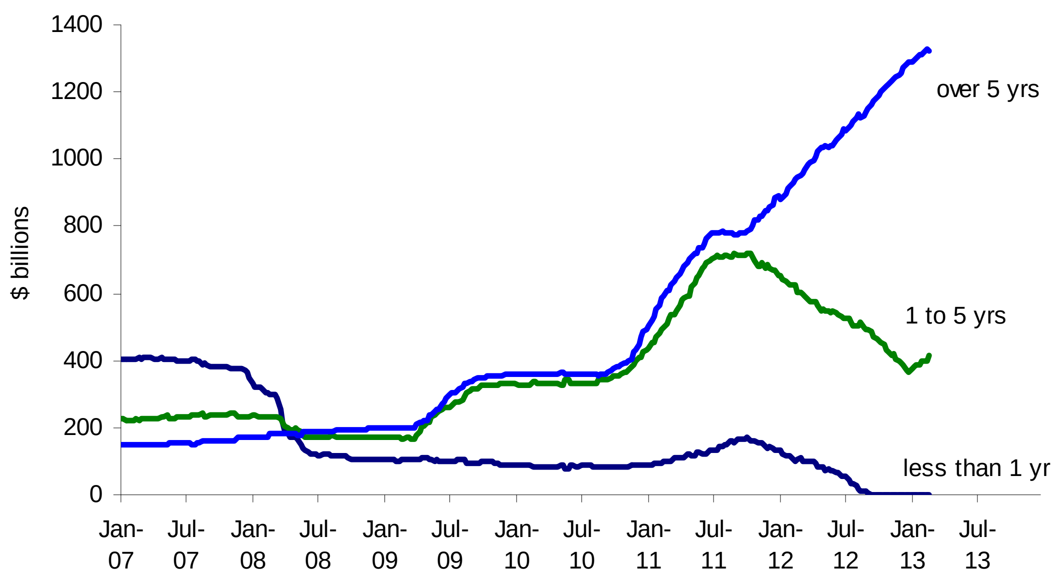
Statement of
David R. Malpass before the
House Financial Services Committee
Monetary Policy and Trade Subcommittee
March 5, 2013

Chairman Campbell, Congressman Clay, members of the Committee, thank you for the invitation to testify on the effectiveness of current monetary policy. It is a great pleasure to join Allan Meltzer, John Taylor and Joe Gagnon on this panel.

I think Federal Reserve policies have been weakening and distorting the economy rather than providing stimulus. The policies are hurting savers, distorting markets, and redistributing capital rather than increasing it. The policies subsidize government, big corporations, big banks, foreign investment and gold, none of which is a robust private sector job creator, at the expense of small and new businesses and other job-creating parts of the economy. The result is a departure from market-based capital allocation that is contractionary in the same way that price controls, income redistribution and industrial policy are contractionary.

The Fed funds rate has been near zero for over four years, unique in our history. By borrowing heavily from banks, the Fed has expanded its balance sheet by more than $2 trillion (from $900 billion to $3.1 trillion). It has substantially lengthened the duration of its assets by selling all of its Treasury bills, which were once a mainstay of monetary policy, to buy longer-term Treasuries. This leaves the Fed with substantial interest rate risk and marks the end of an era for the Fed's once ultra-liquid balance sheet.

Maturity of Fed Treasury Security Holdings (last obs. February 20, 2013)



Source: Federal Reserve; Encima Global

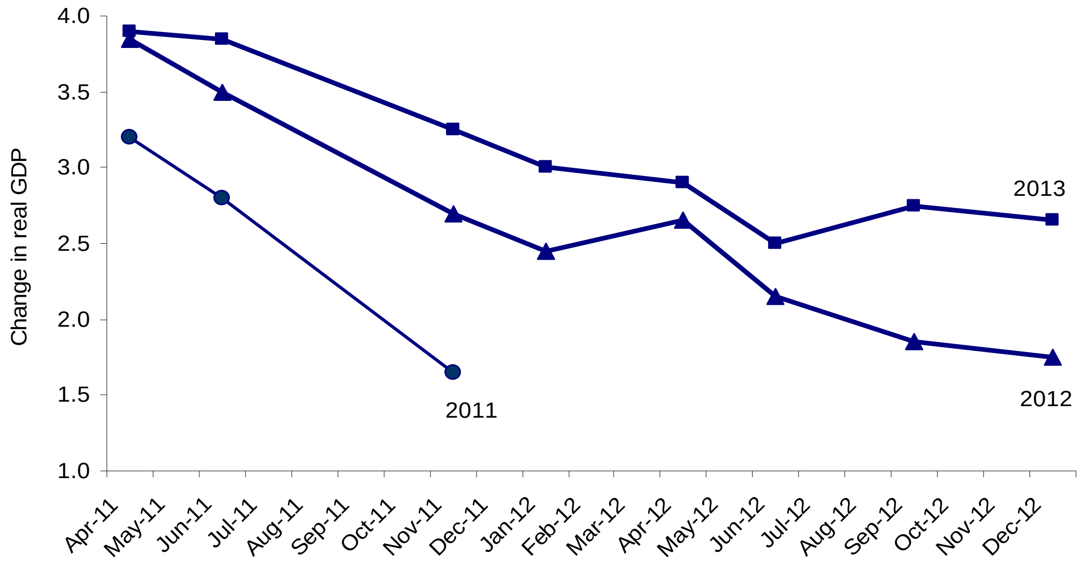
The result is an experiment in extreme monetary policy. It hasn't worked, as shown by the weakening of the expansion. Real growth has slowed from 2.4% in 2010 to 2.0% in 2011 and 1.6% in 2012. Nominal growth, where a stimulative Fed policy should have its most influence, has also slowed – from 4.3% in 2010 to 4.0% in 2011 to 3.5% in 2012. **In effect, the U.S. economy has been going backwards. It is showing unprecedented weakness during an expansion, evidence of poor monetary, fiscal and regulatory policies.**

Real GDP Growth (4th qtr/ 4th qtr, last obs. 2012)

Source: Bureau of Economic Analysis; Encima Global

The Federal Reserve had to lower its original growth projections for 2011, 2012 and 2013. Some of the economy's underperformance is due to factors such as uncertainty over tax policy, Europe's debt crisis and the trauma during the August 2011 debt limit increase. However, I think there is also a problem in the transmission mechanism of QE to the economy. It isn't working under current circumstances of heavily regulated growth in private sector credit, so economic growth has been coming in below the Fed's expectations. The longer the harmful monetary policy persists, the more the weight on the economy, making the distortions more difficult to unwind.

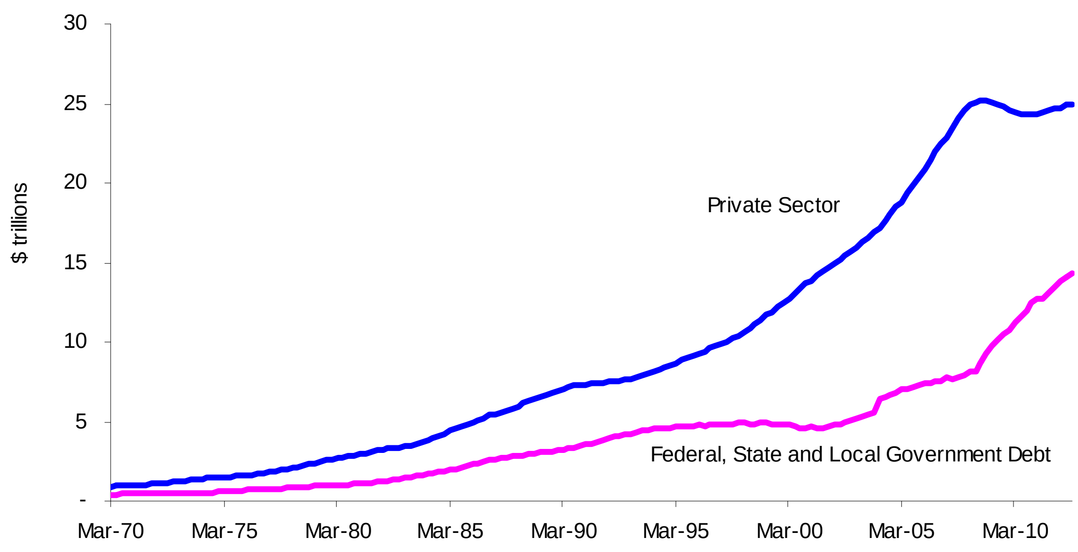
Fed Projected Real GDP Growth Rates (last obs. December 12, 2012)



Source: Federal Reserve; Encima Global

The money multiplier that connects the Fed's creation of bank reserves to private sector credit growth has simply stopped functioning under current monetary and regulatory policies. The Fed's balance sheet has been expanding without a corresponding expansion in private sector credit. Private sector credit growth was up only 1.6% ($384 billion) in the 2010-2012 period (through Q3), one of the factors holding the nominal GDP growth rate down. By comparison, government debt rose 32.4% ($3.5 trillion, nearly ten times as much) and the Federal Reserve's liabilities rose 30.6% ($669 billion.)

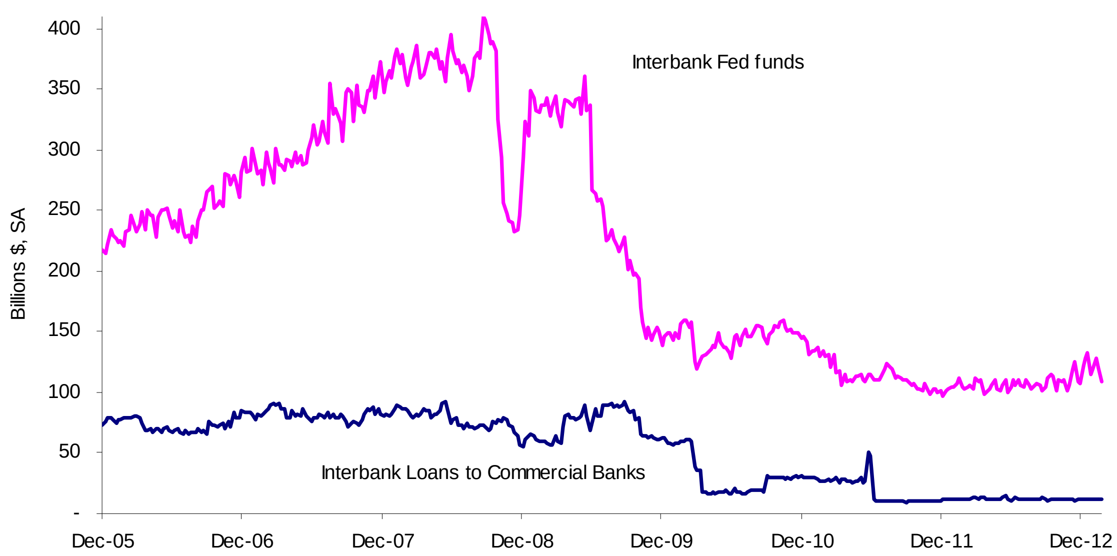
Private and Public Sector Debt (last obs. Q3 2012)



Source: Federal Reserve; Encima Global

The Fed is setting short-term interest rates artificially low. This creates risk and uncertainty in the outlook. In the Fed's September FOMC statement, it promised low future interest rates. It hopes this will encourage consumer spending, but it also undercuts the normal impetus to borrow during a recovery to lock in low rates before they go up. The low-rate policy penalizes savers, distorts capital allocation and undermines critical interbank markets, one of the many problems Professor Ronald McKinnon has highlighted.

Loans through Interbank and Fed Funds Market (last obs. Feb. 22, 2013)



Source: Federal Reserve; Encima Global

The Fed is also pushing down yields for longer-term credit, benefitting a select group of favored borrowers at the expense of non-favored borrowers such as new businesses, small businesses and businesses considered risky by government regulators. Per Fed policy, the weaker the labor market, the more government bonds the Fed will purchase, with no limit. This threatens the private sector with an even more distorted capital allocation process, creating a feedback loop that discourages productive investment.

These distortions have been hurting economic growth throughout the recovery, as discussed in my December 4, 2009 Wall Street Journal article titled Near-Zero Rates Are Hurting the Economy: “Capital is being rationed not on price but on availability and connections. The government gets the most, foreigners second, Wall Street and big companies third, with not much left over… For small businesses and new workers, capital rationing is devastating, spelling business failures and painful layoffs. Thousands of start-ups won't launch due to credit shortages, in part because the government and corporations took more credit than they needed because it was so cheap.”

By under-pricing credit for certain borrowers while applying regulatory limits on traditional lenders, credit ends up being rationed. The Fed stands ready to lend money to the government and the government-backed mortgage market at any price. Since regulators are enforcing capitalization and leverage requirements, the result of Fed bond purchases is a crowding out of lending to small and new businesses. As low rates are pushed out along the yield curve, capital is increasingly misallocated toward government and big corporations. This shows up in declining growth rates and less economic dynamism.

In addition to the contractionary economic impact, current monetary policy raises several other negatives:

1. The Fed is buying some of the most high-priced assets in the economy -- Treasury bonds and MBS -- long after the 2008 financial crisis. Some of the steps the Fed took in the heart of the 2008 crisis were beneficial, for example the reduction in the Fed funds rate from 2% to 1% in October 2008 and the Fed's purchase of high-yielding agency MBS to unfreeze the market in November 2008. However, the huge expansion of non-traditional measures in 2009-2012 extended well after the end of the crisis, harming market-based capital allocation.

2. The Fed has greatly expanded its role in the economy, financial markets and capital allocation. The Fed has asserted the legal authority to make unlimited "large-scale asset purchases" on its sole discretion even when there's no systemic crisis. That has huge implications for the future, when each slowdown will cause the markets to believe the Fed might buy assets.

3. By using short-term financing (overnight bank loans) to buy long-term bonds, the Fed is creating a maturity mismatch for itself and is shortening the effective maturity of the national debt. In just four years, the Fed's balance sheet has been transformed from the world's most liquid to the most mismatched in terms of maturities. Leveraged 30:1 (or 50 to 1 counting currency outstanding), the Fed is using $1.7 trillion of bank reserves as primary funding for $2.8T in very long maturity assets while maintaining only $55 billion of equity capital.

4. The Fed's massive buy-back of long-duration bonds has lengthened the effective maturity of the national debt, overwhelming the Treasury's important role in deciding the maturity. The result is a much more powerful Fed and a risk to taxpayers when interest rates are eventually allowed to return to market-based levels and the government refinances the debt at higher interest rates.

5. The Fed now owes nearly $2 trillion at floating interest rates to a small group of commercial banks. This has taken the place of Treasury debt held by the private sector, which would have been broadly placed in the market (and would pay a slightly lower interest rate than the Fed's 0.25% rate paid to banks.) When interest rates rise, the Fed and taxpayers will face a large increase in their interest

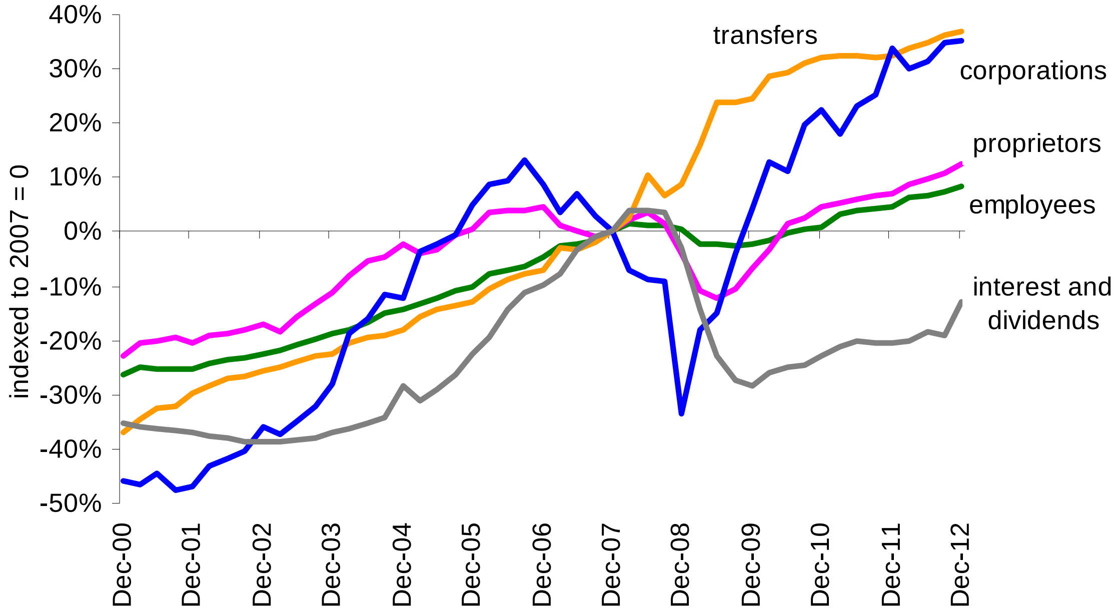
payments to commercial banks, creating severe political challenges and market uncertainty.

6. By connecting monetary policy to a specific 6.5% unemployment rate, the Fed has changed its mandate, in effect making itself accountable for a particular unemployment rate even though its policies don't control the rate. The Fed should be focused on maximizing employment and keeping inflation low. The new target and the Fed's giant bond portfolio interfere with the Fed's decision process in achieving its statutory mandate.

7. The Fed is actively managing consumer and market sentiment and encouraging risk-taking rather than relying on the quality of the monetary framework to encourage investment and hiring. In his September 13, 2012 press conference, Fed Chairman Bernanke said that the Fed assuring the public that it will take action if the economy falters should increase confidence and boost the willingness to spend. This Fed assurance that it will take action to support the economy is often described as the Bernanke put, a reference to a financial derivative that provides protection against losses. It is named after the Greenspan put, which equity and housing markets relied on to justify high leverage ratios in the 2000s on the view that then-Chairman Alan Greenspan would keep interest rates low enough that asset prices were sure to increase. Over-confidence in the low-rate environment of 2004-2007 gave rise to the view that banks and investors should "dance until the music stops," a process the Fed may be repeating. Interest rates and Treasury bond yields are well below the nominal growth rate and the inflation rate, a measure of the market distortion.

Current policy is causing a massive shift in the sources of income in the U.S. economy, with government transfers and corporate profits growing much faster than the income of sole proprietors and employees. This distortion in income growth is a major departure from historical norms. Since 2007, transfers are up 37% and corporate income up an estimated 35%, both of which benefit from zero interest rates and Fed bond purchases, whereas the other two components combined are up only 9%.

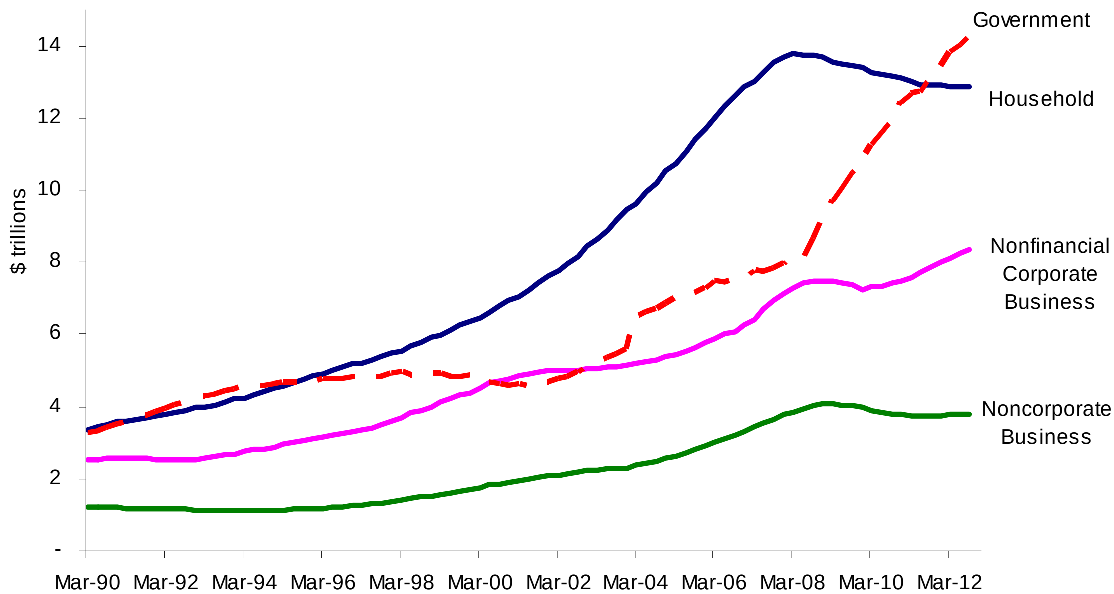
Income and Profits Distorted (last obs. Q3 2012, corp. profits Q4 estimate)



Source: Bureau of Economic Analysis; Encima Global

The Federal Reserve's flow of funds data shows large distortions in the patterns of credit growth, making clear the dramatic shift in the allocation of credit to government and corporations (graph below.) In the year ending September 30, credit to the government was up 8.9% to $14.3 trillion (including federal, state and local marketable debt). Private sector credit was up only 1.9% year-over-year to $25 trillion. Credit to corporations was up 6.3% to $8.4 trillion, but non-corporate credit was up only 1% to $3.8 trillion and credit to households was down 0.5% to $12.8 trillion. The December 31 data, due from the Fed on March 7, is likely to show the same trends.

Debt by Major Sectors (last obs. September 30, 2012)

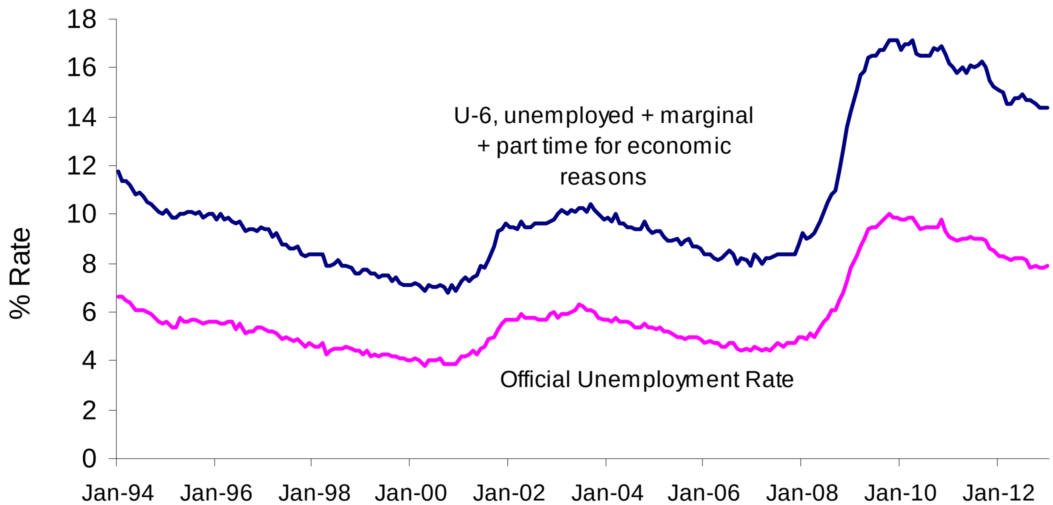


Source: Federal Reserve; Encima Global

Fed Chairman Bernanke raised this problem of capital mis-allocation directly in his August 27, 2010 Jackson Hole speech: "Generally speaking, large firms in good financial condition can obtain credit easily and on favorable terms… bank-dependent smaller firms, by contrast, have faced significantly greater problems obtaining credit… Through the provision of specific guidance and extensive examiner training, we are working to help banks strike a good balance between appropriate prudence and reasonable willingness to make loans to creditworthy borrowers."

This points to a very government-intensive process of credit allocation that has been one of the root causes of slow growth and poor capital allocation in the 2010-2012 period. The result has been weak growth in employment, leaving unemployment very high as small and new businesses lag.

Unemployment and Underemployment (last obs. January 2013)



Source: Bureau of Labor Statistics; Encima Global

Asset Price Theory

The Fed has put forward an asset price theory for transmitting QE into growth. In his November 14, 2010 Washington Post article, Chairman Bernanke said: "Higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."

In his November 4, 2010 Washington Post article, the Chairman emphasized the spending pathway, writing that monetary policies should ease financial conditions, which would promote economic growth. "Lower corporate bond rates will encourage investment. And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."

Over the course of the Fed's bond-buying, however, the virtuous circle has applied more to equities and some other financial assets than to the real economy, which has weakened year by year. For example, high-yield bond markets are hot, but don't create many jobs. I discussed the problem of asset price inflation in my October 19, 2010 Wall Street Journal article titled How the Fed is Holding Back the Recovery: "The Washington policy consensus for a decade has been 'print and spend.' When that doesn't work, the Washington prescription is to double the dose—more monetary easing and dollar devaluation, and always more government spending. The Fed in particular has become accustomed to subsidizing federal borrowing by holding interest rates too low, which distorts capital flows and fosters asset bubbles."

Fed Governor Jeremy Stein's February 7, 2013 speech at the St. Louis Fed (Overheating in Credit Markets) concludes that there is "a fairly significant pattern of reaching-for-yield… Overheating in the junk bond market might not be a major systemic concern in and of itself, but it might indicate that similar overheating forces were at play in other parts of credit markets." Separately, Dr. Stein points out that: "The maturity of securities in banks' available-for-sale portfolios is near the upper end of its historical range… In the spirit of tips of icebergs, the possibility that banks may be reaching for yield in this manner suggests that the same pressure to boost income could be affecting behavior in other, less readily observable parts of their businesses."

Portfolio Balance Theory

The Fed's primary explanation of the transmission mechanism of QE to the economy is through the theory of portfolio balancing. In his August 27, 2010 Jackson Hole speech, Fed Chairman Bernanke explained in detail how he envisioned Fed asset purchases adding to economic growth: "Such purchases work primarily through the so-called portfolio balance channel, which holds that once short-term interest rates have reached zero, the Federal Reserve's purchases of longer-term securities affect financial conditions by changing the quantity and mix of financial assets held by the public… For example, some investors who sold MBS to the Fed may have replaced them in their portfolios with longer-term, high-quality corporate bonds, depressing the yields on those assets as well… Our purchases of Treasury, agency debt, and agency MBS likely both reduced the yields on those securities and also pushed investors into holding other assets with similar characteristics, such as credit risk and duration."

During his December 12 press conference, the Chairman again explained the transmission theory: "What matters primarily is the mix of assets on the balance sheet… the fact that we're acquiring Treasury securities and MBS, taking those out of the market, forcing investors into other closely related assets and that's where the stimulus comes from, not so much in the size of the balance sheet per se."

In effect, the Fed is borrowing from banks to guide capital into Treasuries, government-guaranteed MBS and indirectly into corporate bonds. This Fed-engineered departure from a market-based allocation of capital harms bank lending to other sectors of the economy that would be more likely to create private sector jobs, helping explain the weakness in U.S. GDP growth. The Fed's policies have resulted in a decline in corporate bond yields and greater issuance. However, regulatory policy and capital requirements limit bank leverage, resulting in very slow growth in other forms of credit.

A January 2012 IMF Working Paper reviewing Japan's experience with quantitative easing and portfolio balancing cautioned that: "The evidence on portfolio balancing and signaling, however, was mixed… The impact on economic activity was found to be limited. While some papers suggested that quantitative easing helped create a more accommodative environment for corporate financing and improved the lending attitude of financial institutions, the impact on economic activity and inflation was small. The reason commonly cited was the impaired credit channel due to a weak banking system…"

Injecting Liquidity

In the past, the Fed "injected liquidity" into the private sector by buying Treasury bills from the market when it wanted to loosen monetary policy. It paid by crediting the seller's reserve account at the Fed, which was expected to be used. This added to the M0 monetary base. The private sector then multiplied the new reserves, using them to back multiple bank deposits which were used to fund new loans. Banks with extra lending opportunities could borrow reserves from banks with extra deposits, maximizing the lending from a given Fed injection.

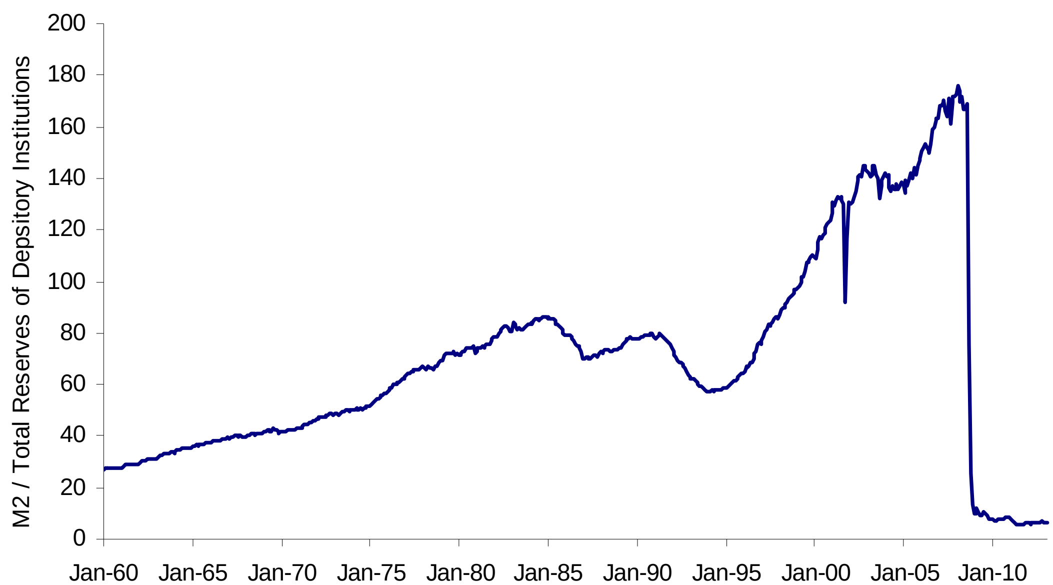
The original injection caused a much bigger increase in the M2 money supply (which includes bank deposits) and usually in private sector credit. The banking system's leverage (the ratio of liabilities to capital) increased as the Fed injected more funds and the regulators permitted more lending. Inflation arose when the Fed injected too much liquidity relative to the output of the economy and regulators allowed more bank leverage. With the advent of floating exchange rates, this weakened the dollar, raised the dollar price of gold and increased nominal prices over time.

Thus, monetary stimulus came from bank reserves being multiplied by bank leverage into bank deposits and bank loans, which in turn added to GDP through the use of credit.

Each part of this chain has been broken. The Fed is creating bank reserves but:

A) The transmission from reserves to M2 is broken;

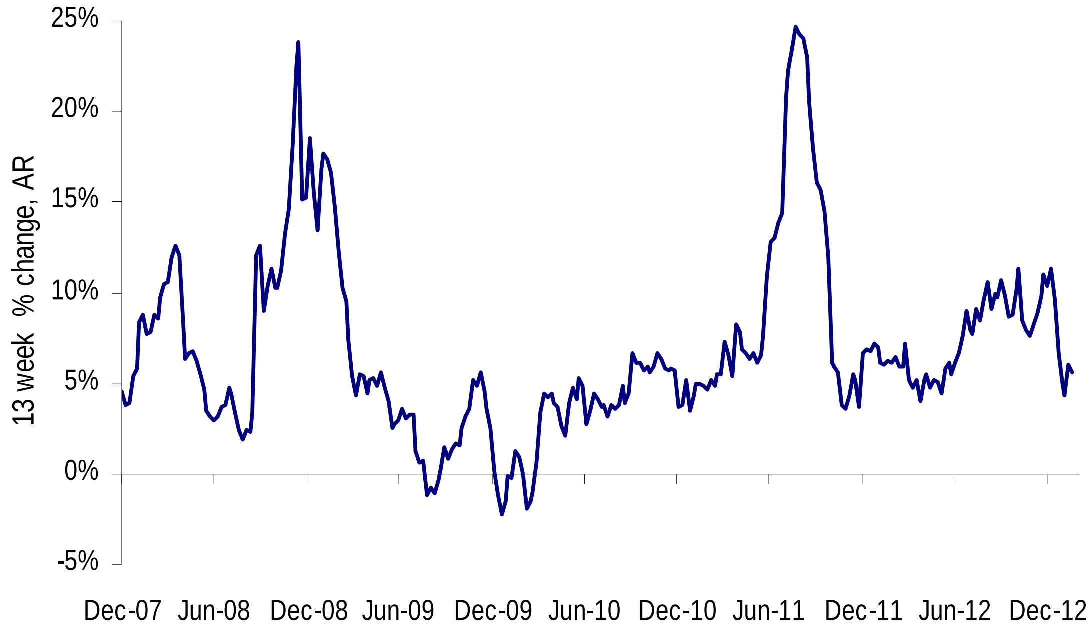
Ratio of M2 to Total Bank Reserves (last obs. January 2013)



Source: Federal Reserve; Encima Global

- The M2 money supply, primarily bank deposits, is at $10.41 trillion. Growth has slowed sharply to a 5.6% annual rate over the last 13 weeks.

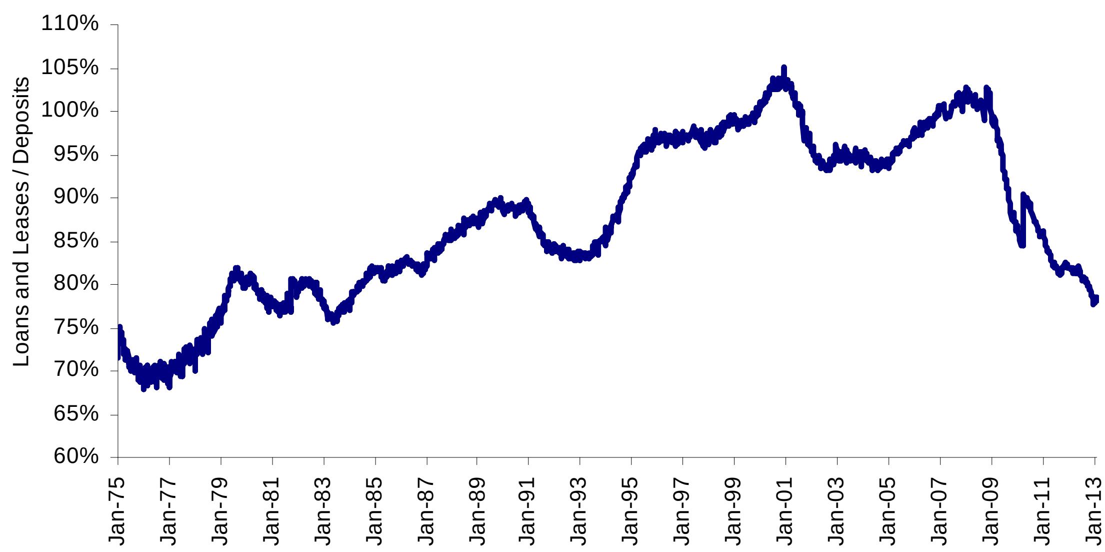
M2 13 Week Annualized change (last obs. February 18, 2013)



Source: Federal Reserve; Encima Global

B) The transmission from M2 and bank deposits to bank loans has broken down, with the ratio of bank loans to deposits down to 78.1%, the lowest since 1984.

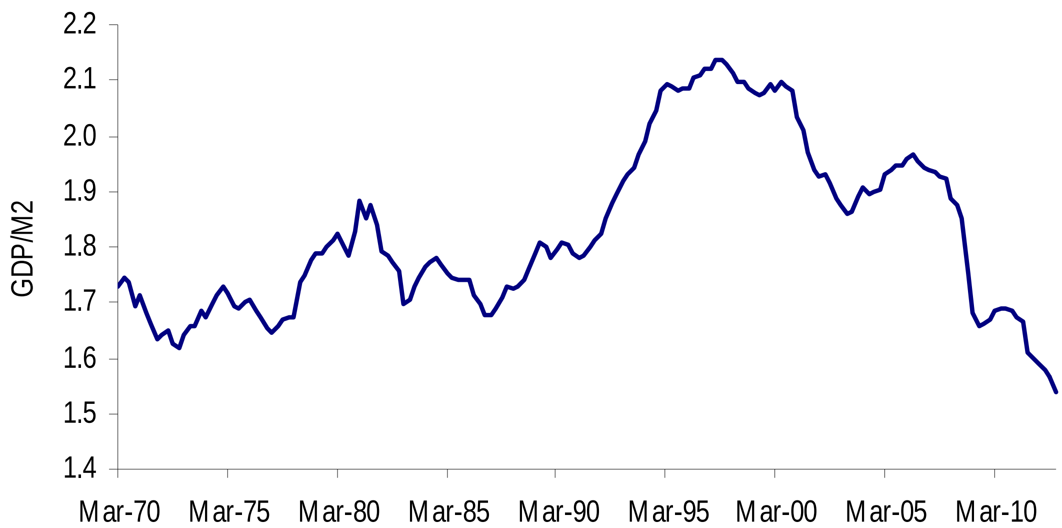
Ratio of Bank Loans and Leases to Deposits (last obs. February 6, 2013)



Source: Federal Reserve; Encima Global

C) The transmission from M2 to GDP is also broken. M2 velocity fell to 1.5 times in the fourth quarter (meaning nominal GDP was only 1.5 times the M2 money supply, down from a 2.1 turnover rate at the peak.) In very rough terms, it used to be that a $1 billion injection of reserves by the Fed allowed an $80-100 billion increase in M2, which would become a $150 billion increase in nominal GDP. This would cause inflation if output and productivity fell behind demand, leaving too much money chasing too few goods.

M2 Velocity – GDP / M2 (last obs. Q4 2012)

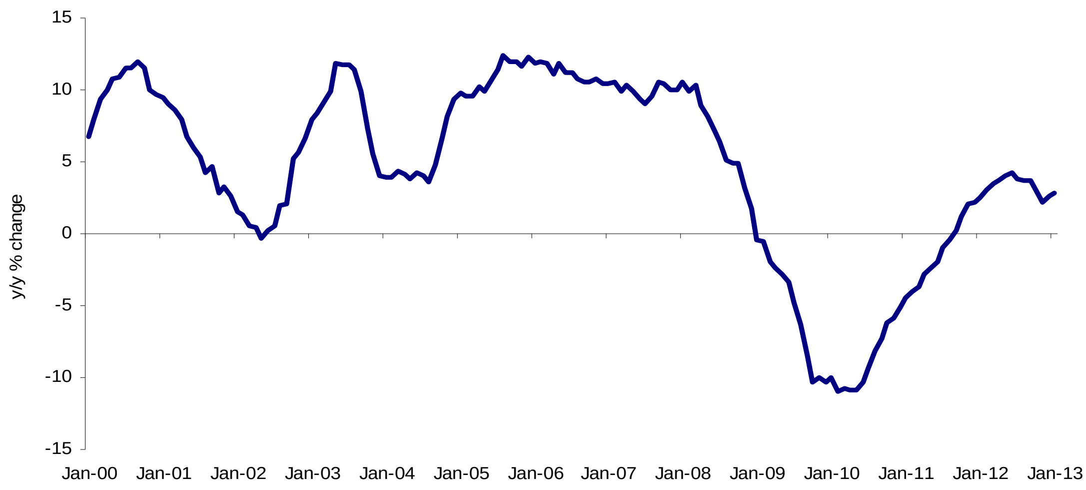


Source: Federal Reserve; Bureau of Economic Analysis; Encima Global

The current system works differently. Over the years, the fractional reserve system changed to a system of direct regulatory control over bank leverage and capital, with sporadic efforts to take risk into account. Rather than the availability of reserves, the binding constraint on a bank's lending activity shifted to the assessment of the bank's leverage ratios and capital adequacy by bank management and government regulators.

In today's environment, the Fed is expanding bank reserves, but their growth isn't connected to private sector bank balance sheets, bank deposits or bank loans, which are barely growing. This was called "pushing on a string" when the Bank of Japan expanded reserves in the 2000s with little positive impact.

Growth in Bank Loans and Leases (break adjusted, y-o-y, last obs. Jan 2013)



Source: Federal Reserve; Encima Global

Conclusion

Under quantitative easing, the Fed has bought trillions of dollars in long-duration bonds, paying for them with short-term interest-bearing reserves borrowed by the Fed. The Fed's balance sheet expanded, but, unlike the old form of liquidity injection, the private sector balance sheet did not increase.

Rather than QE providing stimulus, it is compounding the capital mis-allocation problem by trying to push more credit into corporate bonds.

The Fed is operating as a speculator, borrowing short and lending long while ignoring the conflict of interest this creates when it sets interest rates.

The best exit would be for the government to adopt growth-oriented tax, spending and regulatory policies in parallel with a new growth-oriented Fed resolve to downsize its role in capital allocation and commit to providing a strong and stable dollar. The combination would encourage investment and hiring in the U.S. private sector and would meet the Fed's mandate of maximizing employment by assuring price stability.