



PERSPECTIVES

Prospects for and Ramifications of the Great Central Banking Unwind

William Poole

At the CFA Institute Global Investment Risk Symposium held in Washington, DC, on 7–8 March 2013, William Poole gave a presentation on what he calls the “great central banking unwind.” Total assets on the balance sheets of the U.S. Federal Reserve and European Central Bank have exploded since 2008. The challenges and pressure faced by these and other central banks will probably have serious consequences for the global economy.

I am very uneasy about the current economic and fiscal situation in the United States and Europe. The central bank policies and fiscal disequilibrium in these countries are unlike any circumstances they have endured in the past; it is uncertain how the massive easing of the last five years is going to affect the developed nations' economies as well as the global economy. The world is in uncharted territory.

I am going to focus on the U.S. Federal Reserve System and the European Central Bank (ECB). The Fed is the most important central bank in the world: Without stability in the United States, the world economy will not have stability. Not only must central banks navigate the challenges presented by slower growth and fiscal deficits, but they also face powerful political pressures that, if succumbed to, may have harmful consequences domestically and globally.

Fed Issues vs. ECB Issues

Although both the United States and the eurozone had significant economic downturns and financial disruption during the financial crisis, the Fed's expansionary monetary policy has been motivated primarily by a concern over unemployment whereas the ECB's policy has been motivated by an effort to support the sovereign debt of fiscally weak governments—in particular, the southern European countries.

Figure 1 shows the Fed's balance sheet assets from 2007 to 2013. Before the financial crisis, its

assets were around \$850 billion; they have now risen to nearly \$3 trillion, and the Fed keeps pumping money into the system. It is unclear when the Fed's policy of easing is going to stop or how it is going to be reversed.

But the Fed is not alone. The ECB has been pumping funds into the European markets, as shown in Figure 2. Total assets on the ECB's balance sheet have increased from about €1.2 trillion in 2007 to about €3 trillion in the first quarter of 2013. The Bank of England (BOE) and a number of other central banks have been following suit. A massive monetary expansion has taken place over the last five years.

The ECB is acting as a lifeboat for sinking public finances after a collision of high levels of entitlement spending and sustained low economic growth. The plight of Greece in 2012 has led the way; other nations, Italy prominent among them, will most certainly follow. Greece was unable to raise needed funds by issuing sovereign debt after December 2008 because investors would no longer buy it; the risk of default was too high.

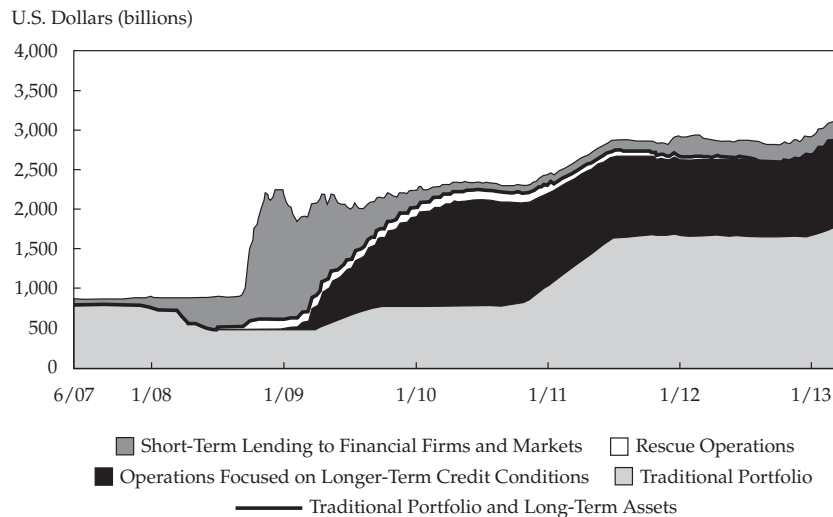
Great Fed Unwind

Given the very large buildup of assets on its balance sheet, it might appear that the Fed has to unwind the position, but that is not necessarily the case. The Fed might keep a very large portfolio indefinitely.

Reserve Ratio. The monetary mechanism that the Fed, or any central bank, uses to control the growth of money and credit is completely different from what it was in the past. The Fed's main instrument of controlling money and credit growth in the past was the reserve requirement, which sets

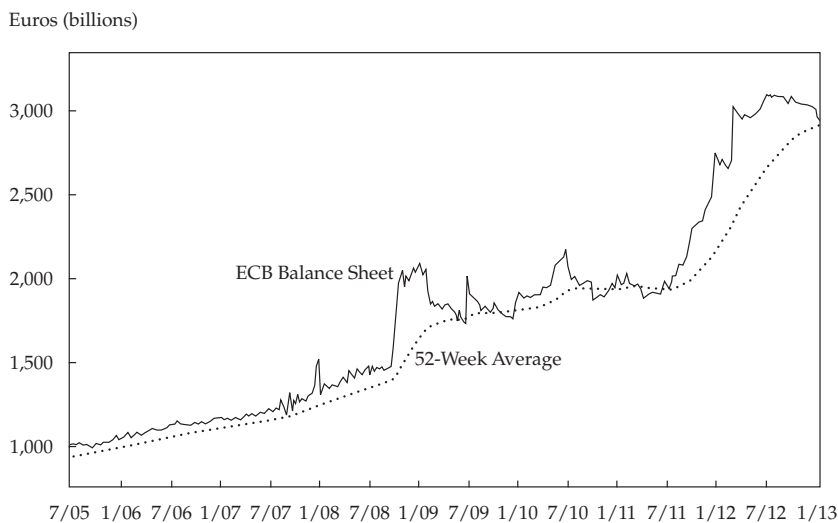
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Figure 1. U.S. Federal Reserve Balance Sheet Assets, June 2007–February 2013



Source: Based on a figure from the Federal Reserve Bank of St. Louis, "U.S. Financial Data" (22 February 2013):7.

Figure 2. ECB Balance Sheet Assets, 2005–2013



Sources: Based on data from Gold Silver Worlds and Weldon Financial.

forth the amount of reserves that banks had to keep on deposit with the Fed. The amount of a bank's deposits with the Fed is a percentage of its total demand deposits.

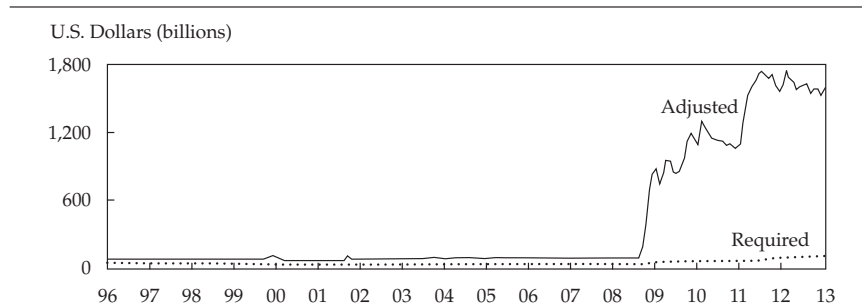
Today, banks are no longer constrained by the reserve ratio. In the past, the Fed had no authority to pay interest on bank reserves, so banks typically held only the minimum amount of reserves required. But in 2008, new legislation gave the Fed the authority to pay interest on reserves, which the Fed has currently set at the rate of 0.25%. That rate

is above other money market rates and thus has provided an incentive for banks to increase their excess reserves at the Fed.

Figure 3 shows the dramatic increase in bank reserves since mid-2008; as of 20 February 2013, they are now more than \$1.5 trillion. Given the latest round of quantitative easing (QE) by the Federal Reserve, these bank reserves will continue to grow. The dotted line in Figure 3 represents the amount of required reserves, which contrasts markedly with the enormous stockpile of excess reserves sitting

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Figure 3. Adjusted and Required Federal Reserves, January 1996–February 2013



Source: Based on a figure from the Federal Reserve Bank of St. Louis, “Monetary Trends” (26 February 2013):6.

on bank balance sheets. Banks are holding these reserves rather than lending them or buying assets with them because the Fed is paying interest on them. Reserves are the raw material for a money and credit expansion, but this raw material is not being actively used. To date, money and credit growth has been moderate. There are no signs of overheating, and the same is true for inflation expectations.

Two measures of the money supply—money zero maturity (MZM) and M2—are plotted in **Figure 4** from 1996 through mid-February 2013. M2 is calculated as M1 (all physical money, such as coins and currency, plus demand deposits, or checking accounts, and Negotiable Order of Withdrawal accounts) plus time deposits, savings deposits, and noninstitutional money market funds. MZM is defined as the liquid money supply in an economy—all assets convertible to cash on demand without penalty. The bigger area of shading at the right is the most recent recession, drawn from the cycle peak in December 2007 to the cycle trough in June 2009. The smaller area of shading on the left represents the much milder recession in 2001. Money stock growth measured by both definitions has recently been well within the normal range.

Inflation expectations can be measured in a number of ways, but I prefer a market-based measure to a survey measure. A market-based measure is derived from the spread between inflation-indexed Treasury bonds and conventional bonds. **Figure 5** compares yields in percentage terms for three different maturities: 5, 10, and 30 years. The spread between the conventional and indexed bonds stays in a relatively tight range from December 2011 to February 2013, and the spreads at the 10-year mark are in the same range they have been in for the past 10–12 years.

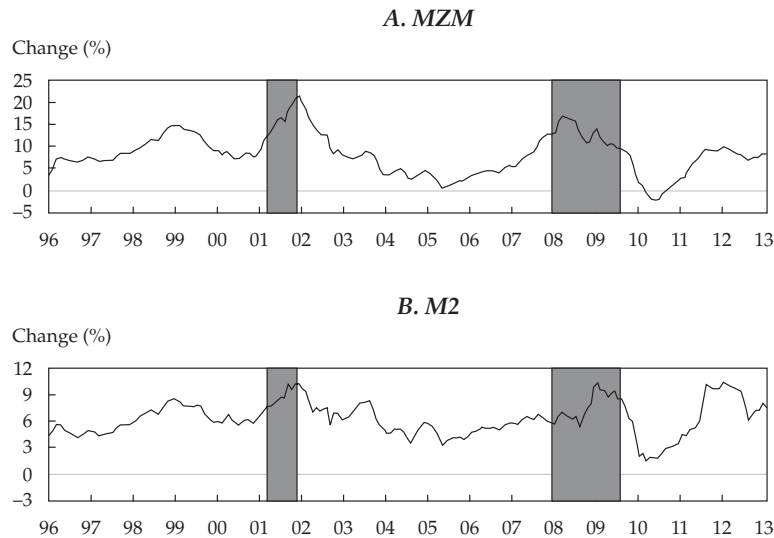
Raising the Federal Funds Rate. If inflation starts to rise, the Federal Reserve’s standard strategy is to raise its target for the federal funds rate,

which is the interest rate on interbank lending and borrowing. Federal funds are nothing more than bank reserves; banks are able to lend the reserve balances they have on account at the Fed. Now that the Fed pays interest on bank reserves, the interest rate on bank reserves is tied, almost to the basis point, to the federal funds rate. The Fed cannot raise the federal funds rate without also raising the rate that it pays on bank reserves, and at some point, the rate increases must be large enough to persuade banks to hold reserves rather than engage in an excessive expansion of money and credit that would create an inflation problem.

Despite all of the progress the financial industry has made in terms of modeling and statistical technology, the Fed basically decides how much to raise the federal funds rate in the same manner that a driver attempts to hold a steady speed when driving in mountainous territory. If the car is going too fast down the mountain, the driver eases up on the accelerator. If that action isn’t enough, the driver eases up more and maybe taps the brakes. Likewise, the Fed reduces its assets to drive up interest rates, but the required pace of reduction is not clear *ex ante*. The basic idea is simple: If the economy is growing too fast, the Fed taps on the monetary policy brake by increasing interest rates. The Fed then adjusts its policy based on feedback and observation of recent data.

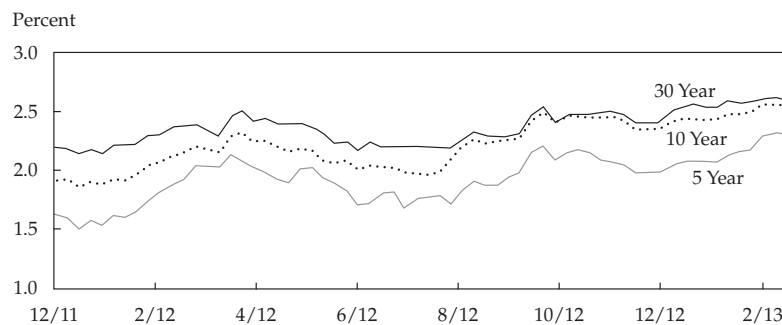
Forecasts. Everyone who deals with portfolio management knows that an action taken in response to a problem depends on the decision maker’s belief about a forecast. And when making decisions, it is easy to be in denial about the most recent information. Likewise, if the Fed starts to see inflation while the unemployment rate is still high, it may choose to deny reality and take the position that the inflation bump is a temporary aberration, perhaps related to energy prices or some other issue.

Figure 4. Change in Two Measures of the Money Supply, January 1996–February 2013



Note: Change is the percentage change from one year ago.
 Source: Based on a figure from the Federal Reserve Bank of St. Louis, "Monetary Trends" (26 February 2013):4.

Figure 5. Inflation-Indexed Treasury Yield Spreads, December 2011–February 2013



Note: Data represent averages of daily figures.
 Source: Based on a figure from the Federal Reserve Bank of St. Louis, "U.S. Financial Data" (22 February 2013):12.

Such inaction on the part of the Federal Reserve might be motivated by a desire to avoid tightening policy too soon because of an overriding interest in and responsibility for advancing the rate of employment growth. But if the Fed is in denial too long, inflation can become embedded in the economy. One of the best examples of Fed inflation denial is illustrated by monetary policy from roughly 1965 to 1979; Paul Volcker took over as chairman of the Fed in August 1979 to deal with the inflation. After 1965, the Fed was concerned that tighter policy would choke off employment growth, so it allowed inflation to creep up and up until the creep became a gallop.

Political Pressure. The Fed is also likely to face political pressure to raise rates only slowly. Federal Reserve chairman Ben Bernanke talks a lot about risk management and the tradeoff between benefits and costs; he maintains that the need to balance these two issues justifies proceeding with the current policy. But Bernanke does not discuss the risk of political intervention in Fed policy despite numerous examples of the Fed giving in to political pressure and waiting too long to change its policy, which results in a detrimental outcome for the economy.

Mortgage finance interests have been extremely well organized politically and are quite influential.

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Part of the Fed's QE policy is to buy \$40 billion of mortgage-backed securities (MBSs) a month. Stopping that part of its expansionary policy—without even considering unwinding the portfolio—will produce a lot of political pushback. This pushback will come through the housing and mortgage interests, through representatives in Congress, and perhaps through the president. Essentially, pressure on the Fed will come from inside the government and may not be very visible; it may be limited to a few op-ed articles from the housing lobby. The true amount of political pressure will largely be hidden.

Pressure to keep rates low will come also from those who argue that the Fed should do its share to hold down the federal budget deficit. Higher interest rates will produce a rapid and enormous increase in the interest expense in the federal budget. The Fed is going to be encouraged to suppress interest rates until longer-run reforms can be put in place to address the budget deficit.

Recent discussion has centered on the impact of Fed policy on a number of issues. For example, is Fed policy creating a bubble in the bond or stock markets or in farmland prices? Is Fed policy pushing down the dollar exchange rate? Bubbles are easy to understand after the fact but very difficult to identify in real time. Many market fluctuations were thought to be unsustainable at the time but turned out to be justified by fundamentals. So, Fed policy may or may not be bubble inducing. But the real issue is the politics of monetary policy.

I believe that the Fed will not successfully resist the political winds that buffet it. I am not a political expert or a political analyst by trade. My qualification for speaking on this topic is that I have followed the interactions between monetary policy and politics for a very long time. As with all things political, the politics of the Fed means that realities often fail to match outward appearances.

I believe the Fed is likely to overdo its current QE policy of purchasing \$45 billion of Treasuries and \$40 billion of MBSs per month. Turning off the spigot would be difficult, but to be effective, the Fed has to stop its expansionary policy before inflation becomes embedded in the economy. For policy to be effective, it needs to be preemptive. Inflation control is better when accomplished before inflation has risen, not after.

Uncertainties. Although forecasts always contain uncertainties, the federal budget and regulatory uncertainties today are greater than at any time over the past 60 years. These budget and regulatory uncertainties are the prime explanation for the slowness of the economic recovery; businesses are hanging back until they better understand, or think they better understand, the way that the regulations

are going to be written and interpreted. The load of regulations on the business sector is larger than it has been since the 1930s: the Affordable Care Act and the Dodd-Frank Wall Street Reform and Consumer Protection Act, as well as the policies of the Environmental Protection Agency and the Department of Labor. I think President Obama and his administration—in large part because they do not understand the markets as well as they might—will not hesitate to pressure the Fed, initially from the inside and perhaps ultimately from the outside by encouraging heavy public criticism once the Fed embarks on a policy of raising rates. Such an approach will likely be counterproductive, and the markets will respond very negatively.

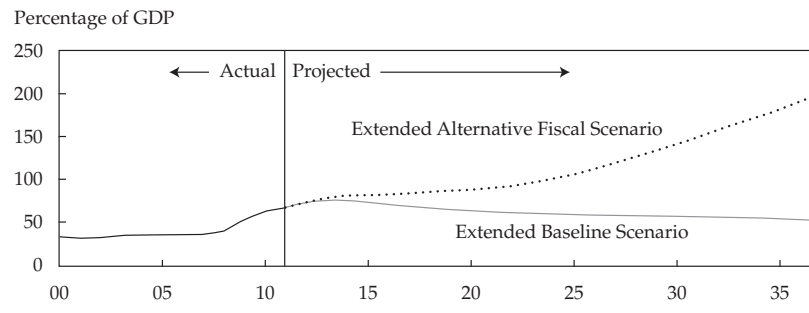
The very deep fiscal disequilibrium in the United States is best understood by looking at the data from the Congressional Budget Office (CBO). The budget games that are played with the numbers are full of screwy and misleading accounting. For example, the alternative minimum tax (AMT) was patched one year at a time so that the forward projections of revenues from the AMT would be in all the official projections of the budget. But the patchwork nature of the process created uncertainty about its final structure. Another example on the expenditure side is from more than 10 years ago: Since the Clinton years, legislation on the books has called for large reductions in Medicare reimbursements to physicians. The "doc fix" was enacted one year at a time so that the physicians would not have their reimbursements cut by a third. The budget encompassed forward projections of outlays that were lower than the outlays that would actually occur.

Figure 6 shows the federal debt forecast under two CBO long-term budget scenarios as of June 2012. This forecast is updated each summer. The dotted line shows the projected debt level over the next 25 years without the kind of budget gimmicks I just described. The shaded line shows the debt-level projection with all the budget gimmicks included. The United States is in the process of struggling with this enormous disequilibrium, although its struggle so far has been about the discretionary part of the budget, without any very serious political discussion—let alone legislative proposals—related to Social Security and Medicare expenditures, which are driving the budget. Until entitlement outlays are addressed, the budget is going to look more like the dotted line in Figure 6 than the shaded line.

Great ECB Unwind

The ECB has acquired a substantial amount of the sovereign debt of the fiscally weak southern European countries. It has also been lending to banks that have, in turn, purchased the debt of the weak

Figure 6. Federal Debt Forecast under the CBO's Long-Term Budget Scenarios, 2000–2037



Note: Forecast is as of June 2012.

Source: Based on a figure from the Congressional Budget Office, "The 2012 Long-Term Budget Outlook" (5 June 2012):2.

countries. The European banking regulations have so-called risk-weighted capital requirements, but the risk weight on all sovereign debt is zero. So, a bank can buy the bonds of Italy or Spain or even Greece and have a zero capital requirement. Obviously, the capital requirements are not truly risk weighted; they are politically weighted. The capital requirements in Europe, as in the United States, are deeply affected by the politics of bank regulation.

The situation in Europe is still very much in flux. Italy recently had a very indecisive election. The citizens of the weak nations are not embracing the austerity that is required to bring their economies back in line. They want to keep their benefits, and they do not want to pay taxes. These desires are perfectly rational but are not conducive to fiscal sustainability. So, the crisis that has long been predicted—because of much larger welfare state commitments than can be financed with an aging and retired population—has finally arrived and is by no means resolved.

The ECB cannot unwind the assets it owns unless Spain, Italy, Portugal, and Greece resolve their fiscal problems. Thus, these countries' debt might remain on the ECB's balance sheet—and the loans to these countries on European banks' balance sheets—for some time. Therefore, if Europe begins to have an inflation problem, the ECB will have its hands tied to a significant extent and will be limited in its ability to deal with rising inflation.

Europe is afraid of contagion, in which a default in one country results in investors fleeing the bond markets of the other fiscally weak countries. Thus, the weak countries remain supported by the fiscally sound countries—essentially, Germany—but Germany does not have the resources to support the weak countries indefinitely.

The ECB's charter was supposed to protect it from this situation, but the ECB has caved in to the pressure. To date, there is no evidence of

inflationary problems in Europe, at least on the continent, although the United Kingdom has experienced some inflation.

It is a close call in Europe, but I believe that the fundamental fiscal weakness in Europe will end in a crisis. The European community encompasses over-extended welfare states, many of which, particularly in southern Europe, have weak administration of tax law and negative politics on decreasing outlays. Many of its public enterprises are inefficient, and its labor markets are burdened by structural rigidities.

The consequences of poor fundamentals in Europe are negative economic growth and rising unemployment. It remains an open question whether Germany's voters will ultimately say that they will no longer support Italy, Spain, Portugal, and Greece. The Merkel administration has retained the support of the German people so far, but without any improvement in the situation, the time may come when Germany's voters ask themselves why they should pay for the excesses of others.

Conclusion

Because no precedents exist for the massive monetary easing that has been practiced over the past five years in the United States and Europe, the uncertainty surrounding the outcome of central bank policy is also vast. So far, inflationary pressures remain subdued, but the ability and willingness of the Fed and the ECB to react quickly to control inflation fears are in jeopardy, largely because of political forces. Total assets on the balance sheets of most developed nations' central banks have grown massively since 2008, and the timing of when the banks will unwind those positions is uncertain.

This article qualifies for 0.5 CE credit.

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Question and Answer Session

William Poole

Question: Is the dual mandate of maximum employment and price stability a burden on Fed policy?

Poole: The dual mandate is not necessarily a problem. The 1977 law stated that the Fed is supposed to work toward two objectives: inflation and employment. In January 2012, the Federal Open Market Committee (FOMC) set forth the principles with which it approaches its dual mandate. At that time, the FOMC adopted an inflation target of 2%, and the target was renewed in January 2013. The published principles state that no central bank can promise to create a certain level of employment growth or a certain level of unemployment because those are real variables that are controlled by the real conditions in the economy, including such conditions as fiscal policy, and are ultimately not the responsibility of Fed policy.

Question: What is the primary weakness of the Fed?

Poole: I fault the Fed for its lack of intellectual leadership on the economy and, in particular, Bernanke's lack of forthrightness about the limits of the Fed's ability to address slow growth and fiscal disequilibrium. Most of the Federal Reserve bank presidents (with the exceptions of Charles Plosser in Philadelphia, Richard Fisher in Dallas, Jeffrey Lacker in Richmond, and to some extent, my successor in St. Louis, Jim Bullard) have been essentially silent on this issue, speaking only in vague terms about the necessity for fiscal stability and not identifying the uncertainty over that issue as a reason for the slow economic expansion.

Question: Is the Fed structured for failure?

Poole: That question is very important. Institutions need to be considered separately from the individuals who inhabit them. If certain individuals are going to make a mess of something,

no institutional structure can guard against that except through a system of checks and balances. Past research has shown that central bank independence produces a better result than monetary policy run by the Treasury. Independence for the Federal Reserve began 100 years ago, when the Federal Reserve Act was signed in December 1913. The Fed's structure provides substantial independence, allowing room for strong leadership to do what has to be done in the face of adverse political pressure. The Fed's structure does not guarantee independence, but it provides the room. Paul Volcker has made significant use of that independence, whereas Arthur Burns, one of the architects of monetary policy and the inflation that culminated from it, did not. No institutional structure can guarantee a good result, but institutional structures can allow strong people to fail because they lose control.

Question: If the Fed were to adopt the equivalent of a Taylor rule today,¹ what should it be?

Poole: A simple Taylor-like rule that relates to only a couple of variables when so much is going on is unworkable at this point. An appropriate goal might be to have a central bank that is more constrained by legislative rules, but I just do not see a workable rule at this time.

Question: What is your opinion about returning to the gold standard?

Poole: I think the gold standard is unworkable. It was not as satisfactory in the 19th century, during its heyday, as is often argued. The basic problem is easy to see. When there is a flight to liquidity, when the market wants more gold, there is no more gold. The supply is fixed. All sorts of liabilities backed by gold have been issued, but those liabilities far exceed the gold supply. Therefore, the gold standard is a recipe for a banking system that collapses under stress, although it did stabilize the price level over a long period of time.

Notes

1. A Taylor rule is a monetary policy rule that stipulates how much the central bank should change the nominal interest rate in response to changes in inflation, output, or other economic conditions.