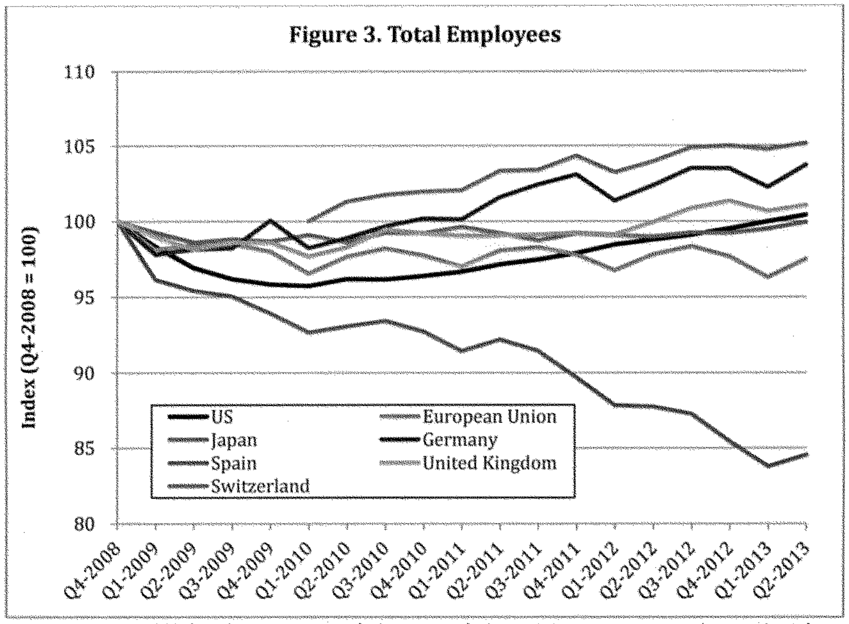
Source: Organization for Economic Co-operation and Development, Quarterly National Accounts statistics
Notes: Gross domestic product, expenditure approach, constant 2005 prices converted with 2005 PPPs, annual levels seasonally adjusted. All countries normalized with Q4-2008 equal to 100. Quarterly data not available for China.

Figure 2 shows the inflation experience of most major countries since 2008. The US has experienced modest inflation with a total price increase of 9 percent over the 5-year period. The European Union, taken together, has experience a price increase of about 10 percent, while Spain and Germany's price increase has been more modest, at about 8 and 7 percent respectively. Switzerland and Japan have experienced modest deflation with Japan's price level falling a cumulative 2 percent over the 5-year period, while the Swiss price level has been virtually unchanged, partly due to the aggressive intervention efforts of the SNB to avoid further deflationary appreciation of the Swiss franc.



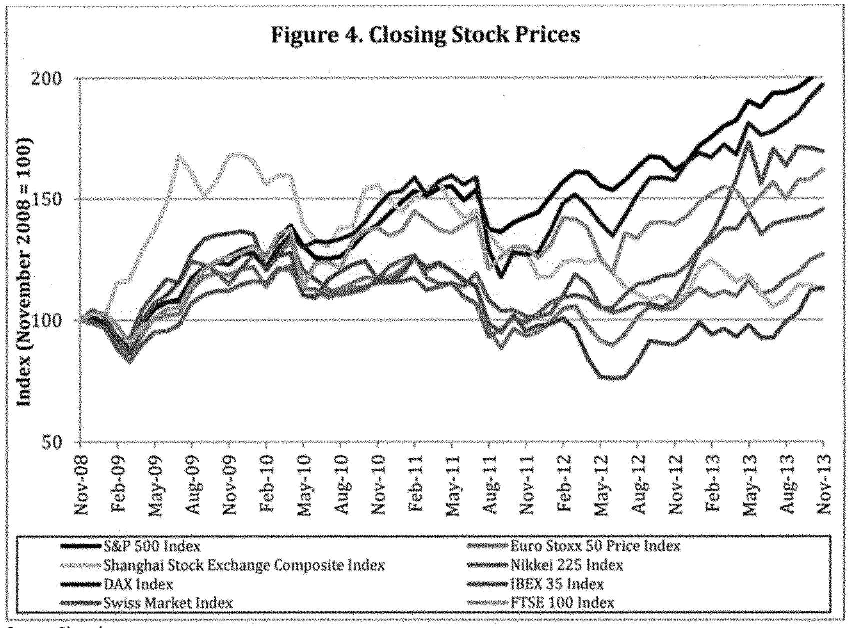
Sources: US data is available from the US Department of Labor, Bureau of Labor Statistics. European Union data is from Eurostat. Japan, China, Germany, Spain, Switzerland, and United Kingdom country data are available from the Organization for Economic Co-operation and Development, Main Economic Indicators database.
Notes: US measures Consumer Price Index for all Urban Consumers. European Union measures Harmonized Index of Consumer Prices, All Items for European Union (28 countries). All other countries measure Consumer Price Index, All Items for Country. All countries normalized with Q4-2008 equal to 100.

Figure 3 shows the employment experience of the major economies over the past 5 years. The US is in the middle of the pack, with the number of employees at mid-year 2013 having just reached the level experienced in 2008. The negative outlier is Spain, with employment 15 percent below its 2008 levels, a victim of a too-tight monetary policy and substantial fiscal austerity. German employment has risen about 3percent since 2008, while UK employment has been about static. Overall the European Union has experienced about a 3 percent drop in employment since 2008.



Sources: US data is available from the US Department of Labor, Bureau of Labor Statistics. European Union and country data is from Eurostat. Japan data is available from the Organization for Economic Co-operation and Development, Main Economic Indicators database.
Notes: US measures All Employees, Total Nonfarm. European countries measure Total Employment (resident population concept) from the EU-LFS. Japan measures Total Employment by Professional Status, Employees for Japan. All countries normalized with Q4-2008 equal to 100, except Switzerland where Q1-2010 equal to 100. Quarterly data not available for China.

Figure 4 shows the performance of major stock markets since 2008 as a way to suggest the stabilization of the economic outlook in the financial sector. German and American stock markets are performing the best, having risen by about 100 percent over the past 5 years. Japan's stock market is in third place, having risen about 70 percent, with a rapid catch-up since the end of last year given the onset of Abenomics, aggressive easing by the BOJ, and 2 percent inflation targeting. A promise to end deflation can be very helpful to stock markets. The British stock market has risen by about 60 percent while the Swiss market has risen by about 45 percent. Lagging markets include Spain's IBEX 35 Index with a modest recovery of only about 15 percent and the Shanghai stock market, which after a rapid run up in 2009, has trailed off to a cumulative increase, since 2008, of only about 10 percent. Overall the European stock market, the right benchmark for the effect of ECB policies, is up about 25 percent, dragged down by the weak markets in southern Europe.



Source: Bloomberg

Notes: Daily stock closing prices averaged over the month. All country stock indices normalized with November 2008 equal to 100.

<u>Summary</u>

The difficult period since 2008 has seen widely-varied practices of central banks and widely-varied performance of economies and markets. Overall the Fed's performance is among the best, both measured in terms of the degree of innovation and in terms of economic performance – increased output and moderated inflation.

Employment has disappointed in most areas, with the US achievement of the 2008 employment level just this year about average for the sample investigated. The best performance came in Switzerland, which was not largely affected by the financial crisis and took preemptive interventions to prevent currency appreciation. Countries like Spain, shown on figure 3, suffered badly from ECB policy choices that were correct for Germany but too tight for southern Europe. Fiscal austerity imposed on southern Europe also took its toll. Employment charts of Italy, Portugal, and Greece would look just-as-bad or worse than Spain's.

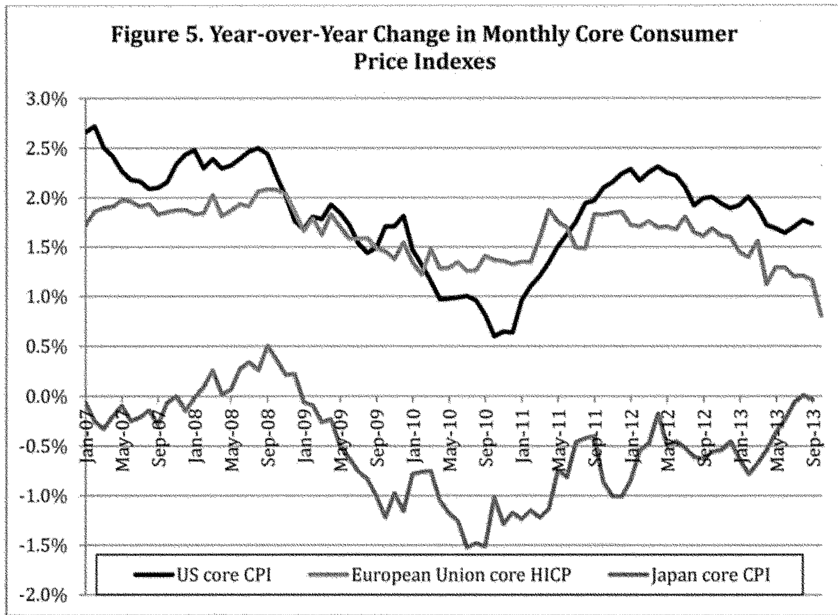
Policy Dilemmas Persist for Central Banks

Central banks face two major issues as we enter the sixth year of the post-crisis period. The first is the bubble dilemma. The second is the risk of deflation, or the deflation dilemma. These two dilemmas pull central banks in opposite directions. The bubble dilemma, or rising prices of financial assets resulting from quantitative easing (QE), raises pressure to withdraw stimulus, as in the case of the May through September Fed "taper trauma". The deflation dilemma, or falling prices of goods and services, creates pressure to add stimulus, as in the case of the ECB's controversial November 7 decision to cut its benchmark lending rate by 25 basis points to 0.25 percent.

The ECB rate cut was driven largely by a report that Europe's year-over-year core inflation rate had fallen to 0.8 percent in October, well-below the informal ECB medium term inflation target of 2 percent and perilously close to zero. European stock and bonds rallied sharply after the ECB rate cut, leading six members of the ECB's 23-member governing council to complain, plausibly, about the increased risk of financial bubbles and, implausibly, about the increased risk of inflation of goods and services prices.

QE experiments have left central bankers facing a dilemma. If QE is pushed too far, inflation will eventually emerge in markets for goods and services, though none is yet evident. In October, the IMF World Economic Outlook estimated inflation for advanced economies at 1.4 percent in 2013, down from predictions one year prior of 1.6 percent. If, alternatively, central banks end QE or tighten too soon, the risk of deflation jumps. A passage over the "monetary cliff", the slippage from falling inflation or disinflation into outright deflation, would be dangerous. [1]

[1] See John H. Makin, "Beware the Monetary Cliff," AEI Economic Outlook (November 2013), http://www.aei.org/outlook/economics/monetary-policy/federal-reserve/beware-the-monetary-cliff/.



Sources: US Department of Labor, Bureau of Labor Statistics; Eurostat; Organisation for Economic Co-operation and Development
Notes: US core CPI measures Consumer Price Index for All Urban Consumers: All Items Less Food & Energy. EU core HICP measures Harmonized Index of Consumer Prices: Overall Index Excluding Energy, Food, Alcohol, and Tobacco for European Union (28 countries). Japan core CPI measures Consumer Price Index: All Items Excluding Food and Energy for Japan.

Deflation is self-reinforcing. As price levels fall, buyers cut spending and hold onto their cash as they await lower prices. Therefore, cash holdings are rewarded by deflation, and more cash holdings and less spending causes deflation to accelerate even further. Deflation would collapse asset markets as investors shift into cash and firms cut capital investment for fear of falling returns.

Central banks and governments have little choice but to continue trying to navigate the narrow path that lies between asset inflation and dangerous bubbles and outright deflation and a collapse of growth, employment, and asset prices. There is no easy way to succeed. The reality is that the bubble-deflation dilemma means that now is a bad time to sharply alter the legislative mandate for central bankers.

The Federal Reserve and Global Central Banking

Statement by Athanasios Orphanides before the Subcommittee on Monetary Policy and Trade of the Committee on Financial Services, United States House of Representatives

Washington D.C., November 13, 2013

I appreciate the opportunity to testify at this hearing on "What's Central about Central Banking? A Survey of International Models." As requested, my testimony examines differences and similarities of the Federal Reserve with other central banks, and in this respect I will focus on the European Central Bank (ECB) and the Eurosystem that comprises the ECB and the National Central Banks (NCBs) of the member states of the European Union (EU) that have adopted the euro as their common currency.

The 100th year anniversary of the Federal Reserve is an apt occasion for reflecting on the structure of the institution compared to other central banks around the world. Over the past century, the United States has evolved into the most powerful nation on earth. In terms of politics, the United States has been the most potent global force for defending and promoting democracy. In terms of economics, the United States has been a global engine of innovation and growth. Historical experience suggests that a well-functioning monetary system is a prerequisite for the greatness of any nation, and it is hard to imagine that the United States could have achieved and maintained its power to the same degree, had the Congress not created the Federal Reserve System 100 years ago.[1]

Since its founding, the Federal Reserve has evolved into the most powerful central bank of the world and serves a leading role in global central banking. As early as the 1920s, it was recognized as a pioneer in global monetary affairs. As a public institution, the Federal Reserve is unparalleled in the professional integrity, technical expertise, dedication to public service, and collegiality that has characterized its staff and leadership. But central banking has always been and remains an activity where knowledge is acquired by experience. Uncertainty is a defining characteristic of a dynamic and continuously evolving market-based economy. Our knowledge of the workings and interrelations of the macroeconomy, banking and finance will never become perfect. From time to time crises materialize and central banks are called to deploy the power of their balance sheets to contain adverse consequences. The only common element in handling crises over time is insufficient knowledge when policy decisions have to be made. Miscalculations and misjudgments are unavoidable, even with the best of intentions. Room for improvement, for making the framework more robust, always remains.

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[1] The historical significance of the founding of the Federal Reserve on the eve of the Great War could be put into perspective when the experience of the Government is contrasted with that during the War of 1812, when the United States did not have a central bank. A consequence of the failure to renew the charter of the First Bank of the United States (the nation's first central bank) in 1811 was the difficulty of the Government to meet its war financing needs the following year. Unlike 1812, the Government could fully utilize the powers of the Federal Reserve to facilitate the war effort after its founding.

In its first 100 years, the Federal Reserve has contributed to the welfare of the nation but has not always managed to avoid major errors. The Great Depression of the 1930s and the Great Inflation of the 1970s are the most notable examples. Historians will undoubtedly debate for years to come the causes and handling of the most recent crisis. In my view, the Federal Reserve's actions in late 2008 and 2009 were decisive for averting what could have become an economic collapse of Great Depression dimensions. Easy money policies proved a potent medicine. But while some risks to monetary stability abate, other risks emerge. Easy money policies can prove as addictive as other potent medicines. The unprecedented expansion of the central bank's balance sheet and the associated continued easing of policy have generated new challenges.

The institutional framework governing a central bank is a critical factor on how well it can preserve monetary stability and how effectively it can handle crises. The mandate of the institution, its decision-making structure, the appointment process of its decision-making bodies, the mechanisms defining its independence and accountability, all jointly influence the probabilities of ensuring better outcomes. In the international community, countries learn from others' experiences about the effectiveness of institutions, and there has been considerable cross-fertilization of ideas in the institutional design of central banks.

Experience from the functioning of the Federal Reserve has influenced other central banks, including the European Central Bank that was established in June 1998, directly and indirectly. Some of the characteristics in the structure of the ECB (and more broadly the Eurosystem) draw on the structure of the Federal Reserve. The ECB setup also drew on the structure of the central bank of the Federal Republic of Germany (the Bundesbank) that in turn was influenced by the Federal Reserve when it was set up in the 1950s.

I would like to draw attention to three elements of the institutional arrangements of the Federal Reserve System and the Eurosystem: Their decentralized nature, the independence of their decision-making bodies, and their mandates.

One common characteristic of the Eurosystem and the Federal Reserve System is their decentralized nature and decision-making structure. This inclusiveness and incorporation of regional perspectives ensures that monetary policy better reflects the needs of the economy as a whole. The 12 regional Federal Reserve Banks in the United States have a role that is similar in some respects to the NCBs in the euro area, and the Board of Governors has similarities to the ECB. The ECB has an Executive Board with 6 members who are based in Frankfurt, similar to the 7 Governors of the Board of Governors based in Washington, DC. Monetary policy decisions for the United States are taken by the FOMC with the participation of members of the Board and the Presidents of the 12 district banks. For the euro area, such decisions are taken by the Governing Council of the ECB that comprises the ECB Executive Board members and the Governors of the NCBs. In both cases, the broad committee setup ensures regional representation and the incorporation of a rich set of views into policy discussions. However, the Federal Reserve is relatively more centralized. In the case of the ECB, the decision-making body for all matters is the Governing Council where NCB governors have more votes than members of the Executive Board. By contrast, in the case of the Federal Reserve, the Board retains a majority of votes on the FOMC and has decision-making powers on its own on many matters, without representation of the Reserve Banks. Another important difference is that in the United States no individual state has control of a Reserve Bank and each Reserve Bank represents an area that covers multiple states. This ensures better integration and makes it far more likely that Reserve Banks will be serving the interests of the United States as a whole compared to the Eurosystem where the jurisdiction of each NCB coincides with the borders of an individual state. This limitation to integration, in the case of the Eurosystem, reflects a more fundamental limitation in the structure of the European Union and the euro area. In contrast to the United States, the European Union remains a confederation of sovereign states that lacks a strong common government.

Independence from short-term political influences is one of the most important characteristics defining the ability of a central bank to serve a nation's best interests over time. Independence enables a central bank to resist short-sighted political pressures that invariably create inflationary biases and compromise monetary stability. Both the Federal Reserve and the ECB are independent central banks but with notable differences. When comparing the influence of the political decision-making bodies of the common currency area as a whole, the ECB is considerably more independent and arguably less accountable than the Federal Reserve. In the United States, the Federal Reserve reports to Congress and its powers are subject to change by law. By contrast the European Parliament has relatively little power over the ECB. The legal framework of the ECB is governed by the Treaties of the European Union and as such cannot be modified by any single government or by the European Parliament. With respect to the influence of individual member states, the relatively greater role of the NCBs in the Eurosystem, and their tight correspondence to individual member states, suggests a greater threat of political interference by individual member states in the euro area compared to the United States.

Once appointed, decision makers are independent from governments both in Europe and in the United States. However, differences in the length of the term and the potential for reappointment suggest differences in the potential for political influence on the decision-making bodies. In the ECB, all members of the Executive Board, including the President and Vice President of the ECB, are appointed for 8-year non-renewable terms. This ensures maximum independence following an appointment and relatively infrequent political battles relating to appointments. In the case of the Federal Reserve, whereas in theory Board members could serve 14-year non-renewable terms, in practice this is rarely observed. Most members serve incomplete terms and if a member leaves before the end of a 14-year term, a new member is only appointed for the remainder of that term. When appointed to serve an incomplete term, a governor can be reappointed for a full 14-year term once the remainder is completed. The chair and vice chair positions also require separate renomination and reconfirmation after each 4-year term in those positions. This structure implies that most Board members, and certainly the chair and vice chair of the Board, must face a potentially bruising reappointment process once or multiple times to serve for several years. Since the prospect of reappointment may make Board members, and especially the chair and vice-chair, more sensitive to political influence, the independence of the Federal Reserve could be strengthened if all Board members were appointed for 8-year non-renewable terms, as is the current practice for the Executive Board of the ECB. The independence of the Federal Reserve would also be strengthened if the remuneration of

Board members were adjusted to better reflect the level of responsibility associated with their position. This should reduce the high turnover rates that have been observed in all positions other than that of the chair over recent decades. As an example, my understanding is that the salary of the Chairman of the Federal Reserve is less than half that of the President of the ECB. In my view, it does not serve the interests of the nation well to underpay members of the Board, especially in light of the expanded responsibilities envisioned for the Federal Reserve System in the aftermath of the crisis.

Perhaps the most significant difference between the ECB and the Federal Reserve is in the legal text regarding their mandates. The ECB's mandate focuses on one objective, while the Federal Reserve's statute states multiple goals and does not offer precise guidance on their relative importance. The comparative lack of clarity leaves open the interpretation of its mandate and poses challenges for the Federal Reserve.

Reflecting best practice following the experience with inflation and disinflation from the 1960s to the 1980s in numerous developed economies, the mandate of the ECB, which was originally formulated as part of the EU Treaty in 1992, has a hierarchical nature defining price stability as the primary objective of the institution. Price stability is the primary mandate of the European System of Central Banks (ESCB) which comprises the ECB and all the NCBs of the EU. In contrast, the Federal Reserve has a so called "dual mandate" that assigns comparable importance to maximum employment. Specifically, the Federal Reserve should "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

An important reason for this difference is the timing of the adoption of the legal text. The current statutory mandate of the Federal Reserve reflects revisions to the Federal Reserve Act in 1977-78, before the crystallization of the modern consensus regarding the primacy of price stability as the most important contribution that a central bank can make to social welfare in the context of modern democracies. A historical digression can help explain the significance of the timing. Prior to the 1980s, rather than focus on price stability, the statutory mandates of numerous central banks emphasized multiple objectives including references to full employment as an explicit goal. As an example consider the following interpretation of the Federal Reserve's objectives, as stated by the Board in the first edition of *The Federal Reserve System: Its Purposes and Functions*, published in 1939: "The purpose of Federal Reserve functions, like that of Governmental functions in general, is the public good. Federal Reserve policy can not be adequately understood, therefore, merely in terms of how much the Federal Reserve authorities have the power to do and how much they have not the power to do. It must be understood in the light of its objective—which is to maintain monetary conditions favorable for an active and sound use of the country's productive facilities, full employment, and a rate of consumption reflecting widely diffused well-being." Although such wide-ranging interpretations of the objectives of a central bank may have been well-intentioned, they did not generally serve as an indicator of good performance. The lack of clarity also made the central bank less accountable. The painful experiences with inflation and disinflation from the 1960s to the 1980s highlighted that the demand to deliver full employment in addition to price stability overburdened central banks, leading to poor performance on both fronts. This led to significant change and/or clarification and/or reinterpretation of central bank mandates towards highlighting the primacy of price stability. Characteristic of this norm has been the advent of Inflation Targeting (IT), a framework originally adopted by the Reserve Bank of New Zealand (RBNZ) in 1989. The main distinguishing characteristics of inflation targeting are the adoption of a numerical definition of price stability and its recognition as the primary objective of the central bank. As Don Brash, the Governor who first implemented IT at the RBNZ noted later, the multiple goals facing the central bank before the adoption of IT created conflicts that generated instability and inflation. "The legislation under which we operated required us, in formulating our advice, to have regard for the inflation rate, employment, growth, motherhood, and a range of other good things" (Brash, 1999). He then went on to explain how abandoning the multiple-goal approach and recognizing the primacy of price stability helped reestablish stability in New Zealand.

The difficulty associated with too literal an interpretation of a multiple-goal mandate was also recognized by the Federal Reserve. Starting in 1979, under the leadership of Chairman Volcker, and continuing under Chairman Greenspan, the Federal Reserve effectively interpreted price stability as a necessary primary goal for attaining other objectives. As explained in the 9th edition of the Federal Reserve's *Purposes and Functions*, published in 2005: "Stable prices in the long run are a precondition for maximum sustainable output growth and employment as well as moderate long-term interest rates." In 2004, Chairman Greenspan pointed to the primacy of price stability in explaining the success of Federal Reserve policy since 1979. As he explained, this resulted from "maximizing the probabilities of achieving our goals of price stability and the maximum sustainable growth that we associate with it" (Greenspan, 2004).

With this interpretation of the Federal Reserve's mandate, closer comparison with that of the ECB suggests more similarities than differences. This is because while the mandate of the ECB explicitly recognizes the primacy of price stability, it does not ignore other objectives. To the extent feasible, the central bank could be expected to contribute to the attainment of other goals, but only if that did not compromise its primary objective. Thus, the EU Treaty specifies: "The primary objective of the ESCB shall be to maintain price stability. Without prejudice to that objective, it shall support the general economic policies in the Union in order to contribute to the achievement of the latter's objectives." And with regard to these objectives, the Treaty states: "The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment." Thus, full employment is one of numerous other objectives the ECB should support, as long as this does not compromise price stability.

The similarity in the interpretations of the mandates of the ECB and the Federal Reserve that had been in place since 1979 is noteworthy, but more recent developments highlight that the lack of clarity in the case of the Federal Reserve comes at a cost. As part of its response to the crisis, the Federal Reserve has sought to improve its communications and provide a numerical definition of price stability. The effort to better anchor inflation expectations over time in this manner has been a welcome development. In light of the wording of its statutory mandate, however, the FOMC also introduced a numerical operational guide for maximum employment. Specifically, in January 2012 the FOMC adopted a "Statement on Longer-Run Goals and Monetary Policy Strategy," which was reaffirmed in January of this year. The statement defines the FOMC's understanding of price stability as consistent with a 2 percent inflation goal and provides numerical estimates of the longer-run normal rate of unemployment that the FOMC views as an operational guide for maximum employment, while recognizing that these estimates may change over time. In addition, the statement suggests that the FOMC would take a "balanced approach" in seeking to mitigate deviations of inflation from 2 percent and deviations of unemployment from its longer-run normal rate.

With the adoption of this language, the FOMC seems to have moved away from its earlier interpretation that placed greater importance on the attainment of price stability. While the new language is closer to a literal interpretation of the Federal Reserve's statutory mandate, it engenders the same risks faced by the Federal Reserve before 1979, the earlier period in its history when a similar literal interpretation of multiple goals with elevated attention to maximum employment was in effect.

In light of the earlier historical experience, the risks of overburdening the Federal Reserve with multiple conflicting goals should be well known. The tensions associated with an overly literal interpretation of the Federal Reserve's mandate were also highlighted in a recent speech by Chairman Volcker: "I know that it is fashionable to talk about a 'dual mandate' – that policy should be directed toward the two objectives of price stability and full employment. ... Asked to do too much ... [the Federal Reserve] will inevitably fall short. If in the process of trying it loses sight of its basic responsibility for price stability, a matter which is within its range of influence, then those other goals will be beyond reach" (Volcker, 2013).

These risks, which are caused by the lack of clarity of the statutory mandate of the Federal Reserve, could be mitigated by Congress. A clarification explicitly recognizing the primacy of price stability as an operational goal for the FOMC would be the best defense of monetary stability over time. Subject to maintaining price stability, the Federal Reserve could be instructed to contribute as possible to other objectives, including maximum employment, similar to current practice in Europe. In addition, and in light of the greater authority the Federal Reserve has gained over banking and financial regulation, financial stability should be more clearly highlighted in the mandate.

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Testimony before the House Financial Services Committee

Subcommittee on Monetary Policy and Trade

Hearing entitled "What Is Central About Central Banking?:

A Study of International Models"

Adam S. Posen[1]

November 13, 2013

Chairman Campbell, Ranking Member Clay, and Members of the Committee, thank you for the opportunity to testify in this hearing. It is a privilege for me to contribute to your discussions of what is central to central banking, when you rightly take stock of the Federal Reserve's performance and governance after 100 years of operation, and after five years of its policy responses to the North Atlantic financial crisis centered here in the US. As someone who has been studying differences in central banks' structures and performance for twenty years, and has worked in a number of the major central banks as an economist, consultant, and policymaker, I commend your taking a comparative international approach to benchmarking the Fed's performance and role.

I would like to address two sets of issues regarding the operational structure of central banks in my testimony. All of these have a significant influence on the ability of central banks operating in democracies with market economies to fulfill their public mission. All of these show some significant

[1] Adam Posen is President of the Peterson Institute for International Economics (contact posena@piie.com). The views expressed here are solely his own, and do not necessarily represent the views of the Institute or of any other member of its staff or Board of Directors.

variation among the major central banks in critical aspects of their capabilities and practices. And some of these represent areas where the Federal Reserve System, and the relationship between the Fed and Congressional oversight, could benefit from improvement.

- Governance of the central bank and setting of its policy goals
- Tools available to the central bank for policy implementation

As my colleagues, Messrs. Lachman, Makin, and Orphanides, have argued in their written testimony submitted for this hearing, and as your Committee staff has documented, the major central banks in democratic countries hit by the financial crisis – the Fed, European Central Bank [ECB], Bank of England [BoE], Bank of Japan [BoJ], Swiss National Bank [SNB], and others – have responded along largely the same lines: cutting instrument interest rates to near zero, expanding their balance sheets by buying securities, aggressively intervening to counteract market disruptions during the height of the crisis, and maintaining an easy stance of monetary policy (to varying degrees) through the present.

The economies and publics they serve have seen largely the same results on the broad macroeconomic aggregates: very low inflation with little inflationary pressure, some improvement in growth and employment but far from total recovery, little market pressure on longer-term government debt securities, and relatively stable currencies after some discrete one-time adjustments. I believe this is the result of these central banks getting policy more or less right, but being insufficiently aggressive about stimulus in some cases, and being outweighed by fiscal and banking developments overall.

Still, below the top line similarities of policy and performance from mid-2008 to present, there are some important differences between the Fed and its peer central banks in outcomes. More importantly, I would argue, there are divergences and vulnerabilities between central bank practices that are becoming highly salient as we get further from the overt crisis and turn to the more contentious issues of when and how to tighten monetary policy, providing financial stability, and handling the feedback from the policies already pursued upon our own and other economies.

Chairman Bernanke and the FOMC are to be praised for their crisis response which saved the American people from terrible economic outcomes, what would have been far worse than what we actually suffered - good leadership and management in a crisis is never a foregone conclusion. But in a sense, during a financial crisis the right direction for monetary policy is clear, and the central bank's choice of tools is simply to use everything you got fast. The FOMC and the members of this Committee should now be thinking ahead about how to prepare our central bank for future policy challenges when there will be more room for genuine debate about the right direction of policy and the right methods with which to pursue that policy goal.

1. <u>Governance of central bank goal setting</u> –

Accountability is a two-way street. The Federal Reserve must be overseen by elected officials, as it currently is, and as all central banks should be. But the form and nature of that oversight must allow for the central bank to make policy without undue political pressure or arbitrary interference. The best practice for making such oversight work is to distinguish between goal and instrument independence for central banks – central banks should have instrument independence, but not goal independence.[2]

That is, the elected officials set the goal of policy, usually called the central bank's mandate, and the technocratic leaders and staff of the central bank are left to pursue those goals by the means and measures they think best. Of course, the central bankers – in the US, the FOMC members – have to be held accountable for their performance in meeting those objectives, but that

[2] As defined by Stanley Fischer in 1994. See: Debelle, Guy and Stanley Fischer. 1994. How Independent Should a Central Bank Be? In J.C. Fuhrer (ed.), *Goals, Guidelines and Constraints Facing Monetary Policymakers*. Federal Reserve Bank of Boston, 195–221.

should be done retrospectively, based on a few years' policies and outcomes at a time. Monetary policy decisions cannot be fully evaluated in real time, given the lags between when policy is set and the full effects are seen. That is part of what makes it so challenging for both central banks and elected legislators.

Perhaps this sounds self-evident. But international experience shows that this distinction matters greatly. Where central banks have too much goal independence, bad things happen. In Japan, throughout the 1990s and most of the 2000s, the BoJ Policy Board was allowed to define price stability as it saw fit, and allowed the economy to enter an extended period of deflation. Worse, the BoJ eluded accountability for its policy failures for much of the period, and publicly blamed deflation and terrible economic outcomes on everything but monetary policy without sustained political challenge. In the euro area, the ECB has to some degree run amok, ignoring its mandate to achieve price stability of near 2% inflation, ignoring its obligation to pay attention to broad credit growth, and ignoring wide divergences in monetary outcomes across the whole of the European Monetary Union. Instead, it has entered into the budget politics of sovereign member states and even their regulations of non-financial sectors like labor markets and tax policy.

As I warned in 1993, when the ECB structure was first proposed, having an unaccountable central bank with no parliament above it, its independence protected by essentially inviolable international treaty, was a recipe for excessively and destructive counter-inflationary extremism.[3] This is indeed what has happened in response to the crisis, though the ECB has moderated somewhat in the last 18 months. In contrast, in the United Kingdom and Switzerland, where the BoE and SNB are very much goal dependent and answerable to elected officials, there were salutary corrections to the

[3] See Adam S. Posen, "Why Central Bank Independence Does Not Cause Low Inflation: There is no institutional fix for politics," in Richard O'Brien, ed., *Finance and the International Economy: 7*, Oxford University Press, 1993.

operational goal of monetary policy in response to crisis developments, to allow for specified areas of flexibility and minimum standards in other areas – more response to real volatility and to slow growth for the BoE, more concern with the exchange rate in opposition to deflation for the SNB.[4] Earlier this year, the new Japanese government did finally hold the BoJ accountable for its failure to deliver on a reasonable operation definition of price stability, meaning its insufficient effort and responsibility to fight deflation. The BoJ has changed policies to meet its clearly and legitimately set goal, and has delivered good results.

Do the Congress and the Fed have it right on goal dependence versus instrument dependence? Certainly more so than the ECB, but the relationship is not perfect. As we have recently established in some new research, having elected officials set and reset central bank goals in a transparent manner has minimal effect on inflation outcomes, and even on the anchoring of inflation expectations (i.e., how much inflation drifts upwards when there is a cost shock or a monetary accommodation).[5] Central bank independence is not fragile to even robust oversight of goals.

Yet, there is much hubbub in the Congress and among some commentators when the Fed adjusts its targets in response to the crisis in a transparent way and in consultation with Congressional oversight that independence is being compromised. This is wrong. So, too, however, is the reluctance of Fed officials to let Congress discuss directly the definition of goals, engendered by the justified fear that any re-opening of the Federal Reserve Act could be a Pandora's Box. We need a process by which the Fed's

[4] See my testimony to the Joint Economic Committee on April 18, 2013, http://www.piie.com/publications/testimony/posen20130418.pdf, and the recent speech by the SNB Chairman Thomas Jordan on October 8, 2013, http://www.piie.com/publications/papers/jordan20131008ppt.pdf.

[5] See Kenneth Kuttner and Adam Posen, "Goal Independence for Central Banks: Is the malign view correct?", November 7, 2013, http://www.imf.org/external/np/res/seminars/2013/arc/pdf/posen.pdf

operationalization of its current Dual Mandate can be reviewed and debated by Congress without the threat of massive institutional change or politicization. This was one of the reasons why the current Fed Chairman with co-authors (including myself) advocated an inflation targeting framework for US monetary policy explicitly in a framework of Congress setting the inflation target.[6] There are other options, but we need a decent process for so re-setting.

The real issue, however, is the extreme distrust which many members of Congress are showing towards the instrument independence of the Fed. The extreme form is the absurd conspiracy theory that seems to be behind the idea of "auditing" the Fed, that somehow there are purchases and sales of Fed assets that have taken place without public knowledge or oversight. This is demonstrably false. The Fed's balance sheet and market operations are more transparent than their or any other central banks' have ever been (some issues over disclosure of specific bank names in crisis bailouts aside). But there are three far more operationally significant areas where excessive Congressional distrust harmfully interferes with instrument independence:

- Minutes – No other central bank is required to produce literal transcript minutes of such detail at such frequency as Congress requires of the FOMC. This has a chilling effect on the willingness of FOMC members to speak on the record, openly debate policies, and to advance ideas and positions that may later be proven wrong (even if useful to discussion). This distorts internal and side meetings of FOMC members as well, and conveys no useful information except for 'a-ha gotcha' purposes beyond what more edited depersonalized minutes as the BoE, ECB, and others produce. This also makes FOMC members less accountable for their individual votes and opinions. Congress should revised this requirement.

[6] Bernanke, Ben, et al, *Inflation Targeting: Lessons from the International Experience*, Princeton University Press, 1999.

- Capital – On paper, all central banks have an amount of capital on their balance sheets that is at the basis of their operations. In financial and economic terms, this is a meaningless line-item not a real constraint – the central bank can always print money and engage in operations, and so long as the elected officials have the central bank's back, the capital can be replenished if temporarily eroded for some reason. But politically, this becomes a huge source of threat to hold over monetary policymaking if it can be used to express dissatisfaction with what means a central bank is using to pursue its mandated goals. This has led to bad self-censoring in the ECB case. In Japan, the BoJ used this as an excuse for inaction. Here in the US, arguably the FOMC is making decisions about how to handle the assets on its balance sheet with an eye as to avoid attracting Congressional opprobrium rather than pursuing the best use of the assets as tools. I would argue that the Fed should be thinking about selling off bonds when it is time to tighten policy, but many would have the Fed hold on to them to maturity simply to avoid registering a paper loss Congress might use as a club. Congress should give the Fed in advance an indemnity against losses on its balance sheet incurring in its monetary operations so long as they are in pursuit of mandated goals (which they would be), as the BoE has from HM Treasury.[7]

- Specific constraints on Fed purchases – While setting goals and evaluating the competence of pursuit of those goals is rightly Congress' role with respect to the Fed, judging what are the appropriate means to achieve those goals a priori is not. The Congress, despite its best efforts and strong staff, is not qualified to make that technical evaluation of what the Fed can buy and sell; no one, even experts, can really make

[7] See my discussion of this issue in a speech from my time on the BoE Monetary Policy Committee, June 11, 2012: http://www.telegraph.co.uk/finance/economics/9324650/Adam-Posens-speech-in-full.html

that evaluation except ex post, and as a judgment dependent upon the economic context in which the purchases and sales are made; and it is inherently a politicization of monetary policy decisions that would be harmful to price stability to have elected officials getting involved in granting and withholding operational options to the Fed. No other major central bank – not the ECB, BoE, BoJ, SNB, or any others - in a democracy has the kind of constraints on its balance sheet operations that Congress has increasingly imposed on the Fed. Had these constraints been in place during 2008-09, we would have had a disaster when other central banks flexibly and aggressively responded to financial crisis. In fact, the ECB actually led the way in so doing and was initially ahead of the Fed in crisis response because of reluctance on the Fed's part due to worries about attracting congressional interference. The Congress should respect the Fed's instrument independence, and only evaluate what tools or assets the Fed uses retrospectively as part of the overall competence accountability.

2. Tools for the pursuit of financial and price stability –

Since the Congress is at present deeply involved in setting limits on the Fed's tools in pursuit of its mandated goals, and since the long-term structure and performance of the Fed is certainly within Congress' legitimate purview, let me now address the issue of what tools the Fed does or does not have in comparison with other central banks. The place to start is with the operational – as opposed to the independence – aspects of the current limits on Federal Reserve asset purchases. These are truly exceptional, and are likely to be extremely harmful to the pursuit of financial stability by the Fed.

Public debate has also been allowed for too long to stigmatize "unconventional" monetary policy, and wax nostalgic for the days of a simpler Fed mission. The Fed has, perhaps understandably, let this happen for fear of provoking further political interference. But such defensiveness and selflimitation is based on a mischaracterization of the past and creates a dangerous vulnerability for the US economy. For literally centuries, central banks have bought and sold private sector assets as a necessary part of their operations. There was a brief interlude, from the late 1970s through the mid 2000s when it looked like the Fed and other rich country central banks could implement monetary policy and maintain financial stability solely by purchases and sales of the short-end of the government bond market. To a large and increasingly evident degree, the extent to which this reliably worked versus the was always overestimated, was based on a theoretical fiction about how interest rates affected the real economy, and was simply politically convenient because it pretended Fed policies did not have an impact on income and wealth distribution.[8]

Congress will have to make it possible for the FOMC to treat so-called unconventional monetary policy as conventional, and establish a viable oversight framework for doing so. The great lesson of the global financial crisis for monetary policy is that there is no one interest rate that determines or even represents credit conditions in the modern economy. Recent events show the more complex reality of how monetary policy is transmitted to the whole economy, as opposed to just bond markets. In the euro area, low interest rates and commitments to government bond market intervention are failing to improve credit conditions for small and medium-sized businesses across southern Europe. The BoJ has only been able to successfully reverse deflation by changing the mix of assets it purchases to longer-maturity and some private assets; when it solely bought short-duration JGBs, its quantitative easing was ineffective.[9] In China, Hong Kong, and Turkey, attempts to constrain property lending booms have required targeted measures as well as rate rises. Right

[8] See my discussion of the distributional issues of monetary policy in Adam Posen, "After Bernanke, Make Unconventional Policy the Norm," Financial Times, July 15, 2013. http://www.piie.com/publications/opeds/oped.cfm?ResearchID=2442

[9] See my discussion of Japanese monetary policy pre-2013 in Adam Posen, "The Realities and Relevance of Japan's Great Recession: Neither *Ran* nor *Rashomon*," June 2010, http://www.piie.com/publications/interstitial.cfm?ResearchID=1592

now, the BoE is allowing the blowing of another housing price bubble by not intervening directly to offset mistaken government policies.

In the United States, the Fed's purchases of mortgage-backed securities have done more to promote the current private housing-led economic recovery than buying long-dated Treasuries alone could ever have done. It is sheer luck that purchases of mortgage-backed securities were still allowed by Congress and that happened to be the right thing to buy to deal with the US mortgage-centered debt crisis. If the next crisis comes in American money market mutual funds or local banks' capital, the US economy may not be so fortunate because the Fed will not be able to intervene effectively.

To repeat, no other major central bank is constrained in this way that Congress has constrained the Federal Reserve – if anything, the right lesson of the crisis is that central banks have to be ready to intervene across a wide range of asset markets and deal with multiple credit markets. That is why all other major central banks have at least as much flexibility with regard to tools as before the crisis, if not having been granted additional capabilities. Congress has taken the Fed in exactly the wrong direction.

Worries about losses on risky assets are nothing but a distraction. The purpose of Fed market operations is to deal with major macroeconomic shocks and trends that have huge impact on the economic well-being of all Americans. Whether the Fed temporarily loses money on a small part of its portfolio or temporarily distorts a hypothetical pure market outcome for a particular asset class in service of that greater good should not be a constraint on doing the right thing. Yet, some in Congress are fixated on these potential paper losses and that fixation translates into both legislative interference and the FOMC pre-emptively ruling out policy options and instrument it should actively consider solely for political fears. And of course, the cumulative gains that the Fed has transferred to the US Treasury over the decades outweigh by two orders of magnitude any potential losses on the Fed's balance sheet in a given set of operations. And we would not want the Fed to have justified let alone pursued the QE policies it did just for the sake of showing a profit!

My final point is to warn the members of this Subcommittee of letting further counter-productive constraints on the Fed's range of policy options creep in through a particular back door. As this is the Monetary Policy and Trade Subcommittee, you are no doubt aware of some initiatives to make strictures against currency manipulation requirements for some trade pacts such as TPP currently under negotiation by the US, or as a pre-requisite for granting Trade Promotion Authority to the Administration to negotiate those pacts. I will leave aside that debate in general terms today. I will, however, say that it would be the ultimate usurpation of the Fed's necessary instrument independence, and even more so of Congress' legitimate oversight of the goals for US monetary policy, were such a trade condition to be used against the Fed's own choice of instruments.

Yet, that is a concrete and significant danger if such trade requirements were to be poorly or too broadly drafted in the legislation. Countries would unfairly and harmfully insist that Federal Reserve monetary policy – necessary to the well-being of the US economy – would have to be limited or even reversed if it could be construed as 'currency manipulation.' They would be pursuing their own mercantilist self-interest at huge macroeconomic cost to the US economy. Thus, any such legislative language much be clearly linked to explicit acts of currency manipulation, involving the one-sided sustained intervention by purchasing with official reserves by countries already in substantial trade surplus. It must not be allowed to treat expansionary monetary policy directed at domestic goals to be constrained from the outside.

Thank you for your attention.

EUROPE NEWS

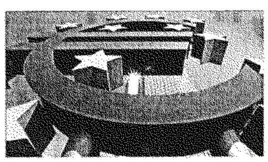
ECB's Praet: All Options on Table

Central Bank Could Adopt Negative Deposit Rate, Asset Purchases If Needed

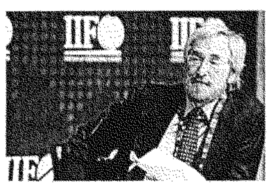
By BRIAN BLACKSTONE

Updated Nov. 13, 2013 2:13 p.m. ET

FRANKFURT—The European Central Bank could adopt negative interest rates or purchase assets from banks if needed to lift inflation closer to its target, a top ECB official said, rebutting concerns that the central bank is running out of tools or is unwilling to use them.



The European Central Bank says it could adopt negative interest rates or purchase assets from banks if needed to lift inflation closer to its target, rebutting concerns that the central bank is running out of tools or is unwilling to use them. WSJ's Brian Blackstone has details. Photo: AP



Peter Praet in Washington, D.C., on Oct. 11.
Bloomberg News

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"If our mandate is at risk we are going to take all the measures that we think we should take to fulfill that mandate. That's a very clear signal," ECB executive board member Peter Praet said in an interview Tuesday with The Wall Street Journal.

Annual inflation in the euro zone slowed to 0.7% in October, far below the central bank's target of just below 2% over the medium term. The euro dipped briefly after the comments appeared on the Journal's website.

Mr. Praet didn't rule out what some analysts see as the strongest, and most controversial, option: purchases of assets from banks to reduce borrowing costs in the private sector.

"The balance-sheet capacity of the central bank can also be used," said Mr. Praet, whose views carry added weight as he also heads the ECB's powerful economics division. "This includes outright purchases that any central bank can do."

Additional stimulus from the ECB isn't needed right now, Mr. Praet signaled, noting that inflation risks for the euro zone as a whole are balanced after last week's unexpected ECB interest-rate cut.

On Thursday the central bank reduced its key lending rate to 0.25%, a record low.

The move came days after the October inflation report fanned fears that the euro zone may slip into a period of excessively low inflation or, in some places, persistent declines in consumer prices, known as deflation. This cripples economic activity by holding wages and profits down and hampering efforts by the private sector and governments to reduce debt.

Some of the countries hit hardest by the euro zone's debt crisis, including Ireland, Greece, Cyprus and Spain, have inflation rates of zero or lower.

The ECB could do more if necessary, Mr. Praet said. "On standard measures, interest rates, we still have room and that would also include the deposit facility," he said.

The central bank's deposit rate has been set at zero for several months. Making it negative would effectively levy a fee on commercial banks that park funds at the ECB.

That would be aimed at spurring bank lending to the private sector, which would boost growth and inflation. However, a negative deposit rate would also weigh on bank profits.

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Another option is to make more cash available to financial institutions, as it has in the past with cheap, long-term loans, known as LTROs, Mr. Praet said.

The ECB has so far resisted large-scale asset purchases as a means to boost growth.

The Federal Reserve and Bank of Japan have used this tool, known as quantitative easing, aggressively to spur lending and keep inflation from falling too low, buying large swaths of government and private debt.

The ECB purchased safe bank and government bonds at the height of the global financial crisis and Europe's sovereign-debt crisis, but in small amounts compared with other major central banks.

Such bond purchases are deeply unpopular in Germany, where long-standing fears of inflation inspire doubts about easy-money policies.

Jens Weidmann, who heads the German central bank as well as serving on the ECB's Governing Council, opposed the ECB's decision last year to create a program to buy government bonds. Nevertheless, the program, which hasn't even been used, has been widely credited with helping calm the bloc's debt crisis.

The ECB's charter forbids it from financing governments, and Mr. Praet said the bank must respect such legal constraints. However the rules "do not exclude that you intervene in the markets outright," he said.

Mr. Weidmann was also in the minority of ECB officials who opposed last week's rate reduction, preferring to wait for more information on the inflation outlook. This has led to some concern that if the ECB can't unanimously agree on a cut to its key lending rate, reaching consensus on more outside-the-box monetary policies will prove tricky.

"For some decisions it's easier than others" to gain consensus, Mr. Praet said. "One thing is clear: the Governing Council has been able to decide. That's really the message."

The need for more aggressive stimulus is increasingly being debated by economists and investors.

Economists at BNP Paribas argue the ECB should buy €50 billion ($67 billion) per month of government bonds of euro-zone countries and start doing so "the sooner the better." Still the French bank places the odds of that happening at under 50-50, "probably by a wide margin," in part because of likely resistance from the ECB's conservative wing.

Mr. Praet rejected fears, particularly in Germany, that low ECB interest rates harm savers by reducing the interest rate they earn on deposits. Low interest rates tend to favor borrowers over savers.

"Creditors and debtors always have an interest in a stable anchor, which is price stability in the medium term," Mr. Praet said. "The action to reduce uncertainty is good for the climate for savers."

The comments sent the euro tumbling to a session low of $1.3391, from $1.3455, just minutes after they appeared on the Journal's newswire and website. The currency later rallied to trade at $1.3447, from $1.3435 late Tuesday.

The euro losses were held in check, as many investors believe the ECB will not make a sudden shift to negative deposit rates, electing instead to stimulate the economy through less-dramatic steps, such as lowering its main refinancing rate below 0.25% or cutting minimum reserve requirements for banks.

—Todd Buell, Christopher Lawton and Ira Iosebashvili contributed to this article.

Write to Brian Blackstone at brian.blackstone@wsj.com

International Central Banking Practices

Testimony Before the House Subcommittee on Monetary Policy and Trade

Lawrence Lindsey

11/13/2013
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Mr. Chairman, members of the Committee, I am honored to be here today to discuss international central banking practices and to compare and contrast how different countries handle the issues attendant to monetary policy. The five areas that I am going to focus on are (1) political independence; (2) its corollary, accountability; (3) the objective of the central bank, often called its "mandate"; (4) how these objectives are communicated; and (5) the tools that are used to implement policies designed to attain these objectives. While many emerging markets such as India, Mexico, South Africa, Indonesia and Brazil have central banking practices that warrant attention, my remarks are going to focus on the four main developed central banks: the Fed, the European Central Bank (ECB), the Bank of Japan (BoJ) and the Bank of England (BoE). In addition my remarks will contain references to the central banks of Canada and Australia.

Before looking at these areas to compare and contrast practices, it is worth looking at some similarities about central banking practices that often get lost in such discussions. These similarities comprise the metaphorical forest that often gets lost when we get preoccupied with a discussion of the trees. And by ignoring the forest we are often skewing the discussion in ways that can be less than helpful.

First, for all the talk about "mandates" single and dual, inflation and employment, ALL central banks have an unspoken mandate that, using a Star Trek phrase, I would call the prime directive. All central banks have primary responsibility for maintaining the stability of the financial system, and doing so in three areas: (1) the banking system; (2) asset prices more generally; and (3) the government's fiscal sector. This three part prime-directive is the sine qua non of central bank behavior since without stability in the financial system targeting inflation and unemployment or some combination thereof becomes impossible.

This reality became obvious in the recent financial crisis as virtually all central banks seriously pushed the envelope with regard to their so-called "mandates" in order to keep the financial system functioning. Every central bank engaged in extraordinary measures in order to keep the system afloat, and some of these extraordinary measures went beyond the traditional mandates. The most obvious case of this was the Bank of England which was forced several times to write the obligatory letter explaining why it had exceeded its mandated inflation target but was still pursuing an aggressively easy monetary policy.

In Europe the ECB is prohibited from monetary financing of the deficits of the nation states. But it was obvious that the financial stability of several key government bond markets was at risk. The ECB handled this with a number of programs. The Securities Market Program (SMP) was nominally designed to improve the monetary transmission mechanism. The LTRO program provided indirect lending by allowing banks to deposit long term government bonds at the ECB as collateral for which they got long term funding in return. And when it comes to asset price maintenance, the Bank of Japan has directly purchased both REITs (Real Estate Investment Trusts) and equity market index funds. The Fed tried, and abandoned, a similar facility through the TALF program.

The second great "forest" that is missed by focusing on the "trees" is that the distinction that is often made between the balance sheets of the sovereign government and the balance sheet of the central bank is merely a useful fiction. In reality, the taxing authority of the government is the backstop of the balance sheet of the central bank and the money issuing authority of the central bank allows the guaranteed redemption at face value of the government's debt. This fact has two important implications, one for fiscal policy the other for monetary policy.

The implication for fiscal policy is that a long term credible fiscal policy is a prerequisite for an effective monetary policy. If the government's balance sheet becomes unsustainable, then its ability to use its taxing authority to support the balance sheet of the central bank becomes untenable. How might this happen? Suppose the central bank takes on a lot of government debt onto its balance sheet and due to a change in sentiment yields start to rise. The central bank balance sheet quickly goes underwater since its bond holdings are now worth less than par. It might not recognize these losses formally, but markets might. The central bank might say that it is holding its long term bonds to maturity, but what if the ultimate redemption of that long dated maturity is not considered credible because the long term fiscal position of the government is unsustainable? The central bank then loses its ability to issue its paper since its balance sheet is both underwater currently and will never become solvent. That is the end of the central bank as it was under Weimar, for example.

This fact is why the Bank of Japan was insistent that the government stick with its plans to implement the Consumption Tax hike that had been passed by the previous government. This is why the European Central Bank always talks about "conditionality" when it discusses programs that link monetary policy to the purchase of debt issued by member governments. It is why the Chancellor of the Exchequer in Britain is careful to keep British deficits on a downward trajectory; it allows the Bank of England to continue to purchase gilts. By extension I would argue, the long term path out of the Fed's current balance sheet position is fiscal consolidation and the long term shrinkage of the unfunded liabilities in our entitlement programs. If this does not happen it will be very difficult for the Fed to engineer a painless exit from Quantitative Easing.

The monetary policy lesson from the effective unity of the central bank and government balance sheets is that Quantitative Easing is lowering the effective duration of government debt at a time when one might imagine government should be mimicking private sector borrowers and trying to lengthen its duration. Of course the very purpose of Quantitative Easing programs in all of their international guises is to flatten the yield curve. To do this in a yield-curve-bullish way, the central bank must shorten the effective duration of government debt while pegging the short end of the yield curve. Of course, the effect of this is to push the private sector into other risky assets, drive up their price, and hopefully create a wealth effect that will lead to higher levels of current consumption and investment than would otherwise have occurred.

But note that this is not a *reduction* in financial risk it is merely its *deferral.* The financial position of the private sector is intentionally being made more risky – that is the point of the exercise after all, to bid up the prices of risky assets. But the long term financial position of the public sector is also being made more risky as its net reliance on short term funding also increases. Some have argued that the central bank is a "patient" holder of government securities, and so it is. So is the Social Security Trust fund. But while transferring government debt to either a central bank or a different subsidiary of the government like a trust fund may reduce the riskiness of the "on budget" balance sheet, it does nothing to reduce the overall riskiness of the entire balance sheet. In fact a hallmark of many financial crises – be it public sector ones like the Asian financial crises of the 1990s or the private sector one of five years ago when institutions were too reliant on short term wholesale funding – is an excessive reliance on short term funding.

This brings us to the third lesson of the "forest" wide view of central banking – its relative independence from the political world. All countries have found it useful to have at least some degree of separation between the government of the moment and the central bank. In practice the degree of independence varies with the personalities involved regardless of what the formal arrangements may be. But one other reality that stems from the issues discussed here – like co-dependence of balance sheets and the ultimate responsibility for financial stability – is that central banks can never be truly separate or independent from their sovereign governments.

A somewhat cynical way of expressing this is that governments allow central banks independence over those matters about which they the government really don't want to have responsibility. One anecdote about this is that Arthur Burns was having lunch with Wright Patman, then Chairman of the Banking Committee and a man known for his attacks on the Fed. When Burns asked Patman why given those views he never let any anti-Fed legislation out of Committee the Congressman reportedly replied, "if we didn't have you to blame what would we do?"

It is useful to bear in mind that when political figures call for some curtailing of the freedom of movement of the central bank that they are implicitly placing more responsibility on themselves for the conduct of that policy. Whether or not the political institutions effectively pick up that responsibility and wield it in an effective way is often left an open question. My conclusion from this view of the "forest" is that elected governments might do well to let central banks exercise considerable latitude but then hold them accountable through hearings for maintaining a logical and coherent set of policies. Limitations on central bank actions, while well intended, often create a vacuum in responsibility that is difficult to fill by political authorities when the time to do so is most needed. Having examined the "forest", let me now turn to the "trees".

Political Independence

Central banks differ quite a bit in the formal degree of political independence they are granted and in how that independence is protected structurally. For example, in three Anglo-Saxon countries: the United Kingdom, Australia, and Canada, the decision of the central bank can be formally overridden by the government. In the United Kingdom the Chancellor can give explicit orders to the central bank under "extreme circumstances" which must then be subsequently ratified by the Parliament. (Due to the nature of Cabinet government in the UK this should be considered a formality or the government would fall.) In Australia the policy of the central bank can be overruled by the Treasury and the bank can then be required to change it. In Canada, the Minister of Finance, with authorization from the Cabinet, can issue a written directive to the Governor of the central bank specifying a change in policy. Although these rules would be considered as depriving the central bank of its independence in the American context, in practice these measures are never used. As noted above, if the government were to issue an explicit order to the central bank, it would then become responsible for the consequences of that order, and governments tend to be loathe to take such responsibility on themselves.

At the other extreme lies the European Central Bank which has independence not only formally guaranteed by the treaty that created it, but has the advantage of not having a strong or unified central government to report to. This latter fact leads to a very independent governing structure. The Chairman is appointed for one single eight year term by agreement by all Eurozone countries. In practice this has meant that the candidate must be acceptable to Germany and France. Having no reappointment means that there is no incentive for the Chairman to try and please anyone. In addition there are five members of the Executive Board with staggered 8 year terms and the heads of the central banks of each of the countries that is a member of the Eurozone. This latter group assures that no single political group can dominate the board. (I might note that this has its echoes in the membership of the FOMC which includes the 12 regional bank Presidents who are accountable to independent boards of directors.)

In between lies the Bank of Japan with a governor, two deputy governors, and six executive directors appointed by the Cabinet on a staggered basis. This does not create any solid institutional basis for independence from the Cabinet. Moreover the law mandates that the BoJ "maintain close contact with government and exchange views". Despite this the BoJ exercises an enormous amount of independence. This became apparent in January when outgoing BoJ Governor Shirakawa negotiated a letter of understanding with the incoming Abe government on monetary policy. The Abe government had just been elected with the largest majority in the history of modern Japan and had run on a platform that included changes to monetary policy. Shirakawa was a lame duck whose term was about to expire. Still, that agreement was not one sided, a tribute not just to Shirakawa but most importantly to the real independence of the Bank of Japan.

In my opinion the BoJ holds its independence due to the enormous respect it possesses in Japanese public opinion. At one point the idea was even floated that BoJ issue its own debt rather than the government. That makes no particular sense given the co-dependence of governments and central banks and the unity of their balance sheet, but it was an indication that the Bank holds greater respect than the Ministry of Finance. One reason for this might be that the BoJ has been a permanent fixture in Japan, with a tradition that long predates the second World War. By contrast, governments in Japan turnover very frequently and have tended to be special interest oriented. So, the real independence of the BoJ is one that has been earned in the court of public opinion, rather than formally granted by the government.

This leads to an important conclusion about the nature of independence. In the end, just as nothing succeeds like success, nothing guarantees a central bank's independence more than the quality of its performance as perceived by the public and the markets. Regardless of formal structure, the true independence of the central bank will vary with the quality of the men and women who serve there. Nominate people to serve on the governing boards of the central bank who are perceived as independence. With such individuals in office it really doesn't matter how much consultation occurs between the central bank and the government.

Accountability

With formal fixed terms for governors and members of the central banks' governing bodies, it is hard to insure accountability in any formal sense. The standard recipe for such accountability is public hearings. There are two a year for the Fed before each House of Congress. The ECB has five formal public hearings before the European Parliament each year. Australia requires a semi-annual testimony and an annual report to the Parliament. In the United Kingdom and Japan central bank governors are required to testify, but not at any pre-set interval.

While testimony does not hold an individual accountable in any formal sense of the word, it does require that individual to listen to the opinions of those who are elected by the public at large. I think that much of what is called "accountability" really amounts to sensitivity. In the formal sense an elected member of the legislature might ask questions in as forceful and argumentative a way as he or she might choose, but the central banker has no more obligation than to listen politely and give an appropriate answer. There is nothing in this practice that need change the central banker's opinion, much less the central bank's policy.

Accountability should therefore be thought of in a much broader context, one that feeds back into the true basis for the central bank's independence: performance. If a central bank can explain what it is doing in a formal hearing or in a regular press conference in a way that strikes those interested as reasoned and coherent, then the central bank passes the true test of accountability. If the argument being presented makes sense then the markets and the public at large are likely to tolerate the central bank pursuing its present course. If rational explanations are not forthcoming or if the central bank seems out of touch with the broader line of thinking in the country then the bank will quickly lose its freedom of action. So as in the case of independence, real accountability is performance based and depends crucially on the ability of the central banker to explain the logic of his or her position.

Communication

With accountability therefore so dependent on the acceptance by the public and the markets of the logical basis of the central bank's thinking, communication has become key. All of the central banks considered here issue a formal statement after each meeting. In all cases this is followed, with a lag, of a written report of the minutes of the meeting. The Fed, the ECB and the BoJ also issue economic projections. In the case of the ECB this occurs at every meeting, and not just every other meeting as here. The central banks of the United Kingdom, Canada, and Australia issue quarterly reports.

This reporting explains what the central bank is thinking and, to a large extent, the reasoning that goes behind that thinking. The issuance of an economic projection attempts to quantify that thinking. This is especially important where the central bank is tied or has tied itself to some target. For example, if a central bank has an inflation target as part of its mandate, it must have an economic projection that shows that the economy is moving toward that target and that the direction of the movement must be consistent with projection and the policy being pursued.

This latter point has now morphed into something known as "forward guidance" where the central bank explicitly projects *future* policy decisions as well as projections of the path the economy is expected to take. The idea behind forward guidance is that it enhances central bank effectiveness. For example, the Bank of England, the Bank of Japan, the European Central Bank as well as the Federal Reserve now project that interest rates will remain accommodative for some extended period into the future. This is to reassure markets that policy will not be changing any time soon and that therefore the current level of short term rates set by the central bank can be extended further out the yield curve. This is thought to hold intermediate rates lower than they otherwise might have been and that this, in turn, will help spur investment and the purchase of durable goods.

It is too early to know whether or not this policy is efficacious. Indeed it will probably take the work of some doctoral students in the early part of the next decade to decide the issue. But even though there is a general perception that more transparency is always good, it is important to consider the possibility that what is being provided may be too much information. The key issue is that economics remains as much of an art as a science and too much specificity about the future course of policy and the economy runs the risk of showing that the "science" of central bank policy making is indeed in its infancy. If markets and the public lose faith in the scientific rationale of the policy, then the "art" of shaping economic outcomes through monetary policy may be placed at risk as well.

Let's say hypothetically that economic projections consistently run on the optimistic side relative to what actually occurs. Those projections naturally assume that the policy that the central bank is running and plans to continue running have an effect on economic policy and presumably that effect is a positive one. But when an economy runs at a rate of growth that is consistently below the projections of the central bank it is natural that the question arises as to why. There are two logical explanations: either that factors outside the central bank's control have consistently, year after year, run to the downside of what was expected or that the efficacy of central bank policy is less than what the central bank had projected. Neither explanation is good for building faith in the central bank.

If it is factors outside of the central bank's control then one must ask why the central bank's economic model consistently misses the mark. Should the markets and the public have faith in a policy process that is built on so flawed a model? The even worse assumption is that the policy itself is less efficacious than the central bank assumed. In that case it is rather explicit that there is something wrong with the policy itself.

A second risk of providing too much information is communicating what the central bank would do if the situation changes. It is fine to project low interest rates and low inflation into the foreseeable future, but what will the central bank do if its inflation projections turn out to be wrong? The central bank will have communicated a path of rates that (assuming it has credibility) has been incorporated into the market's pricing of intermediate and longer term securities. A surprise event that unhinges those expectations therefore will move markets with amplified magnitude. Stated differently, the diversity of market opinion that provides liquidity and dampens price movements is dissipated by forward guidance. Should the forward guidance be wrong, the market reaction will be similar to that in any situation where liquidity is thin and most market practitioners are on one side of the trade.

Objective

Where the relationship between communication, accountability, and political independence come together most closely is on setting a central bank's objective or mandate. In recent years the notion of "price stability" has gained prominence as the central bank objective. The Bank of Japan and the Bank of England both have price stability as their target. In both cases the definition of price stability is a bit flexible, with low rates of measured inflation being the target, typically at a two percent annual rate. The European Central Bank has price stability as its "primary objective" with secondary objectives of balanced growth, social progress and full employment. It also stipulates that all of those secondary objectives are best achieved through price stability. Please note that it is widely accepted in the central banking community as well as within the economics profession that low and stable inflation is a necessary condition for other objectives such as maximizing employment. The reason is that high rates of inflation lead to a reduced rate of efficiency in the economy and that the distortions caused by inflation will inevitably lead to a lower equilibrium rate of employment than would otherwise be the case.

But price stability is not the only objective in the central banking lexicon. Canada has adopted a two percent inflation target but its mandate is to "contribute to the economic well-being of Canadians". That has to be one of the most nebulous and broad mandates possible, but it does not stand in the way of price stability as a target. Australia mandates stability of the currency, full employment, and economic prosperity. Here there is some question about what is meant by stability of the currency since the foreign exchange value of the Australian dollar is one of the main shock absorbers of the economy. It rose sharply during the China boom and is now falling rapidly as Chinese growth slows down. This is hardly a "stable currency" but its flexibility also helps maintain employment and economic prosperity.

Frankly, this comparison indicates that probably too much attention is being paid to defining a central bank's mandate. Central banks are going to do what central banks are going to do. Although far from specific, the Canadians probably have it right. Central banking behavior is designed to "contribute to the economic wellbeing" of the country. There is a broad consensus that this includes a focus on price stability – or more precisely low measured inflation – but that the so-called inflation target is really just a pre-requisite for other objectives like growth and employment. And, to reiterate a point made earlier, when it comes to setting objectives, financial stability is the prime directive of the central bank. Formal mandates and targets have given way to the pursuit of this central purpose for both philosophical and pragmatic reasons.

Tools

All of the central banks considered here have relied on the setting of short term interest rates as their primary policy tool. This has been the chief policy tool since the central bank is both a short term lender of last resort to the banking system, and more broadly, a major participant in the overnight lending of one bank to another. By controlling that overnight rate through its intervention, the central bank tends to set a base price for lending by banks to other agents in the economy and therefore influence the level of economic activity.

It used to be thought that controlling the short term lending rate was sufficient for the conduct of monetary policy. If the short term rate was appropriately anchored, longer term rates in the economy would vary with market perceptions of longer term risks, including the risk of future policy changes by the central bank. The various asset purchase programs now used by the ECB, the BoJ, the Bank of England and the Fed are designed to directly control these longer term rates as well.

Part of the reason for extending the term structure of central bank purchases was purely pragmatic. The volume of monetary policy intervention that the central bank deemed appropriate was often in excess of what was available on the short end of the yield curve. Quantitative Easing is deemed necessary as short rates approached their zero lower bond since it is widely believed that the optimum short term rate should actually be below zero for monetary conditions to be appropriate in meeting the central bank's longer term objectives.

Indeed, even the purchase of longer term government bonds has now been considered insufficient for most of the world's leading central banks. The ECB, which normally could not make such purchases, now utilizes its LTRO program to lend money to banks on a long term basis in order to purchase government bonds indirectly. In addition, it has a covered bond purchase program that purchases both mortgages and other public sector bonds. The Bank of Japan purchases ETFs in the equity market as well as Real Estate Investment Trusts. The Bank of England makes loans to banks based on the amount of their private sector lending.

One would hope that the use of all of these tools would be temporary in nature. They were implemented to deal with what everyone considered an extraordinary situation. We are indeed in big trouble if the extraordinary begins to transition into the ordinary since it will mean that more than just central bank policy making has some serious problems. Again, a review of the behavior of central banks globally suggests that flexibility in the tools they might use is a good idea because when extraordinary situations develop it is probably not a good idea to hobble central bank policy making unnecessarily. An example of this is in the Eurozone where the ECB is constrained in its ability to conduct Quantitative Easing due to prohibitions on its ability to purchase government bonds in large scale.

That said, one area that might be a bright line to watch is credit allocation. It is one thing for central banks to conduct monetary policy through the purchase of large amounts of instruments, it is quite another for the central bank to decide who is a good credit and who is not. The reason that banks and credit markets are assigned that job is that the lender puts itself at risk and therefore has a stake in the quality of its credit decision. The same would not necessarily be true of the central bank.

There is of course a lot to discuss in this area, but I hope this has provided some basic guideposts as to the international conduct of central banks. I would be happy to answer your questions.

THE WALL STREET JOURNAL.

OPINION

Andrew Huszar: Confessions of a Quantitative Easer

We went on a bond-buying spree that was supposed to help Main Street. Instead, it was a feast for Wall Street.

By ANDREW HUSZAR

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I can only say: I'm sorry, America. As a former Federal Reserve official, I was responsible for executing the centerpiece program of the Fed's first plunge into the bond-buying experiment known as quantitative easing. The central bank continues to spin QE as a tool for helping Main Street. But I've come to recognize the program for what it really is: the greatest backdoor Wall Street bailout of all time.

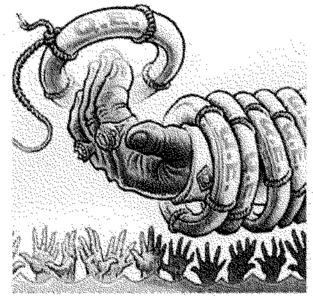
Five years ago this month, on Black Friday, the Fed launched an unprecedented shopping spree. By that point in the financial crisis, Congress had already passed legislation, the Troubled Asset Relief Program, to halt the U.S. banking system's free fall. Beyond Wall Street, though, the economic pain was still soaring. In the last three months of 2008 alone, almost two million Americans would lose their jobs.

The Fed said it wanted to help—through a new program of massive bond purchases. There were secondary goals, but Chairman Ben Bernanke made clear that the Fed's central motivation was to "affect credit conditions for households and businesses": to drive down the cost of credit so that more Americans hurting from the tanking economy could use it to weather the downturn. For this reason, he originally called the initiative "credit easing."

My part of the story began a few months later. Having been at the Fed for seven years, until early 2008, I was working on Wall Street in spring 2009 when I got an unexpected phone call. Would I come back to work on the Fed's trading floor? The job: managing what was at the heart of QE's bond-buying spree—a wild attempt to buy $1.25 trillion in mortgage bonds in 12 months. Incredibly, the Fed was calling to ask if I wanted to quarterback the largest economic stimulus in U.S. history.

This was a dream job, but I hesitated. And it wasn't just nervousness about taking on such responsibility. I had left the Fed out of frustration, having witnessed the institution deferring more and more to Wall Street. Independence is at the heart of any central bank's credibility, and I had come to believe that the Fed's independence was eroding. Senior Fed officials, though, were publicly acknowledging mistakes and several of those officials emphasized to me how committed they were to a major Wall Street revamp. I could also see that they desperately needed reinforcements. I took a leap of faith.

In its almost 100-year history, the Fed had never bought one mortgage bond. Now my program was buying so many each day through active, unscripted trading that we constantly risked driving bond prices too high



Phil Foster

and crashing global confidence in key financial markets. We were working feverishly to preserve the impression that the Fed knew what it was doing.

It wasn't long before my old doubts resurfaced. Despite the Fed's rhetoric, my program wasn't helping to make credit any more accessible for the average American. The banks were only issuing fewer and fewer loans. More insidiously, whatever credit they were extending wasn't getting much cheaper. QE may have been driving down the wholesale cost for banks to make loans, but Wall Street was pocketing most of the extra cash.

From the trenches, several other Fed managers also began voicing the concern that QE wasn't working as planned. Our warnings fell on deaf ears. In the past, Fed leaders—even if they ultimately erred—would have worried obsessively about the costs versus the benefits of any major initiative. Now the only obsession seemed to be with the newest survey of financial-market expectations or the latest in-person feedback from Wall Street's leading bankers and hedge-fund managers. Sorry, U.S. taxpayer.

Trading for the first round of QE ended on March 31, 2010. The final results confirmed that, while there had been only trivial relief for Main Street, the U.S. central bank's bond purchases had been an absolute coup for Wall Street. The banks hadn't just benefited from the lower cost of making loans. They'd also enjoyed huge capital gains on the rising values of their securities holdings and fat commissions from brokering most of the Fed's QE transactions. Wall Street had experienced its most profitable year *ever* in 2009, and 2010 was starting off in much the same way.

You'd think the Fed would have finally stopped to question the wisdom of QE. Think again. Only a few months later—after a 14% drop in the U.S. stock market and renewed weakening in the banking sector—the Fed announced a new round of bond buying: QE2. Germany's finance minister, Wolfgang Schäuble, immediately called the decision "clueless."

That was when I realized the Fed had lost any remaining ability to think independently from Wall Street. Demoralized, I returned to the private sector.

Where are we today? The Fed keeps buying roughly $85 billion in bonds a month, chronically delaying so much as a minor QE taper. Over five years, its bond purchases have come to more than $4 trillion. Amazingly, in a supposedly free-market nation, QE has become the largest financial-markets intervention by any government in world history.

And the impact? Even by the Fed's sunniest calculations, aggressive QE over five years has generated only a few percentage points of U.S. growth. By contrast, experts outside the Fed, such as Mohammed El Erian at the Pimco investment firm, suggest that the Fed may have created and spent over $4 trillion for a total return of as little as 0.25% of GDP (i.e., a mere $40 billion bump in U.S. economic output). Both of those estimates indicate that QE isn't really working.

Unless you're Wall Street. Having racked up hundreds of billions of dollars in opaque Fed subsidies, U.S. banks have seen their collective stock price triple since March 2009. The biggest ones have only become more of a cartel: 0.2% of them now control more than 70% of the U.S. bank assets.

As for the rest of America, good luck. Because QE was relentlessly pumping money into the financial markets during the past five years, it killed the urgency for Washington to confront a *real* crisis: that of a structurally unsound U.S. economy. Yes, those financial markets have rallied spectacularly, breathing much-needed life back into 401(k)s, but for how long? Experts like Larry Fink at the BlackRock investment firm are suggesting that conditions are again "bubble-like." Meanwhile, the country remains overly dependent on Wall Street to drive economic growth.

Even when acknowledging QE's shortcomings, Chairman Bernanke argues that some action by the Fed is better than none (a position that his likely successor, Fed Vice Chairwoman Janet Yellen, also embraces). The implication is that the Fed is dutifully compensating for the rest of Washington's dysfunction. But the Fed is at the center of that dysfunction. Case in point: It has allowed QE to become Wall Street's new "too big to fail" policy.

Mr. Huszar, a senior fellow at Rutgers Business School, is a former Morgan Stanley managing director. In 2009-10, he managed the Federal Reserve's $1.25 trillion agency mortgage-backed security purchase program.