
# THE GREAT MONETARY EXPERIMENT

## CENTRAL BANKING SINCE THE FINANCIAL CRISIS

BREAKINGVIEWS

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# PREFACE

Before the financial crisis, many shrewd observers thought that central banks were well on the way to becoming dull. These politically independent institutions followed such clear rules that their clever manipulation of policy interest rates could support steady economic growth without inflationary overheating. Alan Greenspan, who had been chairman of the U.S. Federal Reserve for longer than most could remember, was considered a master. His successors could probably - it was thought - imitate his approach.

Predictions of boredom proved premature. Central banks' independence has been compromised and the once-clear rules now look distinctly murky. And central bankers have been very busy. During the financial crisis, they brought out extraordinary measures to stave off disaster. Subsequently, they have experimented with new policies, most notably "quantitative easing" (QE), widely viewed as a form of money-printing.

The story is far from over. Central banks still have oversized balance sheets and a tricky road to negotiate before financial conditions look anything like what was once considered normal.

Breakingviews has been there throughout. We have compiled a collection of pieces from the last five years. We hope it provides insight, perspective and some enjoyment.

*Edward Hadas*
*Economics Editor, Reuters Breakingviews*
*October 2013*

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## QE-XIT



**ON THE COVER**

A picture illustration of crumpled kuna, Dollar and euro banknotes, taken in Zagreb January 18, 2011. REUTERS/Nikola Solic

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# INTRODUCTION
# HAS QUANTITATIVE EASING WORKED?

It is nearly five years since the U.S. Federal Reserve slid into quantitative easing, the deployment of artificially created money into the bond market. The era is far from over, but as the Fed prepares to "taper" its bond purchases, a preliminary judgment is in order. Bottom-line verdict? QE could have been worse but should have been better.

The Great Monetary Experiment – quantitative easing and the prolonged period of near-zero interest rates – has dominated the post-crisis era. We know that policymakers could have done a worse job, because they have managed better than their professional ancestors did after 1929, the last time a cross-border credit boom ended in a cross-border credit bust. In the 1930s, central bankers in many countries presided over debilitating deflation, and failed to prevent banking crises. This time, consumer prices have neither collapsed nor exploded, and Lehman Brothers was the only big financial institution to topple.

Still, while monetary policy helped stabilise economic and financial conditions, the importance of monetary policy in the anti-crisis campaign should not be exaggerated. Government bank rescues, large fiscal deficits and the automatic benefits of welfare states all played more important roles. And the manipulation of interest rates and money supply was not the central banks' most important contribution. Their support of weak banks and, in the euro zone, weak governments was more significant.

Perhaps there would have been more financial destruction and less productive investment with tighter monetary policy. No one can know, since the experiment was not tried. What can be said for certain is that QE has not worked economic wonders. Growth remains slow and unemployment rates are high.

Less certain, but still quite likely, is the claim that the injection of additional funds into the financial system has created new problems. The argument is simple enough. Some of the free and cheap money went to buy shares, bonds, commodities and currencies of fast-growing or high yielding economies. The new cash pushed up asset prices and supported unsustainably fast GDP growth in some developing nations.

It all may have looked good for a while, but now the prospect of the end of QE has abruptly reversed some of the flows. The result is wobbly financial markets and a sudden downturn in funding for countries such as India and Indonesia, which had become complacent about running large current account deficits.

So the world looks less financially stable, even as economic growth picks up a bit in developed economies. The withdrawal of QE could start another messy period in the markets. The giddy response to the U.S. Federal Reserve's moves away from money-printing towards "tapering" is hardly encouraging.

It doesn't add up to much to celebrate, especially considering the immense power of central bankers. Central bankers should do better. To improve, they need to know their limits, while demonstrating more intellectual bravery.

The limits?  Poor monetary policy can be harmful. While this is universally admitted, the authorities consistently overestimate their potential to do good. At best, the correct management of policy interest rates and money supply may help cool overheated economies or heat up unnecessarily chilly ones. But no level of rates and no amount of money can deal with excesses of construction, finance or regulation. No monetary policy can train people, create jobs, build factories or change laws.

The bravery? While central bankers try to do too much, they are afraid to use all of their powers. They instinctively want to leave the financial system alone, even though volatile lending poses the greatest threat to monetary stability. They are reluctant to create and destroy money directly, even though balancing the supply of money with the supply of goods and services is the most direct way to ensure price and wage stability. And they are shy about intervening in markets, even when sharp moves in exchange rates and asset prices disrupt economies.

The respect of traditional policy limits reduced the effectiveness of QE. If the newly created money had gone directly into consumer and business bank accounts, rather than into banks, more of it would have been used to pay off excess debts or to invest productively. But at least QE was a new idea. With some more of those, central bankers could do a better job.

*Edward Hadas*
*October 2013*

# BACKGROUND AND BEGINNINGS

*It all happened so quickly. The bankruptcy of Lehman Brothers in September 2008 led to an instantaneous recession in most of the developed world – so fast and so deep that central bankers and politicians could hardly understand what was happening.*

*They regrouped quickly, first with emergency funding and then, by December, with the innovation of this crisis: quantitative easing. Japan had tried out direct money-printing before – but the technique was slightly different and the campaigns in the United States and UK were much larger. The European Central Bank refrained from actual QE, but its willingness to buy government debt eventually played an important role in defusing the latest euro zone crisis.*

## THE GRAVEYARD OF SIMPLE IDEAS

**BY EDWARD HADAS**

Greenspanism is dead, as dead as a subprime mortgage broker. The ongoing financial crisis has discredited the central banking philosophy of the retired president of the U.S. Federal Reserve Board. It's the fourth such intellectual bankruptcy in a century.

The Greenspan approach was simple – leave financial institutions pretty much alone, cut the overnight interest rate fast, increase it slowly and don't worry too much about inflation. Too simple. Greenspanism ignored asset prices, financial imbalances and leverage. The result so far – a meltdown in U.S. housing, huge losses for banks, looming U.S. recession and uncomfortably high inflation.

But Alan Greenspan shouldn't feel too bad about his method's failure. He joins a long list of distinguished economists who haven't managed to get central banking right.

Even before there were central bankers, there was gold. Until well into the 20th century, the authorities assumed that the rare metal would always set the monetary standard. The limited supply of gold was thought to keep businesses sound, governments prudent and workers frugal. Paper money and unsecured lending only spawned booms, which were inevitably followed by busts.

Then came the depression of the 1930s, with its unprecedented levels of unemployment and political turmoil. In response, John Maynard Keynes introduced a new orthodoxy. It was based largely on supporting the economy's "animal spirits", if necessary with high inflation and government deficits.

Keynes' critics said the new technique was what might be expected from a member of the loose-living Bloomsbury set – an endorsement of irresponsibility for the sake of a few years of fun. The double-digit inflation of the 1970s seemed to prove their case.

Keynesianism yielded to monetarism. If "inflation is always and everywhere a monetary phenomenon", as Milton Friedman, the movement's high priest, claimed, then the authorities could keep prices steady and output up by getting a firm grip of the "money supply".

But what counted as money? Cash, loans, lines of credit? It turned out that in a dynamic economy which runs on credit, no consistent measure of cash or spending power could capture pressure on prices. Central bankers couldn't read the monetary runes.

By the mid-1980s, pure monetarism was abandoned as impractical. The apparently more pragmatic Greenspanism took its place. Central bankers thought they could keep growth high and inflation low simply by watching for signs of economic overheating and letting financial markets do the rest of the work.

Die-hard Greenspanians will argue that the system just needs a few modifications. Maybe. But it looks like they should start applying for membership in the Society of Followers of Failed Economic Ideas, where they can meet true believers in the Gold Standard, Keynes and Friedman.

*What next?*

Rather than try to fix up Greenspanism – or wait for a new genius with a new all-encompassing system – perhaps central bankers can learn from their past mistakes.

The most important lesson is that simple rules don't work for long. Financial systems, like companies and countries, are changing and uncertain entities inhabited by people who don't always behave wisely or consistently. Central bankers need to accept complexity, compromise and the odd change of direction.

They also need to broaden their perspective. Rather than trying to search for the few key variables, central bankers should keep an open mind on what matters when. The oil price was crucial in the 1970s while residential real estate did the running before the current financial mess. Trade deficits haven't always mattered, but they do now. Without a long and flexible check-list, the authorities are likely to be blindsided by the next crisis.

The bankers' approach to policy should also be flexible. Greenspanism was marked by a single-minded emphasis on the overnight interest rate and an ultra-light touch approach to financial regulation. That proved inadequate.

Central bankers already have other tools: capital requirements, supervision of lending practices, influence on legislation. They should use them. And if the current toolbox is too small to guide the complicated finance-economy nexus, they should get some new ones. The authorities should be able to intervene in more markets and set more rules for all sorts of financial institutions.

One area demands immediate attention – reckless risk-taking. That is always a threat in the financial industry, whose primary raw materials are credit, which is easy to create, and promises, which are much easier to make than to keep. Perhaps the first initiative of post-Greenspanism central banking should be an attack on financiers who play that most dangerous game: heads-I win, tails-the system loses.

*First published on February 28 2008*

## CENTRAL BANKS TRY TO WARD OFF CANUTE SYNDROME

**BY EDWARD HADAS**

The European Central Bank, the Bank of England and the Swiss National Bank delivered sharp rate cuts on Thursday: 50, 150 and 50 basis points respectively. Brave and bold. But central bankers are still in danger of succumbing to the Canute syndrome of failing to keep the receding tide of bank funding from leaving the economy high and dry.

Overnight policy rates – 3.25 percent in the euro zone, 3 percent in the UK and 2 percent in Switzerland – are low by recent standards. But the U.S. is at 1 percent. There will be more cuts in Europe if the financial and economic situation warrants. That looks increasingly likely.

Central bankers have abandoned all fear of inflation and all hope that the banks can manage on their own. Banks still won't lend to each other, even at high rates, and are trying to shrink their lending to the real economy. That retreat is set to intensify in the face of mounting losses – house prices are still dropping sharply in the UK and problems in eastern Europe weigh on the euro zone.

The infant recession is both an effect and a cause of credit problems. Higher losses reduce banks' ability and willingness to lend, and shrinking loans reduce economic activity. But the central bank rate cuts are not primarily anti-recessionary moves to stimulate lending. Along with central bank liquidity and government capital programmes, they are part of an effort to keep the financial system running.

These cuts are impressive, but aren't likely to do much. When borrowers and banks both want to get their leverage down, even negative real rates aren't particularly alluring. That, at least, was the experience in Japan for more than a decade. The U.S. is learning a similar lesson.

When Canute ordered the tides to stop, he didn't actually think they would obey. The Viking king wanted to make the point that some forces were more powerful than the royal word. The battle between the monetary authorities and the financial tide is more evenly balanced. But the tide is winning. The authorities will be lucky to get away with a mild recession.

*First published on 6 November 2008*

## THE FED'S QUANTITATIVE EASING: A GUIDE FOR THE PERPLEXED

**BY RICHARD BEALES AND EDWARD HADAS**

Federal Reserve boss Ben Bernanke has cranked up his helicopter. Having cut short-term rates to a smidge above zero, and seen the markets push them down even more, the U.S. central bank's principal weapon against deflation is nearly out of ammunition. Now, the Fed appears to have changed gears in favour of boosting the money supply – a strategy known as quantitative easing that was used with some success in Japan after 2001.

*Huh? I didn't hear about any policy shift.*

That's part of the problem – the Fed has been cagey. Fed vice chairman Donald Kohn said two weeks ago that the central bank has been engaged in some forms of quantitative easing (QE), for the sake of brevity but hasn't abandoned rate targeting. And chair Ben Bernanke said yesterday that the Fed could expand its balance sheet to purchase longer-term U.S. government securities, which amounts, essentially, to QE.

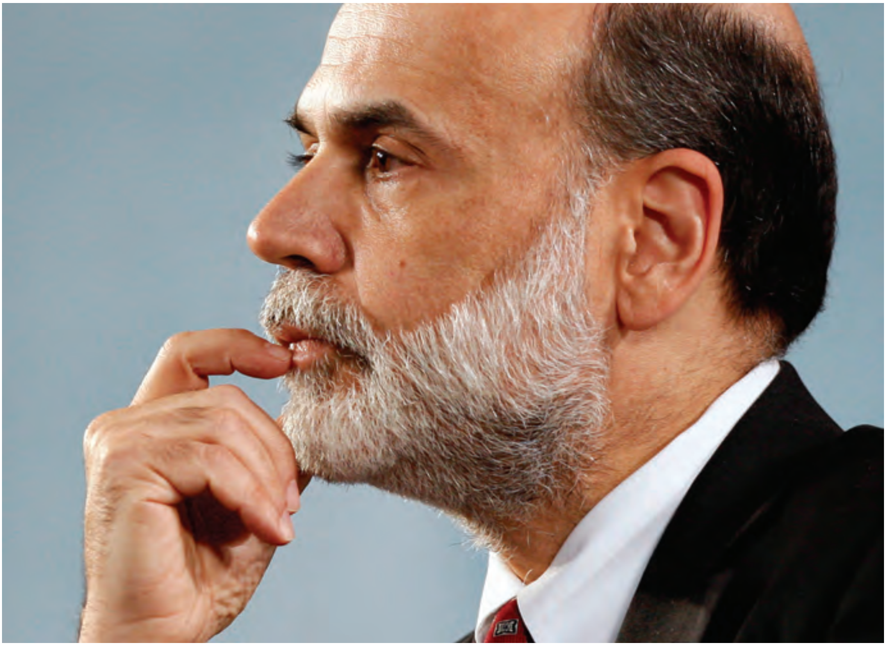
Bernanke actually provided the rationale for the strategy in a high-profile speech in 2002, which also established his image as Helicopter Ben, showering cash on anyone and everyone to pick up.

*So what exactly is QE?*

It's a policy of targeting money supply growth, rather than interest rates. The central bank boosts the money supply by buying government and related securities from banks and paying for them by increasing their Fed reserve account balances. Since no actual cash changes hands, the Fed has essentially created new money without actually printing any. The larger bank balances at the Fed can be used to satisfy loan reserve requirements, theoretically allowing banks to lend more although that's not yet happening.

*So why the shift?*

The Fed's overnight interest rate target, its main lever over the economy, is already a mere 1 percent, so there's little room left to cut. And the market has pushed down the actual Fed funds rate, which has been below the official target since late October and is currently trading at 0.5 percent. That makes the target little more than an indicator of the U.S. central bank's sentiment. Bernanke & Co. simply need another tool.



*U.S. Federal Reserve Board Chairman Ben Bernanke waits to speak at Harvard senior class day in Cambridge, Massachusetts. REUTERS/Adam Hunger*

*Didn't the Fed just start paying interest on reserves to better control rates?*

Yep, but it hasn't worked. Reserves are only held by depository institutions and banks and there are plenty of other types of financial firms participating in the overnight repurchase market that the Fed uses to try to get the actual Fed funds rate to match its target.

*Isn't pumping new money into the system inflationary?*

It certainly could be. But the Fed's current bugbear is deflation. And inflation isn't a pressing concern right now because banks aren't making loans. The money is piling up in their excess reserves accounts, where they keep funds they don't need to satisfy loan reserve requirements. Excess reserve balances have grown from about $1.8 billion a year ago to over $600 billion today.

*So who approved this scheme?*

It doesn't appear that anyone did, officially at least. In fact, critics like former Fed governor William Poole contend that the Fed may have broken the law by not disclosing the change in tack. But Fed defenders say there hasn't actually been a policy shift; the Fed is simply trying to control longer-term interest rates, rather than exclusively short-term ones.

That's a murky issue. If the Fed were to issue, say, short-term debt to fund its purchases of longer-term securities, the money supply and the Fed's balance sheet would stay about the same. If not, it's probably engaging in QE.

And the Fed's balance sheet has ballooned by about $1.2 trillion since early September, to over $2 trillion, as it has piled on a variety of assets. That's clearly not all related to new money creation, but the concurrent increase in excess reserves indicates that some of it probably is.

*What does this mean for the Treasury market?*

QE would be a big factor in its behaviour. In fact, yields on some government securities hit historic lows after Bernanke spoke of the scheme on December 1. If the Fed does put ceilings on Treasury yields, as Bernanke suggested in his 2002 address and as it did prior to 1951, bond investors could largely abandon analysis of inflation, economic growth and other factors that used to affect yields and simply become Fed Kremlinologists.

Also, the Fed will have to shrink its balance sheet to a more sustainable size once the crisis is over. Trouble is, withdrawing its support from the Treasury market just as other investors regain their appetite for riskier assets means rates could rise sharply.

*So what should the Fed do?*

First, it needs to acknowledge and explain the shift in policy and how it will decide when to end it. Then it needs to devise and disclose a target perhaps in the volume of excess reserves or some money supply benchmark. That would provide some assurance, at least, to still-panicky markets.

*First published on 2 December 2008*

## EUROPE'S RATE CUTS TESTIFY TO HUGE PROBLEMS

**BY IAN CAMPBELL**

Today's big interest rate cuts by the UK and European central banks are as essential as the colossal cuts made last month, and equally belated.

The Bank of England and European Central Bank are at last attacking the deflationary monster they helped to create. But the fight is going to be long and bloody. The cuts today will not be the last, and rates will go to 1 percent – perhaps even to zero by the middle of 2009, if economic deterioration persists.

Europe is facing the sort of deflationary Frankenstein that has long dogged Japan. Today's sabre cuts are right, but neither of western Europe's monetary policy-setters can take pride in them. By failing to perceive that deflation, not inflation, was the real economic threat, they have acted far later than the U.S. Fed, which began to slash rates in January.

Nor can Europe's central banks escape blame for the deflationary monster the world now faces. They helped create it. Who was it that allowed UK house prices to spiral upwards, while Britons extracted their paper gains and spent them? The Bank of England ought to have acted to curb house prices, just as the U.S. Fed ought never to have allowed a housing boom to run. The BoE might claim that its remit is not to curb asset price inflation, but it should look further ahead to the inflation and deflation that unchecked booms will eventually cause.

The ECB, meanwhile, also kept its policy interest rate far too low in 2003 to 2006, helping to feed property bubbles in Spain and Ireland, as well as excess in the European and world economy. The global commodity price bubble that distracted the central banks from the looming deflationary threat was also largely their own creation, the result of the excessively low interest rates with which the central banks persisted in recent years.

Sadly, moving now is not going to help quickly. Across Europe, credit markets are now seized and monetary policy's effectiveness is compromised. But the central banks' deep cuts are, for these markets, vital surgery that at least makes healing possible. The debt-service burden of consumers and companies will be eased. Housing and equity markets will be supported a little. The cuts are no cure, but without them, and more to follow, no cure is possible.

*First published on 4 December 2008*

## UK ON THE RISKY ROAD TO QUANTITATIVE EASING

**BY EDWARD HADAS**

The UK is getting ready for quantitative easing. The bank rescue plan announced on Monday morning included a 50 billion pound programme for the Bank of England to buy high-quality assets outright. It noted that the plan provides a framework for the next step: quantitative easing.

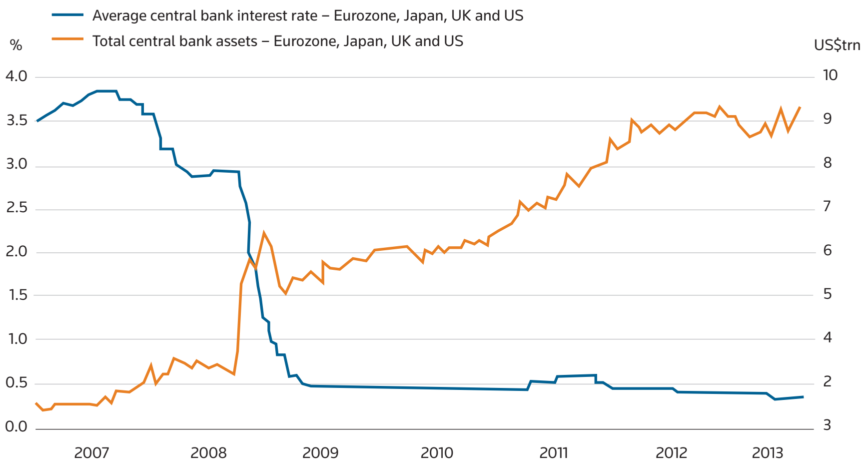
Monday's developments don't go all the way to quantitative easing in its purest form. That's because the central bank will not simply create money to buy the assets in question. Rather, funds will be generated by the UK Treasury selling new debt, a process known as sterilisation. For the economy, the effect should be much the same as if the central bank were using its ultimate power: making money appear from nowhere by using the printing press.

The approved scheme goes like this. The banks sell loans and other assets to the central bank. The BoE gets the money from the Treasury, which has sold new debt, largely to the same banks that are selling assets. In effect, the banks trade assets that need capital backing for government debt which doesn't. That gives the banks more money to lend.

In the US, the fig leaf of sterilisation has already been lifted. The Federal Reserve has started simply creating money to buy assets off of troubled banks. The UK Treasury and the Bank of England seem to be getting ready to follow the American example.

It won't be necessary unless the policy interest rate, currently at 2 percent, gets much closer to zero. But with the financial system still listing badly and the government borrowing wildly, a big dose of money creation is a distinct possibility.

## Central bank rates and assets




Source: Thomson Reuters Datastream, Reuters graphic/Scott Barber 03/09/13

That could put enough money in people's pockets to start a wave of inflation. Most economists aren't worried. The easing can easily be reversed the central bank just sells assets and retires the money it receives. But economists don't fully understand how money and debt interact. If they did, the debt bubble would not have been so large, and the current financial distress would not be so great.

Quantitative easing may soon be the best available tool in the UK, but the authorities should be wary of running large deficits and printing vast amounts of money. Monday's sell-off of the pound was a sign that investors are already worried about just that.

*First published on 19 January 2009*

## CENTRAL BANKERS SHOULD BE HAPPY WITH WEAK GROWTH

**BY EDWARD HADAS**

Normal is a slippery concept. What counts as a normal house in California would look like a mansion in Caracas. And the normal economy of 2009 might have been regarded as a depressed mess a few years ago.

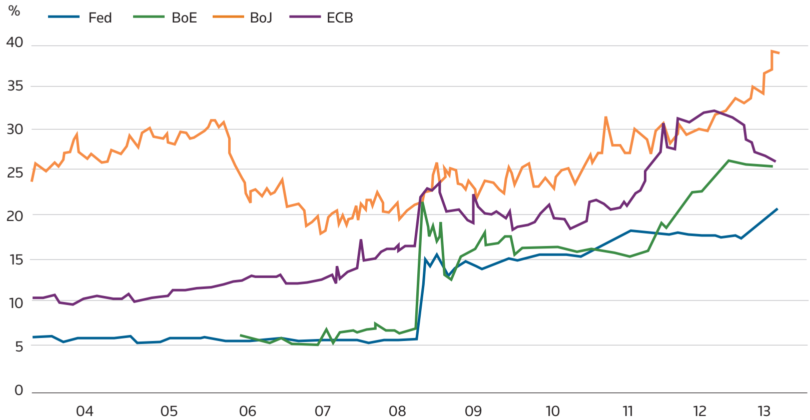
The world's central bankers have to decide on their own definition of normal. Because when the economic situation normalises, they can start to wind down monetary policies which are abnormal by any standard: quantitative easing and very low policy interest rates.

As recently as March, the economic and financial situation was clearly aberrant. But the peculiarities have faded away. Credit spreads have moved from unbearable to high, major banks are no longer threatened with imminent demise and the economic news is hot and cold rather than uniformly miserable.

Central bankers are hardly looking at a robust economy. Current financial conditions are tight by the standards of the last five years. The economy may start growing in a quarter or two, but at an anaemic rate.

Normally, Ben Bernanke, Jean-Claude Trichet and Mervyn King would respond to this environment by cutting policy rates. But their institutions –

## Balance sheets as percent of GDP




Central bank assets as a percent of IMF nominal GDP forecast – %
Source: Thomson Reuters Datastream, V Flasseur 03/09/13

the U.S. Federal Reserve, the European Central Bank and the Bank of England – have already done that, and more.

If central bankers' only goals were fast growth and low unemployment, there would be no question of changing tack anytime soon. Indeed, there are already calls for the even looser monetary policy to keep the recent increase in long-term yields from further dampening the expected feeble recovery.

But the crisis has been a reminder that monetary authorities have wider responsibilities. These include preventing financial disorder. The abnormal policies were instituted in part to do just that. They may have helped keep banks in business, but zero policy rates distort lending markets. And expanding central bank balance sheets encourages governments to borrow heedlessly.

Central bankers are only human and may instinctively prefer faster growth. But that may not be possible to engineer at the same time as a normalisation of the financial system, an increase in the savings rate in the U.S. and UK and a rebalancing of global trade. Bernanke et al should start priming the markets for a policy reversal.

*First published on 10 June 2009*

# THE NEW ABNORMAL

*By the time the first anniversary of the Lehman Brothers' failure rolled around, it was clear that the worst – debt deflation, political disruptions, massive depression – had been avoided. Sadly, it was also clear that the best – a fast snap-back of GDP growth and a rapid normalization of monetary policy – had been missed. Central bankers around the world settled in for a long, hard battle. QE, actual and potential, was a crucial weapon.*

## CENTRAL BANKS ENTER THEATRE OF THE ABSURD

**BY EDWARD HADAS**

John Maynard Keynes thought economists should be seen as "humble, competent people, on a level with dentists". Before the financial crisis, the world's central bankers tried to live up to that image. Policy interest rates were managed in careful quarter-percentage point calibrations. Monetary policy was about as dramatic as a worthy play exploring the emotional micro-movements inside a bourgeois marriage.

But the crisis changed the dynamic from dentistry to emergency room, from boring realism to high tragedy. Interest rates went to near zero. Revolutionary lending policies are everywhere.

Now a further shift is underway – to the surreal. The latest minutes of the Bank of England's Monetary Policy Committee show it voted six-to-three in favour of expanding money-printing from 125 billion pounds to 175 billion on August 6. The Governor was among the dissenters who wanted this so-called quantitative easing programme to reach 200 billion pounds.

The surrealism lies in the total ignorance of what any amount of QE will actually accomplish, and with what side effects. Some economists say the overall approach is pointless, others helpful, others potentially disastrous.

As for the question of precisely how much money to print, that's unknowable, as it's impossible to predict whether the newly created funds will be spent or saved.

The 25 billion pounds could have been 10 billion or 100 billion. The only certainty is that the more that's printed, the more it looks like the central bankers think the economy and financial system are still in real trouble.

Forget the dentists. Central bankers who want to impart dark messages about managing the impossible should study the masters. Playwright Eugene Ionesco sets the standard: "I can buy a pocketknife for my brother, but you can't buy Ireland for your grandfather."

*First published on 20 August 2009*

## FEDERAL RESERVE IS LATE TO ITS OWN QE PARTY

**BY AGNES CRANE**

To get at the American economy, the Federal Reserve has to go through markets. The central bank on Wednesday should unveil its plan to purchase U.S. debt as a way to stimulate economic growth. The indirect route, however, means the intended boost may be over before it even begins.

The Fed has already juiced markets by hinting, back in August, that another round in its unconventional weaponry was in the chamber. Longer-term Treasury yields, the underlying benchmark for most corporate and consumer debt, have fallen between 0.2 and 0.3 percentage points since then, while the S&P 500 is up around 6 percent. Moreover, investors are practically giving money away to cash-rich companies like Microsoft, who paid less than 1 percent on funds raised in the debt market in September.

The underlying point of easy monetary policy is to lower interest rates so investors are encouraged to buy riskier assets. Rising stocks and lower borrowing costs theoretically should make consumers feel a bit richer, brighten their moods and generate growth. With the Fed's primary tool – its short-term target rate – currently bound near zero, its only alternative is to go into the market and buy Treasuries to push lower longer-term yields that influence mortgage rates and corporate debt.

On Wednesday, the Fed should finally announce the details behind its new program. Markets are hoping for clarity on how many dollars the Fed is willing to throw behind so-called QE2 and for how long. New York Fed President Bill Dudley a month ago threw out $500 billion as an example of what QE2 could accomplish – a number that market expectations have coalesced around.

To convince bond markets to take yields down another leg, though, the Fed's announcement will need to be bolder: policymakers either specifying a much larger amount to be purchased or a strong indication that it plans to keep the policy in place for a while – six months or more. Yet the lack of actual deflation coupled with rising inflation expectations makes that kind of call to arms a difficult sell.

That could make it difficult to push yields down much further. In fact, there's a chance they will actually go up. In which case, that would mean the great QE2 experiment would end before it even begins.

*First published on 2 November 2010*

## UK, WORLD'S BIGGEST MONEY PRINTER, GETS NERVOUS

**BY IAN CAMPBELL**

Mervyn King, governor of the Bank of England, has made his final nervous walk to the money printing press in 2009. The decision on Nov. 5 to extend quantitative easing by another 25 billion pounds smacks of compromise by the BoE's monetary policy committee. Monetarists may have wanted more, say 50 billion pounds. Others may have argued for no change. The reality is that growth, inflation, deflation and debt spectres all haunt the UK. The BoE is probably the biggest money printer in the world. And, like it or not, it has become the financier of the government with probably the worst fiscal position in the world excluding outright disasters such as Zimbabwe.


*A London newspaper advertising board is seen outside the Bank of England in central London November 6, 2008. REUTERS/Luke MacGregor*

Outright disaster is what the BoE is trying to avoid. To a degree it can say its policy has achieved that. The UK economy remained in recession in the third quarter, unlike the U.S., Germany, France and others. But deflation and depression do not appear to be at hand and these were the enemies the BoE set out in March this year to repel. The bank's statement even warned that inflation, 1.1 percent at present, could rise sharply to above the 2 percent target because of January's rise in VAT and higher petrol prices.

Rising energy prices reflect global stimulus, which has worked better elsewhere than in the UK. Most of the world is growing. There is inflation in the global economy. Meanwhile the pound is weaker, pushing up import prices. For the bank all this should be a source of comfort. A bit of inflation means its 0.5 percent policy interest rate remains low. If UK prices were falling by 7 percent – as Ireland's are – there would be nothing the bank could do to make lending cheap.

But it is the risk of rising borrowing costs that may be the most frightening of the UK's spectres. The government will issue around 175 billion pounds in debt this year. The bank has bought 173 billion pounds. Next year the government will issue as much and may have to do without the BoE's generosity. The risk is that the government gets into trouble, finding that the world doesn't want the debt it spews out. Then UK long-term interest rates would be driven up. That would push house prices, lending and the UK economy back down.

The UK continues on its risky road. The MPC may think that when a government is close to bust there's only so much an Old Lady can reasonably do.

*First published on 5 November 2009*

## INDIA'S QUIET SUPPORT OF QE2 SHOULDN'T SURPRISE

**BY MARTIN HUTCHINSON**

India and the United States aren't just the biggest democracies in the world. They're also monetary kissing cousins. So it was no surprise to see India's prime minister offering qualified support for the Federal Reserve's attempt at monetary stimulus. India has a large budget deficit, negative real interest rates and an ongoing payments deficit. Like the United States, India wants cheap global money to keep its party going.

While China, Brazil and other emerging markets have sharply criticized the Fed's additional $600 billion quantitative easing, Premier Manmohan Singh was quietly supportive, saying: anything that stimulates the underlying growth impulses of entrepreneurship in the United States would help the cause of global prosperity.

That reflects the fact that India has benefited greatly from the current flood of global liquidity and needs it to continue. While growth in consumer prices is troublingly high and its domestic interest rates are well below inflation, its domestic money market is tight, even with 15 percent growth in M3 money supply in the year to October. Bank borrowings from the central bank hit a record 1.2 trillion rupees ($27 billion) Oct. 29.

The local money market's heat derives from the country's 8.5 percent GDP growth and its high government borrowing. Government receipts recently benefited from $23 billion of 3G cellphone spectrum sales, but the central government deficit is expected to be 5.5 percent of GDP in the year to March, with additional substantial state deficits. Overall government debt is officially estimated at 73 percent of GDP, nearly all domestic, although foreign inflows to purchase domestic debt are currently being encouraged.

Since India runs a continuing payments deficit, the rupee has not been particularly strong, rising only 6 percent against the weak dollar in the past year. High international liquidity encourages fund flows into the market, providing necessary capital for business growth and helping finance the national and state budget deficits. Moderate inflation seems a cheap price to pay for rapid growth and increasing prosperity, while the principal threat to India's recovery remains as always a liquidity crisis, either domestic or international.

Loose fiscal and monetary policies may eventually produce difficult economic times in India – as in the United States – but meanwhile the good times roll on.

*First published on 9 November 2010*

## HOW NUCLEAR CAN THE ECB GO?

**BY NEIL UNMACK**

Europe is running out of options to solve its government debt crisis. Euro zone politicians and finance ministers have rejected calls to expand Europe's bailout funds. That leaves the European Central Bank's bond purchases as the main defence against market contagion. But how much room for manoeuvre does the central bank really have?

On paper, the ECB has plenty of freedom. It is independent and has no explicit limit on the size of its balance sheet. In practice, however, it cannot buy bonds indefinitely without compromising its ability to oversee monetary policy. And the bigger its purchases get, the more its credibility depends on the support of euro zone member states.

At the end of October, the ECB's assets and liabilities totalled 1.89 trillion euros – more than 200 billion euros below the July peak. In theory, that means the ECB could buy 40 percent of all medium-term debt due to be issued next year by Italy, Spain and Portugal without stretching its balance sheet any further than before. That's about twice the rate at which it was buying at the end of October, when the ECB stepped up its purchases to combat the most recent bout of contagion.

However, a much larger bond-buying spree would have an impact on monetary policy. When a central bank buys bonds, it creates bank reserves, boosting the amount of cash circulating in the economy and potentially contributing to inflation. Currently, the ECB's purchases do not expand the money supply because the central bank simultaneously attracts short-term deposits from banks. This sterilises the effects of the purchases.

Were the ECB to dramatically ramp up the purchases, however, sterilisation could become tricky. It may need to offer higher rates to attract deposits. That could push up money market rates – effectively tightening monetary policy. The alternative would be for the ECB to give up on sterilisation and start buying bonds outright. This would be similar to the quantitative easing policies pursued by the U.S. Federal Reserve and the Bank of England – and would represent a radical departure from the bank's current policy.

When the ECB launched its bond-buying programme in May, the decision was approved by a majority of the central bank's governing council, which includes the heads of the euro zone's 16 central banks. It's not clear at what point the ECB would need to formally ask its governing council for further approval.

But in practice any dramatic increase – or a switch to QE – would need the backing of the euro zone's largest members, especially Germany. Bundesbank chief Axel Weber has openly criticised the decision to start buying bonds.

The ECB must also consider its credibility. The network of euro zone central banks, known as the Eurosystem, has 78 billion euros of capital. That means its balance sheet is leveraged 24 times. A large increase in its holdings of peripheral assets could raise questions over its financial strength – and, ultimately, the extent of government support.

The Bank of England received an indemnity from the UK's Treasury for any losses on its bond-buying programme. Given the ECB's fragmented ownership, it would be even more important for investors to know that governments approved the programme and stood ready to support the Eurosystem if it suffered losses.

There are no signs the ECB is planning such a dramatic intervention. Jean-Claude Trichet, its president, has argued that responsibility for the euro zone's debt problems lies with its governments. Despite increased buying in recent weeks, the ECB has bought a total of 69 billion euros – a fraction of what the U.S. and UK central banks have acquired. Moreover, the purchases have concentrated on peripheral states of Greece, Portugal and Ireland – not Spain or Italy.

Though tensions have eased in recent days, the danger is that they could return next year. In theory, the ECB could act quickly to intervene. In practice, however, it can only do so with the support of its member governments.

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## FED NEEDS TO TREAT MARKETS LIKE A SERIOUS ADDICT

**BY AGNES CRANE**

Some Federal Reserve officials are getting antsy. An improving economy and percolating inflation have them talking about the possibility of lifting short term rates later this year. Yet the central bank is still injecting fresh funds directly into the financial system's bloodstream. The plan is to have markets go cold turkey after June. But when the fix has averaged $100 billion a month since November, policy makers need to consider ways to minimize the likely disruptive withdrawal symptoms.

Prominent hawks like the Dallas Fed's Richard Fisher have been vocal about their unease with the latest $600 billion bond purchasing program, known as quantitative easing, or QE2. St. Louis Fed President James Bullard last week argued for buying $100 billion less than planned. Ben Bernanke's inner circle, however, looks committed to finishing the job, in full.

Switching off the drip abruptly, however, does make for a problem. The Fed is buying up the equivalent of 70 percent of new Treasury bond issuance. So its absence is bound to be shocking if private investors don't step into the breach.

The Fed could make its withdrawal less painful by simply extending the program, though not the quantity, for another two months, tapering off its purchases during the summer. It did something similar with QE1. Hawks are sure to hate it. But the Fed could offer them something, too, when the Federal Open Market Committee meets April 26-27.

The market is obsessed with the $600 billon targeted by QE2. But Fed policy allows the central bank to buy up to $300 billion on top of that by simply reinvesting cash generated by the assets on its balance sheet. It could stop doing that entirely, signifying an exit of sorts. It's not cold turkey, but neither would it bring on the shakes.

*First published on 4 April 2011*

## FED'S TWIST PUTS WALL STREET IN A SPIRAL

**BY ANTONY CURRIE**

Operation Twist put bank stocks into a spiral. The U.S. Federal Reserve's decision to buy $400 billion of longer-dated Treasuries and sell the same amount of short-term debt by June pushed the yield on the benchmark 10-year note to a record low 1.73 percent. It's likely to stay under 2 percent for some time. That squeezes financials across the board.

The most obvious victim is a retail bank's net interest margin, essentially the difference between its cost of borrowing and what it charges for loans. Theoretically, the drop in rates means banks should be able to raise debt capital more cheaply to offset some of the drop in income. But lenders and shareholders alike are wary of banks' exposures and earnings potential. The sell-off on Thursday sent most of them even further below book value, with the likes of Citi and Bank of America trading well under half their assets less liabilities. So getting a break on their own interest payments is far from assured.


*US Federal Reserve Chairman Ben Bernanke listens to a question as he testifies before the Senate Banking, Housing and Urban Affairs Committee on Capitol Hill in Washington. REUTERS/Jonathan Ernst*

But the Fed's new policy will also have an impact on fixed-income, currency and commodities traders, traditionally one of the biggest money-spinning operations on Wall Street. They're already struggling thanks to a combination of impending new regulations and a welter of fiscal and economic uncertainties that routinely whack up volatility and scare off customers. Jefferies just reported an 85 percent quarter-on-quarter decline in FICC revenue.

Now, add extended, ultra-low interest rates to the mix. In general, that should have a knock-on effect on all manner of fixed-income instruments, narrowing even further the bid-offer spreads that bring in the dough. In the past, investment banks could respond to such moves by increasing their leverage, usually funded with cheap short-term debt. The 2008 financial crisis put paid to that. Seeking extra juice through prop trading is a no-no for most of them, too.

Granted, volatility can help, but not if it comes with the panicky fits and starts that have characterized the past year or so. That tends to keep even the savviest of hedge funds on the sidelines. With fears also returning of another recession, the Fed's move is leaving banks looking little more than a super-long-term investment.

*First published on 22 September 2011*

## NEW ECB CHIEF MUST SHAKE OFF THE ITALIAN CURSE

**BY PIERRE BRIANÇON**

It is not the best time to be an Italian in the euro zone. It is more than unfair to tar Mario Draghi, the new president of the European Central Bank, with the dirty brushes of Berlusconi's fin-de-règne. But the hazard of nationality means that the new ECB chief takes over at a time his homeland's problems are likely to become his principal headache, and the symbol of his challenges.

Succeeding Jean-Claude Trichet at the head of the ECB is a mixed blessing. The Frenchman will be a tough act to follow. He was one of the euro's founding fathers. He carried with him the weight of 30 years of European financial history. His formidable presence, and his seniority over current euro zone leaders, helped him safeguard the independence of the central bank in spite of rising controversies about the role it should play. He has been the only euro zone leader standing firm throughout the sovereign debt crisis. And he leaves with unqualified success on the inflation front.

But Trichet's legacy also gives Draghi the opportunity provided by a clean slate. He takes over at a moment when crucial ECB decisions are expected, and just a few days after the euro zone tried – yet again – to tackle its debt problems with a "comprehensive" plan that may or may not work. The Bank can choose to keep interest rates steady – or to lower them to take into account the severity of the economic slowdown. It could decide to create a special financial facility for the banking system, such as a two-year funding scheme that some would like to see. And it should send some kind of signal on its controversial sovereign bond-buying programme. There are crucial

*Mario Draghi, President of the European Central Bank (ECB), addresses the media during his monthly news conference in Frankfurt. REUTERS/Kai Pfaffenbach*

choices to be made in the days and weeks days to come, beginning at its first Draghi-chaired meeting on Nov. 3.

Little is known about Draghi's theoretical leanings so it's still hard to tell where he wants to lead the bank. Insiders say that he has been on the hawkish side of debates, ever since he began his term at the Bank of Italy governor in 2006. But everything anyone knows about Mario Draghi points to continuity. And everything in the bank's culture points in the same direction. The ECB is more collegiate than the Federal Reserve or the Bank of England. Its decisions reflect the view of its governing body more than those of its president. Furthermore, Draghi will need time to establish his own presidential powers of persuasion.

Draghi was not destined to become ECB president. He was chosen only after the abrupt resignation of former Bundesbank head and über-favorite Axel Weber. Concerns about his nationality, at a time when Italy's finances and politics are in such a sorry state, were rightly cast aside. In recent months he has taken care to position himself, in calibrated interviews and careful statements, as one of the fiercest critics of the Italian government's inaction. In any case, anyone familiar with Italian politics knows that he and Prime Minister Silvio Berlusconi have never been exactly soul mates.

Independence from Rome is not a worry. Draghi's bigger challenge is not to spend too much time making the world forget he's Italian. Sounding the right noises to secure Angela Merkel's support for the ECB job was one thing. But he must make sure this will not stop him from steering a course that may, at times, ruffle feathers in Berlin and at the Bundesbank.

There may come a time, for example, for the ECB to claim for itself the role of euro zone sovereign lender of last resort. German opposition has prevented this from happening. But it may become unavoidable if recently-decided reforms to the EFSF – the euro zone bailout's fund – do not bear fruit.

At the age of 64, Draghi is beginning an eight-year, non-renewable term – which serves to guarantee his independence. His immediate task is to keep the ECB on track in the pursuit of both inflation-fighting, its traditional goal, and financial stability, a job it was forced to take on by circumstances. In addition, he must win Trichet's mantle of stern father figure to the dysfunctional euro zone. No one said the job was easy.

*First published on 31 October 2011*

## DOLLARS EVERYWHERE – SO WHERE'S THE INFLATION?

**BY MARTIN HUTCHINSON AND CHRISTOPHER SWANN**

Money supply is rising fast, so where is the inflation? U.S. consumer prices rose 0.4 percent in February, but that was mostly gasoline. Year-on-year, inflation is above the Fed's 2 percent target but not by much. Yet money supply is going through the roof. Either inflation is on the way, or Milton Friedman should lose his Nobel prize.

Friedman argued that "inflation is always and everywhere a monetary phenomenon." He proposed that central banks should increase money supply at a constant annual rate, ignoring economic cycles, so as to minimize self-reinforcing bouts of inflation and deflation.

What has happened in recent years is a long way from Friedman's recommendation. Broad money supply, whether by the so-called M2 measure or the St. Louis Fed's money of zero maturity – a proxy for the M3 metric – is up almost 10 percent over the past year, while the adjusted monetary base, a narrower measure of money, is up over 18 percent. Friedman's idea was that the money supply should increase at the same rate as real GDP. Other things being equal, the implication of money supply rising at 10 percent while real GDP has expanded less than 2 percent over the past year is that inflation should be running at more than 8 percent.

The relationship can be delayed. For instance, U.S. monetary policy became unusually expansive around 1965, whereas inflation did not hit 5 percent a year until 1969 and only topped 10 percent in 1974. The so-called velocity of money, essentially the pace at which each dollar is spent and recycled, is also a factor. The 2008 crash and the subsequent deleveraging process may have subdued velocity.

Nevertheless, assuming as recent data suggest that the U.S. economy is now recovering from the 2008 shock, velocity should rise to more normal levels. Applying Friedman's theories, that in turn could bring a rapid acceleration of inflation.

Meanwhile, Federal Reserve Chairman Ben Bernanke and most of his colleagues believe that inflation will remain muted, justifying near-zero interest rates until late 2014. If Bernanke proves right, he'll look smarter than the 1976 Nobel Committee.

*Published on 16 March 2012*

# THE WORLD'S CENTRAL BANKS ARE RUNNING OUT OF ROAD

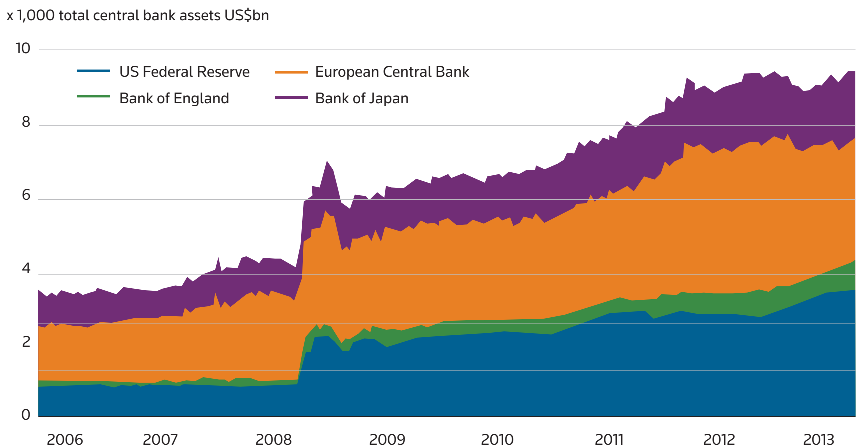
**BY PETER THAL LARSEN**

In the global economic crisis, central bankers are often portrayed as superheroes. Mario Draghi: the only man who can save the euro zone. Ben Bernanke: "please do more" for the U.S. economy. The Bank for International Settlements is unhappy with the image of omnipotence: its latest annual report laments that central bank money-printing and support for the financial sector are reaching their limits.

There's no question that central banks have taken extraordinary measures. They have made negative real interest rates seem normal in the world's advanced economies. They have bought vast quantities of government debt or offered vast sums of cheap, long-term loans to banks. Their balance sheets have swelled: at the end of 2011, the combined assets of the world's central banks stood at $18 trillion – double their pre-crisis level, and equivalent to 30 percent of global GDP.

This monetary largesse has many bad side effects. It reduces the pressure on governments to reform and for banks to recognise bad loans. It distorts financial markets and encourages new recklessness. It pushes up asset

## Major central bank assets




Source: Thomson Reuters Datastream, V Flasseur 03/09/13 prices in emerging markets and other perceived safe havens. And the longer it goes on, the harder it is to unwind.

The BIS is right to worry. Central banks cannot do everything. It is also right that sovereign debt is high: most advanced economies would need to run an annual budget surplus of more than 2 percent of GDP for a decade to get their debt-to-GDP levels back to pre-crisis levels.

And yet, there is something unreal about the BIS analysis. If the world's largest countries simultaneously ran surpluses, or even cut deficits sharply, the almost certain result would be a global slump. Also, the worries about excessive debt do not square easily with historically low government bond yields.

Unless the economy recovers quickly, the pressure on central bankers to "do more" will only increase. The BIS worries that this "puts at risk central banks' price stability objective, their credibility and, ultimately, their independence." True enough, but as long as the likely alternative to heroic measures is a global slump, there will be no realistic alternative. In a new Great Depression, these principles will be even harder to defend than they are today.

*First published on 25 June 2012*

## CAN SUPER MARIO SAVE THE EURO?

**BY HUGO DIXON**

Can Super Mario save the euro? Mario Draghi said last Thursday that the European Central Bank's job is to stop sovereign bond yields rising if these increases are caused by fears of a euro break-up. While this represents a sea-change in the ECB president's thinking, it risks sowing dissension within his ranks. He will struggle to come up with the right tools to achieve his goals.

Draghi seemingly stared into the abyss and had a fright. Spanish 10-year bond yields shot up to 7.6 percent on July 24 while Italian ones rose to 6.6 percent. The high borrowing costs are not simply a reflection of the two countries' high debts and struggling economies. Investors also fear "convertibility risk" – or the possibility that the euro will break up and they will get repaid in devalued pesetas and liras.

The central banker's statement that dealing with convertibility risk is part of the ECB's mandate is therefore highly significant. He rammed home his message, saying: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."

Markets responded swiftly. Spain's borrowing costs fell to 6.8 percent, while Italy's dropped just below six percent. But these yields have to drop below five percent – and stay there – before confidence in the euro project will return. What's more, it's unclear what Draghi will actually do.

One possibility, immediately latched onto by investors, is that the ECB will relaunch its programme of buying government bonds in the market. But such an operation would be tough to calibrate. If the ECB was prepared to do whatever it took to drive yields below a certain level, the pressure would certainly be off Spain and Italy. But politicians might then stop reforming their economies. When the ECB bought Italian bonds last summer, that's precisely what happened.

That's why Germany's Bundesbank, which has a powerful voice within the ECB but no veto over its actions, is opposed to bond-buying – potentially setting the stage for a stormy meeting when the ECB governing council meets to discuss what to do on Aug. 2. It's not yet clear how big a spoke the German central bank will be able to put into Draghi's plans.

On the other hand, if the ECB made its support conditional on good behaviour, investors might not be reassured. Their anxiety would be heightened if central bank bond-buying pushed private creditors down the pecking order. That's what happened when Greece's debt was restructured earlier this year: private bondholders suffered big losses while the ECB theoretically stands to make a profit. A half-hearted bond-buying programme might therefore simply encourage investors to dump their holdings on the ECB while having no lasting effect on Spain's and Italy's borrowing costs.

Draghi may think that the two countries' current leaders – Spain's Mariano Rajoy and Italy's Mario Monti – are more serious about reform than their predecessors Jose Luis Rodriguez Zapatero and Silvio Berlusconi. But even the new leaders have shown signs of losing momentum. Rajoy's latest spurt of action – further budget-tightening and a plan to recapitalise the country's struggling banks – only occurred because his back was to the wall. In Italy, meanwhile, Monti says he will stop being prime minister next spring. It's not clear whether his successor will be committed to reform.

For these reasons, Draghi seems reluctant for the ECB just to buy bonds on its own. Rather, he seems to want to do so in combination with the euro zone's bailout funds, which have the ability to buy bonds directly from governments – something the ECB is banned from doing. One advantage is that Madrid and Rome would have to sign memorandums of understanding setting out their reform plans in order to access the bailout funds. It would then be easier to hold them to their commitments.

A further idea, reported by Reuters, could help deal with private creditors being pushed down the pecking order. Policymakers are working on a "last chance" option to cut Athens' debt – involving the ECB taking a haircut on its Greek bond holdings. If that happened, investors would worry less about being unfairly treated if Spain or Italy ever needed to restructure their debts. They might then not view bond-buying as the perfect chance to offload their holdings onto the public sector.

The two-pronged approach is preferable to the ECB buying bonds solo. But it would still put the central bank in the front line of rescuing governments. A better approach would be to scale up the euro zone's bailout funds and get them to do the entire job of lending to Spain and Italy, if they need help. This could be achieved by letting the soon-to-be-created European Stability Mechanism (ESM) borrow money from the ECB.

Draghi should prefer lending to the ESM than buying Spanish or Italian bonds because, if either country got into trouble, the bailout fund not the ECB would take the first losses.

Unfortunately, the ECB said last year that extending loans to the ESM would contravene the Maastricht Treaty – a position Draghi himself repeated after he took over as president, even though there are plenty of lawyers who think the opposite.

Super Mario is now warming to the idea of lending to the ESM, according to Bloomberg, even though that's not part of his immediate plan. If Draghi does this, he'll have to find a way to eat his words without losing credibility. If not, he will have to rely on second-best options with all their drawbacks. Mind you, it's the job of super heroes to get out of tight spots.

*First published on 30 July 2012*

# THE WORLD GETS USED TO IT

*As the QE era continued, a few people were happy with the way it was turning out. Financial markets were mostly strong and some countries were finding it easy to fund current account deficits. But overall, there was more frustration than joy. Economic growth remained disappointing in developed economies and central bankers resorted to more extreme methods, including a massive QE exercise in Japan. The financial system remained overleveraged and macroprudential regulation was no more than a work in progress.*

## QE3 HONEYMOON MAY BE BRIEF FOR EMERGING MARKETS

**BY WAYNE ARNOLD**

The QE3 honeymoon may be disappointingly brief for emerging markets. The U.S. Federal Reserve's promise to buy mortgage-backed bonds into the indefinite future could lift all boats for a while. But the flood of dollars might soon frighten investors, as well as vexing central bankers everywhere but the United States.

It's no mystery what happens when the Fed buys bonds with newly conjured dollars: anything but dollars tends to rise. In the year after QE1 in late 2008, emerging market bond yields fell, gold rose 56 percent, oil climbed 70 percent and MSCI's index of Asian stocks rose 65 percent. A similar trend was underway after QE2 in late 2010, until July 2011, when the Fed stopped buying more bonds and the European crisis boiled over.

Now the Fed has promised to create $40 billion a month until it deems that the U.S. labour market has responded sufficiently. That opens the prospect of a limitless supply of hot money, driving the prices of risky assets ever higher. The Hong Kong Monetary Authority is already worrying about the effect on the city's property market.

For central bankers, all that hot money turns monetary policy on its head: if inflation is a problem, cutting policy rates will reduce the allure of their country's assets and thus raise funding costs. But if growth is slowing, they can hold rates or even raise them, and let the incoming hot money drive stocks up and corporate borrowing costs down.

But after two rounds of artificial currency injections, investors are becoming sensitised.

All too soon, they'll be looking to see if QE3 is working. If it's not reviving growth or inflation, they're likely to forsake commodities and emerging-market stocks for higher-yielding bonds from fiscal havens like Australia and Indonesia. And if growth stays sluggish but inflation perks up, they'll hunt for higher-yielding debt in less export-dependent economies with relatively strong finances – such as Japan and Argentina.

The most dramatic switch would occur if quantitative easing seems to be working. Then investors may have to resort to a radical, almost forgotten strategy: searching for relative value.

*First published on 14 September 2012*

## FEDERAL RESERVE RUNNING OUT OF TABOOS TO BREAK

**BY AGNES CRANE**

The U.S. central bank is running out of taboos to break. This week, Boston Federal Reserve President Eric Rosengren admitted that the latest quantitative easing broadside would debase the dollar. His counterpart in Minneapolis, Narayana Kocherlakota, traditionally on the hawkish side, said that an above-target inflation rate of 2.25 percent would be tolerable.

Regional Fed bosses have more leeway to speak their mind than, say, Fed Chairman Ben Bernanke – especially when, like Rosengren and Kocherlakota, they're not currently voting members of the policy-setting Federal Open Market Committee. Their pronouncements still carry weight.

Rosengren has a reputation for choosing his words wisely, while the Minneapolis Fed boss is known for vigilance on inflationary threats.

Rosengren's admission that Fed policy may weaken the dollar provides ammunition to the likes of Guido Mantega, Brazil's finance minister. He thinks policies like the Fed's bond-buying devalue the currencies of the countries undertaking them, hurting the competitiveness of economies like Brazil's – though the dollar isn't currently trading too far from where it was two years ago on a trade-weighted basis.

Meanwhile, Kocherlakota's remarks could alarm those who see running the dollar printing presses as feeding inflation. U.S. consumer prices rose a mild 1.7 percent in the year to August. But the Fed's recent pledge to buy mortgage-backed securities on an open-ended basis has fueled suspicions that Bernanke and his colleagues are willing to see prices rise faster than the semi-official target of 2 percent a year.

Those are the most recent sacred cows to be slaughtered. But Bernanke has dispatched several since the start of the financial crisis, from the Fed's participation in the bailout of Bear Stearns to its expansion of emergency lending to banks and the launch back in 2010 of a plan to buy $600 billion of U.S. Treasuries – the first round of quantitative easing. The Fed boss's efforts to head off any repeat of the Great Depression have angered many conservatives, in particular the Tea Party faction, something that could yet bring political efforts to curb the Fed's power.

A weaker currency and an increased risk of inflation follow directly from the Fed's war on stagnation. But actually saying so could bring more domestic and foreign brickbats.

*First published on 21 September 2012*

## BOJ'S CONUNDRUM IS HOW TO BE MORE IRRESPONSIBLE

**BY ANDY MUKHERJEE**

The Bank of Japan has a conundrum: how to make a credible commitment to recklessly printing more money. The central bank wrote the primer on unconventional monetary policy a decade ago when it pioneered quantitative easing. But as other central banks have embraced loose money, the BOJ has become an increasingly forlorn figure in a crowded rogues' gallery.

The U.S. Federal Reserve has set the tempo by promising near-zero interest rates until mid-2015. It has also made an open-ended commitment to buying mortgage bonds at the rate of $40 billion a month until the labour market shows sustained improvement. Meanwhile, the European Central Bank has vowed to buy short-term government bonds of all euro zone countries that officially seek help.

In such a merry season of central bank liberation, the BOJ is stuck with the straitjacket of a predefined, 80 trillion yen ($1 trillion) asset-purchase programme that does expand from time to time – but only when the economy threatens to slip further into its deflationary funk. The result is a Sony Walkman pretending to be an iPhone 5; since the second quarter of 2008, the Bank of Japan has increased its supply of currency and bank reserves by 42 percent. The Fed has more than tripled its monetary base over the same period.

Even the target of the BOJ's limited asset-buying plan is problematic. The most recent monetary easing plan, announced on Sept. 19, added 10 trillion yen in treasury bills and government bonds to the monetary authority's shopping list. That's inadequate for two reasons. First, the BOJ will be making these purchases next year, when they will no longer have any shock value. Second, Japanese banks will be reluctant to part with a three-year government bond that pays a precious 1.4 percent annual coupon if the most likely alternative is to deposit the proceeds with the central bank at a rate of 0.1 percent.

One option is for the BOJ to offer a more generous price – something the central bank has allowed itself to do by scrapping a limit on the minimum yield (and therefore maximum price) it could pay at auctions. But even a negative yield isn't novel any more. Mildly negative nominal interest rates have already appeared in Denmark, Switzerland and Germany, and deeply negative ones will be impossible as long as currency – a competing security that pays zero interest – isn't outlawed.

So what will shock Japan? A new inflation target of, say, 2 percent would induce a yawn, considering that few analysts expect the BOJ to hit even the 1 percent goal it adopted in February. Embracing a new target, such as nominal GDP, lacks the simplicity of aiming for higher prices. The central bank could raise the share of corporate bonds, exchange-traded funds and property-backed securities in its asset-purchase program from their current 8 percent level. That would pile more credit risk onto the BOJ's balance sheet, but would also channel liquidity to non-banks that may use it to boost credit.

A bolder move would be for the monetary authority to use printed money to buy U.S. Treasury bonds until it hits its inflation target. Such a plan would help exporters by weakening the yen, even as it generates domestic liquidity. Currently, the finance ministry orders purchases of foreign securities out of funds that the government borrows and parks in a special account. This roundabout way of weakening the yen through a fiscal operation – rather than a monetary one – only works temporarily, until a fresh bout of global risk aversion makes the yen a compelling haven again.

Purchasing U.S. Treasuries by printing yen would require changes in the institutional arrangements between the BOJ and the finance ministry. It would also be bound to evoke protests in the United States about Tokyo's blatant currency manipulation. Then again, Japanese purchases would play the same role that outsized Chinese demand for U.S. government and agency debt did until a few years ago: they will help to keep long-term U.S. interest rates low.

The BOJ needs to change its failing strategy. Risks of a new recession are mounting. If the central bank doesn't come up with a new policy, Japanese consumers will continue to hoard cash and deny the economy what it has craved since 1999: a little bit of inflation.

*First published on 11 October 2012*

## UK INFLATION IS SYMPTOM OF GLOBAL QE-ITIS

**BY IAN CAMPBELL**

The Bank of England's quarterly inflation report is suitably gloomy. Though UK GDP growth is low, the inflation rate has risen again, to 2.7 percent, about half a percentage point higher than the central bank predicted just three months ago. The surprise can be explained by excessively insular thinking. Central bankers, and not just in the UK, need to consider the global effect of quantitative easing.

When making policy decisions, central banks understandably think local. What the Bank of England sees at present is an economy that needs all the monetary help it can get. After an Olympic jump in the third quarter, GDP could even contract slightly in the fourth, Governor Mervyn King said.

Domestic weakness is supposed to go along with disinflationary pressures. The central bank has consistently believed that inflationary pressures would abate and inflation fall below its target rate of 2 percent. The central bank has consistently been wrong. The inflation rate could now easily increase to 3 percent as utilities raise their prices. In turn, that could depress consumer spending again, weakening growth.

The vicious cycle of unexpectedly high inflation and unexpectedly low growth needs to be broken. To do so, the source of the inflation needs to be better understood. Some problems are domestic, most notably in October the government-mandated sharp increase in university tuition fees.

But the profound source of the inflationary problem is that weak domestic spending does not isolate the UK from high global prices of energy and other raw materials. And why are those prices high? The likely answer is extreme monetary stimulus.

As King himself pointed out, the world's major central banks are all following policies of extreme stimulus. And the U.S. Federal Reserve's commitment to money printing is now open-ended. There can be little doubt that the newly created money does a great deal for financial markets and commodity prices. These have an inflationary impact around the globe – one that is reducing real incomes, and dampening growth, not stimulating it.

Central banks need to think again – and think about the global impact of their policies. QE is supposed to generate growth, but it appears instead to be generating growth-killing inflation.

*First published on 14 November 2012*

## FED NEEDS TO SPEND SOME TIME OUT OF THE SPOTLIGHT

**BY AGNES CRANE**

The Federal Reserve needs to spend some time out of the spotlight. After experimenting with massive new policy initiatives since the 2008 crisis, the hyperactive U.S. central bank has already said it probably won't raise rates for years. Now it's considering specifying levels of unemployment and inflation which could change that. It's a recipe for confusion.

Minutes from the last policy meeting in October, published on Wednesday, show central bankers debated the merits of ditching guidance that keeps interest rates near zero for a defined period of time – currently until 2015. Instead, they could provide thresholds for economic indicators that would trigger a policy rethink. The minutes don't specify which indicators are preferred, but the Fed's dual employment and inflation mandate and a speech this week from Vice Chairman Janet Yellen make the jobless rate and some measure of prices the obvious contenders.

Saying short-term rates would stay low for years never seemed a great idea, though Fed Chairman Ben Bernanke was trying to manage market expectations. Despite the fact it's only a forecast, investors mostly interpret it as a commitment – and that makes them too comfortable. Introducing thresholds might in theory help make them more alert to how Fed policy might change along with economic realities. But in practice it would probably make Bernanke's job even more complicated.

First, there's the problem of what the thresholds should be. Charles Evans, the Chicago Fed president, reckons short-term rates should remain zero-bound while the jobless rate is over 7 percent and inflation under 3 percent. His colleague from Minneapolis, Narayana Kocherlakota, sees the magic

*A policeman walks around the Federal Reserve Building in Washington. REUTERS/Larry Downing*

numbers at 5.5 percent and 2.25 percent, respectively. Even then, Bernanke will have to convince the public that such targets are triggers only for a re-evaluation, not necessarily for action. Otherwise he would compromise the Fed's cherished flexibility.

Any attempt to convey such nuances is risky, with investors looking for simple messages. The Fed would be better off bringing back a little mystery. After all, until the crisis struck in 2008, there was a lot more of that. In fact, weaning markets off a running commentary from the central bank almost counts as a first step in the process of reversing the radical policies of recent years. Keeping quiet occasionally would finally let market forces begin to reassert themselves.

*First published on 14 November 2012*

## BOJ MUST NOW MAKE ITS BOLD INFLATION GOAL CREDIBLE

**BY ANDY MUKHERJEE**

After more than a decade of feigning helplessness against falling prices, the Bank of Japan has finally signed up for combat duty.

Armed with a 2 percent inflation target, twice the 1 percent goal it has been half-heartedly pursuing since February last year, the central bank will now lead Prime Minister Shinzo Abe's battle to reverse the country's endemic deflation.

To demonstrate its commitment to reaching the objective, which the government wants the BOJ to achieve as soon as possible, the central bank has agreed to buy 13 trillion yen ($145 billion) in yen-denominated assets each month, starting in 2014. In terms of sheer size, that makes it even more aggressive than the U.S. Federal Reserve's $85 billion-a-month quantitative easing programme.


*Bank of Japan Governor Haruhiko Kuroda points at a chart projecting his quantitative and qualitative monetary easing plans. REUTERS/Yuya Shino*

Yet the bold money-printing plan suffers from two potential drawbacks. First, it doesn't start for almost twelve months. And second, while further weakening the yen could help Japan's export-dependent economy, the BOJ still needs to persuade markets that it won't abruptly give up the fight. Given the central bank's past track record, that will be quite a challenge.

Unlike the BOJ's current 101 trillion yen asset-purchase plan, which is set to end in December, the new approach is open-ended: The BOJ says the programme will continue as long as it is deemed "appropriate." But the crucial questions are: Under what conditions will the hyper-easy monetary policy become inappropriate? When would the purchases stop, and when might the BOJ start selling?

The central bank needs to convince investors that even when its strategy has succeeded in fuelling inflationary expectations, the BOJ won't tighten policy hastily – which is what it did in 2000 and 2006. One option could be to tie the size of the BOJ's balance sheet to policy makers' inflation forecasts. Until the average forecast breaches a ceiling of, say, 3 percent – above the official target – the BOJ would refrain from mopping up liquidity.

Unless investors are persuaded that the money the BOJ is pumping out into the economy won't be drained at the first whiff of inflation, the deflation enemy will be hard to defeat.

*First published on 22 January 2013*

## INTERVIEW QUESTIONS FOR THE NEW BOJ CHIEF

**BY ANDY MUKHERJEE**

Japanese Prime Minister Shinzo Abe's war on deflation will soon have a new general. A hard-charging Bank of Japan governor with strong conviction and oodles of savvy could help bring Abe's plan to fruition.

The leading candidates to replace Masaaki Shirakawa when he steps down in March are all impressive. Kazumasa Iwata and Toshiro Muto are former BOJ deputy governors. But having been central-bank insiders also carries with it the stigma of policy failures. Heizo Takenaka, who was point man for banking reforms under former Prime Minister Junichiro Koizumi, has a proven track record. Meanwhile Haruhiko Kuroda, the president of the Asian Development Bank, has a weighty Rolodex that might help Japan avoid international censure for its policies.

The nomination will have to be approved by both chambers of Japan's parliament. But here are some interview questions the prime minister can use to test the candidate's commitment to "Abenomics".

*Q. What will you tell critics who accuse you of debasing the yen?*

Correct answer: Thank you. The new governor must eschew the puritanical notion that he must preserve the purchasing power of the Japanese currency. While that would indeed have been the job description in normal times, Japan is stuck in a deflationary quagmire. Only when people understand that their yen will be able to buy less, not more, tomorrow than today, will consumers spend more, employees demand higher wages and investors stop sitting on piles of cash or risk-free bonds.

*Q. What will you do if inflation leads to higher interest rates and losses on BOJ's holdings of public debt?*

Correct answer: I don't care. One of the reasons the BOJ's response to deflation has been inadequate is because policy makers have agonised over the size and quality of the institution's balance sheet. The new governor, too, will undoubtedly face warnings from hawks that a mere 5 percent drop in the value of the central bank's government bonds will wipe out its capital. But running out of capital is a worry for private institutions, not a money-printing central bank.

*Q. Won't debt markets get jumpy if the BOJ chalks up large losses?*

Correct answer: No. What matters to investors is the consolidated balance sheet of the government and central bank, and that will look better if higher inflation causes interest rates to increase. The $1.27 trillion of government paper held by the central bank is a fraction of the net outstanding public debt of about $7 trillion. Higher yields will reduce the present value of this liability. True, there will be pain at the state pension fund, whose assets are largely government bonds. But that problem will need a separate response.

*Q. How will you allay the euro zone's concerns that a weak yen is an assault on its competitiveness?*

Correct answer: By buying Italian and Spanish bonds. To resist international opposition to a weak yen policy, the new governor should champion the Abe administration's idea of a foreign bond fund. If the fund is large – say the equivalent of $500 billion a year – and a fifth of it is used to buy sovereign debt in the euro zone, about 5 percent of the annual gross borrowing requirement of all the governments of the single-currency area will find an assured lender. Under no circumstance, though, must Japan get dragged into another Plaza Accord, which led to a massive appreciation in the yen in 1986. That would risk extending Japan's deflation.

The next governor's place in history is assured. What remains to be seen is whether posterity views him as the peace-time hero who helped to end Japan's chronic deflation or a failure like Masaru Hayami, who became governor in 1998 and did incalculable damage to the economy by refusing to believe – until it was too late – that Japan's deflation was a bad thing.

A final question that Abe might want to slip in at the end of the quiz is: *What will you do after I ratchet up deficit spending and rating agencies downgrade Japan again?*

The correct answer: a shrug.

*First published on 12 February 2013*

## CHINA'S CENTRAL BANK WILL FIND VALUE IN CONTINUITY

**BY JOHN FOLEY**

China's rapid economic growth has broken so many rules that one more can't hurt. Zhou Xiaochuan, the governor of the central bank, may have his tenure extended despite reaching the mandatory retirement age of 65, sources told Reuters on Feb. 20. The PBOC is a rather weak institution, but Zhou, ten years into his governorship, remains the best man to run it.

Unlike the Federal Reserve or Bank of England, the PBOC lacks independence in setting monetary policy. Major decisions must be approved by China's cabinet: the country's leaders deem interest rates and the value of the currency far too important to be left to bankers. Such political meddling makes it hard to judge China's top decision makers objectively. Zhou's non-appearance at the International Monetary Fund meeting in Tokyo last year amid a territorial dispute with Japan – a low point in China's financial diplomacy – showed how political his job is.

If ideas count, though, Zhou is unmatched in China. He masterminded the rescue of China's banks a decade ago, when bad debts made up a quarter of their loan books. He has overseen the 9.5 percent appreciation of the currency since it was unpegged from the U.S. dollar in June 2010. And while his plans to make the yuan into an international tender have underwhelmed, the idea of China's currency becoming convertible is no longer unthinkable.

Ten years of stability have brought risks. China's last decade has been characterized by financial repression, including too-low deposit rates, and a too-cheap currency. Loans and foreign exchange reserves have exploded, while China's broad money supply has increased by 19 percent a year over the past five years. Officially, bad debts remain low, but probably not for long.

The PBOC will eventually have to deal with the effects of that repression, including the runaway growth in "shadow bank" lending outside of the banking system. China may also need to relax its paternalistic policies and allow market forces to rule, even if that means more failure. Politics may put that beyond Zhou's ability, but given his experience, the PBOC is better with him than without.

*First published on 21 February 2013*

## ALL TOGETHER NOW, CENTRAL BANKS DO NOT GO BUST

**BY AGNES CRANE**

Central banks which control their own currencies do not go bust. Yes, the U.S. Federal Reserve and other central banks with bloated balance sheets are likely to book losses when interest rates rise. That must be why U.S. Senator Bob Corker this week asked Fed Chairman Ben Bernanke about the institution's solvency. But no amount of red ink should bleed them dry. That's because despite their name, central banks are monetary authorities, not really banks.

Their main job isn't to lend money. Central banks, instead, squeeze and pull a nation's monetary base, trying to keep inflation low, growth high and the financial system stable. Over the past four years, the U.S. central bank, followed by peers around the world, has exercised that mandate by buying trillions of dollars of bonds.

That sounds expensive, but monetary authorities, unlike real banks, have no trouble finding the necessary funds. They simply create new money.

Take the Fed. It now has a $3 trillion balance sheet with just $55 billion in equity. If it were a normal bank, that would equate to leverage of 55 to 1, breaching capital requirements several times over. But it's not. Central banks don't need equity capital. They put it on the balance sheet for appearances.

There's the rub. Perception matters. Politics do, too. Earlier this year, Fed economists published a paper forecasting what will happen to its vast holdings of Treasuries and mortgage bonds when interest rates go up. In a worst-case scenario, the losses could run as high as $125 billion, leaving the Treasury with zero income from the Fed for six-and-a-half years. After receiving nearly $300 billion over the past four years, lawmakers are sure to squawk about the lost revenue.

Senator Corker's questions hint at the political battle ahead. If it gets heated enough, lawmakers could try to interfere with monetary policy in the middle of what's sure to be a complicated exit. That would be unfortunate. The European Central Bank, however, may even have it worse. Political pushback could jeopardize its ability to recapitalize, since all member countries must agree to an equity injection.

And this is where the danger resides: not in a central bank's solvency, but in the public's perception. If Bernanke and others aren't persuasive enough to allay concerns about losses, the QE experiment could come to an ugly end.

*First published on 1 March 2013*

## DRAGHI'S DANCE ON NEGATIVE RATES ISN'T OVER

**BY NEIL UNMACK**

Mario Draghi is not ready to take the euro zone into uncharted territory – yet. The European Central Bank president has played down hopes of cutting rates below zero, stressing "serious" risks. But if the euro shoots up again, talk of negative rates may return.

A negative rate on the ECB's deposit facility sounds hairy, but could have some benefits. It might force banks to lend out their excess reserves. It could also discourage speculative flows. Examples are rare, with the most recent being Denmark, which cut the rate on certificates of deposit after the ECB lowered its rate in July. Draghi suggested a degree of comfort with the idea in December, when he said the central bank was "operationally-ready". This week he chose instead to warn about the "unintended consequences" of a negative deposit rate.

Draghi was right to stress the risks and he knew them before. Negative rates could impact overall liquidity by hurting the money market funds that banks borrow from – although that's a consequence the ECB can live with. Worse, it may not even help lending conditions that much. Banks may be reluctant to pass on all the costs to their depositors, and instead could try to recoup them from borrowers. Perversely, a cut in rates could then tighten rather than loosen credit conditions.

The concerns are particularly relevant for the euro zone. Cash-rich banks in northern Europe would be most affected by the rate cut, but a small cut in rates won't persuade them to channel funds to the areas that are most credit starved in southern Europe. They may just push money into areas of the economy that are already overheating. The return of political crisis in Italy will make them even more nervous.

That doesn't mean a negative deposit rate is out of the question. A weakening euro, partly driven by the Italian election, has offset previous fears of a rising currency. However, if weak global growth forces other central banks to accelerate quantitative easing, the euro could start to look attractive again, hurting competitiveness. Tinkering with interest rates may be more appealing in Germany than unabashed money printing. The negative rate dance could begin again.

*First published on 8 March 2013*

## INFLATION FEAR SHOULDN'T CONSTRAIN MONETARY POLICY

**BY OLAF STORBECK**

A nagging fear of out-of-control inflation is deeply engrained in the psyche of any proper central banker. For the time being though, they can relax. Current monetary policymakers enjoy more room to manoeuvre than past experiences – and today's inflation hawks – suggest.

The unfortunate experience of the 1960s and 1970s makes it clear that the threat of an inflationary spiral is not purely hypothetical. However, new research by economists at the International Monetary Fund is comforting. The world has changed since then – because prices no longer move to the same extent as the economy. "Over the past decade or so, inflation in advanced economies has become less responsive to changes in economic slack."

If prices had responded to the Great Recession that followed the 2008 financial crisis as they did in the 1970s, the U.S. economy would have plunged into deep deflation. The IMF calculates that even with the Federal Reserve's easy monetary policy, prices would be falling at a 2 percent to 3 percent annual rate. In reality, the Consumer Price Index only fell briefly – by 2.6 percent in the two months between October and December 2008 – and has risen slowly and steadily ever since.

Behind this stability is a self-fulfilling prophecy. If producers and workers expect moderate inflation, they will push for only moderate wage and price increases, and will strongly resist wage and price cuts. Once central banks have a strong reputation for keeping prices fairly stable, the people's moderate behaviour will help them retain it.

The monetary authorities' strong reputation and these well-anchored inflation expectations give much-needed leeway for an expansionary monetary policy – and a cushion of safety. Even if central banks managed to spark excessively fast growth – they should dream of such a problem – the anchors would hold. "Any temporary overstimulation of the economy is likely to have only small effects on inflation", the IMF concludes.

Are you listening, Frankfurt? Many of the world's most serious inflation-worriers hang around the European Central Bank. They should read the IMF study and worry less. There is room for more monetary stimulus, and the opportunity should be seized.

*First published on 9 April 2013*

## GLOBAL INFLATION SLIDE STIRS THE BOGEYMAN

**BY AGNES CRANE**

It wasn't supposed to happen this way. When central banks around the world started their quantitative easing programs, monetary theory said that the newly created funds could be dangerously inflationary. Instead, inflation rates are declining. In the United States, the current 1.1 percent is far below the Federal Reserve's 2 percent target. Policymakers now have to start worrying about their ultimate bogeyman – deflation.

If this fearsome enemy joins the field, the battle is hard to win. As the Japanese authorities have discovered, conventional weapons don't stop prices from falling, and the force of extraordinary ones remains uncertain.

Ben Bernanke and his Fed colleagues think the monster will stay on the leash. They chalk up the slowing pace of inflation to temporary factors, most notably falling energy prices, and they study expectations for future inflation which have not moved far from 2 percent.

That may be optimistic. In the U.S. and the euro zone, inflation rates have been heading downhill for more than a year. Japan, meanwhile, has been stuck with outright price declines since 2012. In theory, faster GDP growth could cause prices to reverse course, but the growth is elusive and the theory uncertain.

Moreover, the Fed's faith in inflation expectations may be excessive. Opinions can change quickly – they did in 2010 – and if commodity prices fall further, consumers might just start to expect overall declines – and then accept flat or falling wages.

For central bankers, that has echoes of the Great Depression and the Japanese economic quagmire. While declining consumer prices reward


*A sign which reads "Kill Inflation not Savings" is left outside following a protest outside the Bank of England. REUTERS/Suzanne Plunkett RTR2SAFY* savers, they are tough on corporate borrowers and falling wages increase defaults on mortgages, credit cards, and student loans. In other words, deflation breeds debt crises.

Central bankers will breathe fairly easily as long as wages keep rising, however slowly. They have been in the U.S. and most of Europe. If that started to change, policymakers would presumably redouble their stimulative efforts.

But that's the point. As long as inflation keeps slowing, central banks will not want to pull back on stimulus. There's a greater possibility they'll have to open up a new front.

*First published on 24 May 2013*

# QE-XIT

*By mid-2013, most central bankers decided that the economies of developed nations were improving. Soon they would be unable to justify totally extraordinary monetary policies. But the recovery also wouldn't be anywhere near strong enough to warrant a return to normalcy. The potential unwinding of U.S. QE rapidly became the most important market story.*

## MEMO TO CENTRAL BANKS: YOU CAN'T CONTROL MARKETS

**BY AGNES CRANE**

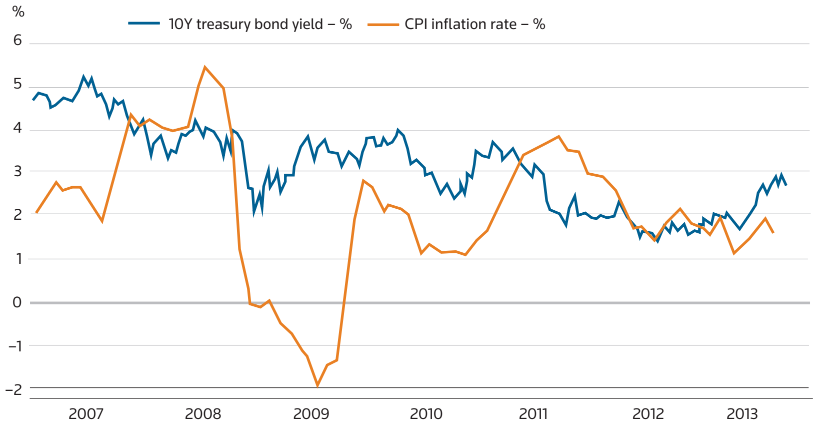
Central banks don't control markets. The U.S. Federal Reserve, Bank of Japan and their peers fix the overnight interest rate and influence everything financial, but the government bond market is not totally under their sway. The rapid rise of global yields in May is a healthy reminder that investors can disrupt the monetary authorities' best-laid plans.

Don't blame Ben Bernanke. Yields started rising before the Fed chairman repeated his longstanding commitment to buy fewer bonds whenever the U.S. economy strengthened. The Bank of Japan is still moving in the opposite direction with its massive bond buying program, but yields on the 10-year sovereign bond rose nearly 50 percent in May, admittedly to a still paltry 0.9 percent. German bund yields are up by a quarter and UK gilts by 15 percent – without much news.

Pundits are puzzled. Sure, the $5.7 trillion mortgage market matters in the United States, and Abenomics might eventually lead to higher inflation in Japan, but the global lockstep march suggests something else.

Perhaps this little yield spike is an early sign that investors are waking up to a difficult truth: central banks will not stay ultra-friendly forever. That suggests a strategic rethink is in order. Headlong dives into commodities, high-yield debt, dividend stocks and mortgage REITs are sensible as long as

## U.S Treasury yields and inflation




Source: Thomson Reuters Datastream, V. Flasseur 23/09/13

interest rates are suppressed. Leverage is cheap and profitable. But when interest rates are rising, such risk-hungry bets are reckless.

Gold is down and many commodities look post-peak, but the speed of the recent yield increases is especially worrying. It hints at how fast and how high yields could go when central banks actually change direction. Investors often move in herds, and a stampede of selling could destabilize nearly every financial market – and choke off an economic recovery.

Central bankers talk a lot about managing expectations, but they cannot force investors to hold bonds. Any effort to keep yields down by monetary force – mega-purchases of bonds – would probably just intensify the stampede. Once that starts, any monetary authorities who try to resist will just get trampled.

*First published on 30 May 2013*

## FED GENERATES THE WEALTH, BUT WHERE'S THE EFFECT?

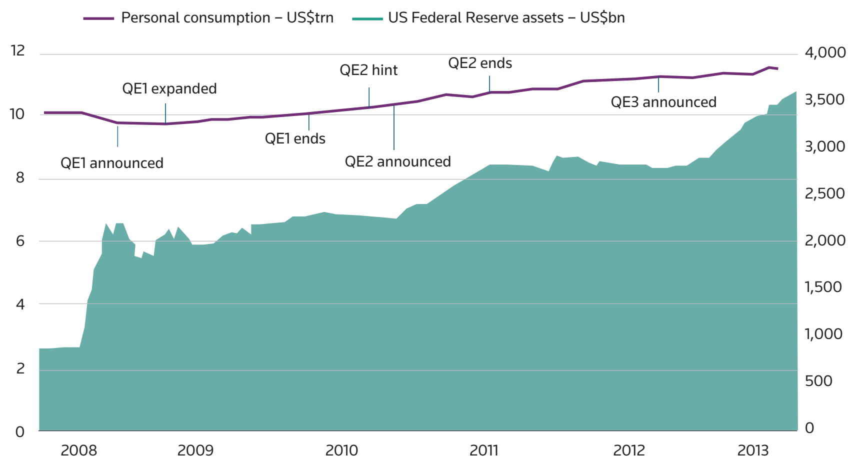
**BY AGNES CRANE**

The so-called wealth effect looks overrated. Americans' private worth grew twice as fast as the U.S. economy last year, according to the Boston Consulting Group, due largely to the rise in stocks and other financial assets. But consumers aren't rushing to spend their gains.

That contradicts one theory behind the Federal Reserve's program of bond-buying, or quantitative easing, now in its third act. The idea is that massive bond purchases, currently $85 billion-worth per month, suppress yields and encourage investors to buy riskier assets like stocks and corporate bonds and regular Joes to purchase homes. Then, rising asset prices make everyone feel wealthier and so more willing to spend. Finally, this greater demand for goods and services stokes faster economic growth.

QE has certainly juiced the markets. The S&P 500 Index, for instance, is up 13 percent since the Fed, chaired by Ben Bernanke, announced its latest round of bond buying. And home prices are on the rebound, making many

### Fed assets, consumption and QE timeline




Source: Thomson Reuters Datastream, C Trevethan 04/09/13

Americans richer, at least on paper. A new BCG study suggests their wealth increased by 8.1 percent last year, while nominal GDP only expanded by 3.5 percent.

Yet one key linkage – the connection between rising asset prices and freer spending – seems to be missing. In April, U.S. consumer spending actually fell 0.2 percent in nominal terms. Though previous months showed at least modest increases, consumers still have reasons to keep their dollars in their wallets. The unemployment rate is still high and home prices, while rising, are well below their pre-crisis peaks. Moreover, paper gains can disappear, as many people learned in 2008.

It's impossible to know if consumers would be even less inclined to go to the mall if the Fed had done nothing. And it could just be a matter of time before spending accelerates, with U.S. consumer sentiment at its highest level in nearly six years in May, according to the Thomson Reuters/University of Michigan survey. Still, five years into quantitative easing, there isn't much to show in the real economy for expanding the Fed's balance sheet by $1 trillion. QE is an untested policy, and the non-appearance of the wealth effect is another reason to wonder whether it's the right on

*First published on 31 May 2013*

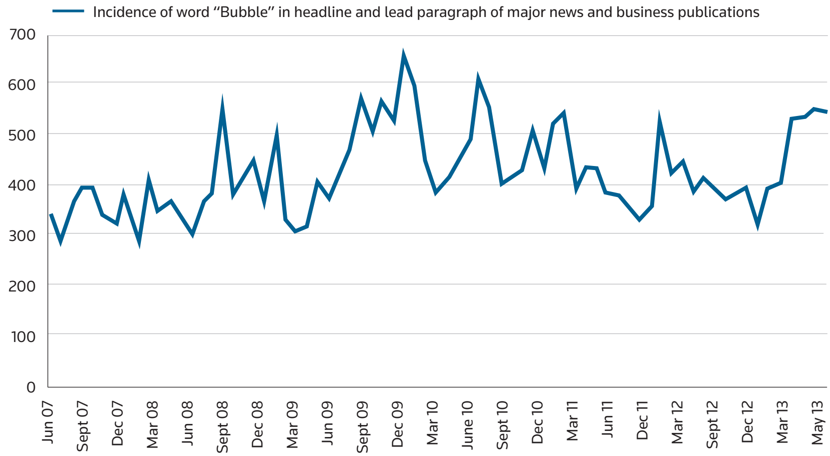
## BUBBLE IN BUBBLES HAS FURTHER TO INFLATE

**BY PETER THAL LARSEN**

Just as generals always fight the last war, investors tend to obsess over past crises. Six years after the peak of the credit bubble, some are convinced another one is being inflated. Use of the word "bubble" is on the rise. But this obsession may still be some way from popping.

It seems that hardly a day passes without a financial guru declaring a bubble in an asset class. In the past few months, investors and commentators have detected signs of irrational exuberance in government debt, prime real estate, junk bonds, gold, Japanese equities, and the virtual currency Bitcoin. The bullion selloff and Bitcoin collapse have emboldened

## Bubble journalism




Source: Factiva, T Larsen, R Mak 31/05/13

the bubble-hunters to search for the next distorted market. Meanwhile, the debate rages about whether central bankers are to blame for it all.

This onslaught of hot air points to the risk of a bubble in the use of the word bubble. In fact, mentions in the media are still some way short of their peak. Major news and business publications carried 544 articles with "bubble" in the headline or lead paragraph in May, according to Factiva. While that's higher than in the recent past, it's well below the high point of March 2010, when the bubble count hit 656.

Is increased talk of bubbles evidence of the real thing? Past experience suggests the opposite. In the summer of 2007 – when everyone involved in financial markets should have been shouting "bubble" at the tops of their voices – the number of articles with prominent mentions of the word ranged between 300 and 400 a month. The bubble count did not rise above 500 until October 2008, the month after Lehman Brothers collapsed.

Measuring bubble journalism is not remotely scientific. Results can be distorted by random articles about gas bubbles, or bubble wrap. What seems clear, however, is that the media is generally more enthusiastic about dissecting the aftermath of bubbles than about spotting new ones. As is the case with genuine financial bubbles, we may not be able to spot a bubble bubble until after it bursts.

*First published on 31 May 2013*

## G8 IS FORUM FOR HARD QUESTIONS ABOUT CENTRAL BANKS

**BY EDWARD HADAS**

G8 summits aren't known as founts of meaningful new ideas. But this week's meeting of the political leaders of eight principal economies in Northern Ireland has a chance to be different. They may discuss monetary policy. If so, they should consider how to replace the discredited shibboleths of central banking, namely narrow inflation targeting and political independence. It's time for more nuanced – and controversial – goals and tools.

In the standard model, central bankers are politically independent technicians whose primary task is to set an interest rate that produces steady and low consumer price inflation. Unfortunately, that job description has been almost irrelevant for the past five years.

Since the 2008 financial crisis, central banks have not had to worry about inflation, which has remained low in most developed economies. Policy interest rates have hardly changed. Instead, monetary authorities have been busy with many other things: inadequate GDP growth, faulty labour markets, currency wars, sovereign debt worries and unhealthy financial systems.

*Taylor Rule?*

There's a lot of denial going around on the topic. For example, in April the Centre for Economic Policy Research, a London think tank, published a document entitled, "Is Inflation Targeting Dead?" This included contributions from 20 "world-renowned scholars, practitioners and market

*Campaigners wearing giant heads resembling the G8 nations leaders, wave as they arrive on a replica Viking longboat, during a protest near the G8 Summit media centre . REUTERS/Andrew Winning*

participants". They came to a remarkable consensus: "Inflation targeting is alive and well; it has been revised, not rejected".

The authors mostly managed to agree that decisions about bank capital, systemic leverage, negative real interest rates and fiscal deficits, not to mention the European Central Bank's pressure for reform of labour market regulations around the euro zone, are somehow anchored by thinking about inflation in the distant future. It is hard to torpedo such a tenuous claim, but on the other hand the same decisions could equally plausibly be based on cogitations about future GDP growth, unemployment rates or financial system stability.

The fact is that inflation targeting has proved inadequate, just like its predecessors in the role of monetary policy Holy Grail – the gold standard, fixed exchange rates, Keynesian fine-tuning, monetarism and the Taylor Rule, which links changes in policy interest rates directly to changes in inflation.

The widely touted principle of political independence is even more absurd. Central bankers' decisions have political implications, and their statements and actions have become part of the political debate. And central banks are not independent. The discussion that could take place at the G8 is typical – politicians, in essence, set their agenda. The best that can be said is that central bankers may be less short-term partisan than elected politicians.

*Tailored rules*

New thinking is needed on how central banking should work. A big hurdle for G8 leaders and central bankers alike, though, is that what's needed is more complicated and less easily expressed than the wishfully simple ideas that have held sway in the past.

The management of the financial system cannot be reduced to a semi-mechanical process. There is too much going on for that: too many economic-financial interactions, too much dependence on psychology, too much uncertainty about cause and effect, and too many unintended and unpredictable consequences of policy decisions.

Simplicity is also precluded by the range of goals which central banks – in the real world – have to keep in mind, including full employment, healthy GDP growth, decent and rising living standards, just income and wealth distribution, sustainable international financial equilibrium, stable currencies, rational bank lending standards, and fair returns for savers.

If all that is not enough to make the idea of a policy Holy Grail dangerous, consider how much of the financial economy is not under the direct control of even the most intrusive central banks. They cannot dictate every private-sector lending decision or the spending habits of people and companies. They have particularly limited sway over government, the biggest economic actor in modern societies.

There's cause for optimism in the wider role assumed by central bankers since the crisis. But as the CEPR's collection of views shows, those involved are still reluctant to let the theory catch up with reality. Theoreticians need to give monetary authorities a framework that is multi-target, multi-tool and multi-rule.

*Gold standard for debate*

Such a framework will necessarily be eclectic. Recent financial innovations, such as derivatives and cheap trading, should be taken into account. So should the latest economic patterns, from persistent fiscal deficits to the global shift in economic weight from developed to developing markets.

The framework should have space for ideas that have in the past been too hastily cast aside by Grail-seeking economists. Tight financial regulation has already made a comeback, and the previously fairly obscure notion of controlling leverage is heading towards the mainstream. Targets and controls for foreign exchange rates merit reconsideration, as does direct fiscal-monetary coordination – the opposite of central bank political independence.

Monetary authorities also need to abandon retail price indexes as the only sign of monetary stability. They might add, for instance, the prices of commodities, especially those not much influenced by industrial supply and demand. In other words, a thorough debate in Northern Ireland this week might include – among many challenges to the standard thinking – a few minutes on something like a gold standard.

*First published on 17 June 2013*

## INVESTORS MOVE INTO "FEAR-ON" MODE

**BY EDWARD HADAS**

Money and moods both move markets. Not much has changed on the cash front in the last few weeks. Interest rates are not rising and the quantitative easing, or money-creation, programmes have not abated. However, the U.S Federal Reserve has changed the emotional tone. After Chairman Ben Bernanke reiterated his intention to slow QE on Wednesday, investors moved further into what is becoming the new normal mode: "fear-on".

It isn't the familiar move to "risk-off" investments. The prices of assets generally considered safe have fallen significantly. Gold dropped 5 percent

*A broker reacts at BGC Partners at Canary Wharf financial district in London August 5, 2011. REUTERS/Luke MacGregor*

from Tuesday morning in London – when investors started to brace for the next day's Fed press conference – to Thursday morning, when European markets took stock of what Bernanke said. Yields on super-safe 10-year U.S and German government debt rose by 9.2 and 4.5 percent respectively.

It certainly isn't the equally familiar move to "risk-on" investments. Equities, the classic risky asset, fell almost everywhere. The MSCI emerging market index, presumed to be high-risk, is down 4 percent in two days. Commodities have continued their descent. Copper dropped by 4 percent, bringing the fall since early April to 11 percent.

The crude "risk-off, risk-on" dichotomy, which has helped describe markets well for more than a decade, has come to an end. But it hasn't been replaced by a more refined and discriminating approach. Investors, fearing the end of ultra-loose monetary policy, are trying to pull back from any and all assets which central banks have buoyed up – a list that includes pretty much everything.

The fear-on world is gloomy. Five years of monetary extremism have tainted the entire globe's finances. Close analysis of any market is scary. Higher yields could shatter profits, disrupt finances and squeeze funding. There's no place to hide. The real return on cash is negative, and every currency is vulnerable.

The old market adage can provide a little comfort: sell the rumour, buy the fact. Perhaps the worst will be over by the time the Fed starts to tighten, in 2014. But the wait will be long and painful.

*First published on 20 June 2013*

## CENTRAL BANKS ARE LONG WAY FROM BECOMING ORDINARY

**BY VIKTORIA DENDRINOU**

Central banks are not omnipotent. That was the main conclusion of the Bank for International Settlements' annual report, published on June 23. The central bank of central banks repeated its current mantra: extraordinary monetary policies are reaching their limits of effectiveness – it's time for structural reform.

There's no doubt that policies are exceptional. Rather than merely set an overnight interest rate that gives savers a fair return, over the last few years central banks around the world have kept rates near zero and bought massive quantities of government debt, as well as helping to rescue and repair troubled financial systems. Their balance sheets have roughly doubled since 2007, to about $20 trillion.

The BIS rightly worries that such policies, which keep bond yields low and banks in business, have done as much good as they can. The benefits of shock and awe policies fade, while the distortions they bring to financial markets linger. Besides, as the BIS rightly frets, the monetary aid let politicians dawdle over much needed changes in financial and general economic regulation.

In short, the report explains that central banks cannot be expected to work economic miracles. They have pretty much done all that their limited powers allow.

So far, so sensible, but it is hard to get from today's extraordinary policy to the conventional monetary policy, even if politicians were incredibly active – rarely the case in the places most in need of boldness. The recent selloff following an indication from the U.S. Federal Reserve that it might slow down its stimulus programme was a mere taste of the bumpy road to monetary policy normalisation. Markets will have to wean themselves off central bank liquidity, and there will be squealing and biting.

What's more, while the benefits of supply-side reforms are undeniable, they often hurt short-run growth, especially when the supply of credit is squeezed. Plus, it can take years before reforms turn into substantial economic improvements.

Alas, the end of the journey to sustainable growth is still distant. Until it comes closer, central banks should expect to stay extraordinary.

*First published on 24 June 2013*

## IS BEN BERNANKE WRONG, OR IS QE IMPOTENT?

**BY AGNES CRANE AND EDWARD HADAS**

Investors are clearly upset, but it's hard to know why. The chronology is clear. The rout in global markets – from U.S. Treasuries to copper, from Shanghai stocks to junk bonds – started after Ben Bernanke, the chairman of the U.S. Federal Reserve, suggested that the American economy might soon be strong enough to need less monetary support from the central bank. The causality is another matter.

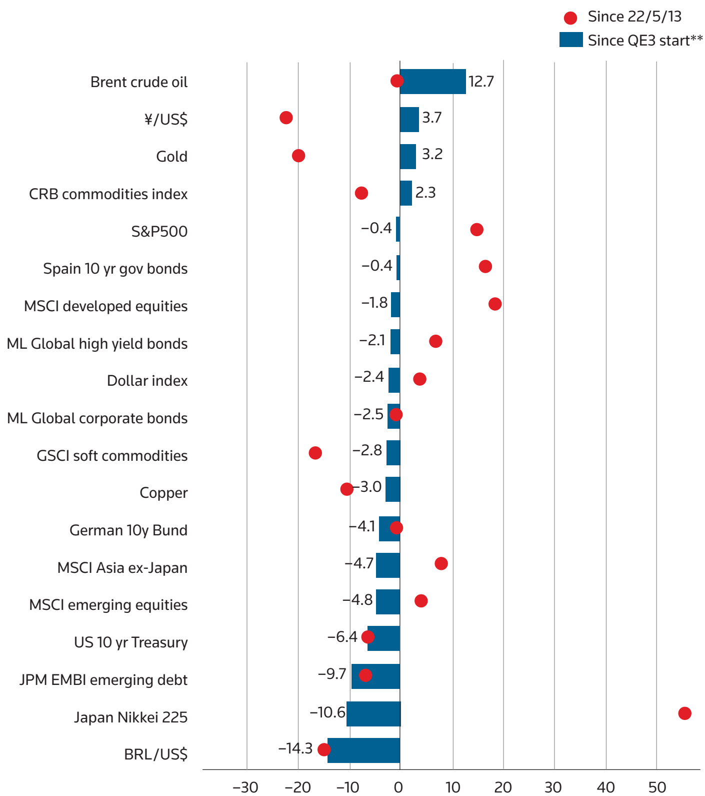
One theory is that investors are trying to scare the Fed and other central bankers into changing their mind on negative real interest rates and the newly minted cash of quantitative easing. Like a herd of "feral hogs", as the Dallas Fed's Richard Fisher put it in the Financial Times, they could be testing the willpower of central banks.

Fisher says the Fed will stay tough, but it may have to retreat if another theory on investors' reasoning is right. Bernanke may overestimate the strength of the U.S. recovery, and so underestimate what tighter money does to the economy. More expensive mortgages could upend the still-fragile American housing market, and a fall in bond prices could wreak havoc on the financial system.

There is one other explanation of the market ructions: a loss of confidence in the power and wisdom of central banks. Last year, it took only three words –

## Asset returns: QE3 and Fed tapering hint

Performance since Bernanke's speech to congress on 22/5/13 – %




* Total return in local currency except currencies, gold, silver and copper which are spot returns
** 13/9/12
Source: Thomson Reuters Datastream, V Flasseur – date to last close 3/9/13

"whatever it takes" – from the European Central Bank's Mario Draghi to turn around the euro zone bond market. And at least until now, investors have shared Bernanke's confidence that QE was effective, and not harmful.

But the Fed's apparent willingness to withdraw QE while there are still question marks on the economy might be a sign that Bernanke has noticed that the ample flow of money distorts financial markets more than it encourages lending and spending. He might even be listening to critics from emerging markets, where much of the cheap funds land in the form of destabilising hot money.

All these explanations probably have some truth. As investors get ready for a QE-free world with less potent central banks, they will move in frightened – and frightening – herds.

*First published on 25 June 2013*

## DRAGHI AND CARNEY WILL FIND LIMITS OF WORD POWER

**BY EDWARD HADAS**

Word power is the new fashion in central banking. Ben Bernanke of the U.S. Federal Reserve showed that a choice utterance can move markets in June. On Thursday, his peers in Frankfurt and London tried the same trick. It worked well on the day but central bankers will soon discover that rhetoric is not a renewable source of financial energy.

The verbal interventions are pointing in opposite directions on the two sides of the Atlantic. Bernanke wanted to prepare the market for tighter monetary policy, while Mario Draghi of the European Central Bank and the Bank of England's interest-rate setting committee want to make monetary policy looser without making any concrete changes. The ECB talked about rates staying very low for "an extended period of time", adding they could go "lower". The BoE said expectations of higher rates were "not warranted".

The UK's traditionally reticent central bank has a new governor, Mark Carney. As for Draghi, he is an old hand at verbal intervention. His "whatever it takes" last year ended a particularly messy chapter of the

*Bank of Canada Governor Mark Carney (L) speaks to the President of the European Central Bank Mario Draghi. REUTERS/Alastair Grant/Pool*

seemingly perennial euro crisis. Novelty and experience were equally effective this time. The pound, euro and the corresponding government bond yields all fell. Even politically troubled Portugal got 30 basis points of relief; the yield on its 10-year bonds dropped below 7.4 percent.

Central bank watchers consider this sort of verbal commitment almost binding. There is no good reason for that trust. Bernanke, Draghi and Carney have not sworn oaths. They have done little more than restate the obvious – if things move as we expect, we will behave as we have explained we will. Such commitments can and will be taken back if things turn out differently.

Right now, investors are quite willing to take the monetary authorities at their word. But their faith, like the central bankers' promises, is conditional. If the U.S. recovery falters, the markets will price in more quantitative easing. If the euro zone and UK economies strengthen, rate increases will be anticipated. And the central bankers will just seem a bit less credible.

*First published on 4 July 2013*

## ECB WRONGLY TOYS WITH TRANSPARENCY GIMMICK

**BY PIERRE BRIANÇON**

Some taboos are meant to be broken. Benoit Coeuré and Jorg Asmussen, the two youngest members of the European Central Bank's executive board, seem to think so. The French and the German have called together for the publication of the minutes of the governing council's deliberations. Unfortunately, Mario Draghi agrees with them. The road to hell is paved with this sort of good intention.

The debate about the publication of the ECB minutes is as old as the euro zone. Advocates say that it would help markets, because openness fosters trust. It would also allow governments and people to check whether the ECB is acting within its remit. Europeans have the right to know what their central bankers say and do when they go to Frankfurt.

The long-standing ECB position – repeatedly articulated by former President Jean-Claude Trichet – was that the euro zone is not a country. The central bankers from member states could face political pressure at home for advocating policies different from their governments' – which might in turn put their independence at risk. Publication would constrain board members' freedom of speech.

Trichet's arguments against disclosure are only partly convincing. If the national central bankers can't stand the heat, they shouldn't be in the kitchen in the first place. But the real problem with publishing minutes is that it would transform the governing council into yet another political forum. Participants would play to the gallery instead of focusing on sound policy, and the technical and complex problems at hand. The last thing the euro zone needs is another forum for members from 17 different countries to engage in unintelligible political posturing.

Coeuré and Asmussen are merely suggesting the ECB follow the lead of the U.S. Federal Reserve and the Bank of England. Whether these central banks did a better job than the ECB over time is debatable. And if so, it was not because they published more details about their deliberations.

The transparency lobby, which includes markets and the media, is powerful but wrong. There's no "right to know" regarding central banks. But there is a right to demand consistent policies that can be implemented firmly because they have been discussed freely and confidentially.

*First published on 31 July 2013*

## FED COULD DO WITH "LUDDITE" LIKE INDIA'S RAJAN

**BY CHRISTOPHER SWANN**

The U.S. Federal Reserve could do with a "Luddite" like India's Raghuram Rajan. Larry Summers, among the frontrunners for leading the Fed, said a 2005 speech by Rajan, then the International Monetary Fund's chief economist, was based on a "slightly Luddite" premise: new-style finance increased the risk of crisis. Rajan may actually be more qualified than Summers to run the American central bank. But he'll do the job for India.

India's next central bank chief is a leading member of the select group of economists who anticipated the 2008 financial crisis. Most of them, for example Nouriel Roubini, cast stones from the sidelines. To take a public stand while in a top official position, as Rajan did, took remarkable courage. Rajan has continued to be brave, although his often expressed doubts about the effectiveness of extreme monetary policy are no longer totally unconventional.

In retrospect, the 2005 speech might be Rajan's greatest hour of glory. He gave it at a global central bankers' conference celebrating the career of Alan Greenspan, a high priest of financial deregulation. Rajan was a party-pooper. He warned that securitisation had made the financial system more vulnerable, not safer. He questioned whether banks had sufficient liquidity to cope "if the tail risk does materialise".

How right he was. And how wrong Summers was. The trademark brusqueness of the then president of Harvard University expressed the conventional pro-finance consensus.

*Raghuram Rajan, newly appointed governor of Reserve Bank of India (RBI), listens to a question during a news conference at the bank's headquarters in Mumbai. REUTERS/Danish Siddiqui*

Rajan's prescience is a credit on the IMF, which has all too often been late to discover the limitations of its economic models. Even Simon Johnson, Rajan's successor and now a leading critic of the finance industry, was confident enough in April 2007 to assure investors that "the financial tail" was not "about to wag the economic dog".

President Barack Obama might take note. The Fed does not only manage monetary policy; it regulates the banking system. Summers has not shown much scepticism about the industry. Perhaps the next boss should have more of Rajan's independent spirit.

*First published on 6 August 2013*

## NOT ALL ASIAN COUNTRIES NEED TO FEAR THE FED

**BY ANDY MUKHERJEE**

Falling Asian currencies have triggered a sell-off in bonds and equities. Some investors now fear a repeat of a 1997-style crisis. Yet while a new Breakingviews' interactive risk map shows no economy in the Asia-Pacific region is entirely sober, it is India that has become most addicted to cheap money.

The risk map ranks the region's economies according to eight vulnerabilities by measuring the deterioration since just before the onset of the global financial crisis. The most pressing concern for investors is the region's worsening trade balance.

India and Indonesia, whose current accounts are in deficit, have predictably suffered big drops in their currencies. But the analysis reveals that trade surpluses of Thailand, Hong Kong and Malaysia have narrowed even more since the second half of 2007. However, this is partly because Thailand and Malaysia have boosted domestic investment, which lifts imports.

A shrinking trade surplus won't cause a crisis if countries can still sell debt and equity to foreigners. This is where India's diminishing net wealth makes it uniquely handicapped. India was a debtor nation even in 2007, and since then, foreigners have acquired another 8 percentage points of GDP in net claims on Indian assets. Understandably, they aren't keen on more. By contrast, all other Asia-Pacific nations have increased net wealth since 2007.

For Singapore and China, where GDP growth has weakened even more than it has in India, a bigger headache is the outsized expansion in private sector credit. Additionally, China's real exchange rate has shot up the most in Asia, making exports less competitive – though that is part of an intended shift toward domestic consumption.

Malaysian and Indonesian companies are grappling with a margin squeeze: The two commodity-producing economies have witnessed the biggest rise in their real cost of capital. The Philippines has the opposite problem: Falling inflation-adjusted returns for savers. This should worry Manila, which is basking in the warm glow of 7.5 percent growth. India has repressed savers for years in the hope that an interest-rate subsidy for

## Who in Asia has most to fear from the Fed?

Ranking countries by their vulnerability to rising US interest rates

| | **Worsening trade balance** | Uncompetitive currency | Diminishing net wealth | Slowing GDP growth | Rising real cost of capital | Falling returns for savers | Rising credit intensity | Growing public debt |
|---|---|---|---|---|---|---|---|---|
| Thailand | 1 | 5 | 8 | 12 | 7 | 7 | 6 | 7 |
| Hong Kong | 2 | 8 | 3 | 5 | 10 | 2 | 2 | 9 |
| Malaysia | 3 | 7 | 12 | 7 | 1 | 9 | 5 | 5 |
| Indonesia | 4 | 6 | 7 | 10 | 2 | 4 | 10 | 12 |
| Singapore | 5 | 2 | 11 | 1 | 4 | 10 | 4 | 2 |
| China | 6 | 1 | 4 | 2 | 6 | 12 | 1 | 8 |
| Japan | 7 | 9 | 5 | 9 | 9 | 11 | 7 | 1 |
| India | 8 | 11 | 1 | 3 | 12 | 1 | 12 | 11 |
| Taiwan | 9 | 10 | 9 | 4 | 3 | 8 | 8 | 6 |
| Philippines | 10 | 3 | 10 | 11 | 5 | 3 | 11 | 10 |
| Korea | 11 | 12 | 6 | 6 | 8 | 6 | 3 | 4 |
| Australia | 12 | 4 | 2 | 8 | 11 | 5 | 9 | 3 |

Source: Thomson Reuters Datastream, Reuters Graphics 02/09/13

borrowers would help keep growth rates high. The misadventure saw the banking system run out of resources.

Rising public debt is mainly a problem for Japan and Australia. Rightly or wrongly, though, the sovereign debt issued by developed countries is perceived as safe. Malaysia is not in the same league, and it is pruning petrol and diesel subsidies to control its growing public debt problem.

Unlike in 1997, most Asian countries have relatively straightforward choices. Malaysia can introduce a goods and services tax to control the 14 percentage point increase in its sovereign-debt-to-GDP ratio since 2007. Indonesia can raise interest rates to tame 9 percent inflation. The main problem is India, with its cocktail of slumping growth, high inflation, a creaking banking system, reckless fiscal policies and political uncertainty. Other Asian nations can't take rising U.S. interest rates lightly, but they are far from a crisis

*First published on 5 September 2013*

## FED DOES TO EUROPE WHAT ECB, BOE COULDN'T

**BY SWAHA PATTANAIK**

The Federal Reserve has just pulled off what the European Central Bank and the Bank of England were struggling to achieve. It has depressed European money market rates by doing nothing. Europe's central banks probably welcome the outcome, but it shows the limits of their ability to steer regional market rates.

How much European markets are in the thrall of U.S. policy became clear after the Fed left its asset-buying programme intact. The sharp interest rate futures rally triggered in Europe by the unexpected decision has pushed back the timing of the first euro zone or UK monetary tightening implied by market rates – at least by a couple of months. That is more than European central bankers managed to do by repeatedly insisting they would keep policy accommodative for the foreseeable future.

True, a pickup in regional economic activity also contributed to the earlier rise in money market rates. And higher euro zone rates are partly due to banks paying back three-year loans taken from the ECB last year, which reduces the amount of excess liquidity. But the post-Fed money market shifts underscores the extent to which U.S. policy is influencing euro zone and UK market rates.

The good news is that these market shifts let European central banks off the hook for now. They are particularly helpful for the ECB, which is dealing with a weaker economy than the BOE and has been frustrated by its seeming inability to act on money market rates. But at some point the Fed will scale back – and, eventually, end – its asset purchases. Its counterparts in Europe will then have to deal with the backwash, again.

They have the tools to cope. The ECB still has room to cut its policy rate or inject more money into the system with new long-term loans. But it leaves European monetary policy open to more influences than the hopes placed in forward guidance suggested. It also shows that in the new financial world, central bank "independence" is a relative concept.

*First published on 19 September 2013*

## RAGHURAM RAJAN WANTS TO BE INDIA'S PAUL VOLCKER

**BY ANDY MUKHERJEE**

Raghuram Rajan, India's new central bank chief, wants to be his country's Paul Volcker. The former Federal Reserve chairman's tight monetary policy tipped the U.S. economy into recession in the early 1980s, but succeeded in curbing double-digit inflation rates. Following in his footsteps, Rajan raised the monetary authority's key policy rate by 25 basis points on Sept. 20.

Investors were shocked. Yes, inflation is high at 9.5 percent, but GDP growth is collapsing. Strip out government consumption, and real demand expanded only 1.4 percent from a year earlier between April and June. Combating the Indian stagflation with higher interest rates will mean an even bigger sacrifice of output. Stocks fell as much as 3 percent in Mumbai.

Yet, the central bank's focus on price stability is necessary. India's myriad state subsidies are inherently inflationary, as they pump cash into the economy without any commensurate increase in production. The federal budget deficit has reached 63 percent of the fiscal-year target in just four months. Recently announced spending cuts are unlikely to be enough to reduce the deficit in a stagnant economy.

Then there's the beleaguered rupee. To Rajan's credit, he is reversing the ill-conceived defence of the Indian currency mounted by his predecessor Duvvuri Subbarao. Even while increasing the policy rate, Rajan cut by 75 basis points the penal rate the central bank charges liquidity-starved lenders which borrow directly from it.

Subbarao's decision to jack up this rate by 200 basis points was ineffective. The rupee slid by 22 percent against the U.S. dollar between May and August. The higher rates did, however, raise the lenders' cost of financing long-term loans with short-term deposits and borrowings, effectively taxing a banking system already creaking under mounting bad loans.

Rajan can hardly take success of his risky strategy for granted. The currency has stabilized for now, but another rupee slump will push inflation even higher by increasing the domestic cost of imported oil. And how much higher can Indian interest rates go before Rajan's political masters stop him in his tracks? After all, they have to face an election next year. Rajan doesn't.

*First published on 20 September 2013*

## DANGEROUS FED ROULETTE RULES GLOBAL MARKETS

**BY IAN CAMPBELL**

Global markets are now an especially dangerous game. Call it Fed roulette. The U.S. Federal Reserve under Ben Bernanke promised clarity, forward guidance, a smooth exit policy. Forget it. The Fed couldn't even guide markets to what it would do in September – let alone in 2015. Its decision last week was as unexpected as a spin of a roulette wheel. And the problems don't stop there.

Fed decisions, of course, have always been unpredictable. And "don't fight the Fed" has always been a market mantra. But Bernanke and other central bankers have promised something different, a radical change from

*A croupier turns the roulette at the Brussels Casino. REUTERS/Francois Lenoir* the "we never pre-commit" of Jean-Claude Trichet, former president of the European Central Bank. Trichet's promises of policy uncertainty were, however, entirely honest. Bernanke's promises of policy predictability aren't. They can't be kept.

Nor are false promises the only problem. There are also false markets.

Global markets are made of players who must buy or borrow their chips. Their decisions have serious consequences. But the Fed and other central banks are printing their own chips in abundance and playing with them. Their aim is to move markets. They distort the prices for all other players at the global roulette table.

How those distortions play out when the Fed and others stop printing is now the greatest uncertainty facing markets and the global economy. The danger is that many assets are seriously overvalued. Bubbles, in other words. The damage being done by the printed chips is hard to gauge, even by the central banks' forward guides themselves. And that creates still more uncertainty about future policy.

For medium term investors all this is terrible. The market is rigged and even more hazardous than usual. But Fed roulette volatility suits speculators, the sort of players central banks shouldn't be serving.

The forward guidance promises of predictable policy, though discredited already, probably won't go out of fashion for a while. But it's time now for the Fed and others to pull their printed chips out of markets. Then real investors can at least begin to play a more honest, risky game.

*Published on 25 September 2013*

## YELLEN'S FED HOPES SOUND LIKE WISHFUL THINKING

**BY EDWARD HADAS**

Everyone wants to know what Janet Yellen will do about the taper. It's too early to know. However, the chairman-designate of the U.S. Federal Reserve has already provided her answer to a more fundamental question:

what can central banks do to improve the economy? Her judgment – a great deal – sounds like risky wishful thinking.

Yellen accepted her nomination with a statement that included a broad interpretation of the mandate of the Fed ("to serve all the American people"), a broad comment on the relevant woes of those people ("too many Americans still can't find a job and worry how they will pay their bills"); and a bold promise ("The Federal Reserve can help.")

The elegant words are the latest expression of Yellen's consistent attention to the Fed's mandate to maximize employment. In line with the dominant economic thinking of the 1960s, when she was a student, she believes that monetary policy can encourage spending, lending and job creation when they are in short supply. Yellen also cares about inflation and financial stability – she mentioned both in her speech – but right now she appears to consider those less important than the power to stimulate the economy.

There are times when more aggressive monetary policy can speed economic activity. This does not seem to be one of those times, not after five years of monetary policy set at maximum support. Even if it is too early to retreat, additional monetary stimulus is more likely to distort financial markets than to increase hiring.

On the other hand, the Fed, and other central banks, could do a great deal more to support financial stability. They could become more intrusive regulators and their leaders could speak out more firmly against leverage and excesses in the financial system. They could look for opportunities to remove the distortions created by ultra-low interest rates.

Yellen is right; the Fed can help. But the best help it can offer is to point out that monetary policy has done pretty much all it can. Now it's over to the politicians.

*Published on 10 October 2013*

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