Bloomberg

Lacker Says Criticism Against Fed Arises From Credit Plans

November 16, 2011

By Craig Torres

Federal Reserve Bank of Richmond President Jeffrey Lacker said the Fed's current purchases of mortgage bonds and financing of private sector assets during the credit crisis has fueled some of the antagonism aimed today at the central bank.

Central bank credit allocation is "bound to be controversial," Lacker said today in remarks prepared for the Cato Institute's Annual Monetary Conference. "We need to recognize the extent to which some measure of antagonism is an understandable consequence of the Fed's own credit policy initiatives."

The Fed decided in September to maintain its stake in U.S. mortgage-backed securities by reinvesting principal payments from its holdings of agency debt and mortgage bonds back into agency mortgage-backed securities. The Fed owned $849 billion of mortgage-backed securities as of Nov. 9.

That step postponed a goal Fed officials agreed to in April to return their portfolio to only Treasury securities "over the intermediate term." The objective would minimize the central bank's impact on "the allocation of credit across sectors of the economy," they said.

U.S. economic growth will probably increase from 2.5 percent to a range of 3 percent to 3.5 percent during "the next couple of years," Lacker said to reporters after the panel. Unemployment will likely "fall only slowly" during the same period, by 1 percentage point or 2 percentage points, he said.

'Upside Risks'

At the same time, Lacker said he is "concerned about the possibility of upside risks to inflation." He reiterated his belief that the central bank should set an objective for inflation.

"Greater transparency should be achievable for us," Lacker said in response to a question about the Fed's internal deliberations on communication policy. "For a long time I have advocated an explicit numerical inflation objective."

The Standard & Poor's 500 Index fell 0.1 percent to 1,256.39 at 1:38 p.m. in New York. The yield on the 10-year Treasury note fell 13 basis points to 2.03 percent. A basis point is 0.01 percentage point.

Lacker warned in his speech that credit allocation policies can "entangle" the Fed in political conflicts that undermine independence, adding that the executive and legislative branches in times of crisis may try to channel credit to particular constituents.

'Inviting Target'

The Fed sits outside the "safeguards of the constitutional process for appropriations," Lacker said. That makes it an "inviting target" for government officials, and "the path of least resistance in a financial crisis."

The Fed's current stake in housing finance oversteps a set of principles recommended in a study undertaken by the Fed system and published in December 2002 which warned against choosing policy tools that would boost credit in specific sectors of the economy.

A Treasury-only portfolio "enabled the Federal Reserve to maintain neutrality vis-à-vis the rest of government and the private sector by avoiding credit-risk intermediation and picking and choosing among particular private borrowers," the study said.

"Given the magnitude of Treasuries outstanding anything we can do with MBS we can do in my mind even better with Treasuries," Lacker said, referring to mortgage-backed securities.

Nevertheless, Fed Governor Daniel Tarullo said last month that the Fed should consider more large-scale mortgage-backed securities purchases to "provide more support to mortgage lending and housing markets."

'Slow Pace of Recovery'

"Concerns about central banks making sectoral credit allocation decisions are understandable," Tarullo said in his Oct. 20 remarks at Columbia University in New York. "But here we are talking about a widely traded instrument in a sector that appears, now more than ever, to be central to the slow pace of recovery."

"Principles do get bent in a crisis," said Vincent Reinhart, the chief U.S. economist at Morgan Stanley who helped write the 2002 System Open Market Account study. "In a time of crisis, you are less convinced that the private sector is working."

Lacker said the Fed has "done a lot" to prepare the banking system for a potential European financial crisis. "I am less confident about the money market funds, and their ability to weather major problems at European institutions," he said.

Lacker becomes a voting member of the Fed committee next year.