Testimony before the
Subcommittee on Domestic Monetary Policy and Technology of the
Committee on Financial Services
U.S. House of Representatives

"Improving the Federal Reserve System: Examining Legislation to Reform the Fed and Other Alternatives"

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Chairman Paul, Ranking Member Clay, and other members of the subcommittee, I thank you for the opportunity to testify at this hearing on improving the Federal Reserve System. I especially appreciate the efforts of this subcommittee to bring these crucial monetary policy issues to a prominent place in the public debate. As you requested, I will first explain why there is a need for improvement and then consider whether this need is addressed by six reform bills:

- *H.R. 245* introduced by Rep. Mike Pence,
- *H.R. 1094* introduced by Rep. Ron Paul,
- *H.R. 1401* introduced by Rep. Marcy Kaptur,
- *H.R. 2990* introduced by Rep. Dennis Kucinich and John Conyers,
- *H.R. 3428* introduced by Rep. Barney Frank, and
- *H.R. 4180* introduced by Rep. Kevin Brady and others.

A Need for Improvement

Nearly a century of experience under the Federal Reserve Act has provided plenty of evidence that more systematic rules-based monetary policies work and more unpredictable discretionary policies don't. The Fed's well-known mistake of cutting money growth in the Great Depression which led to very high unemployment is now part of a much larger body of evidence. From the mid-1960s through the 1970s, the Fed intervened with discretionary go-stop changes in money growth that led to frequent recessions, high unemployment, low economic growth, and high inflation. In contrast, through the 1980s and 1990s and until recently the Fed ran a more predictable, systematic policy with a clear price stability goal, which eventually led to lower unemployment, lower interest rates, longer expansions, and stronger economic growth.

Recently, however, the Fed has returned to unpredictable discretionary policies with disappointing results. Starting in 2003-2005 it departed from the more systematic policies it followed in the 1980s and 1990s. It held interest rates too low for too long and thereby

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encouraged excessive risk-taking and the housing boom. It then overshot the needed increase in interest rates which worsened the bust. Since then the interventions have been truly extraordinary, even if you ignore actions during the 2008 panic—including the bailouts of the creditors of Bear Stearns and AIG—and consider only quantitative easing—the large scale purchases of mortgage-backed securities and longer term treasuries in 2009 and later.

In fact, the Fed's discretion is virtually unlimited. To pay for its large-scale securities purchases, it simply credits banks with electronic deposits—called reserve balances. The result has been an explosion of reserve balances. Before the 2008 panic, reserve balances were about $10 billion. Now they are $1,493 billion. If the Fed had stopped with the emergency responses of the 2008 panic, instead of embarking on quantitative easing, reserve balances would now be back to normal levels. This large expansion of reserve balances creates risks. If it is not undone, then the bank reserves will eventually pour out into the economy, causing inflation. If it is undone too quickly, banks may find it hard to adjust and pull back on loans.

The very existence of quantitative easing as a policy tool creates unpredictability, as traders speculate whether and when the Fed will intervene and guess what the impact will be. That the Fed can intervene without limit into any credit market—not only mortgage-backed securities but also securities backed by automobile loans or student loans—creates more uncertainty and raises questions about why an independent agency of government should intervene in these areas at all. In the spirit of the Constitution, they are best left to the Congress and the president through the appropriations process.

Reform Proposals

For all these reasons, there is a great need for improvement in the degree to which the Federal Reserve follows rules rather than discretion. To achieve this end, some argue that we should abolish the Fed, as does ***H.R. 1094***, repeal the Federal Reserve Act, and perhaps replace it with a commodity standard. The goal of such legislation is to move American monetary policy away from discretion and toward rules. However, a more practical and effective approach, in my view, is to reform the Federal Reserve and create strong incentives for rule-like behavior.

The starting place for such a reform is the recognition that a clear well-specified goal usually results in a consistent and effective strategy for achieving that goal. Too many goals blur responsibility and accountability, causing decision makers to choose one goal some times and another goal at other times in an effort to chart a middle course. In the case of monetary policy, multiple goals enable politicians to lean on the central bank to do their bidding and thereby deviate from a sound money strategy. More than one goal can also cause the Federal Reserve to exceed the normal bounds of monetary policy—moving into fiscal policy or credit allocation policy—as it seeks the additional instruments necessary to achieve multiple goals.

Despite these obvious pitfalls, a multiple mandate for the Fed swept in during the great interventionist wave of the 1970s, when Congress passed the Federal Reserve Reform Act of 1977. This law explicitly gave the Federal Reserve the goals of promoting both "maximum

employment" and "stable prices." This was the wrong remedy for the inflationary boom-bust economy at the time, and monetary policy worsened for a while.

Paul Volcker reversed policy when he became chairman in August 1979, focusing on inflation like a laser beam. Of course he had to interpret the law in a way consistent with this reversal. To achieve maximum employment, he argued that he had to reduce inflation even if that increased unemployment in the short run. While that approach eventually worked well, it also set a precedent that the dual mandate was open to interpretation by Fed officials. In recent years the dual mandate has been used by the Fed to justify massive interventions on the questionable grounds that these will reduce unemployment in the short run.

Thus, an important step toward a more rule-like policy would be to remove the dual mandate and bring focus to a single goal as does ***H.R. 4180***, introduced by Rep. Kevin Brady and others, in which the goal is "long-run price stability" or ***H.R. 245,*** introduced by Rep. Mike Pence, in which the goal is "stable prices." In my view, the adjective "long-run" is useful because it clarifies that the mandate does not mean that the Fed should overreact to minor short-run ups and downs in inflation from month to month or even quarter to quarter. The single mandate wouldn't stop the Fed from providing liquidity when money markets freeze up as they did after the 9/11 terrorist attacks, or serving as lender of last resort to banks during a panic, or reducing the interest rate in a recession.

Some worry that a focus on the goal of price stability would lead to more unemployment. But history shows just the opposite. One reason the Fed kept its interest rate too low for too long in 2003-05 was the concern that higher rates would increase unemployment, contrary to the dual mandate. If the single mandate had prevented the Fed from keeping interest rates too low for too long, then it would likely have avoided the boom and bust which led to very high unemployment.

Recent history shows that a single mandate would help to avoid excessive discretionary interventions. Since 2008 the Fed has explicitly cited the dual mandate to justify its unusual interventions, including the quantitative easing from 2009 to 2011. During the 1980s and 1990s, Fed officials rarely referred to the dual mandate, even during the period in the early 1980s when unemployment rates were as high as today. When they did so, it was to make the point that achieving price stability was the surest way for monetary policy to keep unemployment down. In fact, until the recent interventionist period, written policy statements and directives from the Fed did not mention the "maximum employment" part of the dual mandate in the Federal Reserve Act. There was not a single reference from 1979 until late 2008, just as the Fed was about to embark on its first bout of quantitative easing. It increased its references to maximum employment in the fall of 2010 as it embarked on its second bout of quantitative easing.

While a single mandate would reduce excessive discretionary interventions and encourage more rule-like policy, it would be wise to supplement the existing legislative proposals with additional incentives for the Fed to place greater emphasis on the strategy or rule for setting the monetary policy *instruments* (the interest rate or the monetary aggregates). Until the year 2000 the Federal Reserve Act had a specific reporting requirement about the growth of the monetary aggregates. It called for the Fed to submit a report to Congress and then testify about its plans for money growth for the current and next calendar years.

The reporting requirement was fully repealed in 2000, because the data on money growth had become less reliable as people found alternatives to money—such as credit cards or money market mutual funds—to make payments. The Fed thus focused more on the interest rate, but the problem was that nothing about reporting on its interest rate policy was put in its place of its reporting about money growth.

In order to further encourage more rule-like monetary policy, the Congress could reinstate the reporting requirements. But rather than focus only on money growth, it would also focus on the systematic response of the interest rate that changes in money growth bring about. In doing so, it would not require that the Fed choose any particular rule for the interest rate, only that it establish some rule and report what the rule is. But if the Fed deviates from its chosen strategy, it must provide a written explanation and testify at a public congressional hearing.

In addition to the change in the mandate and enhanced reporting requirements, overall restraints on the composition and the size of the Federal Reserve's portfolio would reduce monetary policy uncertainty. It is therefore appropriate, in my view, to limit asset purchases by the Fed to U.S. Treasury securities, as called for in ***H.R. 4180*** with exceptions as provided in that bill. This would also clarify that the Fed's responsibility is monetary policy not credit allocation policy, and thus strengthen the independence of the Fed. In contrast **H.R. 2990,** introduced by Rep. Kucinich, would effectively reduce the independence of monetary policy decisions by creating a new monetary authority under the general oversight of the Secretary of the Treasury.

Improving the balance of voting rights on the Federal Open Market Committee (FOMC) would also reduce the likelihood of harmful discretionary actions. Giving all Federal Reserve district bank presidents voting rights at every FOMC meeting, as called for in ***H.R. 4180,*** would better balance voting power across the entire economy and reduce the tendency for policy decisions to favor particular regions, sectors, firms, or groups over others. ***H.R. 1401,*** introduced by Rep. Marcy Kaptur, also improves the balance among the district banks and Federal Reserve Board members by having the voting authority of all the presidents rotate on and off in the same manner and by reducing the length of terms of the members of the Board of Governors. ***H.R. 3428*** introduced by Rep. Barney Frank would worsen the balance, in my view, by replacing the district bank presidents who vote on the FOMC with additional Fed Board members thereby concentrating more power in Washington and likely increasing the discretionary power of the Federal Reserve.

In sum, legislative reforms which clarify the Fed's mandate, enhance reporting requirements about its strategy or rule for the monetary instruments, restrict the nature of the its purchases of securities, and balance voting rights on the FOMC would allow Congress to exercise appropriate political control without becoming involved in day-to-day monetary policy operations or otherwise micromanaging the Fed. In my view the reforms would enhance the independence of the Fed by adding reassuring accountability appropriate for an independent agency of government and clarifying that its overall responsibility is monetary policy not fiscal policy or credit allocation policy. History and basic economics tells us that such reforms would greatly improve employment and price stability and would help restore America's prosperity.