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RETHINKING THE FEDERAL RESERVE'S MANY MANDATES ON ITS 100-YEAR ANNIVERSARY

HEARING

BEFORE THE

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U.S. HOUSE OF REPRESENTATIVES

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RETHINKING THE FEDERAL RESERVE'S MANY MANDATES ON ITS 100-YEAR ANNIVERSARY

Thursday, December 12, 2013

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 3:08 p.m., in room 2128, Rayburn House Office Building, Hon. Jeb Hensarling [chairman of the committee] presiding.

Members present: Representatives Hensarling, Garrett, McHenry, Campbell, Posey, Luetkemeyer, Huizenga, Stivers, Stutzman, Mulvaney, Hultgren, Pittenger, Barr, Cotton, Rothfus; Waters, Maloney, Watt, Sherman, Capuano, Clay, Scott, Green, Himes, Carney, and Sinema.

Chairman HENSARLING. The committee will come to order. Without objection, the Chair is authorized to declare a recess of the committee at any time.

I, first, want to thank the panelists for their patience and indulgence on our rescheduling. The committee is most appreciative.

Before getting to our opening statements and testimony, I am going to recognized myself to speak out of order for 1 minute. I am going to recognize the ranking member and one other member, and then the rest of you are out of luck.

On Tuesday night, Mel Watt, the Congressman of the 12th Congressional District of North Carolina, and an 11-term Member of the United States House of Representatives, was confirmed by the United States Senate to be the next Director of the Federal Housing Finance Administration (FHFA). Since coming to this committee, I have known Mel Watt to be a man of honor. A senior leader on this committee, he has served with distinction and led on many critical issues.

At the time that he was confirmed, I sent out a release, and somebody Twittered to the committee that they were surprised I was saying something nice about Mel Watt. And I am still trying to figure out if that was a comment upon me or Mr. Watt.

[laughter]

It is a long journey from Mecklenburg County, North Carolina, to Yale, and a long journey from Mecklenburg County to Congress. Fortunately, it is a short distance from Congress to the FHFA; I am told it is 5/8th of one mile. Thank you, MapQuest.

I do not know the exact timing of our colleague's departure. This may be his last hearing as inquisitor. I will assure the gentleman

from North Carolina that it will not be your last hearing as inquisitee.

But on behalf of the Republican side of the aisle, and on behalf of the entire committee, I wish to congratulate you, and we look forward to continuing to work with you.

And for all the other members, I have spoken to the ranking member, and after we return from our Christmas break, we will have a reception so that our colleague can be sufficiently hosted, toasted, and roasted.

With that, I am happy to recognize the ranking member for 1 minute out of order.

Ms. WATERS. Thank you very much, Mr. Chairman.

I certainly appreciate your comments. And I would like the committee to know that you have been supportive in your own way and in your own style, and that your offer to have a bipartisan reception, with all of us participating, in order to wish our friend and colleague a farewell to this committee and to congratulate him is something that you initiated. And I appreciate that. I appreciate that very much.

As a matter of fact, we have been talking about more bipartisan receptions. We talked about it for perhaps Christmas. I said, "Oh, I don't know if we want to do that." But when you said for Mel, right away I said yes.

And so, Mr. Chairman, it is with a heavy heart and a strong sense of pride that I congratulate my dear friend, Mel Watt, on his confirmation as Director of the Federal Housing Finance Agency.

For more than 2 decades, I have served alongside Mel on this committee, and I have watched him use his knowledge and experience on real estate issues and housing issues to earn the respect of colleagues on both sides of the aisle. And I am very pleased to say that Mel Watt understood what was going on with predatory lending and securitizing and packaging and all of that long before most Members really got in touch with those issues.

Because of his leadership, we were able to follow and to build on what he had initiated so that we could get to the issues of understanding what was happening in the housing market and how we should address some of those issues. So his experience that he brought to this committee was considerable, again, working on real estate issues and housing issues.

Mel is a thoughtful, well-informed, principled, and fair human being. These qualities, and his well-known temperament, will serve him well as he works to address some of the most important challenges facing our economy and our housing market.

His reputation as a legislator focused on openness, collaboration, and good public policy is second to none. Over his distinguished career, he has demonstrated an unwavering commitment to protecting consumers, expanding affordable rental housing, and providing prudent oversight of financial institutions. I know these values will be embodied in Director Watt's leadership of the FHFA.

Today, I am sad to say goodbye to a long-time friend and collaborator, but I am heartened to know that in Director Mel Watt, this committee and this Nation will have a strong partner in one of its most important government agencies.

Let me just say that I learned from Barney Frank that when you have difficult issues which require that someone who is smart, who is patient, and who is not only knowledgeable, but willing to listen to both sides, when you have someone like that you can go and ask to put both sides together and work out a solution, then you should certainly avail yourself of that person's expertise.

That is what Barney Frank did with Mel Watt. He often asked Mel Watt to get in the middle of some of the toughest issues and work with both sides, all sides of those issues, and bring us back a solution.

And so, we are going to miss those qualities in Mel, but we look forward to working with him, because I sincerely believe that in this new position he will help us to understand where we need to go and what we need to do on the great issues confronting us on housing in particular today.

So with that, Mel, congratulations.

[applause]

Chairman HENSARLING. The Chair now recognizes the gentleman from North Carolina for one of the last times, for 1 minute of rebuttal.

[laughter]

Mr. WATT. Thank you. Thank you.

Thank you, Mr. Chairman, and thanks to you and Ranking Member Waters, both friends and colleagues on this committee.

I will be very brief because I am delighted to know you all are inviting me back to host me and roast me before I get to sit on the other side of the table and you really get to go after me. So, I am sure today is a lot more pleasant than it will be sitting on the other side of the table when I come back.

I would just make one comment to put this in perspective, because one of the things you have to recognize about our country and be reminded of quite often is that only in America could somebody be confirmed to this position that has the regulatory authority over the bulk of housing in this country, only in America could somebody come from a beginning, being born in a house with no running water, no electricity, a tin roof where you could look up through it and see the sky at night, and look down through the wooden floor and see the ground, and have the opportunity to get an education, to practice law, and gain experience in some of the most complex real estate issues that the country faces, to come to Congress and serve on this committee, and serve with wonderful people like my colleagues on this committee have been over the years.

Only in America can that happen. That is the great thing about our country, and we have to keep faith in that process. So, I thank you for your kind comments, and I look forward to coming back to visit with you. And I hope you all will be as kind to me when I come back as you have been today.

Chairman HENSARLING. Don't count on it.

[laughter]

And the gentleman yields back.

[applause]

I thank the panelists yet again for their continued indulgence.

Now returning to regular order, I recognize myself for 5 minutes to give an opening statement.

This month marks the 100th anniversary of the Federal Reserve Act. It is on this occasion that I announce the House Committee on Financial Service's Federal Reserve Centennial Oversight Project. Our committee will overtake the most rigorous examination of the Fed's purposes, policies, and track record in its history. At the end of the project, scheduled for next fall, the committee stands prepared to mark up legislation to reform the Federal Reserve, based upon its findings.

The Fed was created in response to the financial panic of 1907. An American Banker article argued at the time, "The financial disorders that have marked the history of the past generation will pass away forever." The Comptroller of the Currency at the time said, "Financial and commercial crises or panics seem to be mathematically impossible."

Clearly, these predictions proved to be somewhat overly optimistic, as well-established by economists Milton Friedman and Anna Schwartz, and economist Chairman Ben Bernanke, that the Fed played a significant role in bringing about the Great Depression. Loose monetary policy, coordinated with fiscal deficits, helped cause the great inflation of 1965 to 1986, in which inflation rates exceeded 13 percent.

Most economists will argue that loose monetary policy between 2003 and 2005 contributed to the housing bubble in our most recent financial crisis. This history is not meant to be an indictment of the Fed, but is intended in the spirit of looking behind the curtain, not unlike the Wizard of Oz, to discover a human face, a human face capable of making mistakes, mistakes sometimes with dire consequences for the lives of millions of Americans.

Not only were the authors of the Federal Reserve Act wrong about its effectiveness, I do not believe they would recognize today's central bank. Classic central bankers followed Bagehot's dictum to lend freely during panics to solvent banks at a penalty rate and against good collateral. Recently, the Fed has lent freely to insolvent non-banks at subpenalty rates against questionable collateral. To paraphrase an old automobile advertising phrase, "This is not your father's Fed."

The Fed's foray into credit allocation policy, distinct from monetary policy, was not confined to the immediate events of 2008, but continues to this day in the Fed's unprecedented purchase of mortgage-backed securities. The Fed's additional extraordinary purchases of Treasury bonds have supported the Obama Administration's trillion-dollar deficits, a threat to the Fed's independence, and one that in prior decades has been a harbinger of runaway inflation.

These extraordinary powers rest with a creature of government that the founders of our republic, who have vested the authority to coin money with the Congress, would not have envisioned: a public-private entity exempt from budgetary appropriation with effective control over much of the economy.

Our first hearing will consider many mandates of the Federal Reserve, including classic monetary policy, prudential regulatory pol-

icy, full employment, systemic risk regulator, lender of last resort, and effective financier of our unsustainable debt.

We will also consider the Fed's role in credit allocation, arguably picking winners and losers, particularly the burdens this has placed—low interest rates have placed on fixed-income seniors.

We will ask questions again about the Fed's role in our unsustainable debt. While most of us maintain our commitment to permit the U.S. Government Accountability Office (GAO) to audit the Fed's operations, we will explore the issues of independence, accountability, and transparency, since rarely has an agency of government been given or assumed greater discretionary power over the economy than the Federal Reserve.

We will consider how other financial market regulators operate under a statutory requirement to measure the cost of the new rules on the economy against the benefits, so we will help ensure that new rules do not violate the Hippocratic Oath principle to first do no harm.

The Fed's role as lender of last resort has expanded over the last few decades and remains ill-defined. We will consider the appropriate boundaries of that emergency power. We will certainly consider the classic debate in monetary policy between rules and discretion in monetary policy. Many would argue that in successful periods in the Fed's history, like the great moderation of 1987 to 2003, the Fed appears to follow a clear rule. In 1995, then-Fed Governor Janet Yellen described the Taylor Rule as "what sensible central banks do."

Milton Friedman once said that, "Money is much too serious a matter to be left to central bankers. None of us are infallible." I respect the dedicated men and women who lead the Federal Reserve, but we have a responsibility to ensure that the Federal Reserve effectively meets whatever mandates it may have.

The Chair now recognizes the ranking member for 5 minutes.

Ms. WATERS. Thank you, Chairman Hensarling, for holding today's hearing to discuss the mandates of the Federal Reserve on its 100th anniversary.

At a critical inflection point such as this, it is important to take stock of the lessons of the past and reflect on whether the Fed has been effective in meeting its charge to keep inflation in check, financial markets stable, and maximize employment.

Although there have been ups and downs in its history, the Federal Reserve has learned from the lessons of the past. Today, it plays an important role in fostering the conditions necessary for both stability and growth in the American economy.

One of the many truths over the last century that holds today is the interdependency between a stable economy and a stable financial system and, in this sense, the Fed's mandate to reduce systemic risk and promote financial stability complements its monetary objectives.

The Fed's regulatory shortcomings in the years prior to the most recent financial crisis were significant. But since the crisis began, the Federal Reserve has been one of the most effective policymaking bodies in stabilizing the financial sector and continuing to support the recovery.

When the first signs of this crisis emerged in 2007, the Fed responded swiftly to address the weak economy. It cut the discount rate, extended credit to banks, and brought the Federal funds rate to its lower bound. When this wasn't enough, the Fed took extraordinary steps to provide emergency liquidity directly to institutions and foreign central banks around the globe.

However, the severe nature of the crisis forced the Fed to enter uncharted territory, recognizing the need to act. It took unprecedented steps by engaging in large-scale asset purchases—a policy known as quantitative easing—which lowered long-term interest rates and has provided a needed boost to our recovery.

As a result of the Fed's stimulus, economists estimate that the economy is 3 million jobs stronger than it would have been without the Fed's courageous efforts. Further, the drop in interest rates triggered by quantitative easing has spurred improvements in the housing sector and, by extension, the larger economy.

This housing recovery has been accompanied by a rise in home prices that has reduced the number of borrowers who are underwater on their mortgages, and expanded the pool of homeowners who are eligible to refinance. While the economic outlook for our Nation continues to improve, we still have a long way to go until we can say that maximum employment has been achieved and the economy has fully recovered from the trauma of the financial crisis.

With close to 11 million Americans still out of work, it is astonishing to me that members of this body would even consider striking the employment aspect of the Fed's dual mandate. What kind of signal does this send to hardworking Americans across the country?

Of course, Congress should do its part, too. I am hopeful that Members will come together to pass a budget that moves away from the antigrowth austerity policies enshrined by the sequester in favor of a responsible budget that puts our long-term spending on a sustainable path.

Mr. Chairman, I believe it is worth noting that before we contemplate legislative changes to the Fed or its mandate, Congress should allow the Fed to finalize the important reforms included in the Dodd-Frank Act that reduce the likelihood of future financial crisis.

The Fed is making important progress on this front. Just this week, the Fed approved the final Volcker Rule, a critical rule which will make our financial system safer. We should not rush into reform merely for the sake of doing so.

So I look forward to the discussion, and again, this hearing, and I thank the chairman for scheduling today's hearing. I yield back.

Chairman HENSARLING. The gentlelady yields back.

The Chair now recognizes the gentleman from California, Mr. Campbell, the chairman of our Monetary Policy and Trade Subcommittee, for 3 minutes.

Mr. CAMPBELL. That is fine. Thank you, Mr. Chairman.

So we are talking about the many mandates of the Federal Reserve today. And those mandates have not ever been thus, as we are doing a little history lesson here. The original architects of the Fed had simple goals, like managing an elastic currency and serving as a lender of last resort. It wasn't until 1977, many decades

after the creation of the Fed, that it received the additional mandates of maximum employment, stable prices, and moderate long-term interest rates. The first two are commonly referred to as the "dual mandate," although there are more than that.

But since then, other responsibilities have been added or increased. The Federal Reserve now has explicit responsibilities in regulating commercial banking activity, conducting macroeconomic surveillance, even serving as the funding source for the Consumer Financial Protection Bureau (CFPB).

It has served other implicit roles, as well, such as providing indirect support to mortgage finance markets and lowering borrowing costs for the Federal Government, which have had direct impacts on house prices and have enabled deficit spending.

So with all of these mandates and responsibilities, whether they are implicit or explicit, that have been piled onto the Federal Reserve in the last few decades, the question we are asking here, that we must ask ourselves is, can the Federal Reserve do as much as it is being asked to do, as well as we expect it to do it?

The primary job of a central bank—to monitor the money supply and monetary policy—is tough enough and has enough impacts on the economy. When we have all of these other things out there, and mandates for this and mandates for that, are we giving the Fed more than it can handle effectively, or are we not?

These are some of the questions that, over the period of the next few months, as we do this—what did you call it, Mr. Chairman, centennial review of the Fed—we want to get to, but we certainly are starting today, right now, with you all in trying to understand your different views on the mandates that are there, whether they are correct, whether they are implicit or explicit, and whether they should be revised.

The Federal Reserve, as I have said several times in the last few days and will continue to say, is independent, but it is not unaccountable. And part of what we are talking about here is accountability for the Fed and its functions and its actions.

And with that, I yield back, Mr. Chairman.

Chairman HENSARLING. The gentleman yields back.

The Chair now recognizes the gentleman from Missouri, Mr. Clay, the ranking member of the Monetary Policy and Trade Subcommittee, for 3 minutes.

Mr. CLAY. Thank you, Mr. Chairman, especially for holding this hearing regarding the Federal Reserve's mandate. As we know, in 1913 Congress enacted the Federal Reserve Act to provide for the establishment of the Federal Reserve Bank.

In 1977, Congress amended the Federal Reserve Act to promote price stability and full employment. This amendment is better known as the Humphrey-Hawkins Act. Price stability is viewed as stable with low inflation, and full employment is viewed as maximum sustainable employment.

The Federal Reserve's dual mandate is in contrast to the European Central Bank's (ECB's) single mandate. The ECB's single mandate of price stability is a primary objective of their monetary policy.

The Consumer Price Index (CPI) produces monthly data on changes in the prices paid by consumers for goods and services.

Currently, the U.S. CPI decreased 0.1 percent in October on a seasonally-adjusted basis.

For the past year, all-items index increased 1 percent before seasonal adjustment. Gasoline fell 2.9 percent in October, and that led to a decline in the entire index. The electricity index rose, but the indexes for fuel oil and natural gas declined.

From the mid-1960s to the mid-1980s, the CPI showed major swings in inflation from low to high to low, and an unemployment rate reaching 11 percent. The economy went through many recessions during that time, with both high inflation and high unemployment.

Currently, the U.S. unemployment rate stands at 7 percent. In Europe, the unemployment rate in several nations is as high as 27 percent. In other nations, the unemployment rate is 15 percent and above. The euro area is around 12 percent and E.U.–27 is around 11 percent.

Still, there are some people who believe that the United States would be better off with a single mandate as opposed to a dual mandate. They believe that monetary policy can achieve the same outcomes with a single mandate as it can with a dual mandate, and I certainly do not agree with that analysis.

Mr. Chairman, thank you. I look forward to the witnesses' comments. I yield back.

Chairman HENSARLING. The gentleman yields back.

The Chair now recognizes the gentleman from Michigan, Mr. Huizenga, the vice chairman of the Monetary Policy and Trade Subcommittee, for 2 minutes.

Mr. HUIZENGA. Thank you, Mr. Chairman. And I appreciate that. I, too, much like my previous colleagues have talked about, the Humphrey-Hawkins Act, the dual or multiple mandate that has been laid out, I think it is worthy to explore to what goal and what end we are utilizing that.

I have an economist friend back in Michigan who is from Chicago, Dr. Robert Genetski, who—he and I have had some interesting conversations about the Fed. He has pointed out that over the last 5 years, there has been about $2.3 trillion of reserves that have been built up in the Fed over the last 5 years. He points to the fact that the Fed is offering 0.25 percent of interest, while Treasuries are at basically zero. It is not a hard decision for some of these banks as they are going in there. He believes that it has destroyed liquidity, as well. And I am inclined to agree with him. I would love to hear that from you all.

But as we are looking at quantitative easing, QE1,–2,–3,–infinity, whatever may be happening, Operation Twist, it certainly seems to me that we are outside the bounds of not only where traditionally the Fed had been, but maybe where it should be and legally should be. And how you put that toothpaste back in the tube is something that has not been clear, and it is all theoretical, as Mr. Bernanke had pointed out here in this committee room.

Earlier today, we had a hearing with Treasury Secretary Lew, where a couple of my colleagues, fellow colleagues from Michigan, talked about the effects of Japan, and their quantitative easing, and their "currency manipulation" they are under.

They believe that should exclude Japan from the Trans Pacific Partnership (TPP) discussions that are going on because of, literally, the quantitative easing that Japan has been doing to make the yen cheaper, and therefore, Japanese products cheaper. I would like some reflections on how that shouldn't apply to us, and what our own Fed has been doing.

So, thank you, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from California, Mr. Sherman, for 2 minutes.

Mr. SHERMAN. This comatose economy still needs stimulus. Monetary stimulus reduces the Federal deficit by reducing borrowing costs of the Federal Government. Fiscal stimulus, which is, in many ways, the alternative, increases the Federal deficit. A 2 percent target inflation rate is reasonable, especially given the disaster that can occur to our economy if we have deflation. Look at Japan or look at our own Great Depression.

Another part of the dual mandate is the dual function that the Fed has: on the one hand, it is a bank regulator; and on the other hand, it is a monetary policy-setting body. I hope our witnesses address that part of the dual mandate dealing with both unemployment and inflation.

We also have the Fed dual governance, where, on the one hand, it is a Federal Government agency, appointed through a democratic government. And on the other hand, its regional executives are appointed, in part, by banks. One bank, one voter, actually, $1 billion of banking, one vote, which is not democracy. And given the tremendous governmental power the Fed has, should all of its Board Members be Presidentially appointed for whatever terms are reasonable?

I hope we look at Section 13(3), which remains the most dangerous economic provision in our statute books. It allows unlimited lending by the Fed, trillions of dollars at times. And we at least ought to make sure that those loans are default-risk-free, or as close to that as they can achieve.

And finally, when it comes to auditing the Fed, as an old CPA, I will just say that given our limited auditing resources, we would normally want to direct them, first, to whichever agency a Federal Government is working hardest to avoid being audited.

So I look forward to these hearings, looking not at just one controversial issue of inflation versus unemployment, as a focus of the Fed's policy, but a broader range of issues, as well.

I yield back.

Chairman HENSARLING. Today, we welcome four witnesses to our panel.

Dr. Douglas Holtz-Eakin is the president of the American Action Forum. Dr. Holtz-Eakin has a distinguished career in the economics field in academia and, like another one of our witnesses, Dr. Rivlin, also served as a former Director of the Congressional Budget Office. He earned his Ph.D. from Princeton, and his undergraduate degree from Denison University.

Dr. Marvin Goodfriend holds the Friends of Allan Meltzer Professorship as a professor of economics at Carnegie Mellon's Tepper School of Business in Pittsburgh. He has previously served on the

Economic Advisory and Monetary Policy panels of the New York Fed. He received his Ph.D. from Brown University, and his undergraduate degree from Union College.

Dr. Alice Rivlin is currently a senior fellow in economic studies at the Brookings Institution, a visiting professor at the Public Policy Institute at Georgetown, and the director of the Engelberg Center for Health Care Reform. As most of us know, she, too, has a distinguished public service career, including service, along with myself, on the President's debt commission, also known as Simpson-Bowles. Somehow, she managed to dodge the bullet on the super-committee; I did not.

She also served as the Founding Director of the Congressional Budget Office, OMB Director, and as Vice Chair of the Federal Reserve Board. She earned her Ph.D. at Harvard, and her undergraduate degree at Bryn Mawr College.

Last, but not least, Hester Peirce is a senior research fellow at the Mercatus Center at George Mason University. Her primary research interests relate to the regulation of financial markets. We welcome her back to the Hill. Ms. Peirce formerly served on the Senate Banking Committee. She earned her law degree at Yale, and her undergraduate degree from Case Western Reserve University.

I think each and every one of you have testified before, so you know that you will each be recognized for 5 minutes. And, no doubt, you know the lighting system. Without objection, each of your written statements will be made a part of the record.

Dr. Holtz-Eakin, you are now recognized for 5 minutes.

STATEMENT OF DOUGLAS HOLTZ-EAKIN, PRESIDENT, THE AMERICAN ACTION FORUM

Mr. HOLTZ-EAKIN. Thank you, Mr. Chairman, Ranking Member, and members of the committee. It is a privilege to be here today.

Certainly, I want to applaud the chairman and the committee for holding this series of hearings. The 100th anniversary of the Federal Reserve is an appropriate time for a comprehensive review. And it is especially timely, because since 2007, the Fed has navigated unprecedented and extraordinary events and undertaken unprecedented and extraordinary measures in response to those events. It would be useful to have a systematic evaluation of their efficacy and their desirability as future tools for the Federal Reserve under the purview of the Congress.

My written testimony points out four major functions for the Federal Reserve: the conduct of monetary policy; acting as a lender of last resort; microprudential regulation, the oversight of bank-holding companies, in particular; and macroprudential regulation, the management of systemic risks. And I think there is fruitful area of inquiry for all four.

Probably the most familiar is the debate over the conduct of monetary policy, rule-based monetary policy versus discretion, the desirability of a single mandate versus a dual mandate. I won't belabor those here. I simply encourage the committee to look into that.

I do think that the lender-of-last-resort function needs some examination. I was privileged to serve under appointment from the

Congress on the Financial Crisis Inquiry Commission. That experience left me with the very strong belief that the Federal Reserve was the single best policy response to the crisis and deserves the lion's share of the credit for the relatively quick turnaround that the United States experienced in response to the downturn in financial markets.

And that involves a traditional and large-scale lending of liquidity against collateral. I am not a big fan of the things they have done since. I will go into that later, but I think in that moment, it did an extraordinary job for the United States.

But it left behind as a legacy some serious questions about the transparency of their actions. It left behind an extraordinary expansion of the balance sheet, which is exposed to interest rate risks, and may constrain further Federal Reserve policy. And I think it is a useful thing for the committee to look at where the limits should be on the lending of last resort and what serves as useful collateral. I will confess that I don't have a firm answer to that question, but I think it is something that is certainly worth investigating and thinking hard about.

In the area of microprudential regulations, the Fed has a very extensive supervision of regime. It had one leading into the crisis, and it missed some material weaknesses in the bank holding companies under its supervision. And I think it has, since that time, been given even greater supervision obligations.

For example, the Volcker Rule that was just announced looks to me to be an extraordinary undertaking, one that is ambiguous, at best, and is going to strain the abilities of supervisors. I think it really is a good question as to whether we are asking too much of the Fed in that area.

And then finally, on the macroprudential, the systemic risk issue—with the finance—the FSOC and the Fed's role in the FSOC, and worrying about systemic risk, I worry about whether we have gone too far. I look at the FSOC's designation of life insurance companies, for example, as systemically important financial institutions (SIFIs), when they have little or nothing to do with the crisis that we experienced, and I think perhaps we have drawn the boundaries too widely and it might be time to rein in the macroprudential regulatory obligations and authorities of the Fed and others.

I look forward to answering your questions. I, again, applaud the committee for deciding to take on this task and think about these issues. They are perhaps among the most pressing public policy issues we face today. Thank you.

[The prepared statement of Dr. Holtz-Eakin can be found on page 48 of the appendix.]

Chairman HENSARLING. Dr. Goodfriend, you are now recognized for 5 minutes.

STATEMENT OF MARVIN GOODFRIEND, FRIENDS OF ALLAN MELTZER PROFESSOR OF ECONOMICS, TEPPER SCHOOL OF BUSINESS, CARNEGIE-MELLON UNIVERSITY

Mr. GOODFRIEND. Thank you, Mr. Chairman, and Ranking Member Waters.

My testimony today will talk about lessons from the financial crisis for Fed credit policy. I am going to reconsider the Fed's performance in meeting its financial stability and employment mandates in the 2008–2009 financial crisis and Great Recession. I am going to emphasize three points, and then I am going to make one recommendation.

First, Fed credit policy employed without bound, and not conventional monetary policy, played the preeminent role in stabilizing financial markets in the fall of 2008 and 2009.

Second, Fed credit policy involves fiscal policy initiatives that are ordinarily the prerogative of Congress, but are not part of conventional monetary policy.

And third, the financial panic and Great Recession were triggered in September 2008 in large part when prominent Members of Congress openly condemned expansive Fed credit support for AIG, and the public became frightened that neither the Fed nor Congress would offer further effective support for the financial system. I will elaborate on that as we go forward.

Let's see if I can turn the page. On the basis of that experience, I would recommend that the Fed's credit policy responsibilities, vis-a-vis the fiscal authorities, be clarified explicitly and narrowed so as to avert a mishandling of the boundary in the future.

Fed credit policy worked successfully on a massive scale, as Doug said, in the fall of 2008 by reintermediating banking and money markets. The Fed sold Treasury Securities from its portfolio, and it is no longer willing to lend to money markets. And the Fed loaned the proceeds from its sale of Treasuries to entities no longer able to borrow at reasonable rates, if at all, in money markets.

While quickly reducing short-term interest rates to near zero, the Fed employed its monetary policy powers mainly to create reserves with which to fund credit policy.

Crucially, the reintermediation powers of Fed credit policy involve fiscal policy, lending to particular private entities, whether financed by sales of Treasuries against future taxes or financed by the creation of reserve money.

Unfortunately, the Fed's very independence, the ambiguous boundary of expansive Fed credit policy, would help trigger the financial crisis of September 2008 and produce the Great Recession, a story that I will tell in the remaining time I have.

Paul Volcker alluded to the problem in an April 2008 speech to the Economic Club of New York, where he described the Fed as having acted at the very edge of its lawful and implied powers when, in March, the Fed employed credit policy to facilitate the acquisition of Bear Stearns by JPMorgan Chase (JPMC).

In retrospect, Volcker's remarks can be seen as a life preserver to help the Fed persuade Congress at that point to make fiscal resources available, if need be, to stabilize financial markets. Instead, the fiscal authorities were not then so involved, and the Fed remained exposed to having its balance sheet utilized, in my term, as an off-budget arm of fiscal policy without formal authorization by Congress.

The problem is this: The Fed credit policy cannot be the front line of fiscal support for the financial system. A Fed credit policy decision that commits taxpayer resources in support or one that de-

nies taxpayer resources is an inherently highly charged political fiscal policy matter.

Initiatives that extend the Fed's credit reach in scale, maturity, eligible collateral, or to unsupervised or potentially insolvent institutions inevitably carry credit risks, incite questions of fairness, and potentially threaten conflict between the Fed and the fiscal authorities, with the potential to destabilize financial markets and employment.

Worse, an ambiguous boundary of expansive Fed credit policy initiatives creates expectations of Fed accommodation in financial crises, which blunts the incentive of private entities to take preventive measures beforehand to shrink their counterparty risk or their reliance on short-term finance and build up financial capital. Events surrounding the Fed's rescue of AIG in the fall of 2008 illustrate the problem.

On September 16th, the Fed chose to lend $85 billion on equity collateral to rescue AIG in order to make AIG's counterparties whole rather than risk worldwide collapse. The politics were such that prominent Members of Congress criticized the Fed's credit policy as overreach and a questionable commitment of taxpayer funds. And the Fed, under Chairman Bernanke, replied the next day that it was stretched and could do no more.

The U.S. Government appeared paralyzed. A run on money market funds was abated only after the U.S. Treasury, on September 19th, guaranteed all money mutual fund assets.

The best evidence of how severe the crisis became was that high-yield spreads over Treasuries then jumped to 16 percentage points and remained elevated for months, well above the 6 percentage point spread that had been their peak since the credit turmoil began.

How did all this result in the Great Recession? Well, the ensuing chaos got the public's attention. The paralysis of government, the conflict between the Fed and the Congress, on the boundary of fiscal policy, frightened the public.

Prudence demanded more saving. Households around the country, on average, saved 5 cents more of every dollar they would have spent in the next 3 months. The national household saving rate jumped by 5 percentage points. In macroeconomics, that is a disaster. It rarely, if ever, has happened in so short a time period.

The collapse in demand pushed unemployment up sharply from 6 percent to 10 percent in a matter of months. And the relatively mild contraction that had begun in December 2007 became the Great Recession.

[The prepared statement of Dr. Goodfriend can be found on page 38 of the appendix.]

Chairman HENSARLING. The Chair now recognizes Dr. Rivlin for 5 minutes.

STATEMENT OF THE HONORABLE ALICE M. RIVLIN, SENIOR FELLOW, BROOKINGS INSTITUTION

Ms. RIVLIN. Thank you, Mr. Chairman, Mr. Sherman, and members of the committee.

I am really pleased to be here to testify on this very important question, which I interpret as, what economic goals should Americans expect of their central bank?

I don't believe there is a simple answer to this question. We can't tell the Federal Reserve, just control inflation or just maximize employment or just keep the financial system stable.

Americans, quite rightly, have multiple objectives for the performance of their economy, including high employment, low inflation, and financial stability. The job of the Fed and other policymakers is to balance those multiple objectives as well as they can.

And that is not an easy task. It requires analysis and judgment in the face of necessarily uncertain forecasts. But focusing on any single objective would lead to less satisfactory outcomes than we have.

First, we do want the economy to create jobs, preferably good jobs, for almost everyone who wants to work.

Second, we want low inflation, or a fairly stable price level. We should not aim for zero inflation, because that makes it harder for resources to move out of falling demand sectors and risks tipping the economy into deflation. But persistent inflation above moderate rates is really dangerous.

Third, we want to avoid financial crises with the potential to endanger economic activity in a major way. And the recent crisis illustrates how bad that can be.

In general, these goals reinforce each other, but sometimes balancing is necessary. For example, reducing the risk of inflation or financial instability may require slowing growth and job creation.

The economy is extremely complicated, and it is impossible to predict accurately. As my colleagues have pointed out, the Fed's past track record is clearly mixed. Skillful monetary policy deserves some of the credit for the fact that inflation has been quiescent for more than 3 decades, although partial credit goes to fiscal policy, for example, the restrictive fiscal policy of much of the 1990s and an increasingly flexible and competitive economy.

The Fed certainly bears some of the blame, along with many other culprits, public and private, for its failure to spot the dangers of the deteriorating lending standards that contributed to the housing bubble and inaction in the face of the overleveraged pyramid of housing-related derivatives whose crash brought the world economy to its knees.

This was a house of cards that would have come down somehow. I am not sure that the AIG actions—although I wasn't very enthusiastic about those either—were actually the triggering event.

Once the unnecessary crisis happened, the Fed moved aggressively and imaginatively, in cooperation with the Treasury, to mitigate the economic damage. The Fed and other regulators had inadequate tools at that time. They now have more, thanks to this committee and your counterpart in the Senate, which, if used courageously and intelligently, can reduce the chances of a similar catastrophe.

I believe that the Fed's policy of aggressive and continuous monetary easing, keeping short-term interest rates close to zero and announcing its intention not to raise them without strong signs of recovery, plus substantial ongoing purchases of Treasury and mort-

gage-backed securities has contributed substantially to recovery from the Great Recession.

The question now is, how much accommodation is enough? There are downsides to extremely low interest rates, which discourage saving and may encourage unproductive trading and risk-taking. Moreover, the Fed should not go on increasing its portfolio indefinitely.

So the question is, does the recovery have enough momentum to absorb a gradual tapering of the Fed's asset purchases, followed by a slow reduction of the Fed's portfolio as the assets mature? This is a judgment call, and people will differ.

But to come back to the mandate, it seems to me that the drafters of the multiple statutes that define the Fed's responsibilities did a good job of encapsulating the major objectives which Fed policymakers should have in mind as they decide on specific policy moves.

I think it would be risky and unfortunate to change the basic mandates under which the Fed operates, although there is plenty to talk about in your series of hearings.

Thank you.

[The prepared statement of Dr. Rivlin can be found on page 65 of the appendix.]

Chairman HENSARLING. The Chair now recognizes Ms. Peirce for 5 minutes.

STATEMENT OF HESTER PEIRCE, SENIOR RESEARCH FELLOW, MERCATUS CENTER, GEORGE MASON UNIVERSITY

Ms. PEIRCE. Chairman Hensarling, Congressman Sherman, and members of the committee, thanks for the opportunity to be part of your centennial look at the Fed. Although the Federal Reserve is turning 100, it has the regulatory appetite of a teenager, and that is what I am here to talk about today. So I would like to talk specifically about some of the new regulatory authorities they have, a little bit about the Volcker Rule, and then, finally, about economic analysis.

Coming out of the crisis, it was not clear that the Fed would get more regulatory power. In fact, there was talk about taking some of their powers away.

But persistent presence during deliberations paid off for the Fed, and they came out with new powers. That included getting new entities that they would oversee. Savings and loan holding companies are one example, certain designated financial market utilities, which are the plumbing of the financial system are another example, and then, of course, systemically important financial institutions.

So we have seen already some of the non-bank systemically important financial institutions have been named and handed over to the Fed for regulation, and that is definitely an area to keep an eye on. The Fed tends to look at the world through a bank-centric lens. It is not clear whether they will be able to realize that these entities are not banks and really can't be regulated as if they were.

Another area in which the Fed got new powers is a little more subtle. They now have a regulatory mandate to consider financial

stability. That is really a very nebulous term, and it gives the Fed quite a bit of discretion in how they will interpret it.

The Fed does not seem satisfied with the regulatory power it has. It has been making noises, Fed Governors and officials have been talking about unregulated areas, or areas they perceive not to be regulated enough in the market, and sort of implicit in that is, they are saying, hey, if you are looking for a regulator, you can look at us.

And so, that includes money market funds. They have been very active in the debate, and quite critical of the Securities and Exchange Commission and its proposals for reforming money market funds. They are also very interested in the short-term financing market.

As was mentioned this week, the Fed, along with four other regulators, finalized the Volcker Rule. The motive for this rule was certainly a good one: protecting taxpayers. It is being done through limiting proprietary trading and relationships with private funds like hedge funds.

Unfortunately, the implementation is quite difficult, and we don't know the full ramifications. A thousand new pages of regulatory text came out this week, and so that will take some time to absorb and figure out what was done.

But there are a couple of things that are really clear. One is that by setting up this massive compliance operation—and it is a massive compliance operation not only for the banking entities that are affected, but also for regulators—we are going to be having folks concentrate on this ambiguous line that the regulation sets up about prohibited proprietary trading versus hedging and market-making, which are allowed to some degree.

And so, you are going to have people spending a lot of resources trying to make sure they are on the right side of that line. Meanwhile, we could have risks over here that are real risks to the banks and financial systems that are completely not paid attention to because so much effort and energy is being spent on Volcker Rule compliance.

Banks will be limited in their ability to hedge their own risks, so that is another area of concern. And then there is very much uncertainty about the effect on market-making, which is really an important function in our markets. It is a function that makes securities trade, ensures that there is a buyer for every seller and a seller for every buyer. So, it is really an area that we want to be careful to protect.

One of the reasons that the Volcker Rule was so poorly done is because of the lack of analysis. There was no thorough, comprehensive economic analysis. And I think this was an area where the Fed really could have taken a leadership position. It is an agency that is rare in the sense that it is not run by lawyers like me. It is run by economists. And so, they didn't take that opportunity, and actually that is not that rare for the Fed. It has a really spotty record on economic analysis.

It is an independent regulatory agency, which means that it is not covered by Presidential Executive Orders requiring economic analysis. But interestingly, in 1979 the Fed put out a policy statement which was basically an endorsement of good regulation. And

included in that was really the importance of bringing in public participation, but also required for every rulemaking a regulatory impact analysis, which would include a look at what is the problem we are trying to solve, what are the options for solving it, and then what are the costs and benefits of those different options, trying to make sure that the costs are proportional to the benefit. Unfortunately, we ended up with a Fed that has this policy, but doesn't actually abide by it.

So just in closing, I think there are a number of things you should consider in your 100-year look: first, does the Fed need a statutory mandate to do economic analysis to make sure that it is disciplined about that; second, you should hold its feet to the fire in the way it exercises its new regulatory authority to make sure that they are doing that in an accountable fashion and a transparent fashion; and third, I think it is important to look at whether the Fed has too much regulatory authority, especially because its main job is monetary policy, and is all this regulatory authority distracting it from that?

Thank you very much.

[The prepared statement of Ms. Peirce can be found on page 59 of the appendix.]

Chairman HENSARLING. Thank you to the panelists for their testimony.

Due to the rescheduling of this hearing, one of our original witnesses, Alex Pollock of the American Enterprise Institute, could not be here today. I ask unanimous consent to make his written statement a part of the record. Without objection, it is so ordered.

[The prepared statement of Mr. Pollock can be found on page 68 of the appendix.]

The Chair now yields himself 5 minutes for questioning.

I believe it was last year, Dr. Rivlin, you appeared before our Monetary Policy Subcommittee, and you testified in that hearing that you believed the dual mandate is "consistent with the principles enshrined in Dr. Taylor's famous rule." Do you still believe that? And if so, could you elaborate?

Ms. RIVLIN. Yes, definitely. I think the dual mandate is nicely illustrated by the Taylor Rule, which actually says if the economy is growing faster than its potential, the Fed should look to raising interest rates. And if it is growing below potential, it shouldn't. That is a very loose translation, but that is what I get out of the Taylor Rule. And John Taylor himself, who was at that hearing, has been critical of the Fed for not raising rates faster early in the last decade.

Chairman HENSARLING. Some argue that the multiple mandates of the Fed should be narrowed. Others, I believe, perhaps believe there are others that should be expanded. So hypothetically, what if the Fed had another mandate in the conduct of monetary policy, and in some form or fashion, some iteration was mandated to abide by the Taylor Rule? How would you see that implemented? Would you advocate that policy? Would you not advocate that policy?

Ms. RIVLIN. No, I am not a rules person. In the first place, there are quite a few versions of the Taylor Rule. And when I was at the Fed, the staff used to provide us with multiple versions for our edi-

fication. But my general point is I think that you can't encapsulate anything as complicated as the economy in a simple equation.

Chairman HENSARLING. Let me follow up on a comment Ms. Peirce had, and if we are looking at potentially increasing mandates on the Fed, you said, Dr. Rivlin, in your testimony—I am not sure if this is an exact quote—that the Fed has to balance multiple objectives as best they can. I know that the SEC and the CFTC as they are balancing multiple objectives, and they are subject to statutory cost-benefit analysis. The Fed is not. Should they be?

Ms. RIVLIN. Oh, I agree with Ms. Peirce that they ought to do more analysis of almost anything. Economists think that way. But, no, I wouldn't put—it depends what you mean. I would encourage them to do analysis, but I wouldn't say that there is any way to quantify exactly the costs and benefits of any particular monetary policy. And trying to do that would be more trouble than it is worth.

Chairman HENSARLING. I think I will go in a different direction now. In viewing the multiple mandates of the Fed, looking at the Humphrey-Hawkins mandate, specifically the full employment mandate, which obviously should be the objective of the government as a whole, as most economists would define full employment still being commensurate with roughly 4 percent to 5 percent unemployment as people transition through.

But if the Federal Reserve's—I believe everybody still believes its principal mandate is that of classic monetary policy—full employment mandate is that critical, should the FDIC have a full employment mandate? Should the CFPB have a full employment mandate? Should the FSOC or the SEC have a full employment mandate? And in the seconds I have remaining, I would be happy to—

Ms. RIVLIN. No, I don't think so. I don't think—the FDIC is a very valuable agency, but I don't think it does anything that influences aggregate employment directly. And the Fed does. So I think it is quite different.

Chairman HENSARLING. I only have 13 seconds left, so I will set a good example and yield back the balance of my time.

The Chair now recognizes the gentleman from California, Mr. Sherman, for 5 minutes.

Mr. SHERMAN. I will point out that the FDIC can discourage, in effect, loans to small business. All of us here are besieged by people who want to start or expand a business and aren't able to get a loan. And all of those arguments are made on the basis of employment.

I think the chairman illustrated well an odd paradox. And that is in every other area, to be a really staunch Republican means you have to be in favor of cost-benefit analysis. We have had at least a dozen votes on the Floor about whether to require cost-benefit analysis for this agency or that agency. They are anxious to say an environmental regulator shouldn't just look at how much cleaner the air can be, but what effect is that going to have on the cost to the economy?

And the dual mandate of the Fed is, in effect, a required cost-benefit analysis. The benefit or hoped for benefit of any easing is to provide additional employment. The cost is an increase at least in the risk of some undesirable inflation. Likewise, tightening the

risk is the possibility that unemployment will go up and the benefit is, hopefully, a reduction in the risk of inflation.

So I think what we should do with the dual mandate is rephrase it as a cost-benefit analysis. That is to say, every time you are seeking to reduce inflation, look also at the cost to employment and vice versa. And I think that a 100-year-old agency should modify its lingo to meet current political needs, which is to say I think we should have a dual mandate, and I am happy to rename it a cost-benefit analysis or a trip to Disneyland or whatever other name we want to put on it.

Mr. Goodfriend, you spoke of the AIG bailout in such glowing terms that you disparage those who would even criticize it. That was done, I believe, under Section 13(3) of the Federal Reserve Act, which allows—at that time, allowed unlimited loans by the Fed. Now, there is a provision that we added in Dodd-Frank which says you can do that for general economic effect, but you cannot make loans under Section 13(3) for the purpose of propping up, say, a company named AIG.

Should the Federal Reserve have unlimited authority to use unlimited funds, well above $85 billion perhaps, for the purpose of bailing out the creditors of a particular financial actor?

Mr. GOODFRIEND. No, clearly not. My point there was that those—that giving the Fed the latitude, the independent latitude to use its balance sheet to make credit available to private entities by any means is not a good policy, because the boundaries are not clarified between what the Fed can do and what the Congress can do. Ultimately—and I said this long before—the Fed will be drawn into situations where it will overreach, and the Congress for political reasons will have to say, "No, no, that is a mistake."

And when the public sees the Congress and the Fed at odds in crisis, that creates an increase in the saving rate, which is a disaster for employment. So my point was about—

Mr. SHERMAN. I want to sneak in one more question for the panel, and that is, nobody is proposing to put the Open Market Committee on C–SPAN. Thank God the Democratic caucus is not on C–SPAN. But what harm would be done to have an audit and continuing audits by the GAO of the Fed? Does anybody have an answer? Ms. Rivlin?

Ms. RIVLIN. In the first place, in the usual sense of audit, the Fed's books are audited. That is clear, and I don't think the public always understands that.

What this other use of the term audit is—I think sort of an independent study to second-guess them on monetary policy. And there are lots of those, actually, that are done. I am not sure commissioning the GAO to be the official kibitzer on Fed policy is particularly useful.

Mr. SHERMAN. And should we somehow exclude the international transactions of the Fed or are those the ones we most want to report about?

Ms. RIVLIN. We should know about international transactions as we should know about all kinds of transactions.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from California, Mr. Campbell, the chairman of the Monetary Policy and Trade Subcommittee.

Mr. CAMPBELL. Thank you, Mr. Chairman.

I am going to kind of follow up where the chairman left off, but do so in a very open-ended manner. We talked about the three mandates, if you will—the maximum employment, stable prices, and moderate long-term interest rates. So, I am going to ask each of you, and we can start with you, Dr. Holtz-Eakin, about those mandates.

Would you support, or if you were king of the forest, would you add to those mandates, reduce from those mandates, or make a modification or amendment or rule or whatever with any of those mandates?

Mr. HOLTZ-EAKIN. I would not add; I would subtract. Certainly, I would like to see far more of a rules-based approach by the Federal Reserve. That doesn't rule out discretion, because they can pick the rule they want to operate.

But if they can provide it to the Congress, and the American people will know what they are up to, they themselves have said forward guidance is crucial. We need to know what they are going to do. Rules provide that.

So, I think there is a much stronger case to be made for that. And then the question becomes, what do you put in such a rule of monetary policy. And I think there is a case to be made for a single mandate focusing on price stability. It has been done in the other central banks.

There is a lot of research to suggest that it produces good employment outcomes, and that is what we want, in the end. And so, I think those are all issues that are very, very sensible things to discuss.

Mr. CAMPBELL. I am going to change my order just a little bit because you advocate a rule. Dr. Rivlin said she is not a rules person. She said that—and I am putting words in her mouth—that you can't simplify or boil this down to a single rule or rules. How do you respond to that? And then, I will ask Dr. Rivlin to respond to his suggestion.

Mr. HOLTZ-EAKIN. Rules can be very complicated. And they don't have to be simple. You don't have to simplify the economy. You can have very complex decision-making.

But you can be clear about it. And I think, for example, a way that the Fed could avoid this issue of auditing is it could say, "Here are the benefits and costs of what we are trying to do." It could do the economic analysis and essentially provide an evaluation of its rule so that you can see what it is trying to do. That is very valuable.

Mr. CAMPBELL. Okay, Dr. Rivlin, I probably butchered what you said, but this is your chance to respond, agree, disagree.

Ms. RIVLIN. I think the Fed should be very clear about its objectives. It should be clear about how it is trying to get there, and if it wants to have a mandate—have a rule like we are trying to keep inflation around 2 percent, that is just fine.

But what I meant was I just don't think that you can put into a single equation and keep following it. An exact rule for anything is complicated, as is the U.S. economy.

Mr. CAMPBELL. So what about the three mandates as they stand?

Ms. RIVLIN. I would leave the three mandates as loosely stated as they are, but urge the Fed to be more specific about its objectives and its policies.

Mr. CAMPBELL. Okay. Professor Goodfriend?

Mr. GOODFRIEND. Two of the three mandates actually are achieved with one stone. Low inflation keeps long-term interest rates low. High inflation is probably the most important factor in raising long-term interest rates.

Fear of inflation, even without actual inflation, is probably the most important in moving long-term rates up. So I will take—low inflation should be a priority because it achieves the first mandate and the third mandate.

What I would say about the second one, employment, is that inflation should get the priority even in the short run. And only if employment proves to be something that the Fed can deal with in the short run in a way that is commensurate with confident, stable inflation, should monetary actions be undertaken to stimulate employment.

The Taylor Rule is a pretty good compromise, I would say. And I think the Taylor Rule would, in any case, serve as a great benchmark against which the Fed should be judged.

Mr. CAMPBELL. Ms. Peirce?

Ms. PEIRCE. As a non-economist, I try to stay pretty far away from monetary policy. But I do think, just as a general matter, it is good to have people concentrate on the thing that they are really able to achieve. And I don't think that is employment for the Fed.

Mr. CAMPBELL. Okay. I will set a good example, and I will yield back the balance of my time, as well.

Chairman HENSARLING. The Chair now recognizes the gentleman from Connecticut, Mr. Himes, for 5 minutes.

Mr. HIMES. Thank you, Mr. Chairman. I really do want to thank you for holding these hearings. I think the hearings that we have had, these are some of the more intellectually and analytically interesting. They are not necessarily partisan, as the discussion is playing out today, but they really are critical.

One of the panelists—and, by the way, thank you all for being here and for your patience—explicitly said that the Federal Reserve's activities in the face of the financial crisis were essential. And I got the sense from, at least most of the panel, that there is general agreement on that.

Those authorities, of course, then, were I think looked on somewhat askance by this Congress. And there are all sorts of proposals to limit those authorities, even though I think most of us would agree that they were, in fact, essential to helping pull us out of the nosedive of 2008, very, very interesting issues.

For what it is worth, Mr. Chairman, my own view is that we as a Congress have a responsibility to conduct oversight. But history would show, and country after country would show, that if we compromised the independence of the monetary authorities, we would be eroding one of the real cornerstones of American economic sta-

bility and growth. The prospect of monetary policy subjected to the tender mercies of the House of Representatives horrifies me, frankly.

I would like to actually take up Dr. Peirce on some of her comments on the Volcker Rule. I have been thinking about it and following the Volcker Rule very closely for some time now. You are very critical of the Volcker Rule. I am not, not because I necessarily think it is a great rule, but simply just that I have never been able to quite figure out an alternative.

You suggest that perhaps better market discipline would work, by which I assume you mean incentives, supply-demand, clear price signals, and that if shareholders and creditors could evaluate proprietary risks taken, that perhaps that would be a better alternative to the Volcker Rule. That is sort of the core of your argument.

I would really like to explore that with you, because it is not at all clear that in a system where a bank comes to believe that they can take big bets, and that if those bets go wrong, they will be able to go to the window, they will be able to rely on Federal support, that the incentives are anything other than to take large and irresponsible bets.

I would also point out that, having worked in a financial institution, credit and exposure changes hour by hour, and it is reported to shareholders, at best, quarter by quarter, and frankly, even on an annual basis, the information is pretty opaque. So I am wondering if you really think that given all of those limitations and incentives, there is a market-based approach to reducing proprietary risk in contrast to the Volcker Rule?

Ms. PEIRCE. I do. I agree with you that we need to make some changes to get there, but I think that the market is actually more capable of monitoring these types of things than regulators who are limited in the amount of information they have.

Mr. HIMES. But surely the market gets a lot less information on day to day and quarter to quarter and even annual risk positions than the regulators do and can.

Ms. PEIRCE. Yes, but I think if you have a market where the incentives are correct so that the shareholders and the creditors know that not only are they going to lose money when something bad happens, but potentially even—in the case of shareholders—be asked to fork over more money, I think then they have a real incentive. And I think incentives are what make people good monitors.

That doesn't mean that they are going to be able to be in the institution and know moment by moment how the credit risks are changing. What it does mean is that they have to put people in place managing those institutions who are going to be on top of that. And when they see a failure, they have to make the call of whether they want to get rid of those people.

Mr. HIMES. Okay. Long topic, but I have one other question, and I hope you can help me with this. I have thought a lot about cost-benefit analysis—economic analysis as well, too. As we think about the costs of regulation, they are pretty clear. And the cost of compliance with the Volcker Rule will be meaningful. We can get pretty close on what those costs are, pretty specific.

The benefits, of course, have to include the avoidance of the kind of catastrophe that we saw in 2008, $17 trillion in eliminated asset value at its trough, I guess. And we didn't know if it was going to be $34 trillion or a hundred—who knew? Who knew?

How do we factor in the benefits, which I assume are mainly the avoidance of that sort of catastrophe. How do we factor in the timing and magnitude and probability of those costs avoided, i.e., benefits?

Ms. PEIRCE. You do have to take that into account. But unfortunately, what usually happens when people have these discussions is they say, "Look, the financial crisis was terrible, and so, any rule we put in place is good." But then you have to link it back and say, "Okay, would this rule actually have helped?" And in the case of the Volcker Rule, proprietary trading really wasn't at the root of the last crisis.

Now, it could be at the root of a future crisis. But the question that you have to ask is, what will this rule actually prohibit? And it may not be that it would prohibit something really terrible. It may be that there is an option that would be cheaper but that would achieve a better result and do it more effectively.

Mr. HIMES. Thank you.

Thank you, Mr. Chairman. I did not set a good example.

Chairman HENSARLING. No, the gentleman from Connecticut did not.

The Chair now recognizes the gentleman from Michigan, Mr. Huizenga, the vice chairman of the Monetary Policy and Trade Subcommittee.

Mr. HUIZENGA. Thank you, Mr. Chairman. And I don't have a track record of setting a good example either, but I am trying to work through that.

Sort of continuing on where my friend, Mr. Himes, was going, Ms. Peirce, you had said that accountability with the new responsibility was one of the things that you believe ought to be held up for the Fed by us.

And I guess the question, sort of a rhetorical question is—maybe not a rhetorical question, but the question you kind of posed—does it have too much regulatory responsibility, is sort of what I heard. I just want to confirm that is sort of where you are at, and then I would like the rest to sort of comment on that. Are we in waters that the Fed should be in, and has the capability to handle?

Ms. PEIRCE. I absolutely believe they have too much regulatory responsibility right now.

Mr. HUIZENGA. Okay. Dr. Rivlin?

Ms. RIVLIN. I was very skeptical of giving the Fed as much microprudential regulatory authority as it has, because I thought that would detract from the concentration on these other mandates, which I believe are really important, including the financial stability. I actually favored the Dodd version of Dodd-Frank, which would have—

Mr. HUIZENGA. He is looking down at—

Ms. RIVLIN. —created a central regulatory agency, not the Fed. But we didn't do that.

Mr. HUIZENGA. Didn't they attempt to do that basically with the CFPB?

Ms. RIVLIN. Pardon me?

Mr. HUIZENGA. Didn't they basically try to do that with the CFPB, at least in some part, and then fund it through the Fed?

Ms. RIVLIN. No, that is only consumer regulation, which I also thought was a good thing to do. I wouldn't have funded it through the Fed. But we needed an agency directed to consumer product regulation.

Mr. HUIZENGA. Professor Goodfriend?

Mr. GOODFRIEND. I feel that the Fed's problem is the problem of regulation in general in the finance area. Regulation is trying to do the impossible. It is trying to compensate for inordinately low capital minimums.

I would be happiest if capital minimums were raised by Congress so as to remove some of the regulatory burden for safety and soundness in the first place. I feel like trying to substitute for excessively low capital minimums with regulation policy is not going to work, and it is a dead end.

And I think the Fed should ultimately be doing less regulatory policy and enforcing through Congress' will higher, much higher capital requirements on banks.

Mr. HUIZENGA. Dr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. I want to echo my colleague, Alice Rivlin's, thought. I think that it was a mistake to have more of the microprudential regulation.

I am even less enthusiastic about the Volcker Rule than is Ms. Peirce. I think it is a big misstep.

And I want to echo what I said in my opening remarks. I do not believe the Fed should be involved, and I don't believe the Financial Stability Oversight Council will be successful, in this macroprudential effort to control systemic risks. And I would take it out of that exercise, as well.

Mr. HUIZENGA. Okay. In my last minute-and-a-half, quantitative easing and the necessity of it. Do you all agree that it was a necessary step? Does anybody not agree?

Mr. HOLTZ-EAKIN. It depends which one you are talking about. I believe—

Mr. HUIZENGA. One, two, three, or—

Mr. HOLTZ-EAKIN. No, I think the Fed, its initial response is to be applauded. It moved from a very mistaken institution-by-institution approach to opening liquidity to vast pieces of the financial markets. That was exactly the right thing to do. Since then, everything else has been a policy error.

Mr. HUIZENGA. It seems to me we might be caught in a catch-22 at this point, because markets are going to react as they have somewhat. But moving on, how do others around the world view our QE stance, positively, negatively?

Mr. GOODFRIEND. So I think what you see around the world is countries feel like they are kind of being whipsawed back and forth by the talk of QE or not QE in the United States. And I regard that as simply what markets are saying, the Fed is trying to run an excessively discretionary policy with respect to QE.

And so it is impossible—whether it is foreign governments to plan, or U.S. businesses or financial participants to plan, because the Fed refuses to specify anything about the glide path where QE

is going. Again, it comes back to the benefit of rules from the Fed. But one of the benefits is letting other countries, letting other businesses, plan for the future.

Mr. HUIZENGA. And can we possibly be critical of other countries trying to essentially do the same thing? I see a shaking of a head, but—

Mr. HOLTZ-EAKIN. No.

Mr. HUIZENGA. I assume there is consensus on that?

Mr. GOODFRIEND. If you are talking about Japan, there is a difference. Japan has deflation. I am for price stability. If a country has outright deflation, then I think you can make a case for stimulative monetary policy. The United States does not and is nowhere near that.

Mr. HUIZENGA. Thank you. I yield back.

Chairman HENSARLING. The nodding of a head goes with the tapping of a gavel.

The Chair now recognizes the gentleman from Delaware, Mr. Carney, for 5 minutes.

Mr. CARNEY. Thank you, Mr. Chairman. I want to second the comments of my colleague from Connecticut, Mr. Himes, and thank you for having these hearings, and for this, I think you said yearlong process. I find it very educational, and very good for me as a relatively new Member. I want to thank all the panelists for being here and bringing your expertise.

I have a lot of questions and very little time. So maybe what I should do is go kind of to the end. The chairman, in his opening remarks, envisioned a process where we would have these reviews. We have actually had another hearing where it was the international central bankers' perspective. And we heard a lot from that panel, a very good panel, very good information, what we are hearing today.

And they basically said that Congress should set the mandate, set the goals, kind of get out of the way, monitor the Fed's actions to those goals, and make adjustments periodically. The chairman envisions the legislation.

How would you change the mandate that the Fed has now? You have addressed this, each of you, I think a little bit. But could you say it simply stated as well for me?

Mr. HOLTZ-EAKIN. I personally would narrow its scope toward a greater focus on monetary policy. I think some of these other activities are a distraction to the Fed, and it is not going to do them very well. And within monetary policy, I want to echo the—you get two of those mandates with one by taking care of inflation. I, for one, believe that inflation should be the primary objective of the Fed. As I said, you can make a case for a single mandate, a price stability mandate. I am not religious about it, but I certainly think that the more clarity the Fed gives to how it is pursuing its mandate, the better off everyone will be.

Mr. GOODFRIEND. I would follow up on that by reiterating the point that you get two goals for the price of one by putting inflation first. I want to add something to that, also.

You not only get low interest rates in the long term, you not only get stable inflation, but if you look back at the history of unemployment fluctuations in the post-World War II period, before Paul

Volcker stabilized inflation, they were literally the result of the Fed putting a priority on unemployment first, and then allowing the inflation rate to get out of control, and then creating recessions, one after the other. This was called go-and-stop policy. So you get even benefits for unemployment by putting a focus on—you get three-for-one, actually.

Mr. CARNEY. So—right, so does the Taylor Rule mitigate against that effect?

Mr. GOODFRIEND. Pardon me?

Mr. CARNEY. The Taylor Rule?

Mr. GOODFRIEND. The Taylor Rule is a way to simplify, putting a priority on inflation, but allowing some room for responding to fluctuations in output relative to—

Mr. CARNEY. So it does give some nod, if you will, to employment? And you said—I think you said earlier that you thought it was a good compromise?

Mr. GOODFRIEND. Yes. The Taylor Rule is a very good benchmark against which central bankers should judge their own actions and against which they should be judged by legislative oversight.

Mr. CARNEY. Ms. Rivlin?

Ms. RIVLIN. I would leave the mandates alone, at least the three we have been talking about: low inflation; maximum employment; and financial stability. It is certainly possible to fold the employment goal into an inflation target, if you recognize the deflation is a bad thing and the Fed should move in both directions.

But right now, when inflation is not anywhere on the horizon, and unemployment is high, for the Congress to suddenly say, "We don't want you to care about unemployment. We want you only to concentrate on inflation," I think the average citizen would say, "Huh? What are they thinking?"

Mr. CARNEY. I think that is part of the problem. In some ways, it is a political problem. Most people understand what employment is. They don't always understand what inflation is, and what causes it, and the relationship.

So if you are talking about just inflation, deflation, price stability, you get—but if you talk about employment, and at least as part of the conversation, then from our perspective, representing the constituents that we do, there is a balance there.

Dr. Holtz-Eakin, you are jumping out of your chair.

Mr. HOLTZ-EAKIN. I agree with everything you said, but I just want to point out something, that if you are very clear about how this would work, it would be about inflation expectations. What are people expecting in inflation?

And in the current situation, the fear of deflation, expectations of price falling, would cause people to move aggressively in exactly the way that Dr. Rivlin wants them to.

Mr. CARNEY. Thanks very much. If I had more time, Ms. Peirce, I would ask you about the alternative to the Volcker Rule. But I don't. Thank you.

Ms. PEIRCE. We can talk offline, if you like.

Mr. CARNEY. I yield back. Thank you.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Ohio, Mr. Stivers, for 5 minutes.

Mr. STIVERS. Thank you, Mr. Chairman. I would like to thank all of the witnesses for being here. And I am going to go ahead and continue on with the line of questioning from the gentleman from Delaware.

What do folks on the panel think would be an alternative approach to the Volcker Rule that would work better, or is there one?

Mr. HOLTZ-EAKIN. I first want to say that I do not believe that proprietary trading had anything to do with the crisis. And for that reason, I would not have pursued something of the type of the Volcker rule. So I think it is a misguided enterprise at the outset.

If you are deeply concerned about the notion that depositors' funds, which are backed by taxpayers' deposit insurance, are being used for an inappropriate purpose, then the answer is to create narrow banks that have the sole function of taking deposits and then use them to invest only in something like Treasuries. Those entities thus are very safe and are not going to cost the taxpayer anything. And the remainder of the financial institutions, labeled whatever you want, are not narrow banks, and they can go do what they want.

Mr. STIVERS. Let's go ahead and let everybody opine on that if you have an opinion.

Mr. GOODFRIEND. To go back to my testimony, I don't believe that the crisis had, at its core, the issues that proprietary trading had to do with, so I completely agree with Doug.

I think what we should be focusing on is, as I said in my testimony, excessive expansiveness of the Fed's willingness to supply credit in crises, which I think had much to do with exacerbating the crisis as it occurred in 2008, especially when the Fed ran into conflict with the Treasury.

Once the government looked paralyzed, we really, in my opinion, got the worst of it. Before that time, the Fed had been handling things, and we were in a mild recession with some difficult deflation of house prices. But once the public saw that the government was at odds with itself, that, in my opinion, caused the great panic, the rise in the saving rate and so forth. And that is, above all, what we should avoid going forward.

So rather than focusing on the Volcker Rule, I would focus on the boundary of the Fed's credit policy powers vis-a-vis the fiscal authorities, so that there can be some prearranged agreement on how to handle crises.

Ms. RIVLIN. I don't think the Volcker Rule is a particularly promising avenue for controlling the real problem, which is excessive risk-taking and bubbles of the sort that we had.

The things that are actually prominent in the Dodd-Frank Act, allowing the Fed together with other regulators to raise the capital requirements and to control excessive leverage, are much more important as general tools, as is the resolution authority to avoid having to have a big institution fail in a disruptive way. So, I would concentrate on those.

Ms. PEIRCE. I think it is important to recognize that lending also can be quite risky, so it is not proprietary trading that should be the target specifically. But it should be putting in measures to make sure the market is watching.

And you can do that through contingent capital. You can do it through having shareholders face—taking away their limited liability, so that they actually have to pay in if there is a problem. There are some creative ways to do that. And, of course, higher capital requirements would be effective at this, too.

Mr. STIVERS. Do any of you—and several of you volunteered in your answers—believe that proprietary trading in any way caused the financial crisis in 2008 and 2009?

Ms. RIVLIN. No, but I think it can be a problem for commercial banks, if it gets out of hand.

Mr. STIVERS. If it got out of hand. That is fair. And I would want to follow up on a couple of things that folks said, because, Dr. Holtz-Eakin, you talked about Treasuries. And under the current Volcker Rule, Treasuries and GSEs are exempt from—they are allowed investments.

But given our mounting national debt and record low interest rates, is it really fair to say—you said they were kind of risk-free. I don't think it is fair to say they are risk-free anymore. They are a lower risk, certainly, than equities.

Mr. HOLTZ-EAKIN. They are. That was just an example of, if you want to have entities that have insured deposits, you can control their portfolios very tightly. And if you are not going to provide insurance, let people trade and invest as they see fit.

Mr. STIVERS. I will yield back the balance of my time. And actually—

Chairman HENSARLING. The gentleman yields back his 2 seconds. [laughter]

The Chair now recognizes the gentlelady from New York, Mrs. Maloney, for 5 minutes.

Mrs. MALONEY. I thank the chairman, the ranking member, and the panelists for being here today.

Although some of you say that proprietary trading was not part of the financial crisis, it has been documented to have been the cause of the London Whale, which caused a loss of $6 billion. That is unquestionable. And some allege, or believe, that the subprime proprietary trading in CDOs, or collateralized debt obligations, was a severe cause of the financial crisis.

But instead of debating it back and forth, we could call for a GAO report on the role that proprietary trading played in the financial crisis and have a legitimate report that comes back to us. I would sponsor such a request. If any Republican would like to join with me, then we could have an independent analysis and research project which would document that.

One of the things I feel we don't have from the financial crisis is what we had after 9/11, and that is a commission that really went in and analyzed in depth and reported on what caused 9/11, with examples, with funding, with staff. That was never done, really, with the financial crisis. It has been many different looks and perspectives, but I think that is worth doing, if my colleagues would like to join in making such a request.

I want to ask—Dr. Rivlin, it is good to see you again. And thank you for your public service. And I thank all of you for your hard work. In your testimony, you said that it is entirely appropriate for the Fed to have multiple mandates, and I agree.

You also said that it is possible but not certain that the Fed's low interest rates in 2003 and 2004 contributed to the bubble that led to the financial crisis. Could you elaborate a little bit on that?

Ms. RIVLIN. Yes. I think there were multiple causes of the financial crisis, and that the principal one was allowing the decline of lending standards, an egregious decline. And I fault all the regulators in not stopping that. But, unquestionably—

Mrs. MALONEY. And then the trading of those, proprietary trading—

Ms. RIVLIN. Later.

Mrs. MALONEY. —of those subprimes—

Ms. RIVLIN. Certainly, there was a whole pyramid of derivatives erected on top of the American housing mortgages, and it was the very overleveraged pyramid that came crashing down. But I think low interest rates always contribute to a bubble. If you can borrow money—

Mrs. MALONEY. I am curious if you would elaborate on how you think the Fed should have balanced its mandates in that situation.

Ms. RIVLIN. I am not—

Mrs. MALONEY. Should they have kept interest rates low to maximize employment, but then adopted stronger bank regulations to protect financial stability? Should they have raised interest rates earlier than they did?

Some are arguing, and in one editorial, even, in The New York Times today, that if you raised interest rates to 3 percent to 4 percent, that would help us in the recovery. And what is your comment on that?

Ms. RIVLIN. I don't think raising interest rates would help the recovery. But to go back to the 2003–2004 period, I think the Fed was in a box then, because it did not have appropriate tools to deal with an asset price bubble, as it did not in the 1990s, when we had the stock market bubble, which was clearly a bubble. I was at the Fed at the time, and we didn't really have the right tools for dealing with that, because raising interest rates at that moment would have damaged—would have slowed the economy drastically. You would have had to raise them very high to affect the bubble. And we didn't do it, and I think we were right.

Mrs. MALONEY. The Fed's unconventional monetary policies during and after the crisis have been extensively debated and commented on today, too. And, obviously, when the Fed adopted many of these policies, they were in clearly uncharted waters.

We can debate whether they should use these policies in a crisis, but do you think the Fed should use unconventional policies only in a crisis? Or should they be willing to adopt new unconventional policies in good times, too?

Ms. RIVLIN. Good times don't challenge the Fed the way a crisis does, so I am not sure exactly what unconventional policies would be appropriate. The main thing is to avoid the crisis. But once you have it, then you have to do everything you can think of to stabilize the situation.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentleman from New Jersey, Mr. Garrett, the chairman of our Capital Markets and GSE Subcommittee.

Mr. GARRETT. Thank you, Mr. Chairman.

And to the gentlelady of New York, that is an interesting idea, as far as a study. So let's just think about—we should probably get together and think about that some more, doing something like that.

Maybe couple it with Ms. Rivlin's comment about the—you were just talking about underwriting standards and the problems in those areas, so there might be—if we are going to ask for something, we might as well ask for a couple of points in—as far as the study goes.

Mrs. MALONEY. I would welcome any opportunity to work in a bipartisan way on this committee. Thank you.

Mr. GARRETT. Great. Thanks.

Earlier today, the committee heard from Secretary Lew to get some answers, or at least we were attempting to get some answers from him. And during that time, I expressed to him my concerns regarding the lack of accountability and transparency that has been part and parcel of, I said, this Administration.

So I want to carry that through here with this discussion and the theme of accountability and transparency, as we examine the broader theme of the Fed.

The gentleman from California has already sort of laid this out, and we agree that the Fed has an awful lot on its plate, and I would argue it has—just as he does, I think—it has too much on its plate. On the monetary side, the Fed must contend, as he said, with the dual mandates. The Fed also maintains responsibility—I will get into those in a minute—on supervising and regulating bank holding companies, providing bank services to deposit institutions and so on. And Dodd-Frank has just added to all that.

Now, with such vast powers, including an independent funding stream outside of the appropriation process, its role as lender of last resort, the Fed, then, should be held to a very, very high bar in terms of accountability and transparency to not only Congress, but also to the American people.

And I am really concerned that the level or lack of level of accountability and transparency at the Fed is disproportionate at this point to its power.

I just have a couple of questions. I am not sure which order I will go in; maybe I will just run down the list this way.

Ms. Peirce, by our count, the Federal Reserve has had only 5 meetings over the last 2 years, 5 open, public meetings over the last 2 years. Considering this expansive power that they have, and it is now as regulator as well, do you think that is an appropriate amount of openness and public meetings?

Ms. PEIRCE. I think that is a really important concern that you raised. They do a lot of their rulemaking behind closed doors.

And as we saw this week with the Volcker open meeting, some really valuable things come out of those open meetings. You get the dialogue between the staff and the Chairman and the other Governors, and that is very helpful.

Mr. GARRETT. I don't have a lot of time. Can I ask you—and anyone else from the panel—after we are done here, to send me any recommendations that you might have on that area, if you would, please?

I will swing down to the other end of the table, and say, you are probably aware that earlier this year, the House passed the SEC Regulatory Accountability Act. This legislation enhances the SEC's existing economic analysis requirements, requiring that it first clearly identify the nature of the problem that would be addressed before issuing any new regulations, and also require economic analysis to be performed by the SEC's Chief Economist.

Under current law, the Fed is not obligated to perform such a cost-benefit analysis. Given its role as—central role in Dodd-Frank, do you think this is appropriate? And if not, what would you recommend?

Mr. HOLTZ-EAKIN. I think the Fed should be required to provide such an analysis. I am cognizant of how difficult this is to do sometimes. This came up earlier in the discussion about quantifying the benefit, but that doesn't mean you shouldn't do it. It tells you, then, if you can quantify the costs exactly, that the benefits have to be at least that big, or it is not worth doing, and you need to know that. So I would ask the Fed to do that on a regular basis.

Mr. GARRETT. Great. We have heard from a lot of community banks that all the regulations under Dodd-Frank are creating a huge problem for them. I will get right to the point here. Over at the OCC, there is something called the community bank ombudsman located within the OCC. In light of all the extra powers now that the Fed has, should we have something akin to a community bank ombudsman within the Fed?

Mr. HOLTZ-EAKIN. I think I would like to have the opportunity to think about that and get back to you. I worry about creating favored constituencies who have their own representative inside the Fed.

Mr. GARRETT. Okay. Yes, sure?

Mr. GOODFRIEND. On cost-benefit, I would like to point out something. The Fed's so-called QE policies today are really what we call in finance a carry trade. Carry trade means you are borrowing very short term to hold long-term securities. That is not a monetary policy. A carry trade is a pure fiscal policy.

So where I would start, if you want to argue that the Fed should be undertaking cost-benefit analyses, I would ask them, well, what do you think are the potential costs or value at risk, so to speak, in the banking business, of a carry trade of the nature that you are carrying on? Then, we can talk about the benefits that you think there are.

Mr. GARRETT. We have tried to get that number from them, yes, but thank you. That is a good point.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from North Carolina, Mr. Pittenger, for 5 minutes.

Mr. PITTENGER. Thank you, Mr. Chairman.

And thank you, panelists, for being here today. It is very good to have heard your responses.

I would like to ask each of you—Chairman Hensarling has shown this debt clock running on either side of the room. I really wanted to get your thoughts on how the policies of the Fed could lead to compounding the problem when it comes to interest rates on the debt. Do you believe when interest rates rise over the coming

years, and the spinning trajectory we are on towards the close of this decade, the interest rate payments, along with the annual deficits, will push America's debt to unsustainable levels, perhaps close to what we are seeing in Europe?

Would you like to start, Mr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. I am already so troubled by the trajectory of the U.S. debt that it will not take higher interest rates to trouble me further. Certainly, we are on an unsustainable trajectory. If we were to get a normalization of interest rates, either quicker or something above what people like the CBO forecast, it is going to put enormous pressures further on the Federal budget. So we are in a dangerous position as a nation, and it should be fixed.

Mr. PITTENGER. How would you fix it? How would you mitigate it?

Mr. HOLTZ-EAKIN. It would be up to the Members of Congress and the Administration to fix the spending problem that emanates from the mandatory spending programs in the budget. That is our problem. That is what we haven't touched. That is what needs to be fixed.

Mr. PITTENGER. As it relates to the interest rates?

Mr. HOLTZ-EAKIN. In the end, we want to pray for higher interest rates. They will, in fact, reveal that the economy is recovering. And so, at all costs, we don't want to avoid higher interest rates. We want them to normalize. And we want the fiscal policies to be put in place that allow us to sustain those higher interest rates without a threat to the stability of the Federal budget.

Mr. PITTENGER. Very good. Thank you.

Mr. Goodfriend?

Mr. GOODFRIEND. I completely agree. I have nothing to add to Doug's comments.

Mr. PITTENGER. Ms. Rivlin?

Ms. RIVLIN. I believe that the trajectory of debt is very worrisome. That doesn't mean that I think we need more austerity now. I think, actually, we need less. But I was very disappointed that the budget deal—which admittedly is a lot better than no budget deal—did not come to grips with the longer-run problem of the debt rising faster than the GDP.

I think that means two big, difficult things. It means entitlement reform, and it means tax reform that will raise more revenues in the long run through a more pro-growth tax system. I served on two commissions, one of them along with the chairman, that explored those issues. I think we can get to a bipartisan agreement on it, and we ought to do it as fast as the Congress can.

Ms. PEIRCE. Again, I am not an economist, but I know we are spending too much.

[laughter]

Mr. PITTENGER. Well said. I concur with that.

Professor Goodfriend, recently I introduced some legislation, H.R. 3240, and it deals with Regulation D as a Study Act. This bill calls for the GAO to take a look at Reg D as it relates to the number of transfers allowed for a given individual, that being six. And working with the Fed, I just wanted to get your take on this bill. If Congress were to eliminate or modify the six-limit transfer under Reg D, would that cause concerns to the Fed?

Mr. GOODFRIEND. I am not aware of what is in the bill. If you can explain it to me a little bit—

Mr. PITTENGER. It is a bill for credit unions. It is really outdated. It is a bill that was—the policy was developed out in the 1980s. And I think through the electronic transfers and other forms of payment, there is a limit to how many transfers can be made. And so, it is a simple bill, and I just wanted to know if you—

Mr. GOODFRIEND. It sounds like there had been a limit on transfers made by credit unions on behalf of their customers—

Mr. PITTENGER. Yes. Yes, there is now.

Mr. GOODFRIEND. Credit unions started out as relatively small collections of people who were allowed to set up banking facilities independent of being commercial banks. And since then, credit unions have gotten huge. They have become very important banking centers.

I think it is time to treat them like banks under the law, and it sounds like your bill would do that. There are different sides of this debate that I am aware of, but I think that credit unions have long since become more and more like banks, and I don't see any reason why they should be treated differently, if that is what this bill is about.

Mr. PITTENGER. Yes, sir. Thank you.

I yield back.

Chairman HENSARLING. The gentleman yields back.

The Chair now recognizes the gentleman from Kentucky, Mr. Barr, for 5 minutes.

Mr. BARR. Thank you, Mr. Chairman. And thanks to the witnesses for being here.

I want to start with Ms. Rivlin, and thank you for your service to the country in many different capacities. I was struck by your testimony just a few minutes ago about your wanting the Congress to resist austerity measures. And just for clarification purposes, the Federal budget, we spent presently, what, $3.7 trillion, is that right?

Ms. RIVLIN. Something like that.

Mr. BARR. And so for the last 5 years, we have had—we have run deficits in excess of $1 trillion for 4 years and close to $700 billion this past year. You are not suggesting that those policy results in any way resemble austerity?

Ms. RIVLIN. I am suggesting now that the deficit has come down quite rapidly, and that puts a drag on the economy, and that cutting discretionary spending as much as the Congress did has retarded recovery. I am glad that part of the sequester was set aside in this agreement. But, yes, I think we do have austerity now.

Mr. BARR. And I noted your favorable comments related to the budget agreement that the Congress will be taking up—the House will be taking up this afternoon. Do I take your testimony to mean that you generally agree with the concept that I think Dr. Holtz-Eakin has advocated pretty vociferously in the past, that replacing, or at least focusing the attention on mandatory spending reforms is where our focus needs to be? And to the extent that the budget agreement today does that, to the extent that we replace some of the sequester with a focus on mandatory spending reforms, are we heading in the right direction, as modestly as we may be?

Ms. RIVLIN. It is modest, but it did not come to grips with the major entitlements or mandatory programs, very modestly with Medicare. But it is the health entitlements over the long run, not immediately, but over the long run, and Social Security, which are driving Federal spending in the future.

Mr. BARR. Thank you.

Dr. Holtz-Eakin, in your testimony, when you talked about the core functions of the Fed—monetary policy, lender of last resort, bank holding supervision and systemic risk management—one thing that the Fed is doing as a result of Dodd-Frank now, which is somewhat unusual, I would argue, is providing the funding for a new agency, the Consumer Financial Protection Bureau. Where in those core functions is—where does this fit?

Mr. HOLTZ-EAKIN. It doesn't. And I don't support that at all. I think that is something that should go through the congressional appropriation and oversight process.

Mr. BARR. Okay. And for all the witnesses, a final question. I have about 2 minutes left in my time.

I wanted you all to comment on the testimony of Chairman Bernanke before this committee earlier this year. And I asked the question about the exit strategy. Obviously, Chairman Bernanke has pursued a very aggressive quantitative easing and accommodative policy. It appears that Ms. Yellen is going to pursue that and continue that policy into the future.

And one thing that we heard from the Fed earlier this summer, and from Chairman Bernanke, was a hint of possible tapering in the event that unemployment comes down to a certain level. And the mere suggestion of tapering resulted in a pretty significant revolt from the market. We saw the 30-year fixed-rate mortgage jump by 42 basis points. The Dow suffered back-to-back declines of more than 200 points. Billions of dollars fled the credit funds after just the hinting of the possibility of tapering.

So my question is—and I asked this question then—how is the Fed going to avoid a catastrophic spike in rates when tapering actually starts? And the chairman's response was, we just have to communicate, we have to be effective in telling the markets what we are doing.

Do you think that is a satisfactory answer? Do you think, given the fact that the Fed's balance sheet is where it is today, is tapering inevitably going to lead to a kind of catastrophic spike in rates that will be very, very damaging to GDP?

Mr. GOODFRIEND. I think that what happened in May was a pulling back on the Fed's tapering to the degree that a lot of the damage has already been done. There might be some reaction in rates. But I think the sooner the better they get on with it. I think there will be a relatively muted reaction. They should just not throw good money after bad, so to speak. And I would start it as soon as possible, especially if the budget deal is done in Congress.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Pennsylvania, Mr. Rothfus, for 5 minutes.

Mr. ROTHFUS. Thank you, Mr. Chairman. And thank you, panel. This has been a very informative discussion this afternoon.

I would like to first talk to Professor Goodfriend. It is always nice to see somebody from Western Pennsylvania, too, and see somebody from the fantastic university up there, Carnegie Mellon University.

Professor, in what ways, if any, do you think the Fed's interventions in financial markets have impaired the efficiency of banking in capital markets?

Mr. GOODFRIEND. I don't want to go over my testimony again, but I think there was a big negative effect in the way the Fed handled its interventions in the crisis. But even now, by intervening in mortgage markets to the tune of $40 billion a month in an ongoing way as part of this QE3, what the Fed is doing is making it very hard for private parties, for private entities to step back into the mortgage market, because what the Fed is doing is keeping the spreads low.

One of the transitions that has to be made at some point is the markets have to become confident that the spreads will be allowed to rise to make it profitable to re-enter. And that is the way the Fed ultimately has to hand off Federal Reserve heavy intervention in these markets back to banking.

And unless the Fed specifies its taper, specifies the extent to which it will go, get out, in a clear way, the markets can't prepare to step in. So, I think the Fed has to come first in this chicken-and-egg problem.

Mr. ROTHFUS. Thank you.

Dr. Holtz-Eakin, Chairman Bernanke has argued that the Federal Reserve's participation in the oversight of banks of all sizes significantly improves its ability to carry out its central banking functions, including making monetary policy. Do you agree with this sentiment?

Mr. HOLTZ-EAKIN. Not entirely. We see other configurations around the world, for example, where we have the central bank not as the primary regulator, and those central banks are able to conduct monetary policy very effectively, so England can do this. And so I am unconvinced that as a matter of structure, it needs to be that way.

The second thing that the Fed argues is that it gives them information that is useful for the conduct of monetary policy. I don't see why that information couldn't be conveyed in an interagency fashion. And so I am certainly open to doing business in other ways, because I think the Fed is overstretched.

Mr. ROTHFUS. Where we sit today, we have an interventionist Fed on the monetary policy side and an interventionist Fed on the regulatory policy side. What are the potential implications and risks for the health of the financial system and the broader economy because of that?

Mr. HOLTZ-EAKIN. My concern with aggressive monetary policies has been essentially that they flunk a benefit-cost test. I am utterly convinced that the Fed can drive investors to riskier asset classes. I am utterly convinced that it has enormous ability to change relative returns to financial markets.

I don't think it has produced any real economic growth. And so I think—or not enough to merit the potential costs in terms of in-

flated asset classes and/or bubbles, and some of them appear to be in the making.

And I worry, as this is all about financial instability coming out of those asset classes, to the larger financial system. I think those costs outweigh the benefits of the policy.

Mr. ROTHFUS. Ms. Rivlin, when asked in October 2008 if Gramm-Leach-Bliley was a mistake, you testified, "I don't think so. I don't think we can go back to a world in which we separate different kinds of financial services and say these lines cannot be crossed. That wasn't working very well. We can't go back to those days. We have to figure out how to go forward."

This week, as you know, the Volcker Rule was promulgated, which does precisely that, a rule that asked some 1,300 questions in the initial proposal, making it effectively a concept release. As a result, the final rule skirted around the notice and comment process.

Given this history and your thoughts back in 2008, wasn't the Volcker Rule misguided and, at a minimum, shouldn't it have been reproposed before final adoption?

Ms. RIVLIN. I don't equate the Volcker Rule with repeal of Gramm-Leach-Bliley or going back to Glass-Steagall, and I still agree with what I said, that we can't do that. We have to figure out how to regulate this complicated situation that we have without reversing it.

As I said earlier, I am not a big enthusiast of the importance of the Volcker Rule. I think other things, such as capital requirements and leverage ratios and other things, are much more important.

Mr. ROTHFUS. I thank the Chair, and I yield back.

Chairman HENSARLING. The time of the gentleman has expired. There are no other Members standing in the queue for questions, so at this point, I would like to thank all of the witnesses for your testimony today, and especially thank you for your patience with rescheduling challenges.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

This hearing stands adjourned.

[Whereupon, at 5:06 p.m., the hearing was adjourned.]

A P P E N D I X

December 12, 2013

Lessons Learned from the Financial Crisis for Federal Reserve Policy

Testimony before the

Committee on Financial Services

U.S. House of Representatives

Washington, D.C.

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December 12, 2013

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I am pleased to be invited to testify before the House Committee on Financial Services on "Re-examining the Federal Reserve's Many Mandates on Its 100-Year Anniversary." My testimony, "Lessons Learned from the Financial Crisis for Federal Reserve Policy," will reconsider the Fed's performance in meeting its mandates in the 2008-9 financial crisis and resulting Great Recession. For the most part, inflation was reasonably stable prior to the crisis and remained so. Hence, I will assess the success or failure of Fed policy with regard to its other two major mandates—financial stability and employment stability. I will emphasize the following six points in my testimony:

1) Fed credit policy (financed with monetary policy) worked well to stabilize short-term credit markets after the full-blown financial crisis erupted in fall and winter 2008-9.
2) However, the ambiguous boundary of expansive Fed credit policy itself triggered the crisis on September 16th when the $85 billion Fed loan to AIG drew criticism from prominent members of Congress as a questionable commitment of taxpayer funds.
3) The public became frightened that neither the Fed nor Congress would offer further effective support for the financial system.
4) The personal saving rate rose sharply by 5 percentage points, collapsed spending, pushed unemployment to 10%; the mild contraction begun in Dec. '07 became the Great Recession.
5) The enormous growth of shadow banking that financed the unstable credit cycle was facilitated, in the first place, by ineffective regulation of banking and money market finance divided between the Fed and the SEC.
6) To better serve the Fed's employment and financial stability mandates I recommend: i) that the boundary of the Fed's credit policy reach be narrowed and clarified and, ii) that the Fed be given authority to make sure that money market rules and regulations preserve monetary stability.

How Fed Credit Policy Differs from Monetary Policy

Briefly, monetary policy refers to the expansion or contraction of currency or bank reserves via Fed purchases or sales of Treasury securities. We think of these operations as monetary policy because—were the Fed to adhere to a Treasuries-only asset acquisition policy as it did prior to the crisis—then when consolidated with the Treasury's balance sheet, the Fed balance sheet would contribute only currency and bank reserves. With short interest rates reduced nearly to zero in fall 2008, monetary policy was employed then only to help finance credit policy.

Fed credit policy involves lending to financial institutions (or the purchase of non-Treasury securities) financed by selling Treasury securities or with the creation of bank reserves. When consolidated with the Treasury's balance sheet, Fed credit policy would contribute loans and purchases of non-Treasury securities as well as reserves, if any, created to fund credit policy. Unlike monetary policy, Fed credit policy involves fiscal policy—lending to particular borrowers—whether financed by sales of Treasuries against future taxes or the creation of reserve (money).

Why Fed Credit Policy Worked in the Financial Crisis

When the full-blown financial crisis erupted in September 2008 for reasons that will be discussed below, Fed credit policy worked successfully on a massive scale to re-intermediate banking and money markets by selling Treasuries to entities no-longer willing to lend in money markets (including in interbank markets) and lending the proceeds to depositories no-longer able to borrow at reasonable rates in money markets, in part, so depositories could refinance their money market clients. By April 2009, the Fed had grown its balance sheet from around $900 billion to over $2 trillion, lending to depositories, to foreign central banks, to a variety of money market credit facilities, and to special purpose entities formed to rescue specific firms such as Bear Stearns and AIG. These Fed credit policy initiatives were financed with around $250 billion sales of Treasury

securities, around $300 billion of funds deposited in the Federal Reserve banks by the Treasury Department, and about $800 billion of bank reserves created by the Fed. Amazingly, prior to the crisis the Fed had supplied only $10 to $20 billion of aggregate reserves to the banking system.

The combination of Fed credit and monetary powers were well-suited to addressing the financial crisis in fall 2008. The Fed made the most of its independence to employ credit and monetary policies on an unimaginable scale. By spring 2009 financial markets were stabilized and the Fed balance sheet was stabilized as well. Unfortunately, there is another side of this story: the Fed's very independence, the ambiguous boundary of expansive Fed credit policy itself, would help trigger the great financial crisis in September 2008 that would produce the Great Recession.

Expansive Fed Credit Policy Helped Trigger the Great Recession

In March 2008 the Fed created and funded a special purpose entity, Maiden Lane LLC, for the purpose of acquiring risky mortgage obligations, derivatives, and hedging products from Bear Stearns to facilitate the acquisition of Bear by JPMC. Maiden Lane was funded by a $29 billion Fed loan and a $1 billion first-loss loan by JPMC. In effect, the Fed purchased the assets in Maiden Lane, with funds from the sale of Treasuries from the Fed portfolio. Since the Fed would have returned to the Treasury interest on the Treasuries it held, the Fed's credit policy support of Maiden Lane amounted to a "debt-financed fiscal policy purchase of pool of risky private financial assets." The Fed acknowledged the loan as fiscal policy by June 2008. Maiden Lane was brought on to the Fed's balance sheet, and the Treasury accepted responsibility for any loss.

Meanwhile, in an April speech to the Economics Club of New York Paul Volcker described the Fed as acting at the "very edge of its lawful and implied powers." In retrospect, Volcker's remarks can be seen as a "life preserver" to help the Fed persuade Congress to make resources available, if need be, to stabilize the financial markets. Instead the fiscal authorities were not then so

involved. And the Fed remained exposed to having its balance sheet utilized as an "off budget" arm of fiscal policy without formal authorization from Congress.

Occasional Fed lending to solvent, supervised depositories on short term, against good collateral is protected against ex post loss and ex ante distortion. Such circumscribed lending deserves a degree of operational independence. However, Fed credit policy cannot be the front line of fiscal support for the financial system. A Fed credit policy decision that commits substantial taxpayer resources in support of the financial system or one that denies taxpayer resources is inherently a highly-charged, political, fiscal policy matter. Initiatives that extend the Fed's credit reach in scale, maturity, and eligible collateral to unsupervised or potentially insolvent institutions inevitably carry credit risk, excite questions of fairness, and potentially threaten conflict between the Fed and the fiscal authorities—with the potential to destabilize financial markets and employment. Worse, an ambiguous boundary of expansive Fed credit policy creates expectations of Fed accommodation in financial crises, which blunt the incentive of private entities to take preventive measures beforehand to shrink their counterparty risk and reliance on short-term finance, and build up financial capital. Events surrounding the Fed's rescue of AIG in fall 2008 illustrate the problem.

On September 7th the GSEs failed and were taken into conservatorship by the U.S. government. On September 15th Lehman failed. On September 16th the Fed chose to lend $85 billion on equity collateral to rescue AIG; this, in order to make AIG's counterparties whole rather than risk world-wide financial collapse. At that point the Fed had no good options left. The politics were such that even prominent members of Congress criticized the Fed's credit policy overreach as a questionable commitment of taxpayer funds. Chairman Bernanke replied on September 17th that the Fed was stretched to the limit and could do no more, and that the time had come for Congress to appropriate financial resources to stabilize the financial system or risk a severe contraction if not

another Great Depression. The U.S. government appeared paralyzed. A run on money market funds on September 17th abated only after the U.S. Treasury made an extraordinary offer on September 19th to guarantee money market mutual fund assets for a year, apparently with backing from the Exchange Stabilization Fund which did not need a Congressional appropriation. The run on money market funds was contained. Congress rejected TARP on September 29th and the DOW dropped 7%. The $700 billion TARP was passed and became law on October 3rd. Equity markets were down over 30% in month to October 10th. Most telling, high-yield spreads over Treasuries jumped to 16 percentage points and remained elevated for months well above the prior 6 percentage-point spread peak reached since the turmoil began in mid-2007.

The public was frightened by the tumult in financial markets, and by the political recriminations, government paralysis, the extraordinary rescue or demise of a variety of financial institutions, and talk of another Great Recession. Out of an understandable degree of prudence, households saved more than otherwise. Unfortunately, the aggregate consequences were devastating for employment. The household saving rate jumped sharply by around 5 percentage points in the ensuing months. Since consumption accounts for over two-thirds of aggregate spending, the collapse in aggregate demand pushed the unemployment rate up sharply to around 10 %. The chaos transformed a relatively mild recession that began in December 2007 into The Great Recession.

Unalloyed flexibility of Fed credit policy, unconstrained by rules or boundaries, proved counterproductive for the stabilization of financial markets and employment in fall 2008. Congress in its oversight role should clarify the boundary of the Fed's responsibilities for taking expansive credit actions and correspondingly restrict its independence in doing so.

The 2010 Dodd-Frank Act recognizes the problem and requires Fed lending extended beyond depositories to be approved by the Treasury Secretary and to be part of a broad program not directed to any particular borrower. The Dodd-Frank requirements do not address the problem

adequately, however, because the Administration is no more authorized to commit taxpayer resources than the independent central bank—only Congress can do so. And the Treasury is as likely as the Fed to favor expansive credit policy in a financial crisis rather than risk immediate financial collapse.

The Fed's Regulatory Authority Should Extend to Money Markets

Financial markets have long had an incentive to employ low interest deposits and money market instruments to finance higher-yielding, less liquid, long term cash flows. Investors will supply loanable funds via deposits and money market instruments at low interest in return for a monetary services (implicit liquidity, convenience) yield. Usually, deposit and money market finance offer a stable aggregate source of long-term finance even as individual deposits and money market instruments change hands frequently. But monetary services everywhere are susceptible to doubt about the quality of assets backing deposits and money market instruments anywhere. Deposits or money market instruments are held at low interest for their monetary services only if the public regards them as perfectly safe without question.

As in the recent credit cycle, money market finance can fuel extreme asset price appreciation, a breakdown in market discipline, and an eventual collapse of asset prices, banks, and money markets. Monetary financing of long-term cash flows is inherently fragile in both theory and practice. The great financial crisis of 1907 that eventually led to the establishment of the Federal Reserve System was precipitated by "trust companies" outside the jurisdiction of the private New York Clearinghouse (which acted before the 1913 advent of the Fed as a private regulator of the commercial banking system). The trust companies of 1907 were the shadow banks of their day. Likewise, the financial crisis of 2007-9 was precipitated by shadow bank finance in money markets outside the jurisdiction of the Federal Reserve.

The problem today is that U.S. regulators play "zone defense" with regard to the regulation of monetary services provided by bank deposits and money markets. The Federal Reserve regulates depositories. The Securities and Exchange Commission (SEC) regulates money markets. The financial services industry takes advantage of "zone regulations" much as a football team adapts its offense to take advantage of a zone defense.

For instance, money market mutual funds have grown enormously since the 1980s in part because securitization and structured finance produced a growing supply of instruments for financing in money markets; but also because regulators allowed depository institutions to guarantee asset backed commercial paper purchased by money funds without requiring that sufficient regulatory capital be set aside against these guarantees. Most importantly, the SEC granted money funds an exemption from mark-to-market accounting, which ordinarily is required for mutual funds operating under the Investment Company Act (ICA) of 1940.

Money funds sought to market themselves as close substitutes for bank deposits, so they could offer a stable net asset value like a bank deposit, but without the regulatory burdens of direct regulatory oversight of the Federal Reserve. Thus did money markets take advantage of "zone regulations" to attract short-term funding of long-term securities by 2007 that rivaled depository intermediation in volume—but without the regulatory oversight, insurance, or central bank backstop lending available to depositories. Despite the runs on money market funds during the crisis, little has been done to address the problem adequately in the Dodd-Frank legislation, by the SEC, or by the Financial Services Oversight Council.

The Federal Reserve's financial stability mandate dictates, above all, that it protect the payments system and those parts of the commercial banking system supporting the payments system. However, in light of the evident power of money markets to fuel excessive investment and asset price appreciation, and to require Fed credit-policy crisis intervention, and to destabilize

depository institutions—the Fed should be given the authority to make sure that money market rules and regulations preserve monetary stability. Among other things, this would mean giving the Fed the power to insist that money market mutual funds mark their shares to market so that investors know immediately the true value of the securities held on their behalf. More generally it would mean ending the ability of financial markets to exploit "zone regulations" to their advantage at the expense of monetary stability.

The macro-economy has proven robust to extreme fluctuations in investment and asset prices not fueled by excessive short-term credit, as during the "1997-2000 dot-com bubble." Hence, the Fed would serve its financial stability mandate well by focusing narrowly on the stabilization of short-term bank credit and money market finance, and the Fed should be given the regulatory authority to do so comprehensively.

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Testimony on:

Rethinking the Federal Reserve's Many Mandates on Its 100-Year Anniversary

Douglas Holtz-Eakin, President*
American Action Forum

Committee on Financial Services
U.S. House of Representatives
December 12, 2013

*The views expressed here are my own and not those of the American Action Forum. I thank Satya Thallam for his insights and guidance, and Marisol Garibay and Cameron McCosh for their comments on earlier versions.

Chairman Hensarling, Ranking Member Waters, and members of the committee, thank you for the privilege of appearing to testify here today. In this, the centennial of the Federal Reserve (the "Fed"), I commend the committee for holding this hearing.

In my remarks today, I hope to make three main points:

- The fundamentals of financial economics dictate multiple roles for a policy body such as the Federal Reserve;
- Corresponding to these policy imperatives are explicit or implicit mandates for the Fed; and
- The exercise of multiple mandates may raise the possibility of diminished performance on any single mandate, such as macroprudential regulation, and leave behind legacy costs like the Fed's expanded balance sheet.

I will now discuss these topics in greater detail.

The appropriate roles for the Federal Reserve have been increasingly debated in recent years. As Martin Feldstein noted in his 2010 essay:

> *The recent financial crisis, the widespread losses of personal wealth, and the severe economic downturn have raised questions about the appropriate powers of the Federal Reserve and about its ability to exercise those powers effectively. As possible changes are contemplated, it is reasonable to ask what powers should reside with the Federal Reserve, what powers might be given to other government entities, and what actions should be left to free financial markets.*[1]

He then argues that the core functions of the Fed include:

- monetary policy;
- the lender of last resort;
- bank holding company supervision (microprudential regulation); and

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[1] Martin Feldstein, "What Powers for the Federal Reserve?" *Journal of Economic Literature*, Vol. 48, Iss. 1, March 2010.

- systemic risk management (macroprudential regulation).[2]

In practice, the Fed also conducts consumer financial product regulation, and the collection and promulgation of macroeconomic data. Clearly, there is no shortage of explicit or implicit roles for the Fed.

The primary mandate of the Fed is to conduct monetary policy. The structure and conduct of fulfilling this mandate in areas such as rules versus discretion, inflation rules versus dual foci on employment and inflation, and other issues have been widely debated. Accordingly, this testimony will eschew discussion of the formal monetary policy role in order to focus on other issues.

Background on the Economics of Finance

Maturity Mismatch

The fundamental nature of banking leaves it open to the potential for market failure, in which the financial intermediation function of banks can unwind due to externality effects and contagion.[3] Put another way, "banks are inherently illiquid institutions, taking deposits that the public can access on demand, and lending those funds to businesses that have much longer times to repay."[4] The provision of liquidity through deposits is welfare-enhancing, but subject to multiple equilibria including bank runs. As a response to this problem and the wave of bank runs and failures in the early 1930s, the United States established deposit insurance.

Although debate still exists about the necessity of deposit insurance,[5] this insurance scheme has been a bedrock principle of America's modern commercial banking system since it's creation, expanding in scope and size in the interim. Although deposit insurance

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[2] *Ibid.* See also Thomas C. Baxter, Jr., "From Bagehot to Bernanke and Draghi: Emergency Liquidity, Macroprudential Supervision and the Rediscovery of the Lender of Last Resort Function," Remarks at the Committee on International Monetary Law of the International Law Association Meeting, Madrid, Spain, September 19, 2013.

[3] Douglas W. Diamond and Philip H. Dybvig, "Bank Runs, Deposit Insurance, and Liquidity," *Journal of Political Economy*, Vol. 91, No. 3, June 1983.

[4] *Supra*, note 1.

[5] See for example, Charles Calomiris, "Is Deposit Insurance Necessary? A Historical Perspective," *Journal of Economic History*, Vol. 50, No. 2, June 1990.

mitigates one major problem, it can create others.[6] As is endemic to insurance (especially public insurance schemes), deposit insurance can induce moral hazard problems. Proper structure and pricing can eliminate or at least minimize this problem, but as the Savings & Loan crisis exposed, insurance can interact with other regulatory realities in such a way that it can have major deleterious effects on the savings institutions themselves, but also spread to the larger real economy. Thus, deposit insurance (or more broadly protection of short-term creditors) must be paired with rigorous and proper supervision of banking activities.

What happened in the most recent crisis was analogous to the phenomena of nervous depositors lining up outside their bank – leading depositors at neighboring banks to worry about the safety of their own deposits. While deposit insurance is meant to reassure depositors of the safety of their funds (of up to $100,000, raised to $250,000 during the crisis), no such insurance exists for other types of funding – although there exists many types of funding which look and act very much like the typical household deposit. Moreover, household deposits have been a decreasing share of bank funding.

Banks increasingly sought and dealt in short-term funding from other banks, commercial paper and money markets, and from nonbank financial sources. Although very different in many ways, these types of funding were still subject to the maturity mismatch problem in which short-term funds were used to finance longer-term loans and investments. Collateralization, credit ratings, derivatives, and other methods were used as means to get around the mismatch problem, but ultimately they proved insufficient in the face of a systemic crisis. What resulted was a version of the classic depositor panic, but instead of individuals lining up to withdraw their funds, we got what one observer referred to as a "21st-century bank run."[7]

Amplification

The most recent crisis began with an asset class amounting to, by one measure, about $300 billion.[8] And yet the impact was far, far larger. The reason is the amplification of shocks owing to the overlapping nature of financial relationships and leverage, which create negative feedback loops. Amplification of financial shocks can occur via several different channels.

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[6] Kenneth E. Scott and Thomas Mayer, "Risk and Regulation in Banking: Some Proposals for Federal Deposit Insurance Reform," *Stanford Law Review*, Vol. 23, No. 5, May 1971.

[7] Arnold Kling, *Not What They Had in Mind: A History of Policies that Produced the Financial Crisis of 2008*, Arlington, VA: Mercatus Center at George Mason University, 2009.

[8] International Monetary Fund, "Global Financial Stability Report," April 2008.

One major channel is the balance-sheet mechanism, which has been implicated in major recent crises including that associated with Long-Term Capital Management and the 1987 crash, as well as the most recent financial crisis.[9] In this mechanism, "an initial shock tightens funding constraints, causing the net worth of institutions to decrease and funding conditions to tighten further."[10] The net worth effect follows from tightening conditions because of the necessity of "higher margins, lower collateral value, lower asset market prices, and higher volatility."[11] It's important to point out here, that although the triggering event(s) may be rooted in changing perceptions of credit quality (e.g., subprime mortgage-backed securities), this amplification mechanism stems from increasing demand for liquidity (increase in liquidity premium). In other words, this mechanism by which the triggering event ripples throughout the system is of a liquidity nature, and not a credit one. This distinction is important in constructing the appropriate policy response.[12]

Another means of amplification is adverse selection. As institutions holding longer-term assets are forced to sell into a declining market in response to a major shock, potential buyers are unable to determine whether the assets for sale are otherwise high quality but available simply to satisfy liquidity demands, or whether they are in fact of low quality (or lower than average).[13] This of course is a classic example of the "lemons" problem resulting from asymmetric information.[14] Recent research has reinforced the role of the adverse selection mechanism in the recent financial crisis, pointing to even small cracks

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[9] Ben Bernanke, "The Crisis and the Policy Response," Stamp Lecture, London School of Economics, London, England, January 13, 2009.

[10] Asani Sarker and Jeffrey Shrader, "Financial Amplification Mechanisms and the Federal Reserve's Supply of Liquidity During the Financial Crisis," *FRBNY Economic Policy Review*, August 2010.

[11] *Ibid.*

[12] Here, the controversy surrounding mark-to-market accounting rules, and the procyclicality thereof is relevant. This may be a corollary which further amplifies the balance sheet mechanism. See Guillaume Plantin, Haresh Sapra, and Hyun Song Shin, "Fair Value Accounting and Financial Stability," *Financial Stability* Review, Banque de France, No. 12, October 2008.

[13] Koralai Kirabaeva, "Adverse Selection, Liquidity, and Market Breakdown," Bank of Canada Working Paper series, 10-32, August 2010.

[14] George Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," *The Quarterly Journal of Economics*, Vol. 84, No. 3, 1970.

in "market confidence" which can then blossom into a complete breakdown in the entire market for certain assets (so-called "toxic assets").[15] In contrast to the balance sheet mechanism, this amplification mechanism is effectively one of a credit nature. Although liquidity concerns could be the cause of the initial shock, the increase in uncertainty surrounding the payoffs of a security owing to adverse selection effects – even a security that is *ex post* high quality – means a lower risk-adjusted return (i.e., the effective *ex ante* credit quality of the security or class of securities).

Other amplification mechanisms no doubt also occur, and further may be *sui generis* to specific market and asset types.[16]

Bubbles and Crashes

Asset bubbles and attendant crashes may be difficult, indeed impossible, to predict with any confidence.[17] As such their occurrence can be fairly disruptive to financial markets. A sudden crash in an asset price (even a narrow asset class) can be the precipitating shock from which larger crises emanate.

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[15] Stephen Morris and Hyun Song Shin, "Contagious Adverse Selection," *American Economic Journal: Macroeconomics*, Vol. 4, No. 1, January 2012. Asymmetric information leading to increases in variance in the payoff distribution for a given security (or security type) is one specific mechanism in which this adverse selection can happen. See Daniel O. Beltran and Charles P. Thomas, "Could Asymmetric Information Alone Have Caused the Collapse of Private-Label Securitization?" Board of Governors of the Federal Reserve System, International Finance Discussion Papers No. 1010, October 2010. A more generalized model of breakdown in trading can be found in Utpal Bhattacharya and Matthew Spiegel, "Insiders, Outsiders, and Market Breakdowns," *The Review of Financial Studies*, Vol. 4, No. 2, 1991.

[16] One study distinguishes the Knightian uncertainty mechanism which ultimately leads investors to disengage in untested or new markets. See Arvind Krishnamurthy, "Amplification Mechanisms n Liquidity Crises," *American Economic Journal: Macroeconomics*, Vol. 2, Iss. 3, July 2010.

[17] Of course, as demonstrated by the selection of the most recent winners of the Nobel Prize in Economics, there are various strains of thinking on this issue. The Eugene Fama strain does not preclude the possibility of wild swings in asset prices, but rather insists they are unpredictable (beyond "random walk" processes) and are not the result of irrational deviations from expectations. The Robert Shiller strain differs very much: bubbles can (sometimes) be predicted because they result from behavioral biases of market participants.

Unfortunately asset price bubbles are an unavoidable part of market systems.[18] Even in economic experiments involving experienced traders and known payoffs, price bubbles occur (prices diverge from rational expectations).[19] Nonetheless, as one canonical study points out, central bank policy should not be dependent on such changes in asset prices. To wit, "once the predictive content of asset prices for inflation has been accounted for, there should be no additional response of monetary policy to asset-price fluctuations."[20] Thus, the Fed, if properly bound by this rule, must take a somewhat passive role with respect to swings in the market. That is, the Fed should not look to "prick" bubbles as they occur (even assuming such proper identification is possible).[21]

Policy Mandates for the Federal Reserve

Lender of Last Resort

The central role of liquidity in financial market crises outlined above leads directly to a role as lender of last resort (LOLR). In the recent crisis, the Federal Reserve exercised the traditional central bank role of acting as a LOLR. "By providing a liquidity backstop, central banks" can help to avoid or limit the asset fire sales which can occur following tightening conditions in the short-term funding market.[22]

Unfortunately the complexity and evolving nature of the liquidity needs of the financial system made satisfying that role less straightforward than in other times, requiring a dynamic response. In the most recent crisis, the earliest programs were the most

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[18] There are at least four categories of models which "can explain crashes even when all agents act rationally." See Markus K. Brunnermeier, *Asset Pricing Under Asymmetric Information: Bubbles, Crashes, Technical Analysis, and Herding*, Oxford University Press, 2001, at chapter 6.

[19] Vernon L. Smith, Gerry L. Suchanek, and Arlington W. Williams, "Bubbles, Crashes, and Endogenous Expectations in Experimental Spot Asset Markets," *Econometrica*, Vol. 56, No. 5, September 1988.

[20] Ben S. Bernanke and Mark Gertler, "Should Central Banks Respond to Movements in Asset Prices?" *The American Economic Review*, Vol. 91, No. 2, May 2001. This view is not unanimous, however. See Nouriel Roubini, "Why Central Banks Should Burst Bubbles," *International Finance*, Vol. 9, Iss. 1, Spring 2006.

[21] This dictum is discrete. It is separate from the *ex ante* role Fed policy may or may not have had in creating asset price bubbles. See for example, Lawrence H. White, "Federal Reserve Policy and the Housing Bubble," *Cato Journal*, Vol. 29, No. 1, Winter 2009.

[22] *Supra*, note 9.

straightforward application of LOLR roles.[23] Indeed, "the externalities of liquidity demand, with potential negative outcomes of credit cycles, bank runs, and financial crises....[have] been the main focus of the Federal Reserve since its founding."[24] The Term Auction Facility, central bank liquidity swaps, Term Securities Lending Facility, and Primary Dealer Credit Facility, in addition to the preexisting discount window facility all aimed to loosen short-term funding pressures (although their use may have been novel). Moreover, they did so specifically with the aim of stopping balance sheet amplification feedback from getting much worse – via these facilities, the Fed did not take on credit risk, but rather applied its lower required liquidity premium to provide short-term, collateralized funds to institutions in need of liquidity, who were otherwise unable to be serviced by the private market without substantial haircuts.

The discount window is of course a longstanding funding facility. It is very much the prototypical "last resort" lending option, self-limited in two ways. First, the cost of such funding, relative to conventional sources during normal times, is usually higher. Second, and perhaps more importantly, use of the discount window carries with it a stigma.[25] If known, use of the discount window by an institution would signal some financial distress or risk of insolvency to other market participants, which may further exacerbate liquidity shortfalls. The incredibly tight short-term funding conditions of the early crisis, the expanded list of eligible collateral and institutions, a declining discount rate, maturity extension, and use of auctions are several of the factors which ought to have encouraged use of the discount window.[26] And yet there is evidence that borrowers paid a premium to use alternative facilities to avoid the associated stigma.[27]

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[23] John Cassidy, "Interview with John Cochrane," Rational Irrationality, *The New Yorker*, January 13, 2010.

[24] Gary B. Gorton and Andrew Metrick, "The Federal Reserve and Financial Regulation: The First Hundred Years," Working Paper 19292, NBER, August 2013.

[25] See, for example, Daniel L. Thornton, "Walter Bagehot, the Discount Window, and TAF," *Economic Synposes* No. 27, Federal Reserve Bank of St. Louis, October 28, 2008; and Oliver Armantier, et. al., "Stigma in Financial Markets: Evidence from Liquidity Auctions and Discount Window Borrowing during the Crisis," Staff Report no. 483, Federal Reserve Bank of New York, January 2011.

[26] Satya Thallam, "The Federal Reserve's Crisis Response," American Action Forum, September 12, 2013.

[27] This amounted to a premium of 37-150 basis points. Supra, note 24. There is also possibility of a "moral suasion" effect.

The Term Auction Facility (TAF), instituted in December 2007, was a way around the stigma effect of the discount window: funds were allocated entirely through auctions and maturities were in the one-to-three month range. Ultimately more than twice as many institutions participated in TAF than the discount window.[28] The Term Securities Lending and Primary Dealer Credit Facilities were also of this type of program—transferring little to no credit risk to the Fed, but applying the central bank's lower liquidity premium to stretch out short-term funding maturities and ultimately halt balance sheet amplification effects following the crash in housing and housing-related securities.

Limited to the scope of true "lender of last resort" programs, it should be noted that none of the loans in question defaulted. Moreover, evidence indicates that the programs were successful in reducing the benchmark funding spreads.[29]

> *Exceptions*
> The Federal Reserve's crisis response was not all extension or creative application of traditional roles. Maiden Lane (April 2008), Maiden Lane II/III (September 2008), Bank of America/Merrill Lynch (January 2009), and Citigroup (November 2009) were all departures from general liquidity and credit market support. Instead, therein, the Federal Reserve (mostly in support of the Treasury Department) extended guarantees, risk-sharing, liquidity, and capital in support of specific institutions or transactions in an attempt to ring fence financial disturbances.[30]
>
> While in some cases, the credit terms extended under these programs ultimately went unexercised, and in others the Fed did not assume any credit risk, these types of transactions are problematic. They open the door to an expanding window of *ad hoc* and discretionary policy choices – choices which are increasingly tailored to specific institutions and not markets. The Dodd-Frank Act changed the 13(3) authority in the Federal Reserve Act to disallow transactions such as these in the future.[31]
>
> Problems arising from funding needs related to a single institution, whether because of counterparty concerns or fear of a disruptive failure, are the primary concerns of macroprudential regulation (married to microprudential regulation to

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[28] *Supra*, note 25.

[29] *Supra*, note 9.

[30] *Supra*, note 25. The Maiden Lane transactions refer to programs to support or expedite takeover of Bear Stearns (to JP Morgan) and AIG (to the Treasury Department)

[31] *Supra*, note 2.

address specific institutional concerns). That is, systemic risk regulations should be focused on preventing the need for institution-specific actions. This should be coupled with a credible path toward reorganization or liquidation through bankruptcy (or bankruptcy-like) procedures. But of course expectations matter: the change in statute should go a long way in decreasing expectations of extraordinary containment measures via individual institutions.

Costs of Monetary and LOLR Mandates

The LOLR and monetary policy functions have greatly expanded the Fed's balance sheet. The quantitative easing programs undertaken recently have resulted in multi-trillion dollar increases in assumed assets and over a trillion dollars in excess reserves. This expanded balance sheet is a substantial increase in exposure: credit risk, interest rate risk, and risk of inflationary effects from unwinding should all be concerns of policymakers. Moreover, on the second concern (interest rate risk), the actual incidence of this risk is dependent on future Fed policy – the risk is therefore compounded by the possibility that balance sheet exposure will constrain future policy. One way to avoid the assumption of these risks in the future would be to require "Congressional authoriz[ation of] Treasury funding of longer-term private credit provisions."[32]

Supervision as Part of Microprudential and Macroprudential Risk Management

The Federal Reserve was not the only central bank or central financial regulator to miss brewing problems, either within the US or abroad. Indeed, the global nature of the crisis that ensued after early market disruptions is evidence that the Fed is not especially culpable for the crisis.

Nevertheless, it is possible there are problems in the Fed's supervisory program. Prior to the crisis, the Fed relied on a fairly explicit and rigorous system of ratings referred to as CAMELs. However, this system did not explicitly account for systemic or other macroprudential risks. Moreover it did not give adequate consideration to the actual range of risks associated with certain assets (especially mortgage-backed securities), in large part owing to a regime promulgated under the Basel II rules.

The microprudential supervision regime has meaningful implications across several dimensions. Of course it goes to the heart of an individual institution's financial health. But more than that, it is the means by which the rules of the road are internalized into management and within the company. Explicit rules are written and promulgated outside this process, but their enforcement via other channels can occur with a lag and without teeth. Supervision is the means by which "the rubber hits the road."

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[32] *Supra*, note 1.

Additionally, it is the channel whereby analysts can identify systemic concerns that would be opaque to broader sector-wide data or analysis. That is, micro- and macroprudential concerns are not distinct but necessarily intertwined. For example, divestiture of problematic counterparty relationships could be identified in this channel. Moreover, while clear and stable capital requirements are necessary, it's more likely that microprudential supervisors would identify the likely problem with certain asset classes that are otherwise hidden by overall compliance with the prevailing capital regime. To wit, the capital regulation regime in place pre-crisis allowed residential mortgage debt to "hide in plain sight" by being given a lower risk-weighting than other assets which *ex post* turned out to much less risky.[33]

Thank you and I look forward to answering your questions.

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[33] *Ibid.*

Bridging the gap between academic ideas and real-world problems

TESTIMONY

RETHINKING THE FEDERAL RESERVE'S MANY MANDATES ON ITS 100-YEAR ANNIVERSARY

BY HESTER PEIRCE

House Committee on Financial Services

December 12, 2013

Chairman Hensarling, Ranking Member Waters, and members of the Committee, thank you for the opportunity to testify at today's hearing. As the title of this hearing aptly notes, the Federal Reserve has many mandates. I will focus my remarks on only one of those—the regulatory mandate of the Board of Governors of the Federal Reserve System (Board). Specifically, I will briefly discuss the recent growth of the Board's regulatory mandate, the adoption earlier this week of the Volcker Rule, and the Board's persistent refusal to use economic analysis and other good government tools.

THE BOARD'S INCREASING REGULATORY MANDATE

When the Dodd-Frank Act was being developed, one issue under consideration was whether the Board should lose some of its regulatory powers in view of its poor regulatory performance prior to the crisis. Instead, Dodd-Frank substantially increased the Board's regulatory powers.[1] One of the most important new powers is the authority to regulate nonbank financial institutions designated systemically important by the Financial Stability Oversight Council.[2] So far, General Electric Capital Corporation, American International Group, and Prudential have been so designated, with additional entities likely to follow. These financial institutions will present the bank-focused Board with new regulatory challenges. It is important that the Board respond with well-vetted, tailored regulations that recognize that these entities are not banks and cannot be effectively regulated as if they were.

The Board also has new regulatory authority over other entities. These include financial market utilities (FMUs) designated by the Council. Two designated FMUs—The Clearing House Payments Company and CLS Bank International—are supervised by the Board, and it has back-up authority with respect to other FMUs. Dodd-Frank transferred regulatory authority over savings-and-loan holding companies from the now-defunct Office of Thrift

1. For an overview and graphic illustration of this expansion, see Hester Peirce and Robert Greene, "The Federal Reserve's Expanding Regulatory Authority Initiated by Dodd-Frank" (Mercatus Center at George Mason University, Arlington, VA, November 13, 2013), http://mercatus.org/publication/federal-reserves-expanding-regulatory-authority-initiated-dodd-frank.
2. Dodd-Frank § 113 [12 U.S.C. § 5323].

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Supervision to the Board.[3] Securities holding companies that opt for consolidated supervision will also be supervised by the Board.[4] Dodd-Frank also strengthened the Board's regulatory hand with respect to bank holding companies and foreign banks operating in the United States. Time will tell how the Board exercises these authorities, but other regulators have expressed concerns about the Board's unwillingness to recognize the role that these regulators already play in overseeing some of these institutions or their subsidiaries."[5]

Dodd-Frank also arms the Board with explicit mandates to consider financial stability,[6] something that could be found by an imaginative or hopeful reader only "in the penumbra of the Federal Reserve Act" prior to Dodd-Frank.[7] Financial stability defies precise definition, which means that there are no clear constraints on how the Board can exercise this authority.

Despite the broad new grants of authority it now exercises, Board governors and other Federal Reserve officials have expressed an interest in accumulating additional regulatory authority. Areas of regulatory interest include money-market funds,[8] short-term securities financing markets,[9] and broker-dealers.[10] Sometimes the regulatory expansion is contemplated as the price of entry into the Federal Reserve's safety net.[11] These officials should not be faulted for thinking broadly about potential risks in the financial markets, but implicit in these comments seems to be a belief that the Board's regulatory reach must be comprehensive. There is a danger in having a single regulator that applies a uniform regulatory approach to the whole financial marketplace.[12] If that regulator is wrong, the entire market will bear the effects. Even if the regulator's choices are reasonable, a common regulatory approach raises the risk of homogenization across financial institutions—and thus greater susceptibility to common shocks.

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3. Dodd-Frank § 312(b) [12 U.S.C. § 5412(b)].
4. Dodd-Frank § 618(b) [12 U.S.C. § 1850a(b)].
5. See, for example, Daniel A. Gallagher, Commissioner, Securities and Exchange Commission, Remarks at "The SEC Speaks in 2013" (February 22, 2013), https://www.sec.gov/News/Speech/Detail/Speech/1365171492342#.UqfRqCfWv_Y. Commissioner Gallagher explained that under the Board's proposal to require large foreign banking organizations to set up intermediate holding companies, the Board would effectively usurp regulatory control over broker-dealers already regulated by the Securities and Exchange Commission. The Financial Services Commission of Korea wrote to object to the Board's proposed approach to regulating foreign banking organizations that "are already regulated by home country authorities (on a consolidated base which covers both U.S. branches and firms)" and explained, "admittedly, I do not see a strong need for enhanced standards. In fact, the proposed rule may only result in inconsistent and overlapping regulations among regulatory authorities. And this, in turn, is likely to undermine regulatory effectiveness." Letter from Chairman, Financial Services Commission, Korea, to Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System (April 30, 2013), 2, http://www.federalreserve.gov/SECRS/2013/June/20130605/R-1438/R-1438_043013_111111_562692058481_1.pdf.
6. See, for example, Dodd-Frank § 604(d) (adding 12 U.S.C. § 1842(c)(7)).
7. See Thomas C. Baxter Jr., Executive Vice President and General Counsel, Federal Reserve Bank of New York, "Financial Stability—the Role of the Federal Reserve System" (speech at the Future of Banking Regulation and Supervision in the EU Conference, Frankfurt am Main, Germany, November 15, 2013), http://www.bis.org/review/r131125e.pdf 78.
8. See, for example, Eric S. Rosengren, President & CEO, Federal Reserve Bank of Boston, "Flirting with Money Market Madness: SEC Proposals that Would Increase Instability Are Worse than No Reform At All," *Wall Street Journal*, November 28, 2013), http://online.wsj.com/news/articles/SB10001424052702304243904579195901233996552.
9. Janet Yellen, Vice-Chair, Federal Reserve Board, "Regulatory Landscapes: A U.S. Perspective" (speech at the International Monetary Conference, Shanghai, China, June 2, 2013), http://www.federalreserve.gov/newsevents/speech/yellen20130602a.htm. Ms. Yellen explained that "more work will remain to reduce systemic risk in the short-term wholesale funding markets that shadow banking relies on. A major source of unaddressed risk emanates from the large volume of short-term securities financing transactions (SFTs)--repos, reverse repos, securities borrowing and lending transactions, and margin loans--engaged in by broker-dealers, money market funds, hedge funds, and other shadow banks."
10. See, for example, William Dudley, President, Federal Reserve Bank of New York, "Fixing Wholesale Funding to Build a More Stable Financial System" (speech at New York Bankers Association's 2013 Annual Meeting and Economic Forum, New York City, New York, February 1, 2013), http://www.newyorkfed.org/newsevents/speeches/2013/dud130201.html. Mr. Dudley remarked that, under an expanded notion of the proper reach of the lender of last resort function, "substantial prudential regulation of entities—such as broker-dealers—that might gain access to an expanded lender of last resort would be required to mitigate moral hazard problems."
11. Ibid. Mr. Dudley "imagined a mechanism that was funded by tri-party repo market participants and potentially backstopped by the central bank."
12. Centralizing regulatory power in the Board also may aggravate conflict-of-interest issues as it may use its regulatory power to achieve monetary policy ends. David VanHoose, "Evaluating the Centralized-Layers Approach to US Federal Financial Regulation" (Working Paper No. 13-08, Mercatus Center at George Mason University, Arlington, VA, April 2013), 33, http://mercatus.org/sites/default/files/VanHoose_Centralized-LayersApproach_v1.pdf.

THE VOLCKER RULE

The Board has numerous specific rulemaking mandates under Dodd-Frank. It completed one of these—the Volcker Rule—on Tuesday, in conjunction with four other agencies.[13] The final rule spans nearly one thousand pages, so analysis of its contents will take some time. A number of concerns, however, have already come to light, and it is likely that the rule will pose significant compliance challenges for affected financial institutions and materially impede liquidity in the financial markets.

First, although the rule is well intentioned, its reliance on intense regulatory oversight rather than market discipline is likely to undermine its efficacy at achieving its objective of sensibly limiting bank risk-taking. Elaborate compliance programs will be designed primarily to meet regulatory parameters, rather than to effectively monitor, measure, and limit risk-taking. Legislative and regulatory attention should be focused instead on encouraging financial institutions' shareholders and creditors to pay attention to the nature and scope of banks' trading activities. Measures that have been discussed include contingent capital, which would provide incentives for shareholder and creditor monitoring, enhanced liability for shareholders in the event that their financial institution fails, and greater transparency into bank activities.[14]

Second, given the nebulous nature of the lines drawn in the rule, banking entities may be reluctant to avail themselves of the rule's exemptions for hedging and market making. As a consequence, trading activity that we would want banks to undertake in order to protect themselves from business risks and contribute to market liquidity will be dampened. Commissioner Daniel Gallagher of the Securities and Exchange Commission explained the concerns with respect to market making this way in his dissent from the rule:

> I believe that market making activities will be impacted most by this faulty rule. The importance of market making to our capital markets—*all* of our capital markets, not just the markets for large cap, well-traded equities—cannot be underestimated. Market makers play a unique role in providing liquidity to investors by buying, selling and building and holding inventory to meet anticipated future customer demand, and often provide the majority of the liquidity for a given security, especially in times of stress.[15]

Changes made to the rule since the proposal heighten concerns that the rule's exemptions will be difficult to use. For example, the hedging exemption was narrowed by requiring that a banking entity not only be able to demonstrate that a hedge was designed to reduce or significantly mitigate a risk, but that it does "demonstrably reduce or otherwise significantly mitigate" the risk.[16] Even this small wording change could make financial institutions less likely to use the exemption for fear of being second-guessed with the benefit of hindsight on their determinations about whether a particular hedge is effective.

Third, the rule will be expensive for regulators and banking entities alike. It relies on the establishment of extensive compliance programs, reporting requirements, and oversight by multiple regulators. Financial institutions and their regulators will have to devote substantial resources to ensuring that essentially arbitrary lines are not crossed.

One of the reasons that concerns about the Volcker Rule persist is that it is the product of a flawed regulatory process. Given the difficulty of crafting the rule, regulators should have first issued an advanced notice

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13. Board of Governors of the Federal Reserve System, Commodity Futures Trading Commission, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Securities and Exchange Commission, "Agencies Issue Final Rules Implementing the Volcker Rule," joint news release, December 10, 2013, http://www.federalreserve.gov/newsevents/press/bcreg/20131210a.htm. The Volcker Rule is the popular name for Dodd-Frank § 619 [12 U.S.C. § 1851].

14. For a brief discussion of some of these measures, see Hester Peirce and Robert Greene, "Rethinking the Volcker Rule" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, January 15, 2013), http://mercatus.org/publication/rethinking-volcker-rule.

15. See Daniel M. Gallagher, Commissioner, Securities and Exchange Commission, "Dissenting Statement Regarding Adoption of Rule Implementing the Volcker Rule" (December 10, 2013), http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370540477693#_ftnref7.

16. See Board of Governors of the Federal Reserve System, et al., "Final Rule on Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds," joint news release, December 10, 2013, http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a2.pdf, at note 1282 and accompanying text.

of proposed rulemaking, which would have laid the groundwork for a subsequent more concrete proposing release. Instead, the regulators issued a proposal that was heavily laden with questions—approximately 400 numbered questions, many of which included subquestions—and then adopted a final rule without soliciting comment a second time.[17] Moreover, the final Volcker Rule did not include economic analysis. The Office of the Comptroller of the Currency conducted a regulatory impact analysis with respect to its regulated entities.[18] Because the rule was adopted under the Bank Holding Company Act, the Securities and Exchange Commission and Commodity Futures Trading Commission took the position that economic analysis required by their statutes was not necessary for this rulemaking.[19] The Board does not have a comparable requirement to conduct economic analysis and did not conduct an economic analysis.

ECONOMIC ANALYSIS AND GOOD GOVERNMENT

The Board's failure to use economic analysis in crafting the Volcker Rule is not unusual. As an independent regulatory agency, the Board is not subject to the executive orders requiring regulatory impact analysis or the attendant review by the Office of Information and Regulatory Affairs at the Office of Management and Budget.[20] The Board also has showed a persistent reluctance to embrace economic analysis, even though it is a useful tool for identifying theproblems the Board is trying to solve, the range of possible solutions, and the costs and benefits of those different options.[21]

In fact, the failure to conduct analysis runs counter to the stated policy of the Board. In 1979, the Board adopted a policy statement intended to "assure that regulations are not unduly burdensome and complex."[22] IThe policy, to which the Board intended to adhere with respect to all rulemakings regardless of significance, pledged that the staff—at the proposal stage—would prepare a "regulatory analysis" that, "at a minimum," would:

> discuss the need for and purposes of the regulation, set forth the various options available, discuss, where appropriate, their possible economic implications, evaluate their compliance, recordkeeping, and reporting burdens, and recommend the best course of action based on an evaluation of the alternatives.[23]

This analysis would be updated to reflect material changes at the final rule stage.[24] Although this policy is decades old, the Board's General Counsel recently cited it as still being controlling for the Board.[25] The Board does not closely adhere to this policy or explain departures from it. As a consequence, rules are being proposed and adopted without the careful consideration required.

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17. For an in-depth discussion of this issue, see Michael S. Piwowar, Commissioner, Securities and Exchange Commission, "Dissenting Statement Regarding Adoption of Rule Implementing the Volcker Rule" (December 10, 2013), http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370540476665#_ftnref14.
18. That analysis was not readily available on the OCC's website as of December 11, 2013.
19. See Gallagher, Dissenting Statement. Commissioner Gallagher explained that "our fellow regulators have argued that because this rulemaking is being promulgated under the Bank Holding Company Act, rather than the securities laws, we don't need the detailed economic analysis that our governing statutes and our own internal guidelines require us to perform for all of our rulemakings. Apparently, our lawyers and a majority of the Commission agree with that legal analysis." Commissioner Scott O'Malia of the Commodity Futures Trading Commission similarly objected to his agency's decision "to forgo any cost-benefit analysis by promulgating the Volcker Rule solely under the BHC Act, and has thus limited its enforcement powers." Scott D. O'Malia, Commissioner, Commodity Futures Trading Commission, "Dissenting Statement" (December 10, 2013), http://www.cftc.gov/PressRoom/SpeechesTestimony/omaliastatement12101.
20. Executive Order 13,563, 76 Fed. Reg. 3821 (Jan. 18, 2011) and Executive Order 12,866, 58 Fed. Reg. 51,735 (Sept. 30, 1993). Executive Order 12,866 excludes "independent regulatory agencies." Ibid., § 3(b).
21. For a discussion of the Board's use of economic analysis, see Hester Peirce, "Economic Analysis by Federal Financial Regulators," *Journal of Law, Economics, and Policy* 9 (2013): 569–613.
22. Board of Governors of the Federal Reserve System, *Statement of Policy Regarding Expanded Rulemaking Procedures*, 44 Fed. Reg. 3957 (1979).
23. Ibid., 3958.
24. Ibid.
25. See Letter from Scott G. Alvarez, General Counsel, Board of Governors, and James M. Lyon, Senior Advisor to the Board for Regulatory Reform Implementation, to A. Nicole Clowers, Director, Financial Markets and Community Investment, Government Accountability Office (October 24, 2011).

Others have noted the inconsistency of the Board's reliance on economic analysis. The Committee on Capital Markets Regulation, for example, recently reported that only slightly more than half of Board rulemakings since July 2011 have included cost-benefit analysis.[26] The Board's Inspector General looked at five Dodd-Frank rulemakings and observed "that the nature of the economic analysis also varied according to the applicable rule."[27] The Government Accountability Office recommended that the Board and other federal financial regulators "take steps to better ensure that the specific practices in OMB's regulatory analysis guidance are more fully incorporated into their rulemaking policies and consistently applied."[28] The Board is correct that "conducting cost-benefit analysis on financial regulations is inherently difficult,"[29] but other financial regulators have undertaken the task despite the trouble.[30]

Particularly in light of the expansion of the Board's regulatory role, a clear requirement that the Board conduct thorough economic analysis before finalizing rules that impose new regulatory obligations is warranted. The Board's unwillingness to adhere to its own stated policy suggests that a mandate is necessary. Conducting good economic analysis is not easy,[31] but it can help to ensure that regulations are effective and do not carry with them unreasonable costs and unforeseen consequences.

The Board can take additional steps to improve the quality and transparency of its rulemaking. One such step would be to increase the number of public meetings it holds. During 2012 and 2013, the Board has only held five open meetings.[32] The interaction among the Board members and between the Board and its staff provide valuable insights into why particular policy choices were made.

New challenges for transparency, accountability, and procedural rigor will be posed as the Board deepens its embrace of macroprudential regulation—a regulatory approach that imposes requirements based on what is good for the stability of the financial system as a whole, rather than the safety and soundness of a particular financial institution. As economist John Cochrane explains:

> This is not traditional regulation—stable, predictable rules that financial institutions live by to reduce the chance and severity of financial crises. It is active, discretionary micromanagement of the whole financial system. A firm's managers may follow all the rules but still be told how to conduct their business, whenever the Fed thinks the firm's customers are contributing to booms or busts the Fed disapproves of.[33]

Vice-Chair Yellen has acknowledged the importance of "fixed rules" but has also admitted that "discretionary interventions will inevitably play a part in macroprudential supervision."[34] To the extent the Board uses ad hoc

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26. Committee on Capital Markets Regulation, "A Balanced Approach to Cost-Benefit Analysis Reform" (2013), at Appendix A, available at http://capmktsreg.org/2013/10/balanced-approach-to-cost-benefit-analysis-reform/.
27. Office of Inspector General, Board of Governors of the Federal Reserve System, Response to a Congressional Request Regarding the Economic Analysis Associated with Specified Rulemakings (June 2011), 11, www.federalreserve.gov/oig/files/Congressional_Response_web.pdf.
28. Government Accountability Office, *Dodd-Frank Act Regulations: Implementation Could Benefit from Additional Analyses and Coordination* (GAO Report 12-151, November 2011), 39.
29. Alvarez Letter, 1.
30. For example, the United Kingdom's Financial Conduct Authority (FCA) routinely conducts cost-benefit analysis in connection with its rules. As the FCA's website explains, "we must ensure that any burden or restriction that we impose on a person or activity is proportionate to the benefits we expect as a result. To judge this, we take into account the costs to firms and consumers. One of the main techniques we use is to carry out a cost-benefit analysis of our proposed regulatory requirements." Financial Conduct Authority, Principles of Good Regulation (December 8, 2013), http://www.fca.org.uk/about/why-we-do-it/our-remit/principles (last visited December 10, 2013).
31. See, for example, Jerry Ellig, "Improving Regulatory Analysis Through Process Reform," Testimony Before the Joint Economic Committee (June 26, 2013), http://mercatus.org/publication/improving-regulatory-impact-analysis-through-process-reform.
32. This count is based on the open meetings listed on the Board's website at http://www.federalreserve.gov/aboutthefed/boardmeetings/201312.htm (last visited December 10, 2013).
33. John Cochrane, "Macro-Prudential Policy." Blog, August 26, 2013, http://johnhcochrane.blogspot.com/2013/08/macro-prudential-policy.html.
34. Janet Yellen, Vice Chair, Board of Governors of the Federal Reserve System, "Macroprudential Supervision and Monetary Policy in the Post-Crisis World" (speech at the Annual Meeting of the National Association of Business Economists, Denver, Colorado, October 11, 2010), http://www.federalreserve.gov/newsevents/speech/yellen20101011a.htm.

decisions to carry out its macroprudential regulatory objectives, they will be difficult to monitor, may evade accountability, and will not allow room for the consideration of public comment or the incorporation of cost-benefit analysis.

CONCLUSION

Thank you for the chance to be part of the discussion of the Federal Reserve in its hundredth year. As with many other aged institutions, it needs to be reformed. That reform needs to reach its regulatory functions as well as its monetary policy functions. Congress should consider whether the Board's regulatory mandate is too big and ways to ensure that the Board crafts its regulation with care and concern for their consequences.

ABOUT THE AUTHOR

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"Balancing Multiple Mandates"

Testimony of Alice M. Rivlin*

Senior Fellow, The Brookings Institution

Committee on Financial Services

U.S. House of Representatives

December 12, 2013

Chairman Hensarling, Ranking Member Waters, and Members of the Committee: Thank you for inviting me to testify on this very important question: what economic goals should Americans expect their central bank to aim for? I do not believe there is a simple answer to this question. We can't tell the Federal Reserve; just control inflation or just maximize employment or just keep the financial system stable. Americans, quite rightly, have multiple objectives for the performance of their economy, including high employment, low inflation, and financial stability. The job of the Federal Reserve and other economic policy-makers is to balance those multiple objectives as effectively as they can. This is not an easy task. It requires analysis and judgment in the face of necessarily uncertain forecasts. But focusing on a single objective would lead to less satisfactory economic performance. I will expand on this basic thought briefly this morning.

Multiple economic objectives. First, we want the economy to grow fast enough to create jobs—preferably good jobs—for almost everyone who wants to work. Even if we start with high rates of employment, the economy must grow fast enough to create sufficient additional jobs to keep up with growth in the labor force and worker productivity. If the economy grows too slowly, unemployment will rise and discouraged workers will drop out of the labor force, but if it grows too fast, shortages will develop and prices will likely begin to rise.

Second, we want low inflation or a fairly stable price level. We should not aim for zero inflation, because that makes it harder for resources to move out of falling-demand sectors and risks tipping the economy into deflation. But persistent inflation above moderate rates (say, two or three percent) can disrupt business and household planning, discourage long-run investment, and generate expectations that could cause inflation to accelerate to truly disruptive rates.

Third, we want to avoid financial crises with the potential endanger to economic activity in a major way. The recent financial crisis of 2008 amply demonstrates the catastrophic cost of a national housing price bubble and an over-leveraged, out-of-control financial sector.

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In general, the goals reinforce each other. Low inflation and financial stability are conducive to long-run investment and stronger growth and employment. But sometimes balancing is necessary. For example, reducing the risk of inflation or financial instability may require slowing growth and job creation.

Navigating uncertainty. The economy is an extremely complex system with myriad inter-related moving parts, which is impossible to predict accurately. Statistical models can be extremely helpful in organizing past data, but they can be misleading when crucial relationships are changing. For example, when lending standards deteriorated dramatically in the last decade, models based on past mortgage payment rates of Americans proved utterly wrong. Policy makers have to use judgment as well as models, and judgments will differ.

The Fed's past track record is clearly mixed. Skillful monetary policy deserves some of the credit for the fact that inflation has been quiescent for more than three decades, although partial credit must also go to fiscal policy (for example, the restrictive fiscal policy of much of the 1990s) and an increasingly flexible, competitive economy, nationally and internationally. The certainly bears some of the blame—along with many other culprits, public and private—for its failure to spot the dangers of the deteriorating lending standards that contributed to the housing bubble and inaction in the face of the over-leveraged pyramid of housing-related derivatives, whose crash brought the world economy to its knees. Arguably, the Fed's low interest rates in 2003-4 also contributed to the bubble and the over-leveraging, but short-term interest rates are not a sharp tool for dealing with asset bubbles. Lax regulation by the Fed and other regulators bears a far higher share of the blame than monetary policy.

Once the unnecessary crisis happened, the Fed moved aggressively and imaginatively in cooperation with the Treasury to mitigate the economic damage and stabilize the financial sector using all the tools it could find. The lessons learned in that desperate period of damage control, helped this Committee and its Senate counterpart craft the Dodd-Frank legislation aimed at avoiding repetition of the debacle of 2008. The Fed and other regulators now have new tools, which, if used courageously and intelligently, can reduce the chances of a similar catastrophe.

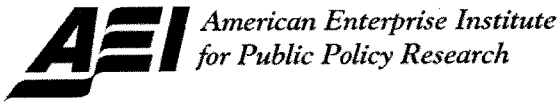
Multiple Mandates in the Current Economic Situation. The Fed's policy of aggressive, continuous monetary easing—keeping short-term interest rates close to zero, announcing its intention not to raise them without strong signs of recovery, plus substantial on-going purchases of Treasury and mortgage backed securities--has contributed substantially to recovery from the Great Recession. The economy keeps adding jobs, although at a slower pace than hoped, and the unemployment rate keeps inching down. In the early part of the recovery fiscal stimulus reinforced accommodative monetary policy, but fiscal policy turned restrictive in the last couple of years, as the stimulus ended, and budget actions cut discretionary spending and raised tax rates (without sufficient attention to reducing the projected long-term growth of debt). That the recovery has been slow is not surprising in the face of the large number of under-water mortgages, the drag of restrictive fiscal policy (including at the state level), and confidence-shattering political brinkmanship in Washington. The Fed's monetary policy has been the only aspect of economic policy supporting, rather than impeding recovery.

The question facing Fed policy makers now is: how much accommodation is enough? There are down sides to extremely low interest rates, which discourage saving and may encourage unproductive trading and risk-taking. Moreover, the Fed should not go on increasing its portfolio indefinitely. Does the recovery now have enough momentum to absorb a gradual tapering of the Fed's asset purchases, followed by slow reduction of the Fed's portfolio as assets mature? This is a judgment call on which opinions differ. Recent signs of strength in the economy argue for starting the taper soon, but the absence of any signs of inflation on the horizon means that doing so is quickly is not particularly urgent.

In any case, a far more effective way of insuring a strong recovery and robust continuing economic growth, would be to pass a comprehensive bipartisan budget plan. Such a plan would include less near-term budget austerity, significant investment in improving skills and modernizing infrastructure, plus a pro-growth tax reform that would enhance revenues, restoring Social Security to solvency, and gradual changes in health delivery that would improve health outcomes and reduce the growth of health care costs.

Why Change the Fed's Mandates? The drafters of the current language on the Fed's responsibilities did a good job of encapsulating the major objectives that Fed policy-makers should have in mind as they decide on specific policy moves. Maximum employment, stable prices, and financial stability are all desirable goals toward which balanced progress is needed. It would be particularly absurd to instruct the Fed to focus only on inflation at a moment when inflation is not a visible threat and employment is so far from any reasonable definition of "maximum." Such a move would not necessarily affect policy much, however. The Fed has historically focused heavily on the need to avoid the damages of both inflation and deflation and would presumably continue to do so. Recent accommodative policy could certainly be defended as needed to avoid the risk of deflation, even without mention of employment. In view of recent history, telling the central bank that it need not worry about the stability of the financial sector is too ridiculous to deserve discussion. In short, I would urge leaving the multiple mandates as they stand.

Thank you for this opportunity to testify. I will be happy to answer questions.



Statement before the House Committee on Financial Services

On "Re-examining the Federal Reserve's Many Mandates on Its 100-Year Anniversary"

How Many Mandates Does the Fed Have? How Many Can It Achieve?

Alex J. Pollock
Resident Fellow
American Enterprise Institute

December 12, 2013

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

Written Testimony of

Alex J. Pollock
Resident Fellow
American Enterprise Institute

To the Committee on Financial Services
U.S. House of Representatives

Hearing on "The Many Mandates of the Fed"

December 12, 2013

How Many Mandates Does the Fed Have? How Many Can It Achieve?

Mr. Chairman, Ranking Member Waters, and Members of the Committee, thank you for the opportunity to submit this written testimony. I am Alex Pollock, a resident fellow at the American Enterprise Institute where I focus on financial policy issues, and these are my personal views. Before joining AEI, I was the President and CEO of the Federal Home Loan Bank of Chicago from 1991 to 2004. I have published numerous articles on banking and financial systems, including the role of the Federal Reserve and central banks in general.

My discussion has two main themes:

1. Discretionary fiat-currency central banking is subject to high uncertainty. Therefore the attempts of central banks to "manage" financial and economic stability are inevitably subject to mistakes, and recurring big mistakes. The naive belief that any central bank, or anybody, could actually *know* enough about the future, and in particular about the future of complex, recursive globalized economies and financial markets, to be an economic "Maestro", is a fundamental error.

2. While the Federal Reserve is often said to have a "dual mandate," which would be difficult enough, it fact it has six mandates. The combination of these mandates has created in the Fed a remarkable concentration of power. But the Fed does not, and because the future is unknowable, cannot, succeed at all its mandates.

Uncertainty and the Lack of Knowledge

In the early 21st century, the Fed and other central bankers gave themselves great credit for having engineered what they thought they observed: the so-called "Great Moderation." But the Great Moderation turned out to be the Era of Great Bubbles. The U.S., in successive decades, had the Tech Stock Bubble and then the disastrous Housing Bubble. In addition, other countries had destructive real estate and government debt bubbles.

Presiding over the Era of Great Bubbles as Chairman of the world's principal central bank from 1987 to 2006, was Alan Greenspan, a man of high intelligence and wide economic knowledge, with scores of

subordinate Ph.D. economists to build models for him. He was then world famous as "The Maestro," for supposedly being able to always orchestrate the macro economy to happy outcomes. In reality, the idea that anyone, no matter how talented, could be such a Maestro is absurd, but it was widely believed nonetheless, just as the idea that national house prices could not fall was widely believed.

In his new book, Chairman Greenspan relates, with admirable candor, that at the outset of the financial crisis in August, 2007, "I was stunned." He goes on to discuss the failure of the Fed to anticipate the crisis. For example: "The model constructed by the Federal Reserve staff combining the elements of Keynesianism, monetarism and other more recent contributions to economic theory, seemed particularly impressive," but "the Federal Reserve's highly sophisticated forecasting system did not foresee a recession until the crisis hit. Nor did the model developed by the prestigious International Monetary Fund."

Even extremely complex models are abstract simplifications of reality and they do not do well with discontinuities like the panicked collapse of bubbles, so it is not surprising that "leading up to the almost universally unanticipated crisis of September, 2008, macromodeling unequivocally failed when it was needed most, much to the chagrin of the economics profession," as Greenspan writes.

Central banking is not and cannot be a science, cannot operate with determinative mathematical laws, cannot make reliable predictions of an ineluctably uncertain and unknowable future. We should have no illusions about the probability of success of such a difficult attempt as central banks' "managing" economic and financial stability, no matter how intellectually impressive its practitioners may be. "We did not anticipate that the decline in house prices would have such a broad-based effect on the stability of the financial system," as another impressive intellect, Fed Chairman Ben Bernanke, has admitted.

Before the Era of Great Bubbles, a vast Federal Reserve mistake was the Great Inflation of the 1970s, under the Fed chairmanship of distinguished economist Arthur Burns, when annual inflation rates in the U.S. got to double digit levels. In the aftermath of this decade of inflation was a series of financial crises of the 1980s, involving among other things, the failure of 2,237 U.S. financial institutions between 1983 and 1992, and the international sovereign debt crisis of the 1980s. The Great Inflation was created by the Fed itself and its money printing exertions of those days.

In the next decade, the 1980s, with some success and by imposing a lot of pain, the Fed undertook "fighting inflation"—the inflation it had itself caused. In the 2000s, it performed a variation on this pattern: the Fed first stoked the asset price inflation of the colossal Housing Bubble, then worked hard to bail out the Bubble's inevitable collapse.

The Fed and other fiat-currency central banks are in the money illusion business, trying to affect the costs of real resources by depreciating the currency they issue at more or less rapid rates, by money creation and financial market manipulations. The business of money illusion often turns into the business of wealth illusion, since central banks can and do fuel asset price inflations. Asset inflations of bubble proportions create "wealth" that will evaporate.

Asset price inflation can be intentional on the part of the Fed when it is trying to bring about "wealth effects," as it did with the housing boom in 2001-2004 and is now doing again with so-called "quantitative easing," including its unprecedented $1.5 trillion mortgage market manipulation.

Future financial histories will reflect something their authors will know, but we cannot: what the outcome of the Bernanke Fed's massive interventions in the long-term government debt and mortgage markets will have been. About this at present we, and the Federal Reserve itself, can only guess. In the 1920s, the then-dominant personality in the Fed, Benjamin Strong, famously decided to give the stock market a "little coup de whiskey." The current Fed has given the bond and mortgage markets a barrel of whiskey, in a way which would have astonished previous generations of Fed governors, and have been utterly unimaginable to the authors of the Federal Reserve Act.

The final outcome of this intervention will probably render the Bernanke Fed in future histories as either a great hero or else as a great bum. The probability distribution appears to me as bimodal, with nothing in between. It represents a remarkable central banking gamble—one which without doubt has greatly increased the interest rate risk of the entire financial system, as well as of the Fed's own balance sheet. It reflects the ultimate in discretionary central banking with multiple mandates.

How Many Mandates?

We constantly hear, not least from the Fed itself, about how it has a "dual mandate" of price stability and maximizing employment. Experts have debated whether the Fed or any central bank can achieve balancing these two mandates successfully. This question much oversimplifies the problem, for the Fed has not two mandates, but six.

To begin with, the provision of the Federal Reserve Reform Act of 1977 that gives rise to all the talk of a dual mandate actually assigns the Fed three mandates. It provides that the Fed shall: "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." Obviously, that is three goals—a triple mandate, not a dual mandate. However, the "moderate long-term interest rates" idea, perhaps because it is impractical, usually gets conveniently left out.

In addition, the Fed has three more mandates. Two are from the original 1913 Act: to provide an elastic currency, and to regulate and promote financial stability. The final mandate is the real essence of central banking: to finance the government as needed.

That makes six mandates. How is the Fed doing on each? Can it ever be expected to achieve them all?

Let us start with "stable prices." This mandate in its literal sense was dropped by the Fed long ago and is now a dead letter. The Fed's frequently announced goal is not stable prices, but a relatively stable *rate of increase in prices*, with a target of 2% inflation a year, continuing indefinitely. Bluntly put, the Fed is committed to perpetual inflation (although I cannot recall seeing it use this honest term) at a rate which will cause average prices to quintuple in the course of an average lifetime. With a straight face, the Fed and other central bankers call this "price stability"—a remarkable example of Orwellian newspeak. While it is confused on the actual legal mandate, a recent article discussing the Fed in *Barron's* correctly describes the current practice: "Half of its dual mandate, inflation."

A classic rationale for inflation is that real wages can be reduced without reducing nominal wages, and that real debts can be reduced without (as much) default on nominal debts. Nonetheless, it is my opinion that the current commitment of the Fed and other fiat-currency central banks to perpetual inflation will be judged in the long run as inconsistent with financial stability, and instead part of the

decades of financial instability which began in the 1970s. However that may be, price stability is what we intentionally don't have.

When the goal of "maximum employment" was added to the governing statute in 1977, many people, including the Democratic sponsors of the bill, believed there was a simple-minded trade-off between inflation and employment. Shortly after enactment of this mistaken idea, the stagflation of the late 1970s demonstrated its error. No one believes it now, but its presence in statute gives the Fed much increased power to exercise inherently uncertain discretionary central banking.

Within a few years of enactment of the "moderate long-term interest rates" mandate, the Fed was pushing interest rates to all-time highs, with the 10-year Treasury interest rate reaching 15% in the early 1980s. This was hardly a "moderate" rate, to be sure.

The history of the Fed and manipulation of long-term rates is instructive. During the 1940s, the Fed was a big buyer of long-term government bonds to finance World War II and to suppress the cost of borrowing for the U.S. Treasury. This was a major precedent considered by Chairman Bernanke for "quantitative easing." After the war, the Fed continued to hold down interest rates; at length it was debated whether it should. President Truman and his Treasury Secretary thought it should, but in the 1951 "Accord," the Treasury and the Fed agreed the purchases would end. In the ensuing three decades, interest rates kept rising, making a 35-year bear bond market, until their 1980s peak.

Now we have had an equivalent three-decade long bull bond market and the Fed, of course, is again a big buyer of bonds. It has again been a success at manipulating long-term interest rates downward, to near zero or even negative real rates. That is also not a "moderate" interest rate.

Of far greater seniority and standing is the fourth mandate of the Fed, which stood very first in the Federal Reserve Act in 1913. The legislative fathers of the Fed told us clearly what they wanted to achieve. The original Act begins:

> "An Act to provide for the establishment of Federal reserve banks, to furnish an elastic currency...."

In 1913, an elastic currency meant the ability to make loans from the Federal Reserve Banks to expand credit and print money to match the economic exigencies of the moment, whether reflecting the agricultural seasons, the business cycle or a financial panic. In the background was the experience of the Panic of 1907. One hundred years after that, in the Panic of 2007 to 2009, elastic currency was furnished with great energy by the Fed. Although the panic is over, the elastic currency is still very expanded, now called "quantitative easing."

As intended by the original Federal Reserve Act, an elastic currency is most certainly what we have got, not only in the U.S., but given the global role of the dollar, in the world. That is one mandate fully achieved. It is, as designed, very helpful in panics, but it also fits well with the more recent goal of perpetual inflation.

The fifth mandate is expressed in the beginning of the Federal Reserve Act as "to establish a more effective supervision of banking in the United States," now also thought of as ensuring financial stability. Although it was hoped at the creation of the Fed that it would make financial crises "mathematically impossible," in fact in the one hundred years since then there have been plenty of crises, right up to the most recent one. The Fed has full command of a very elastic currency, but the crises keep happening.

"Financial crises will always be with us," as Bernanke has written, "That is probably unavoidable." I believe that is correct, optimistic hopes about the most recent expansion of the Fed's supervisory power notwithstanding.

If only the governors, officers and staff of the Fed could know the future! Then they could doubtless avoid the crises. Since they do not and cannot know the future, it is plausibly argued that instead they help cause the crises by discretionary money creation and financial interventions which induce debt, leverage, asset inflation and illusory "wealth," with recurring unhappy endings.

The sixth and most basic central bank mandate of all is financing the government when needed. In the 1940s, the Fed was the willing servant of the Treasury Department in order to finance the war and hold down the Treasury's interest cost. At three years old, it had lent its full efforts to finance the government during the First World War. It is monetizing Treasury bonds as we discuss it. So convenient a thing it is for a government to have a central bank that almost every government has one.

This fundamental relationship is exemplified in the deal which formed the quintessential central bank, the Bank of England, in 1694. The deal was that the Bank would lend money to the government, in exchange it got a monopoly in the issuance of currency. This is still the basic structure of the Fed's balance sheet. Equally instructive is the founding of the Bank of France in 1800: "Bonaparte...felt that the Treasury needed money, and wanted to have under his hand an establishment which he could compel to meet his wishes"—a natural political desire.

Hence the ambivalence of Federal Reserve "independence." As William McChesney Martin, Fed Chairman in the 1950s and 1960s, said, the Fed is independent "within the government."

Yet it is true that "the Fed has also become a colossus," as the provocative historian of the Fed, Bernard Shull, has written. The combined six mandates, whether or not successfully achieved, make what Shull calls "an enormous concentration of power in a single Federal agency that is more autonomous than any other and one in which a single individual, the Chairman, has assumed an increasingly important role."

The accumulated power of the Fed gives it the greatest potential to create systemic financial risk of any institution in the world, while it is claiming and trying to reduce systemic risk. This fact alone warrants the review of the Federal Reserve and its many mandates which the Committee has wisely undertaken.

Thank you very much for the opportunity to share these views.

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