



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

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

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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.

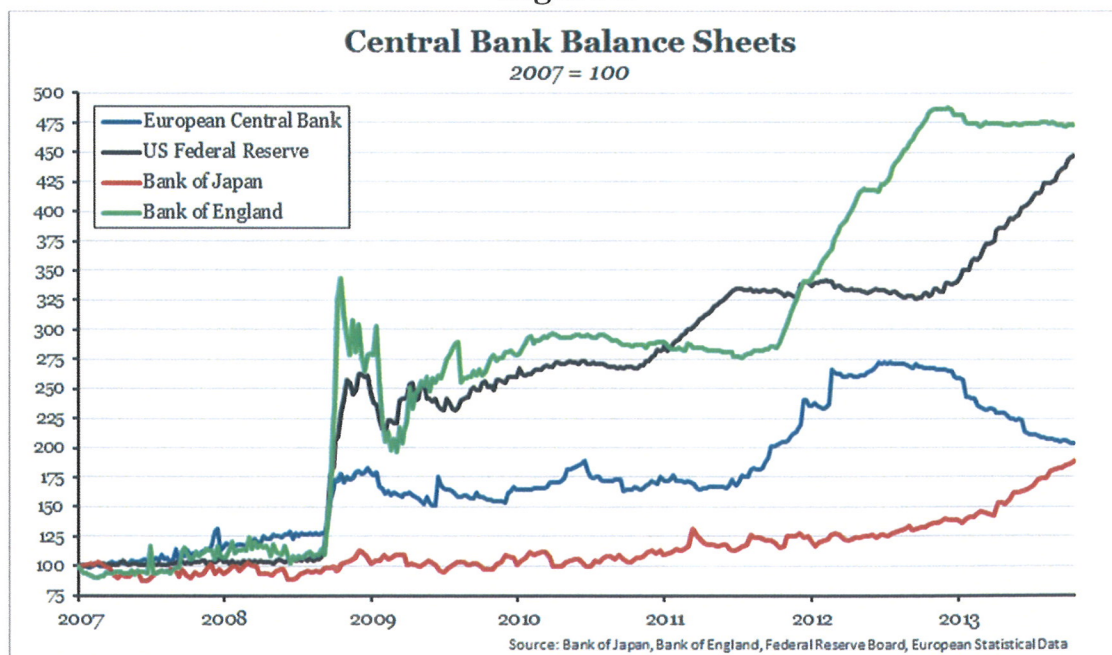
There can be little question that unorthodox monetary policies were successful in stabilizing the major industrialized economies' respective financial systems in the immediate aftermath of the September 2008 Lehman crisis. It also would seem that they have succeeded in providing welcome support to these 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 do 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.

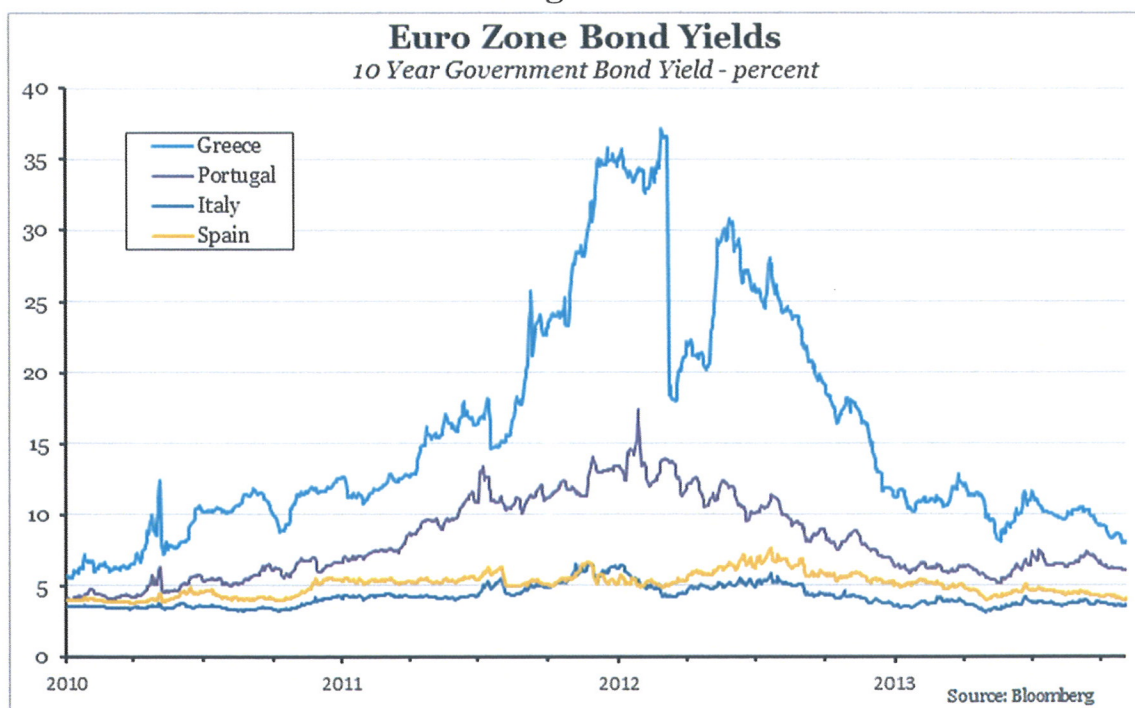
There is little room for debate about the major central banks' success in restoring the proper functioning of the global financial system. Through innovative programs such as TALF, TAF, TARP, SMP, and LTRO, bank access to liquidity was substantially eased. Further, by lending long-term without asking 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.

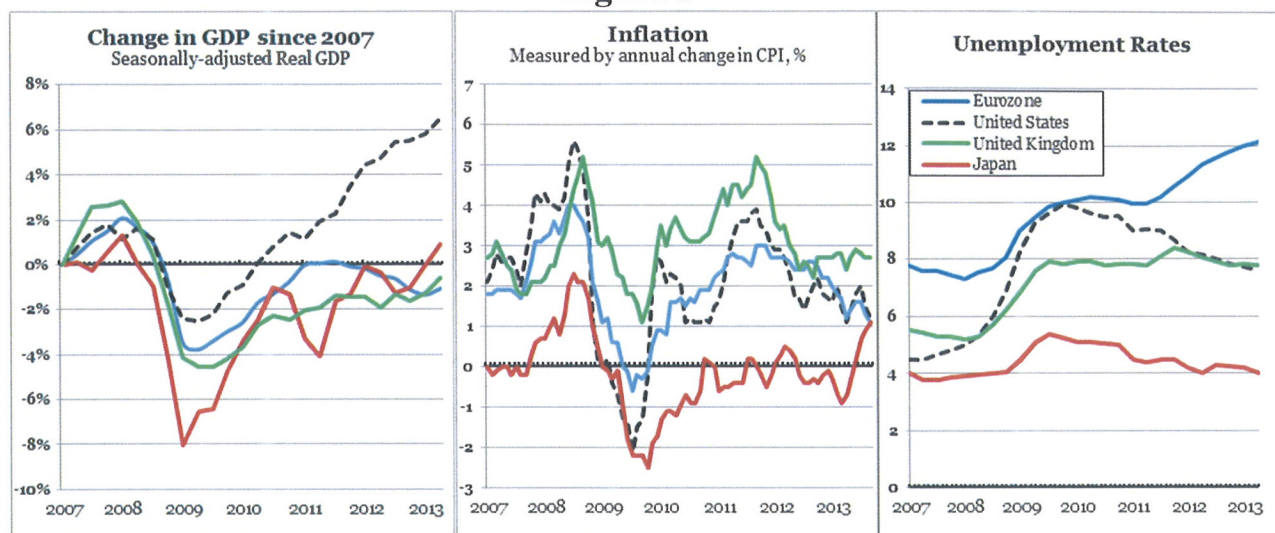
Figure 2



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

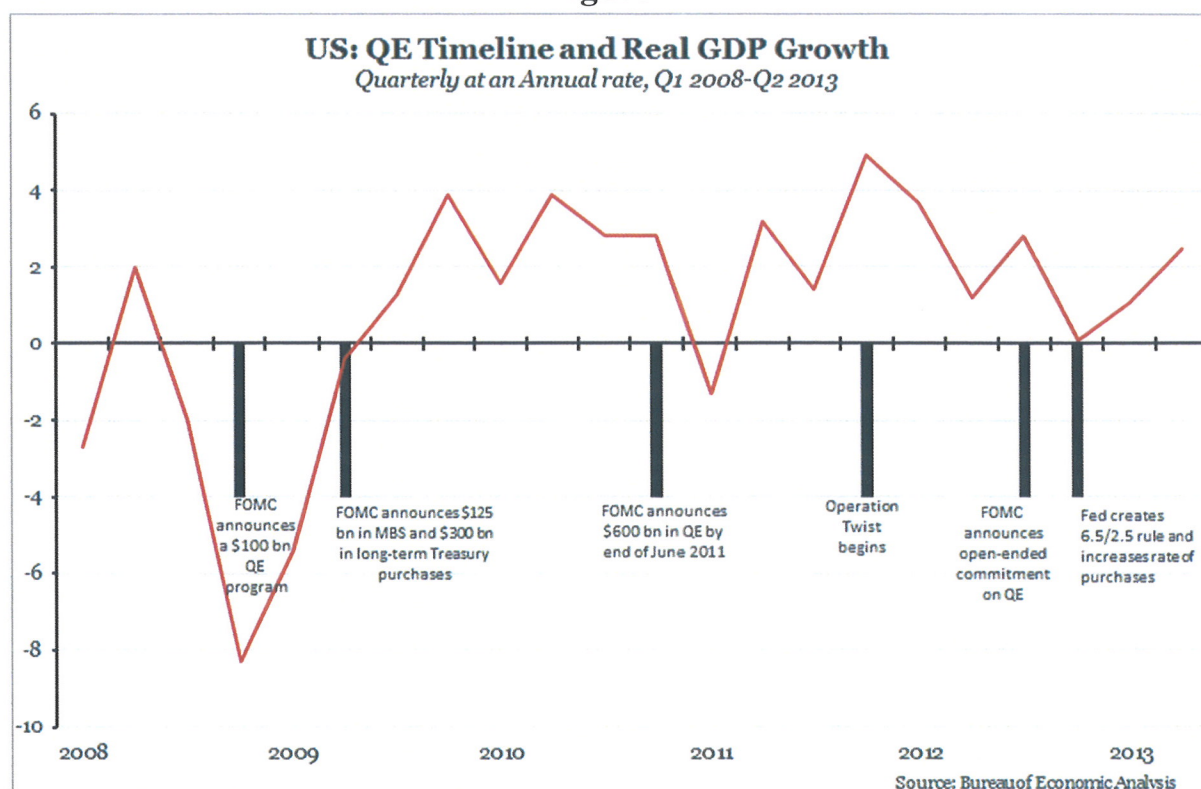


Source: Bloomberg

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



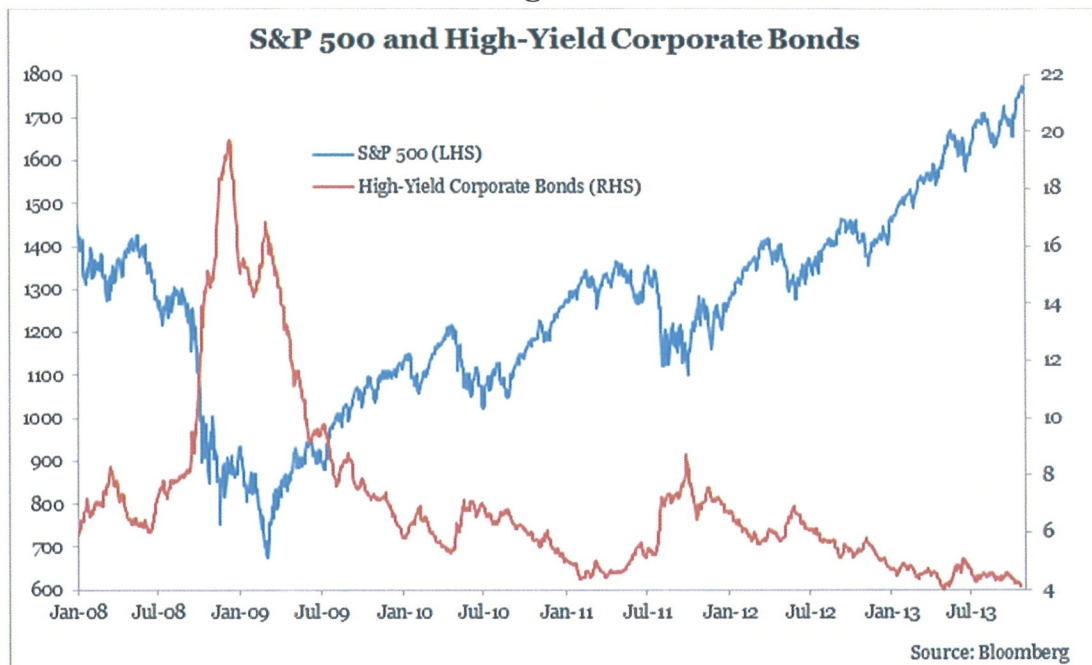
Unintended consequences

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



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.

United States House of Representatives
Committee on Financial Services

“TRUTH IN TESTIMONY” DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name: Desmond Lachman	2. Organization or organizations you are representing: American Enterprise Institute
3. Business Address and telephone number: 1150 Seventeenth St. N.W. Washington DC 20036 <div style="text-align: right;">202-862-5844</div>	
4. Have <u>you</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2010 related to the subject on which you have been invited to testify? <div style="display: flex; justify-content: space-around;"><input type="checkbox"/> Yes<input checked="" type="checkbox"/> No</div>	5. Have any of the <u>organizations you are representing</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2010 related to the subject on which you have been invited to testify? <div style="display: flex; justify-content: space-around;"><input type="checkbox"/> Yes<input checked="" type="checkbox"/> No</div>
6. If you answered “yes” to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets. <div style="height: 150px; border: 1px solid black; margin-top: 10px;"></div> <div style="display: flex; justify-content: space-between; margin-top: 10px;"><div style="font-family: cursive; font-size: 1.2em;">Desmond Lachman</div><div>11/10/13</div></div>	
7. Signature:	

Please attach a copy of this form to your written testimony.

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