What the Federal Reserve Can Learn from the Bank of Israel

The prospective appointment of Stan Fischer as Vice-Chairman of the Federal Reserve Board will add an academic star to the Board as well as valuable international experience associated with his time at the IMF and World Bank. Less well known and understood, but quite important in my view, is what his experience as head of the Bank of Israel (BOI) will bring to the Federal Reserve (FR) at this crucial juncture. Hopefully, some of this will surface at the March 4, 2014 Senate confirmation hearings.

The BOI has successfully undertaken monetary policy during the past decade despite several challenges that many market pundits believe may hamstring the Federal Reserve during the exit.

- The BOI has, and has had, a very large balance sheet—total assets were 30.5 percent of GDP at end-2012 compared with the FR's 18.5 percent.
- The audited BOI balance sheet has consistently shown negative equity for the past decade, averaging - 4 percent of GDP over the past several years—compared with the FR's positive equity of $55 billion or .3 percent of GDP at end-2012.
- The BOI has made significant losses in recent years while the FR has been transferring record profits to the US Treasury—FR net income before distributions amounted to $ 91 billion in 2012 and $ 79.5 billion in 2013. BOI 2010 *losses* as a percent of Israeli GDP (2.1) translated into their US $ GDP equivalent would have amounted to $ 309 billion!

What does all this mean?

Central banks with *balance sheets much larger than the FR's* when measured against the size of their domestic economies have managed monetary policy well. The US "exit" from unconventional policies does not pose a unique challenge and, indeed, for emerging market economies, is not even rare.

Negative equity has not posed insurmountable economic challenges for effecting excellent monetary policy. In addition to the BOI, the Central Bank of Chile and the Czech National Bank both have an exemplary record of policy implementation despite negative equity, in the Chilean case almost continuously since 1982.

Central bank losses do not represent any sort of an economic "tipping" point and can be well overcome over time. There are cases where chronic significant losses *have* negatively constrained policy outcomes but the FR balance sheet is far from being in that position[1]. Furthermore, the problem with large chronic losses is with *accelerating* inflation—hardly one of the challenges facing the FR now. The Bank of Israel has handled both large losses and negative equity without losing sight of its ultimate policy goals.

Upon contemplation of the broad and rich emerging market experience with unconventional policies, we may be assured that the technical and economic challenges confronting the FR during the exit will be

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[1] See Stella, Peter (2009), *The Federal Reserve's Balance Sheet: What Happened and Why it Matters*, International Monetary Fund WP/09/120, and Carpenter, Seth B, Jane E. Ihrig, Elizabeth Klee, Daniel W. Quinn and Alexander H. Boote (2013), *The Federal Reserve's Balance Sheet and Earnings: A primer and projections*, Finance and Discussion Series 2013-10, Federal Reserve Board.

successfully overcome. But then there are the *political* challenges. Those challenges require being in front on the issue of temporarily deteriorating central bank finances which will inevitably accompany the exit. As a former central bank head, Dr. Fischer is well versed in coping with this task and will bring with him the authority of someone speaking with experience. Hopefully he and his colleagues at the Board and on the FOMC will take full advantage of his experience and not allow these secondary issues to impact the conduct of policies nor call into question FR operational independence.

In my view the FR has not—to date—adequately prepared for the eventual deterioration in its finances (nor has the Bank of England). The decision in January 2011 to ensure that any future FR losses will be obscured as a deferred asset account is one case in point. Yes, this will prevent a future FR from showing negative equity, but it will do nothing to hide the fact that the FR will be running losses and that the FR has ceased transferring profit to the Treasury. Better that provisions for this eventuality be created now—see Stella (2009). But the FR has an awkward legal structure…the owners of each independent Federal Reserve Bank are the member commercial banks in their geographical district. It is those banks, not the Treasury who are legally responsible for covering any FR capital deficiency. This rather politically awkward problem may be averted by the deferred asset account. But will all the people be fooled all the time? I think not. Hence let us be grateful that someone who has openly had to deal with central bank losses and negative equity may come to be the Vice Chairman.

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