BANK OF ENGLAND

Speech

Making the most of doing more

Speech given by

Adam Posen, External Member of the Monetary Policy Committee, Bank of England and Senior Fellow, Peterson Institute for Internal Economics

To the Barclays 'Short end rates seminar', London

11 June 2012

I have benefitted from ongoing discussion of unconventional monetary policy issues with all of the current members of the MPC, as well as Kate Barker, Danny Blanchflower, Chris Carroll, Rich Clarida, Brad DeLong, Charles Goodhart, Larry Meyer, Kiyohiko Nishimura, Jonathan Portes, Eric Rosengren, Lars Svensson, Angel Ubide, Kazuo Ueda, Sushil Wadhwani, and especially Joe Gagnon and Ken Kuttner. I have also benefitted from discussion of earlier presentations about related issues in events sponsored by PIIE, Barclays Capital, Bellagio Group, Cass Business School, Centre for Policy Studies, China Finance 40 Forum, Council on Foreign Relations, HSBC, Hull and Humber Chamber of Commerce, ICAP, Oxonia, Reform, Reserve Bank of India, and UBS. Tomas Hellebrandt and Marilyne Tolle provided excellent research assistance. Despite all of that input, the views expressed herein are solely my own, as are any errors of fact or interpretation. My opinions are not attributable to the Bank of England, the MPC, PIIE, or to any members of their staffs.

The title of this conference is a good place to start: “Living in an AA World.” I take that to mean both that the world *is* a riskier place in which to invest than it was prior to the global financial crisis of 2008-09, and that it is widely *perceived* to be riskier.[1] This recognition has been accompanied by a sustained rise in the risk aversion of investors – businesses, portfolio managers, financial intermediaries, and even households. The combination has resulted in an excessive desire for liquidity and relative safety that remains one of the core causes of our economic problems. Monetary policy, including all forms of quantity-based easing, affects expectations about future economic conditions, about the availability of liquidity and, thus, at the margin, the willingness to make risky investments. So I will argue today that:

- A further round of asset purchases by central banks should focus on private sector assets in order to make a sustained improvement in perceptions of risk, if not in risk aversion;
- Such asset purchases can be targeted on dysfunctional financial markets that are both important and potentially sizable, and can encourage securitization in those markets; and
- There are straightforward transparent ways to minimize the credit risk on central bank balance sheets, and any negative spillovers on markets or politics, from so doing;

The well-informed observer will recognize that these are familiar arguments. I advocated a form of what has since been called “credit easing” last September (Posen (2011a)), and a number of others have made varying proposals along similar lines before and since.[2] The need for such programs has become more evident as the recovery has petered out in the UK and elsewhere, and as the risk of disorder in the euro area has reinforced the trends towards excessive reluctance to invest. As too often stated, monetary policy cannot make underlying imbalances disappear - but monetary policy can offset them in part and limit overreactions to them. If central banks do both, as they can, they should keep us from going further into a self-fulfilling cycle of fear and contraction.

Addressing Investors’ Excessive Fears with Sufficient Monetary Ease

One key element of the straits we find ourselves in is the lack of investor confidence. Investors of all types - non-financial businesses, portfolio investors, financial intermediaries, and even households making decisions about savings and durable goods—are highly risk-averse. This can be seen in the very large cash balances accumulated by most sectors of the economy, notably in non-financial corporations and in the banking system. Some of this cash hoarding is rational. If you think the availability of credit is subject to disruption, it makes sense of have a stock of cash on hand. Also, for banks, there is a clear incentive from supervisors to build and maintain adequate liquidity buffers. Nonetheless, even allowing for these factors, and for a world which is genuinely riskier than people previously realized, the fear of risky investment has overshot. (Posen (2010d))

[1] Posen (2012a) gives some long-term reasons for believing that the financial world really is riskier than it was a dozen years ago, and is likely to remain so.
[2] Among others, see Blanchflower (2011), Brittan (2011), Farmer (2011, 2012), Nishimura (2009), Smith (2012), and Weale (2009).

Unfortunately, extreme risk aversion by investors can become self-fulfilling. There is the increasingly recognized hysteresis whereby failure to invest and employ erodes aggregate supply and productivity. There is also good reason to think that lack of confidence can feed upon itself. Macroeconomists have generally been reluctant to take this possibility seriously in recent decades. Investors were thought to be forward-looking and rational. Economies were thought to be in somewhat determinate equilibria and not subject to divergent paths. And more generally, we would like to think there is a reality or set of fundamentals underlying economic outcomes. Yet events of recent years have now been accompanied by more and more developed theories of how shifts in investor expectations can bring about lasting alterations in outcomes.[3] Expectations about the future course of the economy, and in particular about interest rates, are arguably the foundation of monetary policy's impact.[4]

Therefore, monetary policy has a role to play in curtailing the entrenchment of excessive risk aversion and its consequences. This is partly through its direct effect on the outcomes of macroeconomic aggregates, like GDP growth and inflation. This is partly through monetary policy's ability to provide liquidity when demand for it exceeds the ability of the financial system to provide it (or of the financial system to self-insure). And this is partly through influencing the relative price of credit and risk assets at any given time, albeit not lastingly. Ultimately, activist monetary policy can provide necessary insurance to restore confidence.[5] These channels together should allow monetary actions to stem panics and to put a floor on confidence more generally.

So why are we still miserable, given the actions already undertaken by the world's major central banks? There are three possible reasons.

First, quantitative easing may be ineffective under the present circumstances. This could be because money put into the hands of risk-averse investors and banks simply sits there, on their balance sheets. This is the image often invoked of monetary policy 'pushing on a string.' If that is the case, then the appropriate response is to engage in aggressive fiscal expansion, which would directly increase aggregate demand.[6] This may have merit in its own right, but for reasons discussed many times, I and the vast majority of central bankers, as well as of objective observers, believe quantitative easing does have the desired impact.[7] In any event, I am a member of the camp that believes that monetary activism can only help other policies, fiscal

[3] Of course, this is not an entirely new idea. Much of this intuition was developed in the works of Keynes, Kindleberger, and Minsky. Two good examples of the recent more sophisticated attempts to build theories in this vein are Farmer (2010, 2011, 2012) and Soros (2008, 2010), which reach similar conclusions from very different approaches.

[4] On the relevance of monetary policy setting expectations for emergence from the crisis, see Ball (2012), Bernanke (2000), Eggertsson and Woodford (2003), Eggertsson and Krugman (2010), Evans (2012), Farmer (2010), Krugman (1998), Kuttner and Posen (2001, 2004), Posen (1999, 2000), Romer (2012), and Yellen (2011).

[5] In the words of Nishimura (2009), "do not underestimate the beneficial effects of safety-net measures [provided by central bank purchases] especially when investors' confidence is fragile. When market confidence is eroded, investors are "excessively" averse to uncertainty and tend to "wait and see" until they feel more confident about making market transactions. A "safety net" facility has some of the characteristics of insurance or put options and thus substantially reduces this sort of uncertainty."

[6] A strong recent statement of this view is given in Summers (2012b).

[7] On the effectiveness of quantitative easing, at least in the first round, see Bean (2009), Dale (2010), Fisher (2010), Gagnon, et al (2010), Joyce, et al (2010), Posen (2012c), Romer (2012), Transcript (2011, 2012), and Yellen (2011).

and financial, to be more effective and more likely to be undertaken, even if it were to be less powerful on its own than we believe it to be.

Second, even if quantitative easing and the like have had the desired effects, the impact has simply been insufficient to offset the other forces dragging down the economy and confidence. As I have argued previously, I largely subscribe to this interpretation.[8] (Posen (2010c, 2011a)) The developments in the euro area of late, or, rather, the insufficient response to the underlying tensions and problems in the euro area, are of course the primary source of such a strong offset to monetary ease, but not the only one. Fiscal consolidations, last year's oil price shock, and financial sector weaknesses have also played a role. (Posen (2012b)) If this is indeed the case, now as before the answer is to do more.

Third, while quantitative easing may have worked initially, a different form is required now to have the desired effect. As widely noted, in the U.K. at present, the interest rate spreads on mortgages and loans to SMEs have not responded to our most recent easing as much as would have been hoped. In fact, some spreads have gone up and these probably understate the tightness of credit conditions for businesses and households without access to credit, more visible in the near-zero lending growth numbers. It is possible to attribute some of this rise in spreads to risks from the Euro area raising the cost of funding to UK banks, which get passed on. Still, that may call for a differentiated response. If large-scale quantitative easing over the last three years is analogous to pumping water on a fire, perhaps the widening of these spreads may be signs that water is not the right solution for the fire still burning in the kitchen; perhaps the overall blaze has set some grease alight in that room, and sand would be more effective in quenching that. I am increasingly sympathetic to this view.[9]

In other words, I believe it is time for the major central banks, including the Bank of England, to engage in purchases of assets other than government bonds. Those central banks should also aggressively lend against a wide range of banking system assets, appropriately discounted. This has not been tried on a sustained basis at scale as yet. There have been short-lived emergency interventions wherein these central banks have purchased high quality assets, and these seem to have been highly effective. The European Central Bank engaged in its Long-Term Repo Operations [LTRO] and that, too, had the desired effect, but their impact of course has been overwhelmed by other factors.

Some might say these are fundamentals rearing their ugly heads. In other words, they would say there are solvency issues and deleveraging to be done which monetary policy can only delay at best, and may be

[8] My published votes for no change in the stock of asset purchases at the MPC meetings of April and May of this year reflected my expectation that prior QE measures would be sufficient to give the British economy a good chance of returning to sustainable growth consistent with meeting the inflation target. I was too optimistic about the other forces at work, including the impact of the LTROs in euro area, as well as perhaps about QE's impact.

[9] While future research may allow us to better discern between the second and third reasons I offer here, as policymakers in real-time, we need not choose between them. It is possible to simultaneously believe that further QE on gilts would have a beneficial impact and that purchases of other assets could have a more targeted impact and higher return under present circumstances. Admitting that QE is not the perfect fix for everything should make no difference to the real impact the current stock of government bond purchases going forward, and therefore do no harm to monetary credibility.

impotent against. Admittedly, monetary policy cannot remove debt overhangs except through the destructive and self-defeating measure of inducing sustained high inflation. That is not on the table, thankfully. I think, however, that the extent of solvency versus liquidity problems is being exaggerated. There are some specific countries and banks which have unsustainable debts. A much larger share of the West's population and GDP, however, has manageable if significant debt burdens – both in the private and in the public sector. Notably, the non-financial corporate sector and most small businesses have quite strong balance sheets.[10] The majority of households, even in the U.K. and the U.S., are suffering more from poor income prospects than from a need to deleverage further (Broadbent (2012)). If there are undercapitalized banks or unrecognized bad loans on bank balance sheets, these need to be addressed directly, but should not be imputed to whole economies as a limit on investment.

We should not exaggerate the extent of solvency problems and dismiss the importance of liquidity problems (even though there are recurring revelations by public officials and bank CEOs that insolvent institutions called illiquid are in fact insolvent). Credit condition can go wrong for reasons other than fundamentals, sometimes due to expectations about interest rates and availability of liquidity, which brings us back to the potential role for monetary policy. If monetary policymakers can credibly convince investors that good borrowers will not be caught short of liquidity and credit, they will hoard less cash and invest in more risky assets. We have gone a good way towards achieving this by making cash and gilts (or Treasuries) relatively unattractive for solid investors like pension funds and insurance companies while providing funding to the financial system. But the cash sitting on balance sheets of even companies with access to capital markets and the extent of deleveraging in our banking systems indicates that we have not gone far enough.

Yes, some of these companies' and banks' reluctance to invest is due to gloomier prospects for the world economy. Business fixed investment, however, is growing far more weakly than GDP forecasts would justify, particularly given what should be the price of credit. Moreover, historically, it is investment that leads us into recovery, followed by growth in consumption, and that is not happening now. A decade ago, the Federal Reserve and other central banks were criticized for creating a bubble by keeping interest rates too low for too long. To whatever extent the Fed loosened too much in the early 2000s, it is only a fraction as much as they and we have eased monetary policy since September 2008, and we have kept it there – and there has been no commensurate rise in asset prices, let alone an active carry trade or bubble.[11] In sum, we are trying to give away free money and no one is doing much of anything with it. That must be and is an overreaction of investors to perceived risks.

[10] This is in contrast to Koo's (2009) interpretation of the balance sheet recession in Japan, where he argued that monetary policy was ineffective because of the corporate sector's need to pay down its accumulated debt.
[11] See Posen (2009, 2010c, 2011b, and 2012c).

Choosing Assets to Purchase Beyond Government Bonds

Let us begin with the basic premise that a primary channel through which quantitative easing (and monetary policy generally) affects the economy is by influencing portfolio allocation by private investors. Normally, monetary policy does not target this directly. But, as I have just discussed, we have a form of ongoing panic or investors' strike at present, which leads to an excessive demand for cash and insufficient demand for productive investments.[12] As a result, efforts to reassure businesses and investors about ongoing availability of liquidity and credit – and of credit to the banking system on which small and new businesses particularly depend – are a reasonable goal of policy. So QE tries to reduce the relative attractiveness of government bonds and raise perceived (and actual) liquidity.

To the degree that central banks buy types of assets which are less perfect substitutes for cash, the impact of our asset purchases on portfolios should be greater. And to the extent that central banks make or re-open markets for assets that are impeded, there should be an added impact on confidence as well as on financial functioning, beyond asset purchases' overall effect.[13] Given that government guaranteed securities and government bonds are clearly closer to cash than almost any other private asset, their purchases offer less bang per pound, ceteris paribus, although theory tells us that their bang should still be large. I had initially been pleasantly surprised that rigorous empirical studies suggested that purchases of government securities had a large impact, wherever and however pursued in response to the crisis. (Gagnon, et al (2010); Joyce, et al (2011))

Subsequent examination, however, reveals that the composition of the central bank's balance sheet has important effects as well as its sheer size, as theory would lead one to expect. Changing the duration in the US treasuries market was critical to the success of 'Operation Twist Redux' in fall 2011, even as the Federal Reserve's overall balance sheet size was unchanged; the purchases of mortgage backed securities [MBS] had effects beyond those of treasury purchases (Rosengren (2010); Tarullo (2011)). The purchase of short outstanding maturity Japanese Government Bonds was part of the low overall impact of the Bank of Japan's QE efforts, as shown by McCauley and Ueda (2009), but other composition effects have actually mattered a great deal to the varying impact over time of QE in Japan.[14] Note, this is not an argument that the flow of quantitative easing is what counts – rather it is an argument that the *composition* of the stock of central bank assets matters along with the total *stock* amount.

Given this reality, the reasons offered by central banks for buying gilts or treasuries instead of selected private-sector assets come down to the operational and the political (under the heading of risks to central bank balance sheets). Consider first, the operational concerns. There is no question that purchase of and

[12] See Eggertsson and Krugman (2011), Farmer (2010), and Krugman (1998) for relevant models of such outcomes in the macroeconomy.
[13] See Posen (2009, 2011c) and the discussion of this issue by Paul Tucker and myself in Transcript (2011).
[14] See the assessments of Japan's QE experience in Baba, et al (2005, 2006), Bowman, et al (2011), Koo (2009), Kuttner (2009), Nishimura (2009), Oda and Ueda (2005), Posen (2010a), and Shiratsuka (2009).

especially exit from ownership positions is easier, meaning less disruptive to normal market functioning, in government bond markets. Any private asset market is thinner and less liquid. The UK sterling-denominated corporate bond market is an extreme example of such a limited market, where central bank purchases on a large scale would completely swamp normal pricing behavior – which was the primary justification to my mind why the MPC did not engage in asset purchases in that market during my tenure on the committee. This is a legitimate concern, and should guide which types of private sector assets may be purchased.

A second operational concern is that monetary policymakers and central bank staff are unqualified to evaluate the credit risk of variegated private assets. I do not deny this characterization in the slightest, but I am more skeptical of its relevance to decisions about asset purchases. If central banks avoid extremely thin markets for their asset purchases, one of two situations pertains:

- the market is largely functioning, and with appropriately staggered purchases according to transparent announced guidelines, the central bank is affecting prices for an asset type generally (as intended) without disrupting relative prices of specific securities within the market; or,
- the market is dysfunctional, in which case some form of central bank or government intervention is necessary to make transactions possible, and the price has deviated greatly from any normal market evaluation.

In either situation, the benefits of central bank intervention outweigh the costs, and reducing the costs do not require detailed knowledge of specific securities' worth.[15]

Of course, the best way around both of these concerns for central banks is to buy bundles of similar securities (or of similar loans underlying securities) which are clearly labeled and packaged according to general criteria. This means the buyer only needs to know the risk distribution of the set of securities, not the valuation of the individual securities. Such responsible purchases are more than feasible. The failings of the securitization market in the US in the mid-2000s are well known, but these stemmed from lax enforcement against fraud, not from securitization itself. Various securitized markets continued to operate beneficially over the period until the crisis took them down, in part because of tainting by the fraudulent securities, and more had operated for many years if not decades as originally intended. Central bankers should be assisting in the restoration and ongoing operation of useful securitization markets, not least by making some forms of securitized assets eligible for purchase by them, and making evident which forms are not.

[15] It remains possible that there would be adverse selection of portfolio managers selling their unverifiably worse assets (within the selected class) to the central bank. This is another argument for avoiding thin markets with highly differentiated securities for asset purchases, and for pre-announcing purchase criteria. In any event, this risk is far greater when discounting specific loans and illiquid bank assets rather than from marketable securities.

This is in essence the proposal for how to do more that I made in September 2011. (Posen (2011a)) The best securitized loans to buy in a period of ongoing financial fragility and heightened risk aversion are from the market in the economy that offers the greatest combination of impairment and importance to the economy's problems.[16] In the US, this would be the residential mortgage market, and so it is right and sensible that the Federal Reserve has purchased MBS to good effect, and some members of the FOMC are considering purchasing more.[17] As a number of us have argued, in the UK, though the mortgage market is somewhat impaired, the critical gap to be addressed is in lending to small and medium enterprises and new businesses. So the MPC should be contributing to the development of a deep functional market in securitized small business lending by making it clear we will purchase such securities that meet general criteria. I would advise, and I would encourage the Bank to advise, HM Government to create a Fannie Mae-type of entity to facilitate development of such securitization. There is no reason this could not have been done without meaningful cost to the UK government budget in the nine months since I made the proposal – and a profit could be returned to UK taxpayers were the entity to be privatized after being launched, as I suggested.

What about long-term repo operations discounting a large range of loans from banks, in some variant on the ECB's model? Could these be alternative means to the same ends as asset purchases? I believe that LTROs can be quite helpful to putting a floor under the macroeconomic outlook as well as addressing directly disruptions in the bank funding markets. But I do think such operations are best thought of as an emergency response, perhaps an permanent expansion of available discounting facilities at penalty rates, rather than as a mainstay of expansionary monetary policy. In fact, part of the reason I voted for no change in monetary policy at the April and May 2012 MPC meetings was that I was optimistic that the LTROs in the euro area would substantially reduce downside tail risk for a period of a year or more. Even that now disappointed optimism of mine, however, did not mean that I believed that LTROs were more than a partial substitute for additional QE (whether on government or private securities).

If financial stability requires such lending to the banking sector with haircuts by central banks, I have no difficulty backing it. When having a choice about how to make the most of doing more in terms of monetary policy, however, the two operational concerns I have just raised merit consideration – and in terms of what LTROs demand from central banks with regard to exit, dealing with adverse selection of assets made available for discount, as well as to making pricing (haircut) decisions on assets for which there is no market, they are inferior to asset purchases of market securities. In my opinion, LTROs also are likely to be asymmetric in preventing a collapse but failing to expand credit, because they underscore the dependence of banks upon the public sector for financing and the illiquidity of their distressed assets, as well as having a limited duration. All of that means the ability of such LTROs to make a lasting difference to investor confidence is inferior to what I believe that asset purchases would achieve. Still, if LTROs are to be varied

[16] See the discussions of this general approach in Nishimura (2009) and Posen (2009, 2011a, 2011c).
[17] As described by Evans (2012), Rosengren (2010), and Tarullo (2011), among others.

on an ongoing basis to achieve monetary policy goals, rather than just providing a safety net in overt crisis, they are an instrument of monetary policy and should be subject to the same policy setting and discussion by the relevant committee that QE or interest rate setting would be.

Minimizing Credit Risk to Central Banks

The second set of reasons offered against purchases of selected or even bundled private sector assets by central banks are those of credit risk from holding such assets. Credit risk, in this case, is really a proxy for the risk that the central bank might have to get a capital injection to rebuild its balance sheet. And that in turn is really a fear that the central bank might be politically compromised if it were to have to go an elected legislature to get such a capital injection. All of which constitutes a pretty tenuous chain of events, especially for central banks that currently have in excess of 20% of GDP in government bond holdings on their balance sheets. Clearly, the concern is not that central banks will literally require capital infusions, if reasonable care was exercised in the assets are purchased.[18]

The concern instead on the part of some central bankers is that taking on credit risk constitutes ‘fiscal policy’ and will politicize the central bank, because it involves allocating credit between sectors.[19] The underlying concern, however, remains that this will give an opening for elected politicians to have leverage over the central bank in question. One example is that we have seen, of late, political criticism of some central banks which have losses on their foreign exchange interventions, even when done in successful pursuit of macroeconomic objectives. Another example is some of the hostile rhetoric cast in the Federal Reserve’s direction over its purchases of mortgage securities, although government guaranteed. Unpleasant as these examples might be for the central bankers involved, the importance of such pressures should not be exaggerated. As argued convincingly in Romer (2012), that is the point of central bank independence, to do the right thing in the face of such pressures. And none of the central banks subject to such political pressures have reversed policy, or seen a rise in long-term inflation expectations, as a result.[20]

Ultimately, central bank independence depends upon having built a coalition of support in society for that independence – legislative rules and protections regarding the central bank’s ability to set monetary policy will change to reflect sustained variations in that degree of support, albeit with some lag.[21] The only way for a central bank to defend its instrument independence is by making a persuasive case to the public, or at least to a majority of their elected officials, that it is doing a good job. That kind of transparent accountability has been the source of inflation targeting’s success in anchoring inflation expectations, which shows how this can work.

[18] If a central bank were to buy government bonds or lend against bank assets at face value that realistically could suddenly be devalued (in currency terms) or defaulted upon, that of course would be a different matter.
[19] See the discussion of these issues in Transcript (2012).
[20] Though Ball (2012) speculates on the possibility that the Fed has self-limited its actions in part for political reasons, as the Bank of Japan was criticized for doing in Bernanke (2000), in my view there is only one major central bank where such concerns have directly prevented justified policies from being undertaken. (Posen (2010b))
[21] I have been warning about this reality for nearly 20 years. See Posen (1995, 2010b) and the references therein.

Thus, religious declarations of what assets a central bank should or should not handle in its pursuit of monetary policy goals, or of what constitute fiscal versus monetary policy, are shibboleths. They are mouthed with fervor but should not be taken seriously. What matters instead is that the goals of monetary policy being pursued are consistent with the central bank's legislated mandate, that the means used in that pursuit are transparent to monitor, and that the central bank can and does explain why the means fit the goals. In short, monetary policy is like any other delegated public responsibility.

There is a way to take this issue off the table, by dealing with it directly, rather than having monetary policymaking committees worry about self-censoring when setting policy. I would propose that monetary policy committees publicly ask their respective finance ministries for an indemnity against any losses on the central bank's portfolio of assets incurred in execution of their monetary policy duties. In fact, it is better if the finance ministries voluntarily offer such indemnities, as HM Treasury did to the Bank of England upon the start of the 'special liquidity scheme' in Spring 2008.[22] Having such an indemnity in place shows how a central bank can be insulated in its instrument independence without compromising its accountability to elected officials for its competence or the setting of its goals.[23]

Perhaps getting such indemnities would be contentious in some countries, particularly where it had to go to a legislative vote rather than be done by the finance minister's declaration. But the central bank and, more importantly, the elected officials to whom the central bank is accountable, should make the case to the public as required. When we are dealing with extreme measures by central banks in response to severe economic dislocations, only explicit endorsement can offer the needed insulation. In fact, it would serve as an affirmation that the central bank is pursuing the public interest as defined by elected officials. I believe that affirmation in turn would strengthen the central bank's ability to act and would reduce any future excessively opportunist hue and cry about monetary policy. I do not believe that trying to leave matters vague as a way of ducking the issue is a sustainable solution – and being able to invoke this fear of losses on the central bank's balance sheet provides a ready excuse for inaction.[24]

The indemnity currently extended to the Bank of England illustrates how even gilt purchases can be subject to losses (though at present all gilts are showing capital gains, not just on the Bank of England's balance sheet). So talking about 'credit risk' as a threat to central banks makes a bright line of something which is more a matter of degree. By the same token, some will point to the Federal Reserve buying MBS because those securities have a government guarantee. Would it not be better if the guarantee was for the central bank's balance sheet, and neutral with respect to the securities involved, rather than the central bank limiting its operations to whatever securities happen through historical accident, and perhaps political capture, to be guaranteed at a given time? For the reasons discussed above, those government-guaranteed securities

[22] See Alistair Darling, *Back from the Brink: 1,000 Days at Number 11*, London: Atlantic Books, 2011, pages 94-95.
[23] Debelle and Fisher (1994) conceived of the highly useful and politically legitimate distinction between goal independence and instrument independence for central banks.
[24] See Bernanke (2000), Kuttner and Posen (2001), Posen (1999, 2000, 2010b, 2011a) and Romer (2012).

available need not be the best ones for an asset purchase program in terms of impact. Luckily for the US, the MBS market is the critical one for the US at present, but in the UK the critical market of (potentially securitized) SME loans does not have such guarantees, so it is the Bank of England's indemnity that matters. Since the critical securities on which to make asset purchases may vary over time and place (Nishimura (2009); Posen (2009, 2011a) Transcript (2011)), and government guarantees can severely distort financial markets, better to have a flexible guarantee on the activities of the central bank.

Conclusion: Still Against Policy Defeatism

I believe that further asset purchases by central banks can improve the economic situation we are now in. I believe that this is particularly true because a major source of our difficulties is an excessive perception of and aversion to risk on the part of investors, even though some rise in that perception and aversion were justified after the boom years. That rise which we see, and the resultant cash hoarding by businesses and portfolio investors, are excessive because some credit problems really are due to illiquidity and to financial market dysfunction rather than to insolvency and indebtedness. We are at risk of the reluctance to invest becoming a self-fulfilling prophecy, as opposed to investment leading us into recovery as in normal situations. Additional expansionary monetary policy should be effective in breaking this cycle, and must be pursued to meet central banks' mandated goals.

I propose that further asset purchases by central banks should take the form of private sector securities for the time being. This will allow more direct targeting of financial sector dysfunctions, and greater impact on liquidity preferring investors' portfolios, thereby leading to greater impacts on confidence and on the real economy than a similar unit of QE on government bonds. Obviously, not all private sector assets should be eligible for central bank purchases. Central banks should choose those assets which provide the best combination of market depth when functional, importance to the economy, and financial dislocation at present. Securitized bundles of bank loans are in many ways the best kind of private asset to purchase, be they for SME lending in the UK or for mortgages in the US. Where securitized markets of sufficient depth for such assets do not yet exist, as in the UK for SME loans, the central bank should engage in offers to purchase which help make the market for such assets.

I do not subscribe to the standard reasons given for central banks not to purchase private sector assets as part of monetary policy. Worries about credit risk on central bank balance sheets are really concerns for central bank independence from politicians. These concerns, however, are misplaced, for the source of central bank independence is public support from elected officials that the central bank is pursuing desirable social goals. If such support exists, ongoing backing of the central bank balance sheet is a non-issue – if such support is absent, politicians will not require the excuse of paper losses from monetary operations to make attacks on central bank independence. Better to have finance ministries give general indemnities to their respective central banks on any losses incurred in the conduct of monetary policy, as we have here in the United Kingdom. That will also enable better monetary policy by removing self-imposed limits on what assets central banks can purchase without extending distortionary government guarantees to private asset issuers.

This program would be the way for the major central banks to make the most of doing more.

References

Baba, N., M. Nagashima, Y. Shigemi, and Ueda, K. (2006), "The Bank of Japan's Monetary Policy and Bank Risk Premiums in the Money Market," *International Journal of Central Banking, 2:1*, 105-135.

Baba, N., S. Nishioka, N. Oda and M. Shirakawa , and Ueda, K. (2005), "Japan's Deflation, Problems in the Financial System and Monetary Policy," *BOJ Monetary and Economic Studies*, February.

Ball, L. (2012), "Ben Bernanke and the Zero Bound," mimeo, Johns Hopkins University Economics Department, February, available at http://www.econ2.jhu.edu/People/Ball/BB%20and%20ZB.pdf

Bean, C (2009), 'Quantitative Easing: An Interim Report', speech at the London Society of Chartered Accountants Annual Lunch, October, available at http://www.bankofengland.co.uk/publications/speeches/2009/speech405.pdf

Bernanke, B (2000), "Japanese Monetary Policy: A Case of Self-Induced Paralysis?", in Mikitani, R. and Posen, A., *Japan's Financial Crisis and Its Parallels to US Experience*, PIIE

Blanchflower, D. (2011), "Here's my plan for how to kick-start Britain. The MPC should use it."   *New Statesman*, 12 Sept 2011, p. 20

Bowman, D, Cai, F, Davies, S and S Kamin (2011), "Quantitative Easing and Bank Lending: Evidence from Japan", *FRB Working Paper* 2011-1018, available at http://www.federalreserve.gov/pubs/ifdp/2011/1018/ifdp1018.pdf

Brittan, S. (2011), "Use the UK's state bank holdings to speed a recovery", *Financial Times*, September 23

Broadbent, B. (2012), "Deleveraging", speech given at Market News International, London, 15 March, http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech553.pdf

Dale, S (2010) "QE One Year On," speech given at the CIMF and MMF Conference in Cambridge, 12 March, available at http://www.bankofengland.co.uk/publications/speeches/2010/speech428.pdf

Debelle, G. and S. Fischer (1994), „How Independent Should a Central Bank Be?", in J. Fuhrer, ed., *Goals, Guidelines and Constraints Facing Monetary Policymakers*, Federal Reserve Bank of Boston, pp. 195-221, available at http://www.bostonfed.org/economic/conf/conf38/conf38f.pdf

Eggertsson, G and P Krugman (2011), "Debt, Deleveraging, and the Liquidity Trap: A Fisher-Minsky-Koo Approach," available at http://www.nber.org/~confer/2011/SI2011/ME/Eggertsson_Krugman.pdf

Eggertsson, G.., and M. Woodford, (2003), "The zero bound on interest rates and optimal monetary policy," *Brookings Papers on Economic Activity,* 34(1), pp. 139–211, available at http://www.newyorkfed.org/research/economists/eggertsson/BrookingsPaper.pdf.

Evans, C. (2012), "Monetary Policy Communications and Forward Guidance," Speech at International Research Forum on Monetary Policy, Frankfurt, 16 March, available at http://www.chicagofed.org/digital_assets/publications/speeches/2012/03.16.12_frankfurt_print.pdf

Farmer, R. (2010), *Expectations, Employment and Prices*, Oxford: Oxford University Press

Farmer R., (2011), "Confidence, Crashes, and Animal Spirits," *Economic Journal*, 122, pp 155-172, March, available at http://rogerfarmer.com/NewWeb/PdfFiles/Monetary%20Policy%20Rules.pdf

Farmer, R. (2012), "The Effect of Conventional and Unconventional Monetary Policy Rules on Inflation Expectations: Theory and Evidence," NBER Working Paper # 18007, April, available at http://rogerfarmer.com/NewWeb/PdfFiles/Monetary%20Policy%20Rules.pdf

Fisher, P (2010), 'The Corporate Sector and the Bank of England's Asset Purchases', speech at the Association of Corporate Treasurers, February, available at http://www.bankofengland.co.uk/publications/speeches/2010/speech423.pdf

Gagnon, J, Raskin, M, Remache, J, and B Sack (2010). "Large-scale Asset Purchases by the Federal Reserve: Did They Work?", *Federal Reserve Bank of New York Staff Report* No.441.

Joyce, M, Lasaosa, A,Stevens, I, and M Tong(2010), "The Financial Market Impact of Quantitative Easing," *Bank of England Working Paper* No.393.

Koo, R (2009), *The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession*, New York: Wiley

Krugman, P (1998), "It's Baaaack! Japan's Slump and the Return of the Liquidity Trap", *Brookings Papers on Economic Activity*, 1998:2, 137-205

Kuttner, K (2009), 'The Fed's response to the financial crisis: Pages from the BOJ playbook, or a whole new ball game?', *Center on Japanese Economy and Business Working Paper* #282.

Kuttner, K., and A. Posen, (2001), "The Great Recession: Lessons for macroeconomic policy from Japan," *Brookings Papers on Economic Activity,* 31(2), pp. 93-160, available at http://www.jstor.org/discover/10.2307/1209135?uid=3738032&uid=2129&uid=2&uid=70&uid=4&sid=56247961733

Kuttner, K and Posen, A, (2004), 'The difficulty of discerning what's too tight: Taylor rules and Japanese monetary policy', *The North American Journal of Economics and Finance*, 15(1), 53-74, March.

McCauley, R., and Ueda, K., (2009). "Government debt management at low interest rates," *BIS Quarterly Review*, Bank for International Settlements, June, available at http://ideas.repec.org/a/bis/bisqtr/0906e.html

Nishimura, K. (2009), 'Unconventional Policies of Central Banks: Restoring Market Function and Confidence', Remarks at the Conference on Money and Banking, Central Bank of Argentina, September 1. Available at http://www.bis.org/review/r090907d.pdf

Oda, N, and Ueda, K. (2005). "The Effects of the Bank of Japan's Zero Interest Rate Commitment and Quantitative Monetary Easing on the Yield Curve: A Macro-Finance Approach",*Bank of Japan Working Paper* No.05-E-6.

Okina, K., and S. Shiratsuka (2004). "Policy Commitment and Expectation Formation: Japan's experience under Zero Interest Rates," *North American Journal of Economics and Finance*, 15:1, 75-100.

Posen, A (1995), „Declarations are not enough: Financial Sector Sources of Central Bank Independence," in B. Bernanke and J. Rotemberg, eds., *NBER Macroeconomics Annual 1995*, p. 253 – 274, Cambridge: MIT Press

Posen, A (1999), 'Nothing to Fear but Fear (of Inflation) Itself,' *PIIE Policy Brief*, 99-09, October, available at http://www.iie.com/publications/pb/pb.cfm?ResearchID=96

Posen, A (2000), "The Political Economy of Deflationary Monetary Policy", in Mikitani, R. and Posen, A., eds., *Japan's Financial Crisis and Its Parallels to US Experience*, PIIE

Posen, A (2009), 'Getting Credit Flowing: A Non-Monetarist Approach to Quantitative Easing', Speech given at Cass Business School, 26 October, available at http://www.bankofengland.co.uk/publications/speeches/2009/speech408.pdf

Posen, A (2010a), 'The Realities and Relevance of Japan's Great Recession – Neither *Ran* Nor *Rashomon*', Speech given at the London School of Economics, 24 May, available at http://www.bankofengland.co.uk/publications/speeches/2010/speech434.pdf

Posen, A (2010b), 'When Central Banks buy Bonds - Independence and the Power to say No', Speech given at Barclays Capital 14th Annual Global Inflation Linked Conference, 14 June, available at http://www.bankofengland.co.uk/publications/speeches/2010/speech436.pdf

Posen, A (2010c), 'The Case for Doing More', Speech given at the Hull and Humber Chamber of Commerce, 28 September, available at http://www.bankofengland.co.uk/publications/speeches/2010/speech449.pdf

Posen, A (2010d), 'The Problem Is That No One Wants to Invest', op-ed in *Eurointelligence*, 25 November, available at http://www.piie.com/publications/opeds/oped.cfm?ResearchID=1741

Posen, A (2011a), "How to do more", Speech given by Adam Posen at Wotton-under-Edge, Gloucestershire, 13 September, available at http://www.bankofengland.co.uk/publications/Pages/speeches/2011/517.aspx

Posen, A (2011b), "Monetary Policy, Bubbles, and the Knowledge Problem," *Cato Journal*, 31(3), pp. 461-471, Fall, available at http://www.cato.org/pubs/journal/cj31n3/cj31n3-19.pdf

Posen, A (2011c), "Central Bankers: Stop Dithering. Do Something." op-ed in *The New York Times*, 20 November, available at http://www.nytimes.com/2011/11/21/opinion/central-bankers-stop-dithering-do-something.html?pagewanted=all

Posen, A (2012a), "What the return of 19th century economics means for 21st century geopolitics", Speech given at Chatham House, 17 January, available at http://www.bankofengland.co.uk/publications/Pages/speeches/2012/539.aspx

Posen, A (2012b), "Why is their recovery better than ours? (Even though neither is good enough)", Speech given at the National Institute of Economic and Social Research, 27 March, available at http://www.bankofengland.co.uk/publications/Pages/speeches/2012/560.aspx

Posen, A (2012c), "The Uses and Limits of Monetary Policy," Paper presented at the China-US Economists Symposium, China Finance 40 Forum, Beijing, 28 April, available at http://www.cf40.org.cn/plus/view.php?aid=5294

Romer, C. (2012), "Economic View: It's Time for the Fed to Lead the Fight", *New York Times*, 9 June, available at http://www.nytimes.com/2012/06/10/business/its-the-feds-time-to-step-up-economic-view.html

Rosengren, E. (2012), "Small Business Funding and the Economic Recovery", speech to Connecticut Business & Industry Association and MetroHartford Alliance, Hartford,January 6, available at http://www.bos.frb.org/news/speeches/rosengren/2012/010612/index.htm

Shiratsuka, S. (2009). "Size and Composition of the Central Bank Balance Sheet: Revisiting Japan's Experience of the Quantitative Easing Policy", *Bank of Japan IMES Discussion Paper* No.2009-E-25.

Sims, C., and T. Zha (2006), "Were There Regime Switches in U.S. Monetary Policy?," *American Economic Review*, 96(1), 54—81.

Smith, D. (2012), "Britain needs much more monetary oomph", *The Sunday Times*, 10 June

Soros, G. (2008), *The New Paradigm for Financial Markets: The Credit Crisis of 2008 and What it Means,* New York: Public Affairs

Soros, G. (2010), *The Soros Lectures at the Central European University*, New York: Public Affairs

Stock, J., and M. Watson (2002), "Has the Business Cycle Changed and Why?," in M. Gertler and K. Rogoff, eds., *NBER Macroeconomics Annual 2002*, Cambridge: MIT Press

Summers, L. (2012a), "How to insure stimulus today, austerity tomorrow," *Financial Times*, March 25, available at http://www.ft.com/cms/s/2/52818152-74d8-11e1-ab8b-00144feab49a.html#axzz1xNLq4700

Summers, L. (2012b), "Look beyond interest rates to get out of the gloom," *Financial Times*, June 3, available at http://www.ft.com/cms/s/2/7ad17ac2-ab42-11e1-b675-00144feabdc0.html#axzz1xNLq4700

Tarullo, D. (2011), "Unemployment, the Labor Market, and the Economy," speech at the World Leaders Forum, Columbia University, New York, October 20, available at http://www.federalreserve.gov/newsevents/speech/tarullo20111020a.htm

Transcript of oral evidence before the Treasury Select Committee for the Bank of England May 2011 *Inflation Report*, 28 June 2011, available at http://www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/uc1326/uc132601.htm

Transcript of oral evidence before the Treasury Select Committee for the Bank of England February 2012 *Inflation Report*, 29 February 2012, available at http://www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/uc1867/uc186701.htm

Weale, M (2009), "Quantitative easing: how to help businesses," National Institute Economic Review, No. 208, April, p. 47

Yellen, J (2011), "Unconventional Monetary Policy and Central Bank Communications", speech delivered at the University of Chicago Booth School of Business U.S. Monetary Policy Forum, 25 February, available at http://www.federalreserve.gov/newsevents/speech/yellen20110225a.htm