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

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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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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.

<u>Overview</u>

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.

<u>Central Bank Tools and Goals</u>

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.

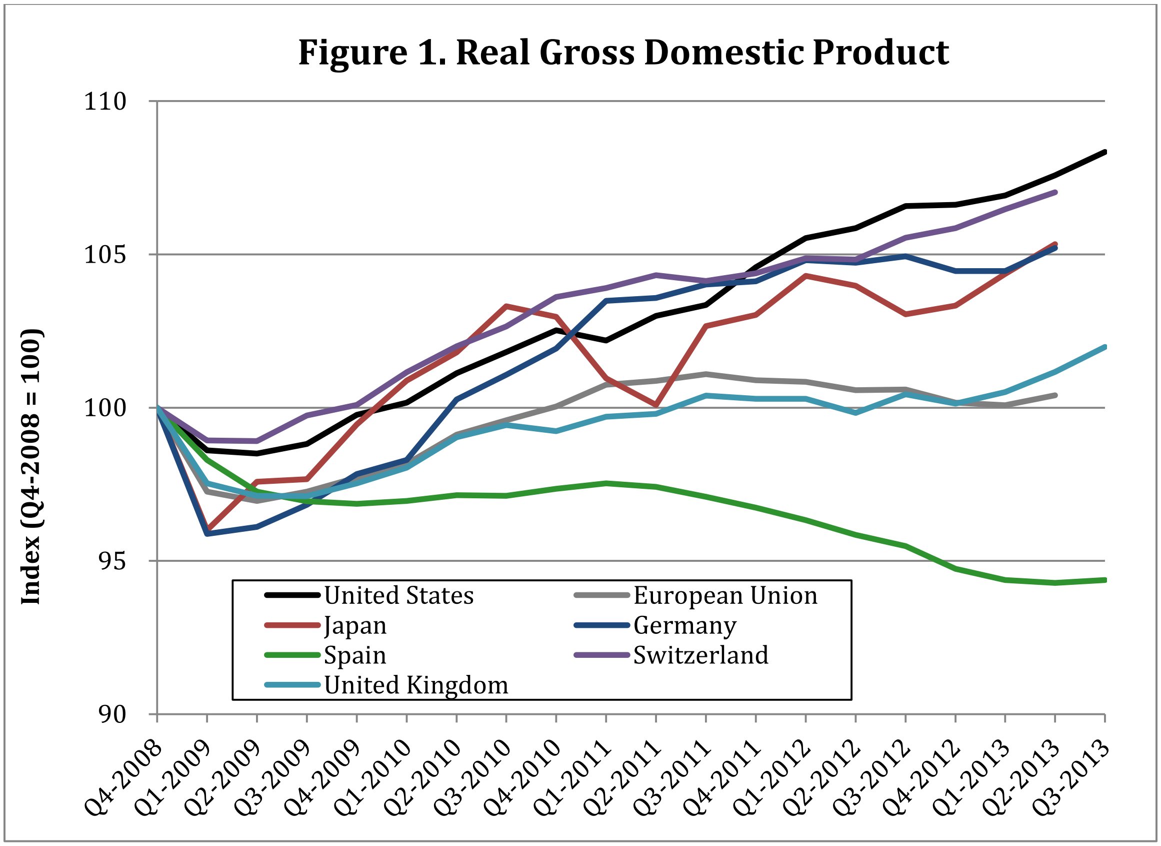
People's Bank of China

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>

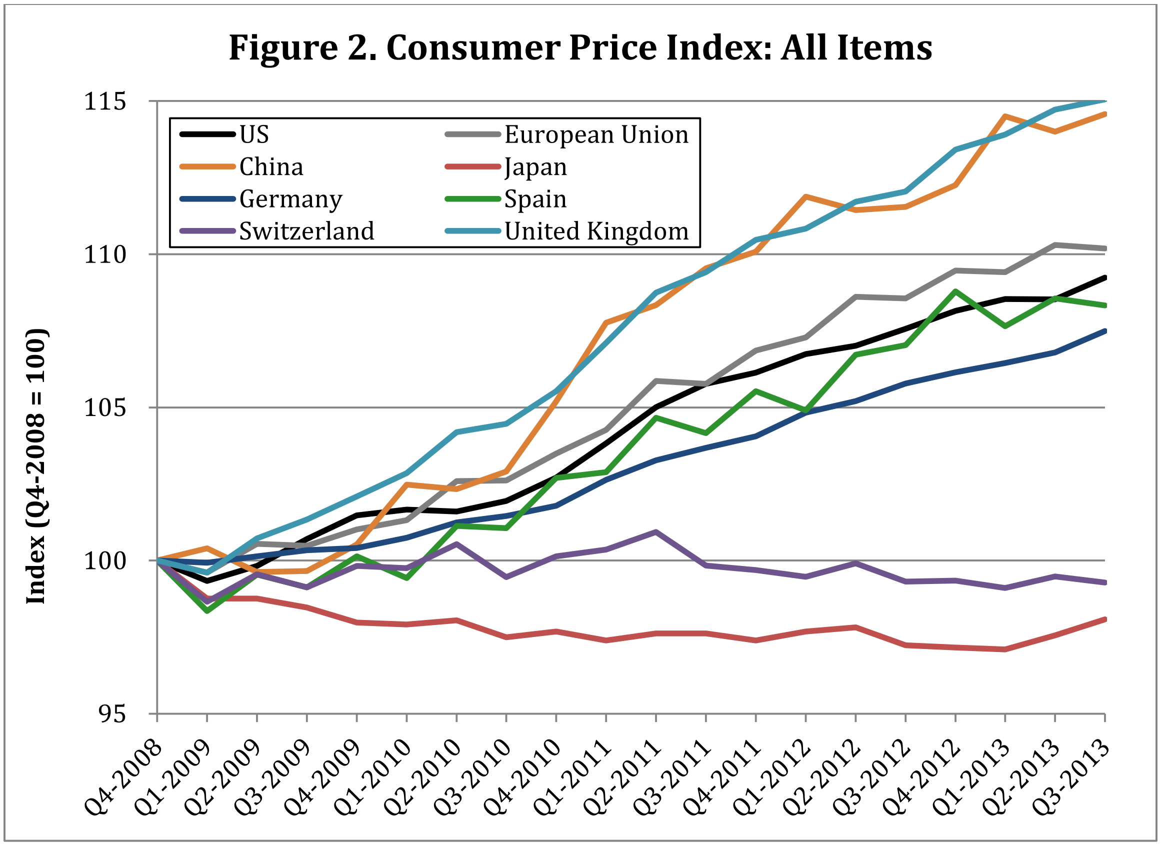
Figures 1 through 4 summarize the performance of most major economies since 2008.

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.



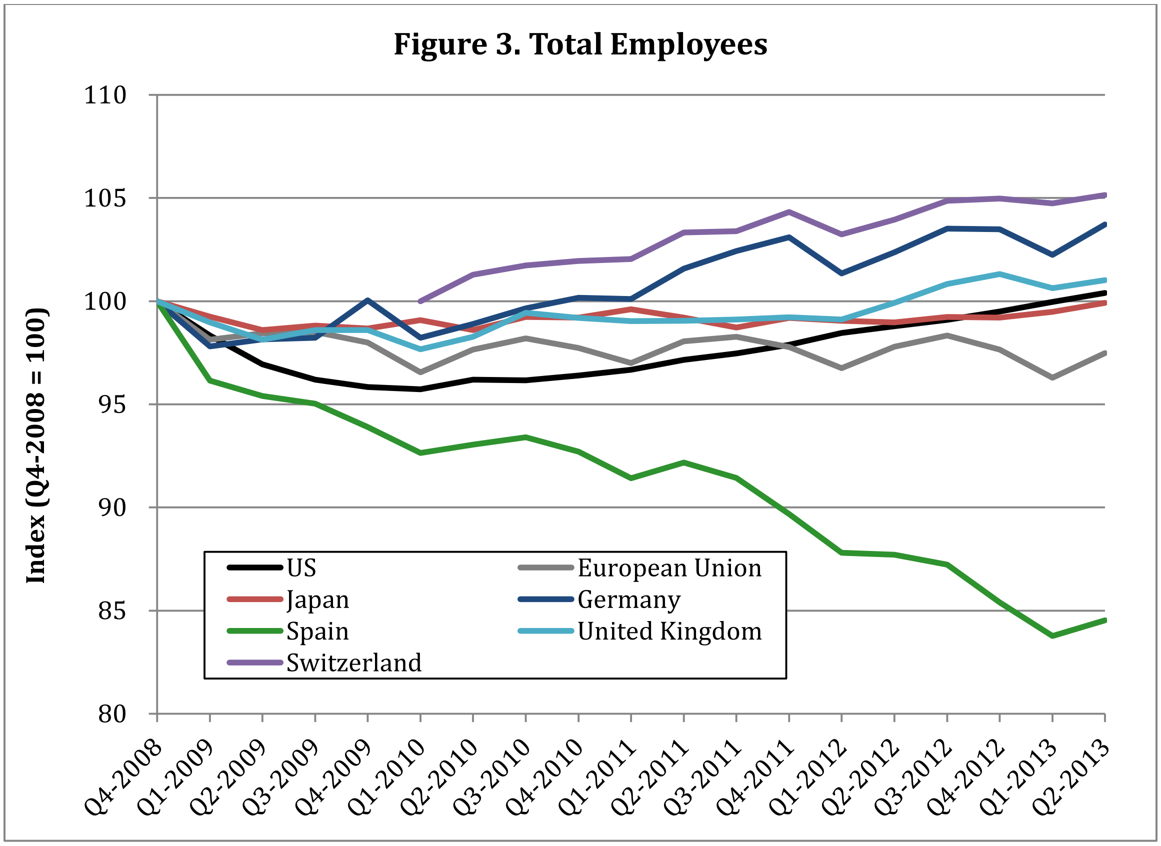
Source: Organization for Economic Co-operation and Development, Quarterly National Accounts statistics
Notes: Gross domestic product, expenditure approach, constant 2005 prices converted with 2005 PPPs, annual levels seasonally adjusted. All countries normalized with Q4-2008 equal to 100. Quarterly data 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.



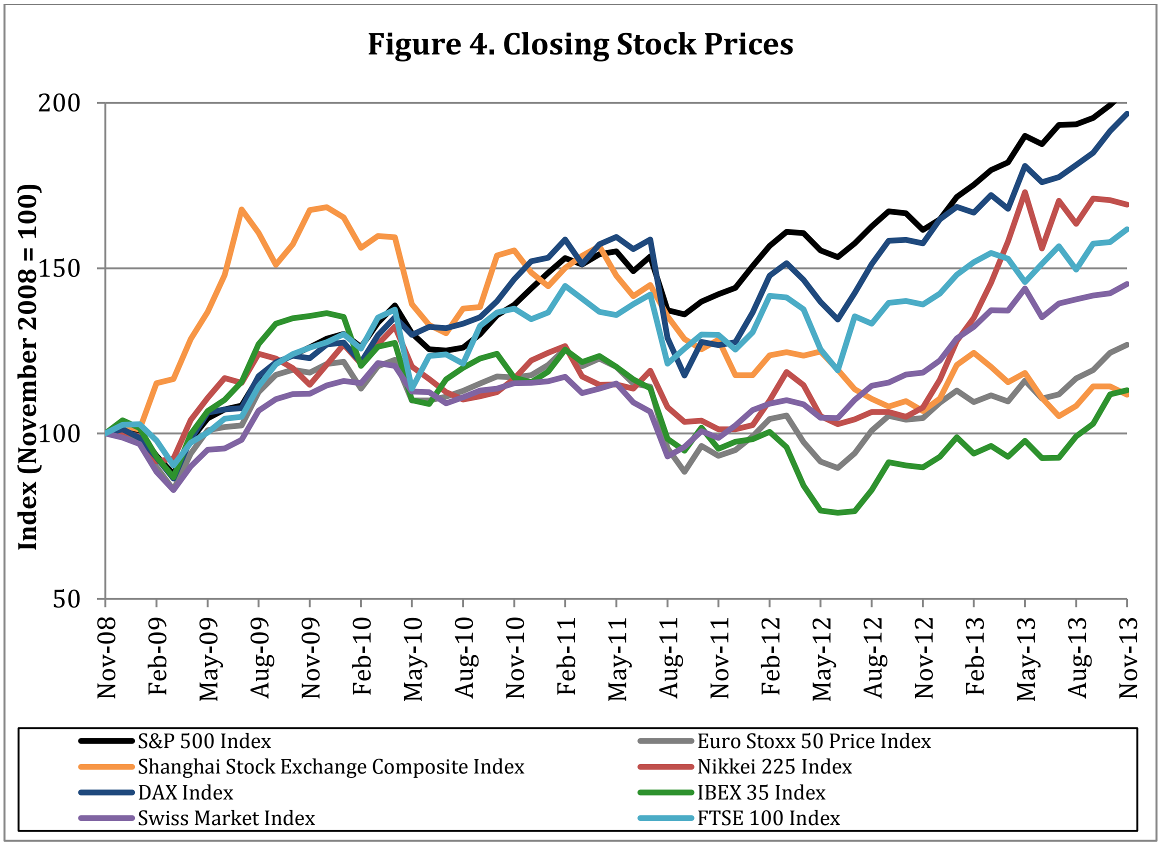
Sources: US data is available from the US Department of Labor, Bureau of Labor Statistics. European Union data is from Eurostat. Japan, China, Germany, Spain, Switzerland, and United Kingdom country data are available from the Organization for Economic Co-operation and Development, Main Economic Indicators 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.

Summary

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.

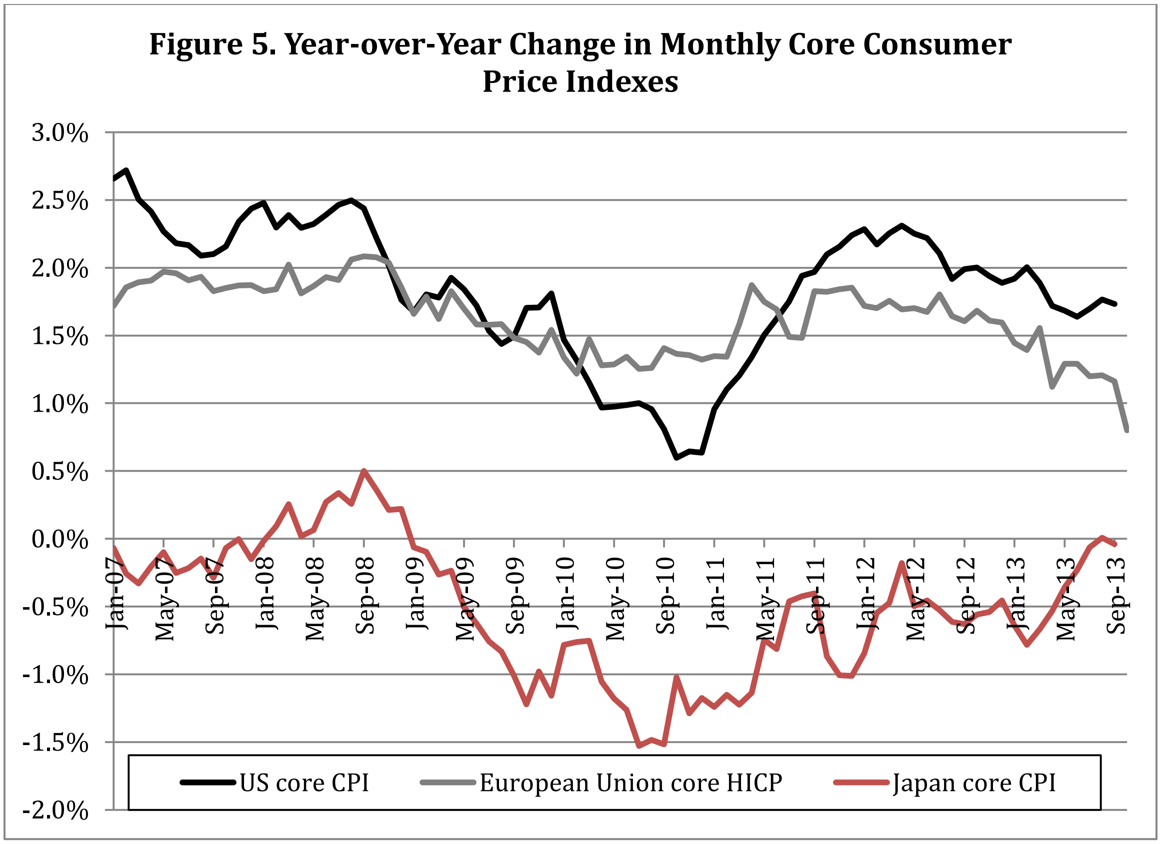
Policy Dilemmas Persist for Central Banks

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.