UNCONVENTIONAL MONETARY POLICY

HEARING

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Wednesday, December 7, 2016

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON MONETARY
POLICY AND TRADE,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:08 a.m., in room 2128, Rayburn House Office Building, Hon. Bill Huizenga [chairman of the subcommittee] presiding.

Members present: Representatives Huizenga, Mulvaney, Pearce, Stutzman, Schweikert, Love; Moore, Foster, Sewell, Kildee, and Heck.

Ex officio present: Representative Hensarling.

Also present: Representative Hill.

Chairman HUIZENGA. The Subcommittee on Monetary Policy and Trade will come to order. Without objection, the Chair is authorized to declare a recess of the subcommittee at any time.Also, without objection, I ask unanimous consent that any member of the full Financial Services Committee who doesn't sit on this particular subcommittee be able to participate and ask questions during today's hearing.

Today's hearing is entitled, "Unconventional Monetary Policy."

I now will recognize myself for probably the better part of that 5 minutes. So lacking logic or evidence, today's macro economic oracles endorse unsustainable deficits and unconventional monetary policies. The oracles say the economy would be booming except for fiscal austerity. However, as the debt clock in this hearing room clearly shows that is often up, not unfortunately right now, but as often is displaying fiscal policy is anything but austere.

Denying that their prescriptions created a heavy drag on our economy, the oracles point to ever-changing head winds. For example, they tell us that an aging population is causing labor force participation to plumb bottoms last seen in the 1970s. Their hypothesis is short on facts, however. For example, median age in the 1970s is a decade lower than today's. So if aging is a problematic, then the oracles would predict strong labor participation in the 1970s, even though it is the same disappointing level as today.

The 1970s is also similar to the 2010s on another important dimension. Separated by four decades, they both suffered from distortionary economic and monetary policies. Refusing to let facts get in the way of fantasy, the oracles tell us that the American households would even be worse off except for these unsustainable deficits and unconventional monetary policies. The evidence. Well, we are doing better than the likes of Japan or the European Union. That story might fly in the faculty lounge, but it certainly doesn't around dinner table. The star pupil in the class of central banks gone wild has nothing to brag about.

The American dream is at a risk. Pre-recession productivity meant that living standards could double every generation. Under today's opaque and distortionary monetary policies, however, productivity has been cut in half. The oracles call this the new normal.

Well, I believe they are wrong. This is neither normal nor acceptable. Not too long ago our children could reliably look forward to the doubling of their living standards. Under today's monetary and economic policies, a doubling of living standard might instead wait for our children's children. With logic and evidence having left their side, perhaps the oracle should embrace the strategy from Seinfeld's George Costanza.

Now, Mr. Chairman, I am not sure if we have ever quoted George Costanza in this committee, but here we go. "If every instinct you have is wrong, then the opposite would have to be right."

The oracles tell us that without their seat-of-the-pants response to the Great Recession, our economy would be even further below potential almost 8 years post recession. The opposite would have had a hard time doing worse. Today's macro economics aim policies at highly aggregated variables that have little if anything to do with what drives our economy.

Their answer for economic fluctuations is to further distort spending on consumption, investment, or government. But just as businesses cannot hide mismanagement for long behind the income statement manipulations, governments cannot mask malaise by diverting money into politically favored national income accounts. This pretense of knowledgehas grown from a macroeconomic orthodoxy where repeated failures of unconventional monetary and economic polices count as evidence that we didn't do enough.

Economic opportunity reliably increases when monetary policy adheres to its vital duty, that is, facilitating commerce wherever it shows promise. Throughout our current economic malaise, monetary policy has not only ignored this duty, it continues to ignore the consequences of ignoring this duty. Annually, since 2007, the Fed's monetary policy committee predicted that its principle-free decisions would trigger a more resilient economy. Each year, reality fell further from prediction, and according to the Fed's own researchers, the FOMC, quote, did not anticipate the great recession, underestimated the severity of the downturn, and consistently overpredicted the speed of the recovery.

A decade of economics-free monetary policy is not working because it cannot work. Returning to a robust economy requires a more firmly grounded and transparent policy. That transition cannot happen until the Fed shrinks its balance sheet, brings interest rate and credit risks out of the bureaucratic shadows. In the same vein, policy distortions will remain elevated until the Fed also returns to a monetary policy that does not only what it can, produce an efficient exchange medium so that goods and services, which includes labor, can easily find their most promising opportunities.

The Chair now recognizes the ranking member of the subcommittee, the gentlelady from Wisconsin, Ms. Moore, for 5 minutes as well for an opening statement.

Ms. MOORE. Well, thank you so much, Mr. Chairman, and let me thank this distinguished panel for yet an opportunity to talk about our economy, our monetary policy, and to really sort of dig down deep into the theoretical and the what will really work in the real world and the practical application.

I want to make a couple of observations about this, our what is it, Mr. Chairman, our fourth or fifth hearing on unconventional monetary policy. Which one? I yield. Is that 4th or 5th? Anyway—

Chairman HUIZENGA. Pretty much any time we have been discussing monetary policy, it's been about—

Ms. MOORE. Great. And we have had a great discussion, particularly, Dr. Taylor, on your Taylor rule, so we have examined this in the abstract, I must admit. And speaking of dinner table conversation, this is great dinner table conversation, it is great economic journalism, but how would it have really worked in the real world? And we are having this conversation, of course, Mr. Chairman and witnesses, because we have faced an unprecedented financial crisis. So the Fed has done its job, and they have been forced into unconventional solutions.

We know, from past conversations, that had we had a Taylor rule, the Fed, with its responsibility, would have had to have deviated from it at exactly this kind of—because of this kind of economic crisis. And I believe, Dr. Taylor, you will get a chance to talk to us some more in your testimony, but you yourself indicated to us that it was merely a guidepost. It was not something that was locked down.

So it is not like we have had wild unruly monetary policy precrisis. I commend Dr. Taylor's work, recognize his utility and intellectual circles, but I don't see, Mr. Chairman, any reason for this committee to endorse the idea for real world application.

Secondly, this hearing is admission by the majority that the real problem all these years has been Republicans' refusal to seek, demand side fiscal solutions to help the economy. Seventy percent of our economy is actually based on consumers having money in their pockets and being able to support a fledgling economy. The austerity measures supported by our Republican friends hurt the economy, hurt people, and force the Fed's hand on monetary policy.

Now, you know, Republicans want us to buy the fact that tax cuts for the rich are the cure for this disease. Shareholders of the rich have been the ones helped by monetary policies by way of stock prices.

Now, Mr. Chairman, if you want us to unwind the unconventional monetary policy, we need to look at ways to help the poor and the middle class, things like strengthening the safety net, like helping mothers, like investing in public education, how about public infrastructure? These are the kinds of things that stimulate the economy, the very things you will find in my bill called, "The Rise Out of Poverty Act," helping everyday Americans still hurting in the housing downturn by robo foreclosures by men like our proposed Treasury Secretary who has helped himself by this government in crisis.

Thank you, and I would yield back the balance of my time.

Chairman HUIZENGA. The gentlelady yields back. Well, today, we welcome the testimony of four distinguished folks: Dr. John Taylor, professor of economics at Stanford University; Dr. Charles Plosser, visiting fellow at the Hoover Institution, Stanford University, and former president and CEO of the Federal Reserve Bank of Philadelphia from 2006 to 2015; Dr. Mickey Levy, managing director and chief economist, Berenberg Capital; and Dr. Simon Johnson, who is the Ronald A. Kurtz professor of entrepreneurship, professor of global economics and management, the Sloan School of Management at MIT.

So each of you will be recognized for 5 minutes to give an oral presentation of your testimony, and without objection, each of your written statements will be made a part of the record.

With that, Dr. Taylor, you are now recognized for 5 minutes.

STATEMENTS OF JOHN TAYLOR, PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY

Mr. TAYLOR. Thank you Mr. Chairman, Ranking Member Moore, other members of the committee, and Chairman Hensarling for inviting me here to speak about unconventional monetary policy.

I think the Federal Reserve's move toward unconventional monetary policy can be traced back a dozen years to so-called "too low for too long period" of 2003-2005. During this period, the Fed held its policy rate, the Federal funds rate well below what was indicated by the experiences of the previous two decades of good economic performance. During this 2003-2005 period, the Fed also started giving forward guidance that its policy rate would remain very low for a considerable period and that it would be raised only at a measured pace.

These actions were a departure from the policy strategy that had worked well in the 1980s and 1990s. Regardless of the reasons, the results were not good. The excessively low rates along with promises that they would remain low brought on a risk-taking search for yield and excesses in the housing market. Along with a breakdown in the regulatory process, these policies were a key factor in the financial crisis and the great recession.

During the panic in the fall of 2008, the Fed did a good job in its lender-of-last-resort capacity by providing liquidity to the financial markets and by cutting its policy interest rate. But then Fed policy moved sharply in an unconventional direction. The Fed purchased large amounts of U.S. Treasury and mortgage-backed securities in 2009, financed by equally large increases in reserve balances, which enlarged the Fed's balance sheet. And long after the recession ended, these large-scale asset purchases continued and the Fed held its policy interest rate near zero when indicators used in 1980s and 1990s suggested higher rates were in order. The Fed also utilized forward guidance in this period would change the methodology several times, which increased uncertainty.

My research and that of others over the years shows that these policies were not effective and may have been counterproductive. There is now a growing consensus that the extra low interest rates and unconventional monetary policy have reached diminishing or even negative returns.

The unconventional policies have also raised public policy concerns that the Fed is being transformed into a multipurpose institution, intervening in particular markets, and allocating credit, areas where Congress may have a role but not a limited purpose independent agency of government.

In many ways, this recent period can be characterized as a deviation from our rule-like systematic, predictable, strategic, and limited monetary policy that worked well in the 1980s and 1990s. The policy implication of this experience is clear. Monetary policy should be normalized. The Fed should transition to a sound rule-based monetary policy like the one that worked in the past while recognizing, of course, that the economy and markets have evolved.

As part of the normalization process, the size of the Fed's balance sheet should be gradually reduced. For reasons I gave when I testified at this committee last May, reserve balances should be reduced to the size where the interest rate is market determined rather than administered by the Fed as it sets the rate on excess reserves.

Normalization is easier if there is an understanding of the basic monetary strategy. This and recent experience point to the need for monetary reform. A good reform is now part of the format. It would require the Fed to describe the strategy or rule of the Federal Open Market Committee for the systematic quantitative adjustment of its policy instruments.

I think monetary normalization and reform have important implications for the international monetary system as well. Unconventional monetary policies with near zero policy rates have spread internationally to other central banks. Because a key foundation of a transparent rules-based international monetary system is a rules-based policy in each country, normalization and reform by the Fed is a key part of international monetary reform, and I think international monetary reform will in turn benefit the United States.

In conclusion, let me emphasize that monetary reform, tax reform, regulatory reform, and budget reform often go together. They reinforce each other. All are crucial to a prosperous economy. I think the opportunity for monetary reform is now better than it has been in years.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Taylor can be found on page 75 of the appendix.]

Chairman HUIZENGA. Thank you. And with that, Dr. Charles Plosser, you have 5 minutes for your presentation.

STATEMENT OF CHARLES PLOSSER, VISITING FELLOW AT THE HOOVER INSTITUTION, STANFORD UNIVERSITY, AND FORMER PRESIDENT AND CEO, FEDERAL RESERVE BANK OF PHILADELPHIA (2001-2015)

Mr. PLOSSER. Thank you, Chairman Huizenga, and members of the subcommittee, I appreciate this opportunity to come share with you some thoughts on the Federal Reserve.

Let me begin with two important points that illustrate the challenges as we think about central bank reforms. Central banks, for the most part, are given the responsibility to preserve the purchasing power of a nation's fiat currency. One way the Fed does this is by buying and selling securities in the open market to control the growth of credit and money. This gives the Fed extraordinary powers to intervene in financial markets, not only through the quantity of it purchases but also of the types of assets it can buy.

The second point is that history teaches us that economic stability and prosperity are far more likely when there is a healthy degree of separation between government officials who are responsible for tax and spending policy and those in charge of printing money. Otherwise, printing money seems to become an easy substitute for tough fiscal choices.

Argentina is an example that has been stagnant and rife with periods of inflation and financial turmoil over the last three decades, at least. In large part, this is due to a lack of effective separation between the central bank and the fiscal authorities.

These two points highlight a major tension in the discussions of central bank reform. How, in a democratic society, do you preserve a central bank's independence while ensuring that it has adequate tools for success and can be held accountable to the public?

I believe there are three responsible ways to address this tension: Simplify the goals, constrain the tools, and make decisions more systematic and predictable. All three steps can lead to clear communications and a better understanding of monetary policy on the part of the public without undermining independence. In my brief time, let me just touch on two of these strategies.

The Fed is said to have a dual mandate, price stability and maximum employment, yet the broader the mandate, the more opportunity there is for discretion, and the more discretion means there is more scope for political interference and uncertainty over the direction of policy. Policymakers can find themselves futilely chasing one goal after another.

Unfortunately, over the last decade, the Fed's mandate seems to have experienced mission creep, expanding the scope for discretionary action, and the opportunity for political interference. The public and the Fed have talked as if monetary policy should be responsible for stock market valuations, income inequality, labor force participation rates, real wage growth, and an expanding list of other dubious objectives.

Indeed, around the world, it seems that central banks are being asked to solve all manner of economic ills from fiscal crisis in Europe to low productivity and structural challenges in Japan and the United States. I think this is a mistake and potentially dangerous for the institution and the economy.

Moreover, these broad mandates make it extremely difficult to hold a central bank accountable. I am reminded of the old saying: Responsible for everything but accountable for nothing. Institutions are guaranteed to fail when they are assigned responsibility for outcomes that they cannot substantially influence. The hubris of central bankers and the unrealistic expectations of the public and governments are out of line with what we can realistically expect for monetary policy.

As the Nobel Laureate Milton Friedman warned us almost 50 years ago, "We are in danger of assigning to monetary policy a larger role than it can perform, in danger of asking it to accomplish tasks it cannot achieve, and as a result, in danger of preventing it from making the contribution that it is capable of making."

One way to address these concerns and to help reset expectations is to narrow the monetary policy mandate to focus solely or at least predominantly on price stability. Many major central banks around the world already have such a more narrow mandate or hierarchal mandate of this kind. It would focus the Fed's attention, reduce the opportunity for discretion, and make it easier to hold the Fed accountable for its actions. It would also provide some protection to the Fed from demands arising inside and outside central banks to pursue other mostly unachievable objectives.

A second way to restrict central bank interventions is to limit the types of assets that can be purchased, thus constraining the composition of the Fed's balance sheet. For the U.S., I suggest that the Fed be restricted to an all-treasury portfolio. During the crisis and recession, the Fed engaged in large scale purchases of mortgage backed securities in an effort to help the housing sector. It also purchased distressed securities during the rescue of Bear Stearns and AIG. Such actions are a form of credit allocation and thus a type of fiscal policy. Fed independence should not include making fiscal policy decisions as it undermines the separation of authorities and thus independence. Fiscal authority should take responsibility for fiscal actions.

If the Fed is to engage in the purchase of private sector securities or credit allocation, it should do so at the request of the fiscal authorities. The Treasury should then take possession of those assets in exchange for Treasury securities so the central bank can resume its task of conducting monetary policy, and maintain the separation of fiscal and monetary policy remains intact. Thank you very much for your attention.

[The prepared statement of Dr. Plosser can be found on page 54 of the appendix.]

Chairman HUIZENGA. Thank you, Dr. Plosser, and I have a sneaking suspicion that your Milton Friedman quote just beat my George Costanza quote.

With that, Dr. Levy, we would like to welcome you here as well, and you have 5 minutes for your presentation.

STATEMENT OF MICKEY D. LEVY, MANAGING DIRECTOR AND CHIEF ECONOMIST, BERENBERG CAPITAL

Mr. LEVY. Mr. Chairman and members of the committee, I really appreciate this opportunity not just to speak about monetary policy but also economic policies in general.

The Fed's unconventional policies do deserve credit for lifting the economy and financial markets from crisis in 2008 and 2009. However, it is quite striking that since then, Fed's sustained negative real interest rates, quantitative easing and forward guidance, while they successfully stimulated financial markets, pushed bond yields lower, pushed up asset prices, encouraged risk taking, they failed to stimulate the economy. Nominal GDP growth, that is, current dollar spending in the economy is actually decelerated. Real economies languished.

In recent years, the Fed's unconventional policies have not had their intended impact but instead have created mounting distortion and have been inconsistent with the Fed's long-run objectives and its objective of macroprudential risk.

Why have the Fed's policies been ineffective? Because the constraints on growth are nonmonetary in nature. Along with many factors, government policies have been a key source of the weakness. The adverse impacts are particularly apparent in business investment. Consumption and housing have been growing fine, but business investment has been notably weak, and this has not only been the weak link in the economy, it has been the source of the weak productivity and estimates of lower potential growth.

Beyond the mounting government debt and expectations of higher taxes, there has been just this growing web of government regulations, mandated expenses, and higher tax burdens not just on the Federal level but on the State and local levels that have weighed very heavily not just on the banking and financial sectors but also in business investment and the broader economic environment.

The burdensome micro regulations imposed by Dodd-Frank have deterred bank lending, particularly of medium- and small-sized banks, and they are at cross-currents with the Fed's easy monetary policy. In nonfinancial sectors, an array of regulations and government mandated expenses and taxes have reduced efficiencies of production, inhibited labor mobility, and lowered risk adjusted after tax rates of return on investment, and they have added a tremendous layer of uncertainty in business decisionmaking.

So while the Fed has very effectively lowered the real cost of capital, these government policies have forced businesses to raise their hurdle rates required for capital spending and expansions. So potentially productive expansion plans have been sidelined, businesses are taking advantage of the low interest rates environment provided by the Fed to issue bonds, but they are buying back stock rather than expanding, corporate indebtedness rises, and it doesn't add to productive capacity, and also, there are a lot of distortions in labor markets.

The critical point here is these policies are beyond the Fed's monetary policy scope, and trying to offset these negative impacts with excessive monetary eases, generated mounting financial distortions, and unfortunately, I think just now we are just beginning to feel the negative effects of the Fed having been too easy too long. The next couple of years may be kind of tough.

So the Fed has recently come to acknowledge that its monetary policies have lost their punch and has recommended a shift toward fiscal stimulus. So before I outline some suggestions for monetary policy, I have a critical point to make on fiscal policy.

It is critically important to distinguish between fiscal reform and fiscal stimulus that simply involves more deficit spending. The economy is in its eighth consecutive year of expansion, the unemployment rate is 4.6 percent, and the economy is growing at a pace consistent with the Fed's potential. What is not needed is countercyclical fiscal stimulus in the form of more deficit spending.

The focus of fiscal reform should be tax and spending reforms that raise potential growth, corporate tax reform which involves lower rates and a broader base through reducing deductions, deferrals, credits, exemptions, these and lower rates and simplification, this would encourage business investment and expansion.

Infrastructure spending initiatives, we have to focus on projects that add to productive capacity and provide benefits that exceed cost while avoiding quick-spend projects aimed at temporarily boosting growth and jobs. I mean, it is critically important. Reform, fiscal reform does not just mean more deficit spending, and that is going to be critically important as we enter 2017.

Now, on monetary policy and—

Chairman HUIZENGA. Dr. Levy, I am going to have to ask you to wrap it up here quickly.

Mr. LEVY. Quickly. Raise rates, cease reinvesting—cease reinvesting maturing assets, de-emphasize the short run and fine tuning, change policy statements accordingly, and move toward more rules-based policies that provide flexibility.

[The prepared statement of Dr. Levy can be found on page 47 of the appendix.]

Chairman HUIZENGA. I will yield some of my time to allow you to expand on that when we come back to questioning.

So with that, Dr. Johnson, you have 5 minutes.

STATEMENT OF SIMON JOHNSON, RONALD A. KURTZ PROFESSOR OF ENTREPRENEURSHIP, PROFESSOR OF GLOBAL ECONOMICS AND MANAGEMENT, SLOAN SCHOOL OF MANAGEMENT, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. JOHNSON. Thank you, Mr. Chairman. I agree with you completely, Mr. Chairman, with regards to your initial statement on the fact that this is not normal, what we have now, and it is not acceptable. I think you and I may have a slightly different reading of recent economic history, but maybe it is not that different.

We had an enormous financial crisis and collapse. I was the chief economist of the International Monetary Fund in 2007 through August 2008. We were worried about how bad it was getting in the United States, and we encouraged preventive measures. None of that was effective, and the crisis turned out to be much bigger than what we anticipated and much bigger than what we had seen and what I had worked on over the past 30 years.

Now, I agree with Chairman Hensarling that an undercapitalized financial system was the core of what went wrong. I think we disagree on some of the ancillary related measures, but capital, lack of capital in our financial system, and funding it with way too much short-term debt was the core problem. Massive financial crisis result in anemic recoveries. I am afraid that is not—that is not just astatement about the United States. That is a general statement about what we have learned over the past 200 years of finance and economics.

The second point on which I share, I think—I certainly agree with most of my fellow panelists is that monetary policy is a limited tool that cannot do very much. And I think it is—and I agree with Dr. Plosser, you shouldn't overreach with monetary policy. I would say, and I think I have seen this in some of the other testimony, including Dr. Levy's, that QE1 done at the end of 2008, 2009, absolutely unconventional monetary policy, yes. Specifically targeted supporting mortgage-backed securities and a piece of the key pipeline for credit and securities markets that are broken completely, that is what they did. I think it was a good idea. The fog of war applies in finance as well as in war, you don't know exactly what is happening at the time, but I fully support what the Fed did in that instance.

Subsequent iterations and attempts to continue with that policy, we can discuss. I think much less effective would be a fair way to say it, and that is also what Mr. Bernanke says.

Rules can help monetary policy, and if, hypothetically, Dr. Taylor or Dr. Plosser end up back on the FOMC, I will be fully supporting their rights and ability as members of that committee to determine rules. I really don't think you want to micromanage the Federal Reserve. It is not what we have been historically. You can set the objectives, and I commend you, Mr. Chairman, for focusing our attention on that. I think you should continue with the existing objectives personally, but I think we are going to discuss that a lot more.

The third part of what went wrong in the economic history, which is a piece I am sure we absolutely disagree on completely, which is fiscal policy. Again, former chief economist at the IMF. I don't run around the world telling people to stimulate their economies, and I am not in favor, generally speaking, of using fiscal policy for any, any short-term response to anything, all right. That is more a job of monetary policy if, you know, subject to Taylor rule type considerations.

However, again, largest financial crisis since the great depression, limited ability of monetary policy to respond, QE1, but perhaps we are not convinced of anything beyond that, what else do we have? We have a massive crisis. You said—actually, I liked your formulation of monetary policy, was one of my favorites ever, I wrote it down: Monetary policy should be to facilitate commerce. Absolutely. Completely correct.

The private sector economy was broken, and 99 percent of people in the private sector economy had no responsibility for what went wrong. They were completely innocent bystanders, and that includes all the people in finance, by the way. They were just doing their jobs. Devastating impact, limited ability of the government to respond with monetary policy, what else are you going to do?

In those circumstances, and only in those circumstances, I think, and I testified before other committees of Congress to this effect at the time, some fiscal stimulus, including large tax cuts, I argued for bigger tax cuts than were actually put through by this Congress, by the way, as well as other measures on the spending side.

We are out of that phase. Now the issue for fiscal policy is medium term, how do we get away from this for normal, "normal," how do we get to higher rates of growth? And here I am completely siding with Congresswoman Moore. I work a lot with the private sector. My job at MIT is to help companies grow in the United States and around the world. What do they need? They need people. They need human capital. They need infrastructure.

I am not saying that this is the miracle cure. I am not saying you do it on a 1- or 2-year time horizon, but I think over a 10- to 20-year period, when you look at productivity prospects in the United States, when you look at our ability to compete, when you look at the ability of our companies to stand up and to do better than other companies with regard to innovation and employment, people, really good people. And of course, that is about opportunity. It is about who gets the education and who can climb up the social ladder, which we used to be good at in this country, but unfortunately, the past three decades, we have lost that.

Thank you.

[The prepared statement of Dr. Johnson can be found on page 42 of the appendix.]

Chairman HUIZENGA. I appreciate that. Thank you very much. At this point, I will recognize myself for 5 minutes, and I would like to go back to Dr. Levy because I think we have stumbled into something, and we did this in another hearing previously with the ranking member and myself that we agree that, frankly, the rich on Wall Street have gotten richer, while most others have been left behind. And kind of getting to where Dr. Johnson was going, you know, the question is, is why and how.

And is this because we have not borrowed enough money to do more stimulus spending, as some would seem to argue, or—and Dr. Levy, when you were talking about this, I had written this out on my notepad of a recent example. I sat down with a CEO of a publicly traded company, large influential, sort of in the financial services space, and he walked me through the pressures that he is feeling from his shareholders, including institutional investors like CalPERS and others to take advantage of the artificially low interest rate environment, to borrow money, to then buy back his own stock, and as he said, or the stock of a publicly traded company, as he said, I have become fabulously wealthy. In fact, I looked it up. He has just cashed in a seven figure amount of stock again. He said: I have become fabulously wealthy, but it is not the right thing for the economy overall.

And it was in stark terms, and he is like, but if I don't do this, so you know, I have one small little corner of this, but I have CalPERS, and I have a number of other institutional investors who literally could take me to court for not fulfilling my requirement of maximizing the return for them. And that was rather stark for me, and I just wanted you to maybe comment on that a little bit, and I would love to hear from all four of you quickly.

My original question, has the Fed become more political, and I kind of maybe altered this, changing it slightly, has the Fed been politicized is really what I want to know. And so Dr. Levy, I want to start with you and give you a brief opportunity as well to touch on, and if you had any of those other points that you wanted to make towards the end when I had to cut you off, so—

Mr. LEVY. Has the Fed become politicized? Yes, on the inside the way it operates and on pressures from the outside, and I think it is a real concern because we all benefit from a central bank that pursues its long run objectives, and so I—there is a laundry list of ways that the Fed has become much more politicized.

Back to your point on Wall Street, and I am an economist and not an investment banker that has benefitted by all the Wall Street largesse. Wall Street makes a lot of money through leverage, okay, and so, you know, when they have had low capital positions and a lot of leverage and they have played the positive carry game and taking advantage of their leverage, this generates very large profit. So I would be very much in favor of legislation that requires higher capital adequacy while at the same time reducing a lot of the micromanagement from the Fed, the OCC, and the like. And so I think this would be—that would lead to better balance of people on Wall Street.

Chairman HUIZENGA. And isn't it true that—I mean, companies, whether they are in the financial services space or whether they are, frankly, in manufacturing or any other space, they are not just looking at tax rates. They are looking at the regulatory environment that is causing uncertainty, correct? I mean, when they are going in, I think that is why we have seen—at least some would argue that we have seen some rebounds, in the overall optimism, is that there is going to be some stability, hopefully, and some predictability in the regulatory space, not just in that tax space.

Mr. LEVY. I completely agree. Surveys of businesses, they are big—business' biggest concern, of course, is product demand, but right behind that are concerns about taxes and regulation. So once again, while the Fed has been very successful lowering the real cost of capital, businesses, when they think about expanding and investing, their hurdle rate is pushed up by taxes and by regulations not just on the Federal level but the State and local levels where they operate, and it adds a huge layer of uncertainty, and they have to put that in their calculation.

And so unwinding that, the build up in regulations, I think, would really lift a great cloud off of business investment, and expansion, and employment. And I think what I think the other panelists would totally agree with me on is if you could put in place policies that would lift productivity and potential growth, that would lift real wages.

Chairman HUIZENGA. All right. And unfortunately, my time has expired. I wanted to get to a comment from Jeffrey Lacker about markets being better judges of creditworthiness than central authorities, but maybe we will have a round two or one of my colleagues can pick up on that as well.

So with that, I would like to recognize the ranking member for 5 minutes.

Ms. MOORE. Thank you so much, gentlemen, and of course it is a pleasure to have you all here. I just want to start with, I think, Dr. Levy. This is very sound testimony from you, and I got really, really interested in your comments on page 1, 2, 3, 4, where you talked about household behavior, and dim expectations of disposable income and so on, people—household spending more money on health care, tight mortgage credit standards, and so I guess where I am leading to this is some comment or observation on your part about the lack of income, of the policies, the austerity policies that were put in place here while simultaneously experiencing this downturn.

Do you see that there is any nexus between the tightening—because you say here monetary policy can only do so much, so do you see any nexus between the lack of income that people have and the inability for our economy to grow?

Mr. LEVY. So real, or inflation just as disposable income, has been growing at a moderate pace, and the data show that people are basically spending it, so consumption is growing, once again, at a moderate but not a robust pace, and you know, at the same time, some government regulations and government mandated expenses, particularly in health care, have forced households to allocate more of their out-of-pocket spending toward healthcare insurance premiums and the like.

Ms. MOORE. So just to be clear, you don't necessarily see $7.50 an hour as the minimum wage as contributing to the slow growth. You see it all being caused by, of course, the downturn in the market, the lack of regulation—I think somebody testified to the lack of regulation being one of the causes, so you don't see the lack of income on people's part as contributing to this?

Mr. LEVY. My honest assessment is the biggest factor that is inhibiting stronger wage growth is productivity, and I think—

Ms. MOORE. People are more productive than they have been. Maybe, Dr. Johnson, maybe you can help me out here.

Mr. JOHNSON. So I think the—where you are going with this, Congresswoman Moore, is absolutely correct, that the impact of fiscal policy and austerity has been disproportionately at the lower end of the income scale. Obviously, income inequality has been a issue with us for a long time, and the big question we have, and also to the point the chairman raises, if productivity increases, that is good, it creates potential for wages to rise, but wages at the lower end, incomes at the lower end of the income scale have not risenvery much over the past three decades, actually, so there is a bigger problem there, and I think that is one reason why raising the minimum wage to an appropriate degree would be part of a response that would make some sense.

Ms. MOORE. And you know, lack of providing adequate monies for infrastructure, educational funding and so on.

Dr. Taylor, I just want to—since you are our distinguished guest here, I do want to give you a chance to answer a couple of questions.

You think QE1 was okay, right, but not the other monetary policy? Is that—did I hear your testimony correctly?

Mr. TAYLOR. There is sometimes confusion of what QE1 means. To me that was the purchases of securities—

Ms. MOORE. Right.

Mr. TAYLOR. —in 2009. There was also a big intervention in 2008, and that is the one, that is the lender of last resort, to firms in distress, liquidity operations, and those actually phased out very early 2009. It is really after that that I think there was questions about the effect.

Ms. MOORE. Okay. Thank you. I just want to ask, in my last 25 seconds, back to you, Dr. Levy, fiscal reform versus fiscal stimulus. So is it your testimony really that fiscal stimulus would not be an effective tool? And this, of course, would be done in Congress, not as a monetary policy.

Mr. LEVY. I would love to see fiscal stimulus, but I think that involves more—not just increasing deficit spending that provides income support and gooses up jobs in the near term, but increase spending, reallocating spending in a way that helps out the economy in less productive capacity. And once again, if you look at the whole size of the government's budget, there is certainly enough ways to reallocate, to spend a lot more on things like infrastructure, education, and training.

Ms. MOORE. Thank you. Thank you, Mr. Chairman, for your indulgence, and I yield back.

Chairman HUIZENGA. You are very welcome. And with that, I would like to recognize the vice Chair of the committee, Mr. Mulvaney for 5 minutes.

Mr. MULVANEY. Thank you, Mr. Chairman. The last time that Janet Yellen was here, she and I had a chance to talk very briefly about another type of unconventional monetary policy that we haven't discussed yet today, and that is the purchase by central banks of actual equities.

She had given a speech, I asked her a couple of questions, and I had a chance to follow up and ask her some questions, written questions for the record, and I want to read you, gentlemen, very quickly, the three paragraphs in that letter, and also, I would like to add the record to the—the letter to the record.

Chairman HUIZENGA. Without objection, it is so ordered.

Mr. MULVANEY. This is her response. It says: In my remarks at this year's economic symposium in Jackson Hole, I noted the challenges for monetary policy posed by the effective lower bound on interest rates and the possibility that when they face these challenges more frequently in the future, given the apparent decline in the so-called equilibrium real interest rate. To address such challenges, I noted that monetary policymakers may again need to rely upon unconventional tools such as forward guidance and asset purchases to promote statutory goals such as maximum employment and stable rates.

On the subject of asset purchases, it is important to note that the Federal Reserve Act provides authority for the Federal Reserve to purchase only a relatively narrow risk—excuse me—a narrow range of low risk assets such as Treasury and agency securities. The Federal Reserve does not have the statutory authority to purchase a broad range of private sector obligations such as corporate bonds, equities, asset-backed securities, or household debt.

In contrast, other central banks such as the European Central Bank, the Bank of England, the Bank of Japan, and the Swiss National Bank have the authority to purchase a relatively wide range of financial assets. Moreover, these central banks have utilized their authority in recent years in different ways to address severe economic shock.

And she and I went on to talk about the fact that I think the Bank of Japan and then I think Swiss bank had actually started buying equities. The Bank of Japan, I think was buying ETFs. I can't remember what the Swiss were buying.

So let's talk about this other unconventional type of monetary policy. We will start with you, Dr. Taylor. Your thoughts on that generally. Have you given any specific consideration to this topic?

Mr. TAYLOR. Well, I think the Fed should stay away from buying equity.

Mr. MULVANEY. Why is that?

Mr. TAYLOR. Simple as that. Because first of all, it is a form of quantitative easing, and it is other things to do with respect to monitoring. Monetary policy can adjust its balance sheet to make the interest rate move in a desired way without touching equity. There is plenty of securities to buy.

So I think it also goes in the direction of potentially helping certain firms and not others. It is a form of intervention, which is, seems to me, not broad based or limited as monetary policy should be. You can choose one firm versus another. There is also some things that can happen and it is not necessary.

Mr. MULVANEY. And in fairness to her, she went on through a list of advantages and disadvantages, so I couldn't read the whole letter. But when she comes back and if she were sitting here and you are having a conversation, and she says: Yes, John, but we are out of bullets, we need something else. What would your response be?

Mr. TAYLOR. I don't think you need anything else. I think we, have had a lot of history, we even had ideas about what to do at the so-called Zero Bound, which doesn't require that. It is some indication of what is going to happen after the Zero Bound. There has been lots of work on that. There is plenty of other securities to buy to set monetary policy.

Mr. MULVANEY. Dr. Plosser, Dr. Levy, I would curious to know your thoughts. As I am not going to get a chance to ask you questions, I would do it in writing, because I enjoy my back and forth with Dr. Johnson so much, because he is a really good participant in these hearings.

So Dr. Johnson, I give you the last minute-and-a-half of my time. What are your thoughts on this particular unconventional monetary policy?

Mr. JOHNSON. Well, I think I am going to surprise you, Mr. Mulvaney. I think you are asking a very good question, and this is the right time to ask it, in a time of peace not— and I agree with you. I don't think—I agree with Mr. Taylor.

Mr. MULVANEY. I yield back the balance—no, I am sorry.

Chairman HUIZENGA. The Chair will suspend the clock here because I am not sure we have ever seen a compliment like that paid to the vice chair, so—

Mr. JOHNSON. I am happy to make your day. So I think that, in the United States, I would stick with the authority that the Fed has, and I think that is what I heard Dr. Taylor said. I can't imagine circumstances in the United States in which buying equities would be appropriate. Other central banks do different things because different market structures, sometimes they feel they don't have enough bonds and so on. I am not going to comment on that, you know.

I don't think that—you know, what Dr. Taylor—you don't want the central bank to be directing credit, you don't want to be playing favorites, you don't want to be—you know, I think the Fed is politicized from the outside, as Dr. Levy said. I think they have actually retained an impressive degree of nonpoliticalization on the inside. If you they get into allocating credit more than they have, that will be a problem.

So just on QE1, if I might. What they did was a specific purchase of mortgage-backed securities that were underwritten by or issued by Fannie Mae and Freddie Mac, which have been taken over by the government. So they have to buy government-backed securities, no credit risk, that included those housing securities at that moment. I think actually we are agreed—so that is a slightly uncomfortable we should discuss also, but I think what you heard from all of us is at that moment, not a bad call given the fog of war that they faced, but you know, I think you should push us on that.

Mr. MULVANEY. Thank you, diligent gentlemen. Dr. Plosser, Dr. Levy, again, my apologies, in the limited time I didn't get a chance to ask you, but I do hope to have a chance to follow up in writing. Thank you. Thank you, Mr. Chairman.

Chairman HUIZENGA. The gentleman yields back. And with that, we will recognize Mr. Foster of Illinois for 5 minutes.

Mr. FOSTER. Thank you, Mr. Chairman, and thank you to our witnesses here. You know, one of the most important inputs to monetary policy is inflation, and there is a strand of debate going on in economics right now about whether we are significantly mismeasuring inflation in large part by underestimating the technological price reductions and quality improvements or just the existence of products that were not previously available.

I mean, examples of this are medical care, for example. If you give the average person the choice of having today's medical care at today's prices versus 1970s medical care at 1970s prices, most people would choose today's medical care, which tells you mathematically that healthcare inflation has been negative; whereas, in fact, we carry it on our books at 6 percent a year, and that's, I don't know, 17 percent of the economy, so it is not a small error, if this is true.

There are other things. You know, we carry in our pockets a super computer that has a value of tens of millions of dollars in 1970 dollars and somehow we are not scoring it in a naive way.

And you know, this drives the debate in a number of things when you ask the question is the median family better off than it was a generation ago? You know, if you look at the basket of goods by the median family a generation ago versus today, you know, I think most people would agree it is better off, despite the fact that if you look at, you know, the wealth or income of the median family, it is not so good. So that so my questions are this.

First, you know, do you agree with this narrative that we are actually making a significant error in how we are measuring inflation? And secondly, what are the implications for monetary policy if in fact we are not measuring inflation properly? Anyone who is up for fielding any part of that.

Mr. JOHNSON. I think, Mr. Foster, it is a very good point and a rather broad and subtle point which affects both how we think about inflation and obviously purchasing power, and you are right, that where we have—some parts in our consumption basket didn't exist or where it would have been—would have cost a fortune previously, and we don't take that into account very well.

I think to the point about monetary policy, which is obviously the focus today, this is heuristic that central banks have. There is nothing that says that inflation should actually be 2 percent. I mean, there is no law of economics or physics. That is a heuristic that was developed over a very long period of time where central banks feel that at that rate of inflation, you can facilitate commerce, you can have growth, it is consistent with high levels of productivity growth in the past.

Now, that heuristic may change. I mean, I think this is why—I like what John Taylor has said in his testimony, which is the Taylor rule is not a hard and fast this is the law. It is guidance which Doc Taylor spotted and helped us understand in terms of what the Fed did in the past.

So a good reason not to micromanage the Fed going forward is we want to have very smart people there on the board of governors, and I am confident that Congress will put smart people—the President will put smart people in there in the next iteration, and they need to be thinking about all these issues, including this one, Mr. Foster, and think about, okay, how do we continue to operate monetary policy, is it the 2 percent implicit inflation target with the dual mandate, which I think works, and other people on the panel don't think it works, but that is a decision I—I mean, Congress sets the mandate.

I think you want the Fed, the board of governors, and the FOMC to have the ability to think deeply about these issues. A lot of very smart people there, a lot of engagement with the private sector, and think about do we have the right way of managing monetary policy, do we have the right implementation of monetary policy given the kinds of concerns you are raising.

Mr. FOSTER. Anyone else have—I mean, it was—specifically, if we conclude that we are mismeasuring inflation by say 1 percent, what implication would that have for monetary policy? I am just, I guess, from a straight mathematical point of view—

Mr. TAYLOR. So I would say, first of all, our measures of inflation are—they are different. There is different measures, and it is a constant decision for central bank, the Fed to decide which one, and so they have gone through it, and we also have statistical agencies that worry about the problems you are saying. I am not saying they do it effectively, but they try to take into account.

Given all that, it seems to me monetary policy should take the indicators that are there and stick with those. If there is a lot of evidence that there is something wrong because of the computer technology you are mentioning, then we need to know that. It is actually, to me, almost more important a problem for measuring productivity. I think productivity growth is very low now. It is distressing. That is why I think we need to actually reform regulatory reform.

Some of my colleagues in Silicon Valley say, no, we are just fine. We are doing great in productivity. I don't think so, but that is really, I think, where the productivity issue really comes to be most important.

Mr. FOSTER. Also, the divergence of labor factor, productivity, and you know, machine factor productivity is, I think, accelerating and will become very significant in our thinking in the coming decades. Any other comments on the inflation issue?

Mr. PLOSSER. I would just reiterate what both the other panelists said. For monetary policy purposes, it is, yes, you need to be aware of the mismeasurement, but it is a heuristic, it is a way to commit to something, and it doesn't mean it is the optimal or the best rate of inflation. A lot of people would have argued the inflation rate target should have been lower, some think they should have been higher, but it is a guide to policy, not so much as an objective way.

I would also point out that if inflation, true inflation is really much lower than we think it is, then it means things that we do to calculate, for example, real wage growth over the last 30 years, would suggest that actually real wages are higher than we think they are because inflation has been lower than what we made.

Mr. FOSTER. Which would change the narrative we see in our politics tremendously.

Mr. PLOSSER. Exactly. Exactly. So you know, I think there are lots of—I think we need to distinguish that issue from the issue of what is useful for monetary policy purposes, and I think that is what John was getting at.

Mr. FOSTER. Yes. So what you are saying is essentially it is—as long as you have a stable definition and you are using it as your feedback loop, you know, your—

Mr. PLOSSER. For monetary policy purposes, that is the critical.

Mr. FOSTER. But it is still a useful thing to make a stable feedback group. All right. Well, I guess that was my main question.

Mr. MULVANEY [presiding]. The gentleman's time has expired. I thank the gentleman. I now recognize the gentleman from New Mexico, Mr. Pearce for 5 minutes.

Mr. PEARCE. Thank you, Mr. Chairman. I appreciate each one of you being here today. John Taylor mentions in his paper, his presentation that maybe the Fed should start selling assets.

So Dr. Plosser, I think you might be the one who is closest to the process. What would happen if the Federal Reserve started selling mortgage-backed securities that they purchased back at a time when you were in the system?

Mr. PLOSSER. Well, I think the committee and the Fed was terribly worried about the effect of selling securities into the open market. They certainly expressed concern about that. But I think that the first step the Fed ought to be taking is not selling, necessarily. I think what they could stop reinvesting would be a good practice because, in effect, they are still buying securities in the open—buying mortgage-backed security to replace the ones that run off just naturally. So I think they wouldn't have to start selling securities immediately. They could just stop reinvesting.

I would also note that the process of selling securities, now that the financial crisis and the functioning of the markets is highly—has returned to more normal activities, one of the concerns during the purchase of securities was that the markets weren't functioning very well. There was sort of lots of gaps, there were lots of concerns about where buyers and sellers were, and some of the trading and information in arriving at prices.

That is no longer the problem anymore.

Mr. PEARCE. Have all of the valueless MBS' been choked out of the system?

Mr. PLOSSER. Right. So I think—

Mr. PEARCE. The ones with no value are gone. They are not—they don't exist anymore?

Mr. PLOSSER. Well, not many of them, no, but we are still—but the Fed is still buying them. So I think there is less of a problem now to disrupt—

Mr. PEARCE. What happened to the ones with no value? I mean, I think we—that was at the basis of what caused the collapse.

Mr. PLOSSER. Right.

Mr. PEARCE. Valueless loans that were made across the country—

Mr. PLOSSER. The Fed was buying—

Mr. PEARCE. Secured by and put in—so what happened to them? They just vaporized? What, I mean—

Mr. PLOSSER. Well, some of them restored some of their value. The Fed was busy trying to make a market.

Mr. PEARCE. So they have achieved some value.

Mr. PLOSSER. So they have achieved—

Mr. PEARCE. Dr. Levy—I mean, Dr. Levy, I was interested in what your perception is on the answer to Mr. Mulvaney's question. I looked back several years ago, and the State of Ohio started buying assets. They got into buying coins, chasing yield, trying to find anything they could do, and so this idea of buying assets is one that is concerning, and then when you look at the CalPERS, I think the Chairman Huizenga mentioned them, all of the pensions are going to be chasing yield because they are promising payouts based on totally false assumptions that they can make 6 to 7 percent in the market, so they are paying out to the recipients.

So I would like your observation on what chairman—or what Vice Chairman Mulvaney asked about the process of buying assets and stocks.

Mr. LEVY. Well, let me just address your first point.

Okay. So the Fed has, through its QE programs increased excess reserves in the banking system up to about 2-1/2 trillion and the Fed's balance sheet is nearly 4-1/2 trillion, and it has kept rates artificially low. And this has create the distortions. And now as I think the Fed begins to normalize, particularly, I believe, there is an economic regime shift underway and rates are going to rise, there is going to be pain.

But during the period of low rates, it has forced insurance companies, pension funds, and the like to, you know, reach for yield, take on more risk than they would otherwise. And there is a downside of that that we are going to face now.

Now, with regard to QE, should the Fed be buying stocks? Absolutely not. For what purpose? Do you want the stock market to go higher? And as Dr. Johnson said, do you want the FOMC members to deliberate on which companies to boost? It makes no sense.

And all of the excess reserves and low rates have not stimulated aggregate to manning the economy the last 5 years. So for what purpose?

Mr. PEARCE. Isn't that a process they have moved into in Japan and isn't that one of the causes of trouble? Again, I will just yield to you, Dr. Levy.

Mr. LEVY. When we look at Japan, let's call a spade a spade.

The central government runs a very large budget deficit, very large, and primarily to finance retiree pensions, and they don't want it to show up in their general—as an increase in the outstanding debt, publicly held debt, and so they use the Bank of Japan, and they stuff—the BOJ, through its QE, buys more than 100 percent of the increase in the debt. And so the BOJ buys JGBs and it buys corporate bonds and it buys ETFs. It is all a financial shell game. And it is the poster boy for what we should avoid.

Mr. PEARCE. Which, again, gets towards my concern that some of what we are doing appears to be a shell game in a lot of ways.

I yield back, Mr. Chairman.

Chairman HUIZENGA. The gentleman yields back, with that, the Chair recognizes Mr. Heck of Washington for 5 minutes.

Mr. HECK. Thank you, Mr. Chair. I have question for Dr. Johnson, before I ask it, with all due respect, sir, I just thought I might point out you referred to Congressman Foster as Mr. Foster. He, in fact, has a Ph.D. In theoretical physics from—I grant you it is only Harvard, sir, but he likes to remind people that he is the sole remaining actually scientist in the United States House of Representatives. Point of future reference is all, Dr. Johnson.

Mr. JOHNSON. It says Mr. Foster in his name tag, so you should see if you can have that changed.

Mr. HECK. Point well taken.

So, Dr. Johnson, I have been on this committee and in this body for almost 4 years now, and I have tried to be an unwavering advocate for increased spending on infrastructure to not just stimulate the economy but to stimulate growth over a long period of time, a little bit lay foundation for increased productivity. I have even gone so far as to encourage then Chairman Bernanke to consider using their tools to help with infrastructure spending by municipalities. He said they didn't have the authority. That, despite the fact, by the way, that they actually did exactly that when metro was built here several decades ago. I also suggested to him that is what they were doing with QE in the housing market. He denied that. I take a different conclusion out of the net effect of that particular activity on the part of the Fed.

But here is what I am struck by: I try to get Chairman Bernanke to do it. I have had this conversation with Chairperson Yellen. And I have encouraged all of my colleagues to step up to an increased infrastructure spending bill. We did the FAST Act, which was very modest, frankly, very modest compared to what I think the need is.

But that was when unemployment was 8 percent. And unemployment now is 4.6 percent. And an awful lot of the same people that resisted aggressively, increased expenditures on infrastructure are—have now come around to be an advocate for it.

And so my question to you, Dr. Johnson is, why would increased spending on infrastructure be a bad thing when the unemployment rate was 8 percent but a good thing when it is 4.6 percent? I do not understand that.

Mr. JOHNSON. Well, Congressman, I think the main case for infrastructure, which I think is physical infrastructure, transportation, schools, and the human capital infrastructure, which is everything else around the way we train people, I think it is hugely important for productivity growth. You know, in the parlance of the IMF, you know, it is medium term objectives that you should have fiscal policy. I think that is exactly what you have been saying.

Now, there is an additional argument for fiscal policy if you think that monetary policy is limited in its effectiveness and the economy, the private commercial part of the economy, needs some additional help. And I think that was a good argument at 10 percent or 8 percent unemployment. That piece of the argument, is I think, weaker now. But the medium term argument is incredibly strong. In fact, we are, I think, agreeing that there are big medium-term issues, and I would certainly get at them in this way.

Now, if the question is alluding, as I think it may be, to what President-elect Trump has said about infrastructure and what appear to be the plan to materializing, I am not confident, Mr. Heck, that that actually is infrastructure spending of the kind that you are invisioning and that I just stated. I think it may be some different form of tax breaks of some kind either for existing infrastructure projects or for some other projects that will end up being more expensive and will get less effectiveness out of them compared with doing it through Congress.

I would emphasize, though, and I think we are all agreeing on this, that fiscal policy infrastructure is responsibility of the fiscal authority, which is the Congress in the United States acting through the executive branch. It is not the responsibility and should not become the responsibility of the Federal Reserve.

I take your point about the metro. I wasn't—I don't know how they did that one, but—

Mr. HECK. What about my—what about my QE?

Mr. JOHNSON. So what they do in QE, and this goes back to the point—

Mr. HECK. Was is it not in effect a stimulus of the housing market indirectly?

Mr. JOHNSON. Yes, Mr. Heck, it was. But this is back to our point of violent agreement among ourselves and with Mr. Mulvaney. QE1 was targeted at a specific breakdown in the mortgage-backed security market. That was hugely important to housing, to house prices, and for reasons you all understand, the financial sector and the economy. So in that fog of war moment, it was a good call. And, yes, it was a specific target—

Mr. HECK. Okay. My point isn't—my point isn't that they should embark upon this journey, although I have made that point in the past. My point was—and I take from your remarks, it was a good idea to increase our investment in infrastructure at 8 percent unemployment, it is a good idea to do it at 4.6 percent if it is done the right way—

Mr. JOHNSON. Yes.

Mr. HECK. —especially with an eye toward long-term growth and increased productivity where he can gauge it?

Mr. JOHNSON. Absolutely.

Mr. HECK. Fair enough?

Mr. JOHNSON. Yes.

Mr. HECK. I see I am close to being out of time. I am given to believe that we may have a second round. So maybe I will have another chance to get into auction here with you all. Thank you all for being here very much.

With that I yield back, Mr. Chair.

Chairman HUIZENGA. The gentleman yields back.

With that, I will recognize Mr. Schweikert of Arizona for 5 minutes.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

One of the problems is a lot of the really interesting questions have already been part of the exchange. Can we all have an agreement, though, that expansive monetary policy does enable those of us who are responsible for fiscal policy, it sort of indemnifies us from doing things that are hard, are controversial, are sometimes ideologically hard to explain. So I am not even asking that. I am just sort of saying it.

Can I walk through a handful of things? And There is one just because Mulvaney and I have talked about. And I am just curious. So this one, Dr. Johnson, if we were to talk about sort of nonconforming monetary policy that would be within the rules of the U.S. Federal Reserve, let's say we will talk about, like during the type of QE1, could they have bought the lost piece of an MBF securitization instead of buying the entire securitization? It is just a quirky idea I have often wondered about. Would that have also been a way to change the bandwidth of the exposure for investors?

Mr. JOHNSON. They are not allowed to take credit risk. And then they are only allowed presumably to buy government guaranteed securities, which in normal times means treasuries, but after Fannie and Freddie were nationalized, that included the agency securities. So I think the answer would be if you are just talking about, you know, picking and choosing within the Fannie and Freddie securitites—

Mr. SCHWEIKERT. Let's say, if Fannie, you know—a nationalized Fannie Mae selling—

Mr. JOHNSON. Perhaps. But what they did was much smarter than that, Congressman. What they did was they bought new issues. That was the pipeline that had broken down. And they targeted the QE1 on enabling that process to restart. So think of it like a kick start or cranking the engine. Right? And that I think was a good use. And to do that, you would really be buying the entire issue, not picking and choosing within the issues—

Mr. SCHWEIKERT. Okay. So one side it would be an approach for what is collapsing, the other side would be keeping the channel healthy? Or at least keeping it healthy?

Mr. JOHNSON. Yes. Ongoing or restarting it.

Mr. SCHWEIKERT. And this may be more for Dr.—is it Levy or Levy? If I came to you right now and said, what is our greatest exposure for a difficulty that could happen in our markets right now? If interest rates start to move upward, simple example I can give you is, just the other day I was looking at a number of nonpublicly traded REIT's that were paying some fairly healthy rates of return. But if you looked at the underlying asset, they were varied interest and sensitive, tenant sensitive, those things. Are we headed towards a moment where the next economic difficulty we see is as interest rates are moving away from us, that the cap rate compression that we have had now starts to move against them and all of a sudden we once again have another great difficulty in parts, whether it be commercial real estate market, these nonpublicly traded REIT markets, what is our next rate exposure you see on the horizon?

Mr. LEVY. Well, there is certainly a risk, because after keeping, rates really, too low for too long and pumping so much liquidity into financial markets and encouraging risk taking, global portfolio managers base their investments on that framework, and now things are going to change and there are going to be some losses along the way.

Now, I would point out that the interest rates have increased rather significantly in the last couple of months, particularly post election. I would say that is healthy, because you actually want rising real interest rates reflecting healthier expectations for the future.

Mr. SCHWEIKERT. I guess my concern was just being—our brothers and sisters being sort of emotionally prepared that we do have a lot of misallocation in the capital, you know, yield chasing and some of that is going to have some difficulties as the rates move.

Mr. LEVY. And I would say the answer to that is yes. You just cannot do what the Fed has done the last 7 years and expect there to be no eventual unwind. I think the offset to that is if, in fact, we do get economic reforms, raised—not just temporarily, but raised potential growth, then there is a very, very positive offset.

Mr. SCHWEIKERT. Let's—and we won't have time for this, but I am hoping if we get to a second round, we have a discussion sort of that is one off from sort of the monetary and those are of us who are fixated that there has been a massive misallocation of capital not going through its most productive allocation.

But what would you have us do from a fiscal policy that would maximize productivity gain? Because I think that is something we all agree there is something wrong out there for the last decade and our productivity numbers.

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

Chairman HUIZENGA. The gentleman yields back.

With that, we will recognize Mrs. Love of Utah for 5 minutes.

Mrs. LOVE. Thank you. Thank you, Mr. Chairman.

Thank you, the panel, for being here.

This has been really just a great, a great panel, and it's been—given me quite a bit of insight. So I guess I am just going to explain what I have heard and then get your comments on what you think, whether you think that this is—if I am getting it correctly.

So one of the comments that was made by Dr. Levy, which I think is right on, is a clear explanation, by the Fed, of the monetary policies and the factors that have contributed to the lower potential growth, weak capital spending, and productivity, and structural unemployment would help steer the economic policy debate towards the issues that really matter for performance. I think that that hits the nail on the head.

So if I look at where we were at the beginning, 1913, versus where we are today, where the Fed was involved in dollar stability, low inflation, bank oversight, to 2016 where its inflation, full employment, expanded bank holding companies oversight, FSOC, you name it, a whole host of responsibilities that have been put on the Fed's table responsibilities. We talk about the CFPB, we talk about all of these other arms that really start to effect the economy and how everything is run. I start thinking about what is happening today. And the frustrations of the American people today is not really the responsibility or—should be reflected towards the Federal Reserve. It should be towards Congress.

If you think about the whole—when we think about what the panel is saying and a whole host of things that the Federal Reserve is dealing with right now, the fact that this body today is made up of mainly Republican—of mostly Republicans, also the Senate, and the White House is a reflection upon the frustration of the American—that the American people have today.

So I believe that it is not about what the Federal Reserve is doing, but it is about what the House of Representatives, what Congress is doing altogether. And that we have literally said we are not going to take the responsibilities of the economy, but we are going to put it on the table in the hands of the Federal Reserve. And I think that it is time for us to decide what the Federal Reserve is responsible for and what we are willing to take responsibility for.

I am going to give a short example, and then I want you to explain, to tell me if I have it right. So if I look at my home, and I have a child, for instance, that is sick, that has a fever. My job is to go into the cupboard. I grab Tylenol, and I decide what the best dosage is for the right age of that child and give that child the right dosage. And when I look at what the policies of Dodd-Frank and all of these other things, the responsibilities the Fed have, I feel at this time right now we have literally taken the entire bottle of Tylenol and given it to the child, where now we have all sorts of problems that we are trying to adjust and we are trying to fix, and it is not working.

So I just want to get your thoughts on that and tell me if we are on the right track and what we need to do as a body to make sure that we are gaining—we are taking back the reins, to what happens, our responsibility to what happens in this economy.

I did quote you, so Dr. Levy, I was wondering if you could comment on that?

Mr. LEVY. All I can say is great comments. And I really appreciate that. Because I think what is needed when we look at the challenges facing the economy—and let me just point out that 2007, both the Congressional Budget Office and the Fed estimated potential growth to be 2.6. And now the Fed is down to 1.8 and the CBO is at 2.0. That is dramatic change.

Mrs. LOVE. Right.

Mr. LEVY. So what policymakers need to do is think about the challenges and what are the true sources of the economic weakness and address them with the correct policy tools and not just rely, as it has recently, on the Federal Reserve.

Mrs. LOVE. You have a comment—I just wanted to make sure I got a comment on both sides.

Dr. Johnson, do you have a comment on that?

Mr. JOHNSON. I think, Mrs. Love, you put the problem well. And I agree with Mr. Levy, productivity growth is lower in these estimates, and that is not acceptable. You know, I guess the good news for your side is you get—you are in charge. Right? You have all the branches of government, and you are going to make the policies. I am skeptical that you are going to have the sorts of positive effects on growth that Mr. Levy thinks, but go ahead, do it, and we will be measuring it carefully and be evaluating it on that basis.

I do think, though, you want to be very careful with financial stability, because it has been a good question for our economy for a long time. You talk about the formation of the Federal Reserve, and you should think very carefully what you want Congress to be responsible for. I would not—maybe you don't want the Fed to do it, fine. You need some responsible body—

Mrs. LOVE. But there is a balance. There is a right—it is getting the right balance?

Mr. JOHNSON. Absolutely correct. Yes.

Mrs. LOVE. Thank you.

Chairman HUIZENGA. The gentlelady's time has expired.

And at this point, we would like to welcome Congressman Hill from Arizona, who is not a regular member of the committee, but I am sure—I am sorry. Yes, sorry. I believe I said Arizona, but Arkansas. But I would like to thank Mr. Hill. It was a conversation that he and I had had that really prompted us to put together the panel in this hearing.

With that in mind, I would welcome you to the subcommittee and recognize you for 5 minutes.

Mr. HILL. I thank the chairman. I appreciate the opportunity to be a guest today for the hearing. I appreciate the panelists being here.

And despite my affection for Mr. Schweikert, I am completely delighted that I don't live in Arizona.

Mr. SCHWEIKERT. Hey.

Mr. HILL. I knew that would get your attention.

I want to start out and ask about—we have had a lot of discussion—I appreciate Mr. Mulvaney bringing up the subject of non-treasury purchases, the limitations in section 14 on open market operations.

Would it be beneficial for the Congress to amend section 14 and explicitly restrict the Fed from buying corporate securities? It is left open, and in this world of chevron deference and lawyers in Washington, I have concerns that open market operations could be expanded just by clever lawyering at the Fed.

Dr. Taylor, what is your view on that?

Mr. TAYLOR. I think it would be a good idea to clarify. There seems to be an opinion that they would find it difficult to do now, but I think it would be better to clarify it for the reasons you said.

Mr. HILL. Well, in her testimony, Chair Yellen dodged the question here, but then a week later, on September 29, gave a speech to the Kansas City Fed where she said, there could be benefits to ability to buy either equities or corporate bonds. They would have to be weighed carefully. And she said in her view, that the Fed does not have the authority to do that without Congress changing the law. But if you read a lot of legal precedent around the city, I think that could be argued. And so that gives me great concern that we would follow these other central banks.

Dr. Plosser, you want to add to that comment?

Mr. PLOSSER. I would agree. I think it would be beneficial. The Fed, by its nature and history, you know, always prefers to have the option and the discretion to do what they think is the right thing at the right time, and those intentions are often good. But what discretion also does is allow you to do the wrong things at the wrong time. And so I agree with Dr. Taylor. I believe it would be useful to be more explicit about what the Fed can and can't do than leave it to discretion.

I think the discussion of the Fed buying equities is a dangerous one. There are other central banks around the world that do it, do it for different reasons, there are institutional reasons. The ECB, for example, has to respond to 17 different governments. So if you confine them to only government securities, there is a whole big political debate on which country you prefer and which one you don't, and so it gets them out of a different set of institutional problems. So I think it would be beneficial. I agree.

Mr. HILL. You have also—in your testimony, you talk about during the crisis and the recession, the Fed purchased distressed securities under 13(3) and that such actions were a form of credit allocation, fiscal policy.

Dodd-Frank partially addressed the issue of discretionary lending under 13(3), but you said you would go further. Could you talk about how you would go further?

Mr. PLOSSER. Yes. Back in 2009, I first started talking about this, is that I think that 13(3), again, was a loophole, if you will, or it is a thing you can drive a truck through. It is a form of fiscal policy. I don't think the Fed's role is to buy distressed securities and bail out individual organizations and, yet, 13(3) allowed that.

Congress did address that by restricting 13(3) to be broad-based programs that didn't—weren't targeted at any one company. But I think that, again, all of us know that there are ways to write an action that sort of really is targeting, even though it doesn't sound like it is targeted.

My preference, though is that we really do need what I have called a new accord about financial crises and about the role that the Fed plays in them, and particularly when it comes to purchasing private sector securities, whether it be equities or whether it be under 13(3). And that accord, from my mind, is to sort of keep the Fed—and I alluded to this in my remarks, keep the Fed from engaging in discretionary fiscal policy actions, that there needs to be expanding, that is up front, an agreement about how such a circumstance would work. And I call that a new accord.

And what that does is, it would work something like the following: Suppose there really was a crisis—and we did have one. We had a crisis with AIG; and we had a crisis with Bear Stearns. In those types of environments, things do happen, and you have to make tough decisions. So what I would recommend is that the Fed not be given the authority to buy those, particularly, distressed securities in a crisis. That is not monetary policy.

What should happen in my view is that there should be an agreement in advance that under those circumstances, under a crisis like that, it is the fiscal authorities, in this case would be the Treasury, let's say, make that decision and determine, perhaps in conjunction with the Fed's consultation, about what to do. And if that was decided that was appropriate, from a fiscal and financial stability point of view, that the Fed certainly could be instructed by the Treasury to actually conduct an operation on very short notice, but, and here is the key, but those securities that were acquired during such an emergency would then be swapped by the Treasury for U.S. Treasury securities that would be given to the Fed in exchange for the private sector securities or distressed securities that were actually purchased. That way it becomes clear that

that action has the responsibility of the fiscal authorities in making a fiscal decision, and the Fed would be given the treasuries in exchange, and they could go about conducting monetary policy as they saw fit.

Mr. HILL. Thank you. Mr. Chairman.

Chairman HUIZENGA. The gentleman's time has expired, and let that go for the salient point.

With that, I would like to recognize the vice chair—I am sorry—the ranking member of the committee, Ms. Moore, for 5 minutes.

If it is okay with you all, we would be entering into a second—second round here.

Ms. MOORE. Thank you for your generosity of your time, gentlemen.

I wanted to ask this during the first round, but my time didn't allow it.

Dr. Taylor, you—in your testimony on page 3, you talk about the importance of monetary normalization, and you talked about it in the context of the international community. You said that unconventional monetary policy, so the near zero policy rates have spread internationally. And so you say that if United States—if we normalize and have a rules-based approach, that this would spread as well. I have a couple of questions.

Number one, do you think it would be a greater possibility of kind of gaming the system if people sort of knew that we had this rigid policy that wasn't flexible with changes, and what makes you think that we can, you know, what evidence do you have that if we were to, you know, given that we sort of poisoned the well with our monetary policy, should Europe and other central banks not have done what we did?

Mr. TAYLOR. So I think there is lots of evidence that the unusual policies spread, and there is various reasons for that. The low interest rates, other central banks are worried about their exchange rate, and so they will tend to—

Ms. MOORE. I mean, should they have done that?

Mr. TAYLOR. Well, one of the questions is whether they overdid it or not. But if we had had, in my view, a more normal rules-based predictable policy, the likelihood of that diminishes a lot. In a way, the United States is being more transparent about its policy, and that leads other countries to do the same. So that is what the research says. I talked to many of these heads of central banks about it. That is my sense, and it would be conducive to a more rules-based international monetary system if we had a more rules-based monetary policy.

And so I think there is discussion about that. It is not clear how it would work, but that is how I—from my research and from talking to many people in central banks around the world, that is my sense about—

Ms. MOORE. Your comment on that, Dr. Johnson?

Mr. JOHNSON. Well, again, if FOMC decided to follow a rule of the kind being proposed, that is fine with me. I don't think Congress should be micromanaging, that is the bottom line. In terms of—I mean, the U.S. is clearly a leader, thought leader among central banks, with whom I have also worked extensively. You know, the Europeans have a very difficult set of problems. I don't think—

and Dr. Plosser talked about, you know, how that impacts what we can do and can't do in terms of monetary policy.

I don't think that us changing—going to a more rules-based approach would have a big impact. Japan has a long very, very deep structural issues. Dr. Levy has talked about those. Again, I don't see exact parallels.

The British have trapped themselves in an extremely bizarre and difficult situation, again, very different. So I wouldn't—I think the discussion which we are having is a very good one about the U.S.—what is good for the U.S. economy. I think the impact on the rest of the world would be pretty second or third order.

Ms. MOORE. I agree.

Dr. Taylor, I want to ask you another question. You have been an—you have been a critic of intervening in markets. So I am curious as to what your thoughts are about President-elect Trump's intervention in Carrier and now threatening Boeing. Do you think that that is—what would your advice to President-elect Trump be?

Mr. TAYLOR. Well, I don't know the details of either of those cases. What I would say is that with respect to making the U.S. an attractive place to invest and stay here, that is the key. And to me, there are opportunities for that, and that is regulatory reform and tax reform.

We talked a few minutes ago of where monetary policy would play. I think there is a sense in which if the Fed is viewed as some—an organization which will take care of all of our problems, interventionists perhaps, and that reduces the chance for these reforms, like the regulatory reform and the tax reform. So I am quite optimistic now, that especially if you get some monetary reform, will move in that direction. And that is really what I would argue we should do in these cases.

Ms. MOORE. Versus interfering in that way?

Your thought on that, Dr. Johnson?

Mr. JOHNSON. Well, if we apply Dr. Levy's sensible principles that, you know, generating uncertainty and if you confuse about what is going happen is a problem, then you shouldn't, up should not absolutely use presidential authority to mess around with individual companies.

Ms. MOORE. And so, Dr. Taylor, I do want you to be on the record saying that you don't think we should do that.

Mr. TAYLOR. Well, I say what we should do is make this country an attractive place to invest. That is what we should do. How you do that is a question. I think it is regulatory reform. I think it is tax reform. I think it is a lot of reforms. You mentioned education, there are a lot of things in education to do. All those things make our country more attractive place to invest, more attractive place for job creation and for higher incomes and productivity. I think it is pretty straightforward. Hard to do, but that is what we should do.

Ms. MOORE. Thank you.

Chairman HUIZENGA. The gentlelady's time has expired. So at this point I will recognize myself for 5 minutes, and I do—if I have time let, I want to come back to Dr. Johnson's discussion of the Fed rule.

Dr. Levy, I want to start with you and also hit Dr. Taylor. Your statement notes that, “The Fed’s fully discretionary approach in conducting policy highlighted by its ever-changing explanations for delaying rate increases adds confusion, and it has created a very unhealthy relationship with the financial markets.”

In light of your statement, Dr. Levy, can you please share your opinion about whether the Fed could do a better job by referencing a more principled policy strategy and providing a more accessible explanation of how the FOMC decisions depend on data rather telling us in plain English what data matter, and why they, and how they matter, and would measures like these help us safeguard monetary policy independence and help goods and services, which obviously includes labor as well, find their most productive employment?

Mr. LEVY. The Fed has created an extremely unhealthy relationship with financial markets. It not only bases its actions but also bases what it says on how it thinks the market is going to respond. And the markets respond and think about what the Fed is going to say. And when you get to the point about data dependence, you come in and you see another Fed member gave a speech on something, and they said they are data dependent. You say, what is that? And the honest answer is it is anything they want it to mean. And that is not the right way to conduct policy.

So I think what the Fed should do is move towards a flexible rules-based monetary policy framework and, in particular, de-emphasize short-term financial fluctuations and economic fluctuations. That comes. That comes with the territory. Stay away from that, and move—and look to the long run and base policies on the long run. And absolutely change its communications and its official policy statements toward achieving its long-run objectives and away from day-to-day fluctuations in the markets that it can’t do anything about and has no impact on the economy at all.

Chairman HUIZENGA. Dr. Taylor, you care to comment on that?

Mr. TAYLOR. Well, basically, I agree. I couldn’t put it any better than what—he says it is flexible rules-based. I think rules-based should be flexible, just to clarify.

Chairman HUIZENGA. Well, I do too, which means maybe we weren’t as clear in format as we would have liked. But I at one point in the hearing dubbed it the Yellen rule. They can set whatever, you know, guideline that they would like. It is just having some sort of guidepost to reflect upon. And I guess that is—Dr. Johnson, your quote that I wrote down here, roughly is—I guess it wouldn’t be a quote—roughly I wrote down, if the Fed cares to adopt a rule, fine, but Congress should not mandate a rigid rule. And I don’t think I would disagree with that. I don’t think that the rest of the panel would disagree with that, but I just want to give you a moment to address that if you would like to.

And then I do want to very quickly, in my remaining time, Dr. Levy had answered this, but I would like to hear about the politicization of the Fed, and he is addressed that a couple of times. So go ahead.

Mr. JOHNSON. So I like what Dr. Plosser is saying on this issue, and he has been a member of the FOMC, and I haven’t. Flexible rules-based is a little bit of an oxymoron but not really. And the

Fed has actually improved its communication in transparency a lot since, for example, 1990. The second half of the 1990s Ben Bernanke did a lot when he was also chairman. I think it is really hard to legislate that, Mr. Chairman. And I worry that it goes with all the best intentions, it will become micromanagement and too much control.

I think you want to have this kind of discussion. This is very helpful. Put good people on the board of the Fed and the FOMC and let them figure out how to improve communication and transparency, which is what—

Chairman HUIZENGA. Will they do that without a legislative nudge? That is the question that I have, and I haven't been convinced of that.

Mr. JOHNSON. I think—you get—I think the Republican administration and Congress will appoint most of the members of the board of governors, and we will see what happens to the FOMC over the next number of years. But I expect you will—

Chairman HUIZENGA. As we have learned, elections are not predictable, and there are changes. And I want to make sure that what is belt and suspenders in one administration is belt and suspenders on another. And that is really the purpose.

So, Dr. Taylor, real quickly, and Dr. Plosser, you haven't had a chance to discuss the politicization of the Fed.

Mr. TAYLOR. You know, I think this idea that the Fed sets its strategy, its rule, that is its job. It communicates what it is explicitly. If it deviates from it, it says why. Is it done through hearings, it creates a much better process. And, you know, individuals can make a difference, but this is beyond individuals. We have had over 100 years of experience, and it would be a great value in terms of how the Fed operates, how the Fed operates with its staff, with its researchers and the decisionmakers and how it discusses, not just to you but the American people generally about what it is doing. It would be far better to have a description of what it does, and I don't think it is as hard as people think it will be.

Chairman HUIZENGA. Okay.

And my time has expired.

With that, I recognize the gentleman from Washington, Mr. Heck, for 5 minutes.

Mr. HECK. Thank you, Mr. Chairman.

This is for any of you. It seems as though most, if not all of you argued against using unconventional monetary policy in the future, presumably to rely more on the traditional means, the overnight lending rate or whatever.

And I am wondering if you believe as well that that implies that the Fed ought to have a higher inflation target? And the reason that I ask that is that the Fed's current inflation target is about 3 percent and, yet, in fact, in past recessions—and we should all acknowledge that God has not outlawed the business cycle. We are going to have another recession at some point. The Fed has typically cut by more than 4 percent.

So do you believe we should have a higher inflation target so that the Fed has a bigger buffer so that they can avoid using QE, which you seem to say is a bad thing to do? Anybody.

Mr. TAYLOR. Well, I just—I don't think the Fed should raise the inflation target. There is something there to be said for keeping it.

One thing it would probably prolong these unusual policies, but it is fine. Sometimes we—since this was instituted, it is sometimes taken as a reason to gun things just because the inflation rate is 1.7 rather than 2, so that should be looked at to some extent. These are—inflation rates that are measured with some error. But I see no reason to be raising the inflation rate target.

Mr. HECK. So what leads you to conclude that they won't need the same latitude for reduction in interest rates that they have typically utilized to combat the recession?

Mr. TAYLOR. So one of the rationales for raising—that people make, for raising the inflation rate is that for some reason the equilibrium low interest rate has changed, declined, and so there is less room for policy to move it down. I think that is quite questionable. I know there are a lot of people who think that. If you look at the Fed's forecast, they have ratcheted that down by a percentage point over the last 3 years.

When I look at the U.S. and the world, I don't see evidence for that. And, in fact, I think to some extent the backup in long-term rates over the last month or so is some evidence there is not just simply a low equilibrium interest rate as the Fed describes it. So I don't think there are reasons for that. And also, we have had much experience about how to manage monetary policy at this 2 percent inflation target. There is also an international aspect. Most of the countries are in that same region. And so with respect to stability of the overall exchange rate system, it is a subvalue to have a common inflation target. If anything, maybe in the future when we get better measures, it should be lower. But I think it is fine right now.

Mr. HECK. Dr. Johnson?

Mr. JOHNSON. Mr. Heck, I agree we shouldn't lower the inflation target. I think it is 2 percent, roughly speaking.

But, I think you hit a really important nail on the head. It goes to what Mr. Huizenga was saying, which is about, you know, what should Congress decide and what should be in legislation? So if monetary policy is gong to run out of bullets or conventional monetary policy is going to hit this zero interest bound on a regular basis, which is what you are saying, and I agree, and if we agree that unconventional monetary policy is only appealing in very, very specific circumstances and probably isn't much use over a regular business cycle, then what should we be doing when the economy turns down by that much? Well, I think—thinking about the legitimate—and so Dr. Plosser is calling for a new accord. I think a new accord broadly constructed would include Congress thinking about the use of fiscal policy for countercyclical purposes.

And I would remind you, Mr. Chairman, that in early 2008, President George W. Bush proposed, and there was a lot of Republican support for and Congress passed, a tax cut for countercyclical purposes. Early 2008 right? So before Bear Stearns. That was a good idea. Well done.

That was a good idea, use of countercyclical fiscal policy, in a relatively moderate way. Yes, in retrospect, perhaps too small. But it was a good idea—I mean, we have somehow developed or you developed this aversion to any countercyclical use of fiscal policy. I don't think that is a good idea. I think that there is a measured use for it, and that is where Mr. Heck is going with his question. Don't rely on the central bank to save the day, because they will not be able to, necessarily, next time.

Mr. HECK. So my favorite personal characteristic is humility. I don't have much time left. But I am wondering if any of you would be willing to put yours on display by acknowledging that you argued in advance of the use of quantitative easing, or during it, that it would lead to inflation, which we have not yet experienced. And if so, if you are willing to admit it, if you would also tell me why you were wrong.

Dr. Levy, are you admitting you are wrong, sir?

Mr. LEVY. Yes. And—so, typically, when you move to QE and there is tremendous liquidity and you leave rates too low too long, it generates excess demand in the economy, and that has not happened. Where I was wrong is the Fed's excessive ease did not translate into excessive bank lending and acceleration of nominal GDP relative to productive capacity that would have boosted wages and inflation.

Having said that, beginning with QE3 in the summer of 2012, this just was clear to me, even if inflation didn't rise, that the distortions created by the Fed's QE and forward guidance were going to be very costly, and I think we are going to bear out those costs.

Back to your earlier point on the flexibility of monetary policy, should there be a recession I don't—

Mr. HECK. Should there be? Sir, don't you mean when there is?

Mr. LEVY. There will be. I don't think you would be having those same concerns now if, over the last couple of years, as the economyis growing along its potential path, that the Fed would have normalized rates. And so as Dr. Taylor said, if the Fed had normalized, history suggests it would have had no negative impact on the economy, and real interest rates would be higher and the Fed would be having that much more flexibility than it is now perceived to have from the vantage point of where our rates are now.

Mr. HECK. I would acknowledge hindsight is a wonderful thing in this regard and all regards including our forecast about the net impact of quantitative easing.

Chairman HUIZENGA. The gentleman's time has expired.

I would love to hear how regulation might have hampered that excess lending with that equation, but I do need to move on to Mr. Schweikert from Arizona, who is recognized for 5 minutes.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

You know, it is a complex ecosystem, but let's stay a little bit on this theme.

And, Mr. Chairman, thank you for tolerating. Sometimes my questions get a little off track, but I am trying to sort of understand some things.

If I was sitting in your lecture halls 10 years ago, and during that lecture the discussion was we are going to substantially, dramatically, increase monetary supply, liquidity in the United States but all over the world, what would you have put up on the board as saying, and this is our prediction of what will happen to productivity gains because of new equipment, new—and why has not—

what I would have assumed would have been obvious, why hasn't it happened? What has happened—and if we had had this discussion 10 years ago, what did we get right in our predictions and what have we gotten wrong, and what is the solution to productivity? Is it purely on the fiscal side and monetary should not even—even put it into its calculus? Anyone willing to play on this subject?

Mr. PLOSSER. So let me offer at least one reaction. And that is, the first thing to recognize is that monetary policy is not a solution to any form of productivity problem.

Mr. SCHWEIKERT. Okay. And you actually beat me to my punch line, but I was going to wait to the 5-minute mark for that.

Mr. PLOSSER. I am sorry.

Chairman HUIZENGA. Can you pull your mike a little closer?

Mr. PLOSSER. Yes. And I think it is a mistake for the public or Congress or anyone else to believe that putting that in the hands of central bank is the right thing to do.

Now, economists really don't understand a whole lot about the evolution of productivity. It is not something that we know much about. We don't predict it very well. We know some of its determinants, but at the end of the day, the long run health of the economy, and our ability to gradually continually increase our standards of living, is all about productivity. But nothing else really matters very much at the end of the day.

Mr. SCHWEIKERT. And, look, this one should be nonpartisan, but there is something wrong in the formulas we all went to school under. If I put this much money into education; if I put this much money into tools and equipment; if I put this much money in lending capital for business, plants and equipment, you will get this type of productivity gain. And now we are living in a world for several years now where lots of liquidity, lots of money has actually gone into those, and I am not seeing it. So what did we get wrong?

Mr. PLOSSER. Putting money through a central bank doesn't solve the problem. The productivity is generated by how that money gets used at the end of the day.

Mr. SCHWEIKERT. Okay. So is the formula and the amount of liquidity that central bank expansionary policy that cash ended up on money center banks' books buying—

Mr. PLOSSER. So this—

Mr. SCHWEIKERT. I am sorry.

Mr. PLOSSER. I am sorry. So this goes back to the previous question about why we haven't had inflation. I think what many economists, myself included, were wrong about, in part, had to do with a lot of the money—I will call it money, but that is not really what it is. A lot of the reserves that were created through quantitative easing are still in the banking system.

Dr. Levy said they haven't been spread out in the economy, which is actually turn them into money and then turn them into inflation.

Mr. SCHWEIKERT. So if I were even to look at banking sectors and a couple of other sectors and take a look at what we would all around here refer to as sort of this tier one, or Boswell compliant capital, a lot of that you might have, if you could do the formula backwards, may have come from the quantitative easing?

Mr. PLOSSER. Right. So I think quantity easing and low interest rates did two things that were not terribly helpful. One is they led to what I would describe as a lot of financial re-engineering, companies buying back debt, or buying back stocks, or taking a form of leverage. It didn't get used in the usual form of lending and productive capacity.

Mr. SCHWEIKERT. Solicitation of the entire panel. So if I came to you and said, all right, productivity gain is important for my friends on the left, for particularly those on the right, whether we are going to be able to afford our social contracts, all the other bells and whistles that society wants, but it is going to come from fiscal policy or from types of fiscal policy where we create barriers for growth and we need to stop doing it, more rational, everything from taxes, from regulatory system, and the interplay between those, and we have to stop thinking somehow the Federal Reserve is going to bail out our failure to act, am I speaking heresy, or do we sort of from all sides, do we agree that it is fair?

Mr. TAYLOR. So we teach, I think all of us, the productivity growth comes from investment and from technology. You know, as a famous formula tells us that.

And right now, if you look at our low productivity growth, it is, you know, less than half a percent for the last 5 years. We also see very low capital accumulation, and we also see very low so-called total factor productivity. So those are the reasons. And how do you get more private investment? I think it is just regulatory reform. It is the tax reform.

Mr. SCHWEIKERT. Okay. If the chairman would allow me, I want to hear—

Chairman HUIZENGA. Very quickly.

Mr. LEVY. So as I pointed out, the Fed has very successfully lowered bond yields and the real cost to capital. Why hasn't that stimulated more capital spending that has been the weak link in the economic expansion and productivity? Why haven't businesses responded to the lower cost to capital? And survey suggests businesses' biggest concerns is taxes, regulation, and the like.

And once again, I think it gets to the point where we need to address those concerns with the right policy tools rather than more monetary ease, which the Fed's model tells us it should do.

Mr. SCHWEIKERT. Mr. Chairman, thank you for your patience. I guess the theme I was working on in many ways we can build a model that demonstrates that there is a massive, massive misallocation of capital, and it was arrogant of us to somehow think it was going to go where we all wanted it to go, and that at some point those of us who do fiscal policy need to do the hard things.

We need to do the tax reform. We need to do the regulatory reform. And some of us, I think—I believe technology, whether it be the super computer we carry in our pocket, we could have a revolution on how we regulate in a more dramatically effective, less expensive, rational model, and I am terrified I don't hear enough discussion about it.

So with that, I yield back.

Chairman HUIZENGA. The gentleman's time has expired.

With that, the Chair will recognize Mrs. Love, of Utah, for 5 minutes.

Mrs. LOVE. Thank you. What I failed to mention in my Tylenol analogy is that, you know, when you give your child way too much, you end up hurting parts of the body that had nothing to do with the fever to begin with.

So I would actually say, in other words, that when the Federal Reserve ventures out of monetary policy, and they expand into regulatory policies and practices, they actually hurt parts of the financial world that had nothing to do with financial crisis, which is some of the examples that we have seen.

I actually wanted to go and expand upon what I was talking about earlier in the Federal ReserveAct and the amended Humphrey-Hawkins to include full employment.

What, in your opinion, have we gained from that amendment?

I haven't spoken to—I haven't asked your opinion, Dr. Plosser, if you wouldn't mind.

Mr. PLOSSER. I am not sure we have gained a whole lot. I think there is no other central bank in the world that has a mandate like that. Many of them have inflation targeting mandates. Many of them have article mandates where it puts inflation first then says, well, if inflation is okay, you can sort of do some other things that help the economy. I think what we have done, unfortunately, is opened the door for asking the Fed or expecting the Fed to do all sorts of things that it is not particularly suitable to do.

And my comments, remarks, I made—and they seem to sort of want to take responsibility for everything from real wage growth to participation rates, to how many part-time workers we have, all sorts of things that monetary policy just really can't do. And so the whole thrust of my argument is that by narrowing the things we asked them to do, the easier it is to hold them accountable for whether they are successful or not.

Mrs. LOVE. And I would think—

Mr. PLOSSER. —it has to be you don't ask them to do the things they can't do.

Mrs. LOVE. Yes. And it would also be easier for us not to have look at every aspect and manage the thing that they do also.

Do you have a comment with that, Dr. Johnson?

Mr. JOHNSON. Congresswoman—

Mrs. LOVE. In terms of what we have gained. In your opinion what we have gained from that.

Mr. JOHNSON. Sure. Sure. Look, I think the legitimacy of our government institutions is really important, for whom does the Fed work and how do you communicate that? I think we mustn't lose track of that. It has taken a beating probably through their own, I think, inattention to financial regulatory issue, precrisis, pre-2007, 2008.

And, you know, I think if you remove the employment mandate, it would be misunderstood—that would be—you know, I agree other central banks formulate this somewhat differently, but I think it would be misunderstood by the American people, and that would not be my recommendation. But, you know, that is your business.

You know, what is the problem you were trying to fix? On Monday, I was with Chairman Volcker at an event that was organized by the Volcker alliance. And I was reminded by his leadership and his ability with his colleagues to bring down inflation. It was a very bad problem when he came in. And Chairman Volcker, with others of the Federal Reserve, really put the country on the path to what was then an impressive economic recovery. And I don't think it was anything in his ability to do that job, which is an incredibly hard job with a lot of political pressure.

I don't think the Humphrey-Hawkins amendment made it harder for him to do that job. So I don't think—I think the problem is, actually, what you said, you know, what is the nature of a financial system, how unstable is it, and what we are going to go about that? That is a good question. Should the Fed be on the job for that? Mr. Volcker, actually, has some other ideas. You might want to look at those. I really recommend the work done by the Volcker alliance. That is a really good question, the financial stability part.

The Humphrey-Hawkins part, I really would not recommend that you repeal that. But, you know, again, you are in charge, and if you want to do that—

Mrs. LOVE. I just asked what we gained from it, and I haven't heard any real—

Mr. JOHNSON. Legitimacy. Legitimacy.

Mrs. LOVE. —yes, legitimacy on what we have actually gain from that. I mean, we can sit there and say, hey, well, I wouldn't remove it for fear that we would something happen. But I haven't heard any example of what we have actually gained from that—from that amended to include full employment.

Anyway, I just have one more—well, I don't know if I have enough time to ask one more question.

But some of you mentioned that the Fed continued to expand its role in systemic regulation and credit allocation. In your opinion, Dr. Levy, very quickly, do you think that should make us worry about its ability to produce sound monetary policy?

Mr. LEVY. Yes, in general, because this is just an—by getting into credit allocation and expanding its scope, it is just move monetary policy beyond where it becomes capable, and it only generates, you know, distortions in economic and financial behavior.

Mrs. LOVE. Thank you. Great panel today. Thank you. Thank you.

Chairman HUIZENGA. And, certainly—well, last but certainly not least, we have Mr. Hill from Arkansas who will be recognized for 5 minutes.

Mr. HILL. I thank the chairman. Thanks again to the panel. Good discussion about the fact that we have $4 trillion on the Fed's balance sheet up from 8- or 900 billion before the crisis and yet we don't seem to show much for it. As I have said to Chair Yellen before, with deficit spending, with a $4 trillion Fed balance sheet, shouldn't we be in some sort of Keynesian Nirvana of economic, which we are obviously not.

In my view, it is the fundamental issue is that not since the 1930s have we seen a money multiplier rate at 4, at this low, low level, and I think it speaks to—I mean Eccles in the 1930s called it "pushing on a string," and everybody understands that, but it hasn't been lower since say 1935 than it is today, period, full stop.

And so, Dr. Levy, I loved your testimony, and it seems to me that the reason is nonmonetary policy structural impediments, which we never get an answer to when the administration come and testifies. Secretary Lu, zero; Chair Yellen, zero on this topic. They will not admit explicitly that there are major nonmonetary policy structural impediments such as the fact that operational and credit risk has been completely mangled by Dodd-Frank, that there is just plain fear on the part of market participants, whether they are small business people trying to comply with Department of Labor new rules or implementing the Affordable Care Act or maintaining limits on their employee to comply with avoiding the Affordable Care Act, that their staff, in my judgment, is misdirected from productive functions to compliance oriented functions.

And finally, that Dodd-Frank, I think, has made all the institutions sort of aligned in a pro-cyclical sort of way instead of allowing diversity in risk parameters among the activities of our banking institution. So what, in your view, and be specific, would get our multiplier up?

It took 30 years or more for the multiplier to rebound from the 1930 depression, a long time, but it fell off a cliff from 8 or 9 in 2007, straight to the bottom. It has never moved since we started all this stimulus.

So Dr. Johnson, what, in your view, what is the single biggest thing we can do in the government to stimulate a faster expansion of the multiplier?

Mr. JOHNSON. Great question, Mr. Hill, and you know, and I don't disagree with the formulation, although it is not exactly the standard economic version. I think we focus on the productivity growth and the money multiplier, the monetary policy will adapt to be consistent with that. Look, I am a skeptic with regard to the regulatory impediments, but you know—

Mr. HILL. Why? Why? Give me one reason why.

Mr. JOHNSON. Because I spent a long time studying that question, that issue, and those measures around the world, and I don't see that—

Mr. HILL. So you believe that banks are lending more and have higher productivity, and credit is getting to consumer and businesses better today—

Mr. JOHNSON. No, sir.

Mr. HILL. —than it was in 2005?

Mr. JOHNSON. No, sir. Can I finish answering the question?

Mr. HILL. Of course.

Mr. JOHNSON. No. Look, we had a huge financial crisis, Mr. Hill, and I think if we are looking at medium term, longer term growth, the most important thing is avoid having another crisis like that, right. So that was the goal of Dodd-Frank, you don't like it, I understand that, you are going to repeal and replace it, I understand that. Let's see what happens. I am very worried. I am very worried about that. But on the regulatory pieces, it is going to be fascinating. I am just watching this from the side, and I—you know, I wish you well because I want good things for the American economy, but I think the story that you have, that narrative that you are going to remove those regulatory impediments and very good things will happen because the impediments were the problem, I am skeptical. I am not disagreeing with—

Mr. HILL. Okay. I will put you down as—

Mr. JOHNSON. Sorry.

Mr. HILL. Excuse me, it is my time. I will put you down as a doubter on regulatory. How about tax reform?

Mr. JOHNSON. I have testified to this Congress a number of occasions in favor of various forms of tax reform, and I think if you can find ways to simplify the corporate tax code, remove a lot of the special treatments and so on, that could be extremely helpful. I am in favor of lowering taxes, absolutely, on the lowest paid Americans. I don't see why anybody earning under $50,000 a years pays any tax, and I am including Social Security contribution.

So yes, I am all in favor of that, but be careful with those projections, the dynamic scoring that says it won't impact the budget deficit, because it will, and I think you want to be cognizant of the impact on the budget deficit, which I know you talk about a lot, and so please really take that seriously because otherwise the debt numbers the next time we come back here are going to be a lot higher.

Mr. HILL. Ten seconds, somebody else want to tackle that? Dr. Levy.

Mr. LEVY. Yes. Okay. I think if you were to get rid of a lot of the micro-regulations in Dodd-Frank, banks are sitting on trillions in excess reserves that would increase banks' willingness to lend, and you would see the biggest increases among small- and medium-sized banks and a lot of their lending is to medium- and small-sized businesses that generate a lot of jobs.

Okay. But that is on the financial side. On the nonfinancial side, tax reform, and I emphasize reform and not just increase deficit spending, corporate tax reform that lifts the gray cloud off of corporations, simplification, individual income tax cuts, but don't go overboard, and the third point is normalize interest rates. You raise interest rates that reduces the demand for money that increases velocity, so what you—what I am really talking about here is resetting monetary policy but also resetting fiscal and regulatory policies in a way that I think what has happened over the last, I don't know how many years, these inhibitions to growth have constrained both aggregate supply and aggregate demand.

Let's reduce those inhibitions through wise policies, both within the financial system so that banks are putting to work the excess reserves and on the nonfinancial system so that businesses—and once again, if you look at economic performance so far this expansion, consumption has grown at a fine pace, so has housing. The weakness is capital spending, as Dr. Taylor said, the capital stock net of depreciation has been declining, this means not just lower capital ratios relative to labor but there is less training of labor of new capital. You really need this kind of regime change, and then you are going to get the multipliers moving back up.

Maybe the reason why monetary policy has worked is because it hasn't worked. I would love to see the regime changes that really force monetary policy to normalize.

Chairman HUIZENGA. I think therein lies our—we have done one thing here. We have successfully bent time; therefore, the last 10 seconds. So I do deeply appreciate the time invested by our panel and by our members on this very important issue, and I would look forward to continuing the conversation.

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.

And with that, the hearing is adjourned.

[Whereupon, at 12:13 p.m., the hearing was adjourned.]

A P P E N D I X

December 7, 2016

Testimony submitted to the House of Representatives Committee on Financial Services, Subcommittee on Monetary Policy and Trade, hearing on "Unconventional Monetary Policy," Wednesday, December 7, 2016, 10am (embargoed until the hearing begins).

Submitted by Simon Johnson, MIT Sloan and the Peterson Institute for International Economics.[1]

A. Main Points

1) The Federal Reserve System has been tasked by Congress with maintaining full employment while keeping inflation low.[2] All well-functioning industrial democracies have a central bank with a similar mandate.
2) During normal times, central banks respond to shocks and attempt to smooth out the business cycle primarily by altering the short-term "policy" rate of interest. In the U.S. this is the federal funds rate, and monetary policy decisions are in the hands of the Federal Open Market Committee (FOMC), comprised of the Federal Reserve System's Board of Governors and the presidents of regional Federal Reserve Banks.[3] (For the remainder of this testimony, I will refer to these officials and their decision-making by the generally used collective name, "the Federal Reserve.")
3) In the face of a severe financial crisis, any sensible central bank will consider taking more dramatic measures – to prevent another Great Depression. This is standard practice across all countries. The range of policy options depends on the income level of the country, the credibility of the central bank, and the "fiscal space" available (i.e., public debt levels and the ability of the private market to buy newly issued government debt at low interest rates).

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[1] Johnson is co-founder of MIT's Global Entrepreneurship Lab (GLAB) which, over the past 16 years, has helped nearly 500 companies to grow and create jobs. He was previously chief economist at the International Monetary Fund. He is currently Ronald A. Kurtz (1954) Professor of Entrepreneurship, Sloan School of Management, MIT; and Senior Fellow, Peterson Institute for International Economics. He is also a member of the Federal Deposit Insurance Corporation's Systemic Resolution Advisory Committee, the Office of Financial Research's Financial Research Advisory Committee, and the independent Systemic Risk Council (created by Sheila Bair and now chaired by Paul Tucker). Only personal views are represented here. Underlined text indicates links to sources and supplementary material; to see this, please access an electronic version of this document, e.g., at http://BaselineScenario.com. For important disclosures, see http://baselinescenario.com/about/.

[2] "The Congress established the statutory objectives for monetary policy--maximum employment, stable prices, and moderate long-term interest rates--in the Federal Reserve Act." https://www.federalreserve.gov/faqs/money_12848.htm

[3] See the explanation of "Open Market Operations" on the Fed's webpage; https://www.federalreserve.gov/monetarypolicy/openmarket.htm

4) Prior to 2008, the defining historical experience regarding major crises, deflation, and depression was the large financial shock caused by the stock market crash of 1929, which caused lasting damage to the real economy in the U.S. (and in other countries) because of the way in which banks were allowed to fail – and because the Federal Reserve allowed the nation's money supply and credit availability to decline sharply.
5) As a result of that experience, the United States introduced deposit insurance to discourage bank runs and to protect retail depositors. The Federal Reserve – as well as leading independent analysts, such as Milton Freidman and Anna Schwartz – also thought long and hard about how exactly to respond to deep crises, and how to prevent the collapse of money and credit.[4]
6) When the world's financial system encountered serious problems in 2007-08, initially the Fed responded by lowering interest rates. In August 2007, the FOMC's target for the federal fund rate was 5-1/4 percent. By the end of 2008, this target had been lowered to nearly zero.[5]
7) With the economy in decline and the financial system on the verge of further serious problems, the Federal Reserve understandably launched a program of large-scale asset purchases of longer dated government and government-backed securities, an operation which became known as "quantitative easing". As part of this approach the Fed also expanded its "forward guidance" – attempting to signal that short-term interest rates would remain lower and for longer, as a way to reduce longer term interest rates.
8) After the economy stabilized, unemployment remained high and the recovery was slow – so there was a great deal of macroeconomic "slack". While there was an initial fiscal policy response, in early 2008 under President George W. Bush and again in early 2009 under President Barack Obama, this proved to be small relative to the scale of the problem. Further attempts to provide meaningful fiscal stimulus – including as recommended by the Fed – proved futile due to opposition in Congress.
9) As a result, the Fed engaged in two further rounds of quantitative easing. The form of the operation varied, but the goal was the same – to lower long-term interest rates below what they otherwise would have been.[6]

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[4] Friedman and Schwartz's book, *A Monetary History of the United States, 1867-1960*, Princeton University Press, 1963, influenced generations of economists and policy makers – and can reasonably be regarded as one of the most influential books ever within economics.
[5] See "Monetary Policy since the Onset of the Crisis," speech by Chairman Ben S. Bernanke at the Federal Reserve Bank of Kansas City Economic Symposium, Jackson Hole, Wyoming, August 31, 2012, https://www.federalreserve.gov/newsevents/speech/bernanke20120831a.htm.
[6] Several good Fed explainers are available, e.g., https://research.stlouisfed.org/pageone-economics/uploads/newsletter/2011/201104.pdf.

10) Assessing the effectiveness of this kind of Fed operation is difficult, but the available evidence is that long-term rates were lowered, not just on Treasury debt but also on more risky securities.[7] Lower interest rates on credit help to support investment and the consumption of consumer durables, as well as house prices. The effects were not large and the recovery still proved slow, but quantitative easing at least helped push the economy in the right direction.
11) At the same time, while serious concerns were raised at the start of the quantitative easing program, the problem of unintended consequences was relatively minor. Inflation did not spiral out of control – in fact, inflation expectations have remained remarkably well anchored throughout this experience.
12) There is also no evidence that the Fed's policy caused a first-order distortion in asset markets, although Fed officials have always emphasized the need to "exit" this program carefully. So far, they have done exactly this – edging towards the normalization (increasing) of interest rates as the economy recovers.
13) In summary, quantitative easing was a legitimate and sensible response to extraordinary difficulties. This policy approach was well-grounded in history and long-standing analysis, including by Milton Friedman. Ben Bernanke, as a leading historian and analyst of the Great Depression, was well-placed to lead this program. The consequences were positive, although not large. Undesired side effects have remained relatively small.
14) Looking forward, however, there are two broader lessons.
    a. The U.S. should be more willing to use countercyclical fiscal policy in the face of crisis conditions. There continues to be an unfortunate lack of political consensus on this important point.
    b. We should focus on avoiding such crisis conditions, including by ensuring that our financial system is well-regulated and properly capitalized. We have made some progress on this front since 2008 but unfortunately not enough. And the latest indications from the incoming Trump administration suggests that the hard won lessons of the last crisis may soon be disregarded. This would put us on the path to another disruptive and damaging boom-bust-bailout cycle, which undermines medium-term growth, damaging the prosperity of most Americans, and undermining our role in the world.

[7] Estimates vary, but the overall effect may have been around 100 basis points (one percentage point) on 10 year Treasuries, although there is a large error band around that number.

B. What Went Wrong?

Discussing the effectiveness of monetary policy – and the way it should be combined with fiscal policy – is important. But we should not lose track of the deeper underlying issues – and what forced the Fed to take dramatic action during and after 2008. The nature and structure of our financial system led to the deep crisis and still poses real risks to our collective economic future.

We should be attempting to strengthen the safeguards in the Dodd-Frank financial reform legislation. Repealing or rolling back that legislation poses a major fiscal risk – and it also raises the probability that the Fed would again have to enter unchartered territory with monetary policy.[8] The potential downside fiscal and monetary "tail risks" are not currently scored by the Congressional Budget Office, but this does not reduce the probability of disaster or reduce the impact of such a problem if it does occur.

In effect, a financial system with dangerously low capital levels – hence prone to major collapses – creates a nontransparent contingent liability for the federal budget in the United States.[9] This can only lead to further instability, deep recessions, and damage to our fiscal balance sheet, in a version of what senior officials at the Bank of England refer to as a "doom loop".

On December 5, 2016, the Volcker Alliance launched a very pragmatic report on the state of financial reform – arguing that we should continue to address risks caused by excessive reliance on short-term funding, the structure of money market funds, and the way risk has become concentrated in clearing houses.

In a discussion at the launch event, held at the National Press Club, Federal Deposit Insurance vice-chairman Tom Hoenig emphasized the need to ensure a proper (and higher) level of capital in the financial system, along with measures

[8] See Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and The Next Financial Meltdown*, Pantheon, 2010.
[9] See Anat Admati, Peter DeMarzo, Martin Hellwig, and Paul Pfleiderer, "Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is *Not* Expensive," Stanford University, March 2011 (revised), https://gsbapps.stanford.edu/researchpapers/library/RP2065R1&86.pdf. For a comprehensive assessment of banking and why capital requirements should be significantly higher, see Anat Admati and Martin Hellwig, *The Banker's New Clothes: What's Wrong with Banking and What to Do about it*, Princeton University Press, 2013.

that limit the availability of safety net support both to large banks, as well as to the nonbank financial sector.[10]

Unfortunately, the pricing of risk suggests that participants in financial markets believe that some financial institutions are still Too Big To Fail.[11] The deeper underlying problem is that too many of our financial regulations and regulators remain captured, one way or another, by large banks.

Regulatory capture is not a new problem and George Stigler of Chicago University is still the best guide to the general issues. Unfortunately, since the 1970s, this form of cognitive capture has become a major macroeconomic risk – a big part of what went wrong in 2008 and a significant issue today, including for the next administration.[12]

[10] All of Mr. Hoenig's speeches and writings on this point should be required reading. For one recent example, https://www.fdic.gov/news/news/speeches/spnov0916.html.
[11] On this point, see the recently released report by the Minneapolis Fed, "Ending Too Big To Fail," https://www.minneapolisfed.org/publications/special-studies/endingtbtf.
[12] In *13 Bankers: The Wall Street Takeover and The Next Financial Meltdown*, James Kwak and I analyze the history and issues in more detail.

Resetting Monetary Policy

Mickey D. Levy*

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

December 7, 2016

Chair Huizenga and members of the Subcommittee, I appreciate this opportunity to present views on the Federal Reserve's monetary policy. You directed today's hearings to focus on the Federal Reserve's departure from conventional monetary policy and whether it has worked and how monetary policy can reliably support economic growth going forward.

An assessment of the conduct of monetary policy in recent years provides important lessons for the Fed and its proper role and economic policymaking in general. This is particularly true now that an economic policy regime shift is underway.

The Fed's unconventional policies in 2008-2009 deserve credit for helping to lift the economy and financial markets from crisis. However, it is striking that in recent years while the Fed's unconventional policies of sustained negative real Fed funds rate, quantitative easing and forward guidance have successfully stimulated financial markets, lowered bond yields, encouraged risk-taking and boosted asset prices, they have failed in their ultimate objective of stimulating the economy. Nominal GDP growth has actually decelerated to 2.8 percent in the last year from its subdued 3.9 percent average pace of the prior six years, and real growth has languished.

Extending excessive monetary ease well after economic performance normalized and the Fed's dual mandate was largely achieved has been costly. Instead of stimulating aggregate demand, monetary policies have contributed to mounting financial distortions and disincentives and are inconsistent with the Fed's macro-prudential risk objectives. Unfortunately, the Fed and financial markets now may be beginning to pay the price for the Fed's extended excessively easy monetary policy.

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I will now describe some reasons why the Fed's policies have not stimulated faster growth and how the Fed should change its conduct of monetary policy and make some suggestions for strengthening the economy.

Throughout this slow economic expansion, consumption and housing have grown firmly, but business investment has been disappointingly weak despite the lower the costs of capital and strong corporate profits and cash flows. Soft capital spending has contributed to very slow productivity gains and diminished estimates of potential growth. The Fed has reduced its estimates of potential growth to 1.8 percent and the Congressional Budget Office to 2.0 percent, dramatically lower than their estimates of 2.6 percent in 2007. This has far-reaching implications for employment, wages and standards of living.

Recent trends make it increasingly clear that economic performance has been constrained by factors that are beyond the scope of monetary policy. The slow growth has much less to do with the Fed than real, nonmonetary issues, particularly growth-depressing economic, tax and regulatory policies. However, the Fed's excessive monetary ease has not helped and may have harmed economic performance. It has generated mounting financial distortions that eventually must be unwound.

The Fed's approach to monetary policy has changed little even with the unemployment rate below 5 percent and inflation rising toward 2 percent. The Fed has kept the Fed funds rate well below inflation and continues to reinvest maturing assets to maintain its bloated balance sheet and nearly $2.5 trillion of excess banking reserves. Whether maintaining a negative real Fed funds rate for eight consecutive years is deemed "unconventional" —it has never happened before in Federal Reserve history—it certainly reflects poor policy judgment. Moreover, the Fed's fully discretionary approach to conducting policy, highlighted by its ever-changing explanations for delaying rate increases, adds confusion and has created a very unhealthy relationship with financial markets.

Factors constraining investment and growth

Government policies have been a key source of the weak economic performance and have constrained the Fed's efforts to stimulate growth. The adverse impacts have been particularly apparent in business investment and the availability of bank credit. The negative economic impacts of the rising public debt overhang and expectations of future tax increases have been widely discussed. In addition, to some extent the weak business investment reflects the rising share of GDP in less capital intensive production, rising overseas investment and measurement issues.

However, it is clear that a growing web of government regulations, mandated expenses and higher tax burdens have weighed on banking and the financial sector, business investment and the broader economic environment. In banking, the burdensome micro regulations imposed by Dodd-Frank have deterred bank lending, even by medium and smaller banks that do not face the Fed's stress tests. This has worked at crosscurrents to the Fed's easy monetary policy, clogging the normal channels through which monetary policy affects economic activities. In financial markets, the distortions generated by persistently negative real interest rates, excess liquidity and Fed-induced risk-taking are widespread, and now must be unwound.

In nonfinancial sectors, an array of new regulatory policies and government mandated expenses that have been imposed by Federal, state and local governments increase operating costs, contribute to inefficiencies in production processes and labor inputs, and lower after-tax rates of return on investment. They add an additional layer of uncertainty in investment decisions. A lot of these tax and regulatory burdens and government mandated expenses stem from administrative rulings and sometimes questionable interpretations of laws. Anecdotal evidence and business surveys indicate that in addition to slow product demand, government taxes and regulations are the largest concerns of businesses. Considered separately, most of these policies have little macroeconomic impact. However, their cumulative effects are large and generally not captured in standard macro models, including the Fed's FRB-US.

While the Fed's monetary policies have lowered the real costs of capital, the governments' economic and regulatory policies and related uncertainties have led businesses to raise their hurdle rates required for capital spending and expansion projects. Potentially productive expansion plans have been sidelined. Some government mandated expenses and labor laws have induced businesses to adjust labor inputs, including relying more on part-time workers. With less new capital, employee training has been cut back. Businesses have expanded overseas and bought foreign firms for tax reduction purposes. Businesses have issued more bonds in the Fed's low interest rate environment, but the proceeds are being used to buy back shares to meet the demands of yield-hungry investors. This raises corporate leverage but not capital spending or productive capacity.

Household behavior is also affected. Dimmed expectations of future disposable incomes have led to more precautionary saving, and real consumption has not quite kept pace with real disposable incomes. Working households are allocating more out-of-pocket spending to medical care and health insurance that have resulted in part by the Affordable Care Act, so they have less to spend on other goods and services. Tight mortgage credit standards and more onerous administrative costs have adversely affected the housing market.

These policy-induced constraints on economic growth and productive capacity are beyond the scope of monetary policy. Yet up until recently the Fed has perceived that the underperformance in labor markets and the economy has reflected insufficient aggregate demand that can be remedied by monetary stimulus. It has expanded the role of monetary policy on many dimensions. Monetary policy is involved in credit allocation through Fed purchases of mortgage-backed securities. It attempts to manage and fine-tune the real economy, respond to labor force participation rates, wages and an array of international trends that have little impact on the US. The Fed has frequently argued that had it not pursued aggressive monetary ease, economic performance would have been much worse. Again, the Fed deserves credit for lifting the US from crisis in 2008-2009, but it grossly overstates the efficacy of monetary policy in recent years.

Recently, the Fed has expressed the view that its monetary policy is having a diminishing economic impact and some Fed members are expressing concerns about mounting financial distortions. Noteworthy, former Fed Chairman Ben Bernanke stated in a recently blog that there may be supply constraints inhibiting economic growth, and if so, the Fed cannot do anything about it. That sets the stage for the current situation.

What Should the Fed Do?

I recommend that the Fed should reset the conduct of monetary policy. It should: 1) raise rates gradually but persistently toward a neutral policy rate consistent with its estimates of potential growth and its 2 percent inflation target, and cease reinvesting its maturing assets, 2) de-emphasize short-run economic and financial fine-tuning and not allow monetary policy to be influenced by global and financial turmoil that does not materially influence US economic performance, 3) shift the focus of its communications, including its official Policy Statements, toward the Fed's long-run objectives and away from short-run economic and financial conditions that are always subject to volatility, and emphasize that the scope of monetary policy is limited and that the economy is influenced by other factors including the government's economic and regulatory policies, and 4) shift toward a more rules-based guideline for conducting monetary policy that provides flexibility for the Fed but at the same time avoids the big mistakes of discretionary policy deliberations.

Gradually raising rates would leave monetary policy easy. It would not harm and may even help economic performance. The financial system is awash with excess reserves and the real Fed funds rate is roughly negative 1.3 percent, far below the Fed's 1 percent estimate of the appropriate long-run real policy rate (The median FOMC member's estimate of the appropriate Fed funds rate is 3 percent, 1 percentage point above the Fed's 2 percent inflation target.) During prior economic expansions when the Fed has raised rates following monetary accommodation, growth has been sustained. Witness the sustained growth when the Fed raised rates in the early 1980s, mid-1990s, or the mid-2000s. Raising rates would actually stimulate more bank lending and loosen the intermediation process. A clear Fed explanation of why it is normalizing rates—and why there is no need to delay—would boost confidence.

Ceasing to reinvest the proceeds from maturing assets in its portfolio would allow for a very gradual and passive unwind of excess reserves and would have no impact on credit supply. The Fed's reinvestment strategy is based on its fear that any change would signal faster interest rate normalization that may jar financial markets. That policy has not stimulated capital spending or economic growth and has only raised the costs of eventual monetary normalization, and should end.

A clearer explanation by the Fed of the non-monetary policies and factors that have contributed to lower potential growth, weak capital spending and productivity, and structural unemployment would help steer the economic policy debate toward the issues that really matter for performance. The Fed needs to correct the misperceptions that monetary policy is capable of managing every aspect of economic performance. It needs to emphasize that monetary policy is not a substitute for growth-depressing fiscal or regulatory policies and also dispel the notion that activist monetary policy is necessary and appropriate because the government's economic and fiscal policies and processes are misguided and dysfunctional.

The Fed should also spell out clearly how its low policy rate and bloated balance sheet have reduced the government's net interest costs and allowed fiscal policymakers to avoid making necessary fiscal and budget reforms.

Clarifying a more limited role of monetary policy may not sit well with those who have come to rely excessively on the Fed, but it would constructively reset monetary policy and enhance the Fed's independence and credibility.

Several observations on fiscal and economic policies

First, the Fed and others have been advocating for fiscal stimulus to boost the economy. ***It is critically important to distinguish between fiscal reform and fiscal stimulus that simply involves more deficit spending.*** With the economy in its eighth consecutive year of expansion and growing at a pace close to current measures of potential, and the unemployment rate at or below standard estimates of full employment, countercyclical fiscal stimulus in the form of increased deficit spending is unwarranted and inappropriate.

Second, the focus of fiscal policy should be on tax and spending reforms that raise potential growth. This should involve tax reforms aimed at creating an environment conducive to investment and expansion. Spending initiatives should focus on reallocating spending toward productive activities while reducing wasteful spending, and changing the structure of entitlement programs to lower the government's future long-run unfunded liabilities. These changes can be made in fair and efficient ways that do not affect current retirees. There is a lot of impetus toward more infrastructure spending. Such initiatives must aim at improvements and upgrades that add to productive capacity and provide benefits that exceed costs, while avoiding the pitfalls and political impulses toward more deficit spending aimed at short-term fiscal stimulus and temporary job creation. Moreover, initiatives that improve education, training and human capital are critically important to improving the nation's infrastructure.

Third, regarding regulatory initiatives, banking and financial regulations should focus on establishing high capital adequacy standards while easing micro regulatory burdens that constrict bank credit. In the non-financial sectors, reform efforts should involve reducing burdensome regulations that inhibit business investment and expansion and constrict labor mobility and whose economic costs far exceed benefits.

The Fed must be prepared to raise rates higher if new economic policies raise potential growth.

Thank you for your attention today. I would be pleased to answer any questions.

Making the Fed More Accountable -- Not More Political

Charles I. Plosser[1]

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

December 7, 2016

Chair Huizenga and members of the Subcommittee, thank you for the opportunity to share some thoughts with you on the Federal Reserve.

Let me begin with two important points that illustrate the challenges to central bank reforms. Central banks for the most part are given the responsibility to preserve the purchasing power of a nation's currency. One way the Fed does this is by buying and selling securities in the open market to control the growth of money and credit. This gives the Fed extraordinary powers to intervene in financial markets, not only though the quantity of purchases but also through the types of assets it chooses to buy.

The second point is that history teaches us that economic stability and prosperity are far more likely when there is a healthy degree of separation between government officials who are responsible for tax and spending policies and those in charge of printing money. Otherwise, printing money simply becomes an easy substitute for tough fiscal choices. Argentina, for example, has been stagnant and rife with periods of inflation and financial turmoil over the last three decades. In large part, this is due to the lack of an effective separation between the central bank and the fiscal authorities.

These two points highlight a major tension in discussions of central bank reform. How, in a democratic society, do you preserve central bank independence while ensuring it has adequate tools for success and can be held accountable to the public?

I believe there are three ways to address this tension in a responsible manner: Simplify the goals; constrain the tools; make decisions more systematic. All three steps can lead to clearer communications, and a better understanding of monetary policy on the part of the public without undermining political independence.

In my brief time let me touch on the first two of these strategies.

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The Fed is said to have a "dual mandate" – price stability and maximum employment. Yet, the broader the mandate, the more opportunity there is for discretion, and more discretion means there's more scope for political interference and uncertainty over the direction of policy. Policymakers can find themselves futilely chasing one goal after another.

Unfortunately, over the last decade, the Fed's mandate seems to have experienced mission creep, expanding the scope for discretionary action and the opportunity for political interference. The public and the Fed talked as if monetary policy should be responsible for stock market valuations, income inequality, labor force participation rates, real wage growth, and an expanding list of other dubious objectives. Indeed, around the world it seems that central banks are being asked to solve all manner of economic ills – from fiscal crises in Europe to low productivity and structural challenges in Japan and the U.S. I think this is a mistake and potentially dangerous for the institution and the economy. Moreover, these broad mandates make it extremely difficult to hold the central bank accountable. I'm reminded of the old saying: "responsible for everything but accountable for nothing."

Institutions are guaranteed to fail when they are assigned responsibility for outcomes that they cannot substantially influence.

The hubris of central bankers and the unrealistic expectations of the public and governments are out of line with what we can realistically expect from monetary policy. As the Nobel Laureate Milton Friedman warned almost 50 years ago; "...we are in danger of assigning to monetary policy a larger role than it can perform, in danger of asking it to accomplish tasks it cannot achieve, and, as a result, in danger of preventing it from making the contribution that it is capable of making."

One way to address these concerns and to help reset expectations is to narrow the monetary policy mandate to focus solely, or at least predominately, on price stability. Many major central banks around the world already have just such a narrow or hierarchical mandate. It would focus the Fed's attention, reduce the opportunity for discretion, and make it easier to hold the Fed accountable for its actions. It would also provide some protection for the Fed from demands arising from inside and outside the central bank to pursue other, mostly unachievable, objectives.

A second way to restrict central bank interventions is to limit the types of assets that can be purchased, thus constraining the composition of its balance sheet. For the U.S., I suggest that the Fed be restricted to an all-treasury portfolio. During the crisis and recession, the Fed engaged in large scale purchases of mortgage-backed securities in an effort to help the housing sector. It also purchased distressed securities during the rescue of Bear Stearns and AIG. Such actions are a form credit allocation and thus a type of fiscal policy. Fed independence should not include making fiscal policy decisions as it undermines the separation of authorities and thus independence. If the Fed is to engage in the purchase of private sector securities or credit allocation, it should do so at the request of the fiscal authorities. The Treasury should then take possession of those assets in exchange for treasury securities so the central bank is free to conduct monetary policy and the separation of fiscal and monetary policy remains intact.

Thank you for your attention and I would be happy to answer any questions.

A Limited Central Bank

Charles I. Plosser

Douglass C. North, co-winner of the 1993 Nobel Prize in Economics, argued that institutions were deliberately devised to constrain interactions among parties—both public and private (North 1991).[1] In the spirit of North's work, one theme of this article will be that the institutional structure of the central bank matters. The central bank's goals and objectives, its framework for implementing policy, and its governance structure all affect its performance.

The Importance of Institutions

Central banks have been around for a long time, but they have clearly evolved as economies and governments have changed. Most countries today operate under a fiat money regime, in which a nation's currency has value because the government says it does. Central banks usually are given the responsibility to protect and preserve the value or purchasing power of the currency.[2] In the United States, the Fed does so by buying or selling assets in order to manage

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[1]For more about North and his co-winner, Robert W. Fogel, and the 1993 Nobel Memorial Prize in Economic Sciences, see Nobel Media (1993).

[2]Countries can and do pursue different means of setting the value of their currency, including pegging their monetary policy to that of another country, but I will not concern myself with such issues.

the growth of money and credit. The ability to buy and sell assets gives the Fed considerable power to intervene in financial markets not only through the quantity of its transactions but also through the types of assets it can buy and sell. Thus, it is entirely appropriate that governments establish their central banks with limits that constrain the actions of the central bank to one degree or another.

Yet, in recent years, we have seen many of the explicit and implicit limits stretched. The Fed and many other central banks have taken extraordinary steps to address a global financial crisis and the ensuing recession. These steps have challenged the accepted boundaries of central banking and have been both applauded and denounced. For example, the Fed has adopted unconventional large-scale asset purchases to increase accommodation after it reduced its conventional policy tool, the federal funds rate, to near zero. These asset purchases have led to the creation of trillions of dollars of reserves in the banking system and have greatly expanded the Fed's balance sheet. But the Fed has done more than just purchase lots of assets; it has altered the composition of its balance sheet through the types of assets it has purchased. I have spoken on a number of occasions about my concerns that these actions to purchase specific (non-Treasury) assets amounted to a form of credit allocation, which targets specific industries, sectors, or firms. These credit policies cross the boundary from monetary policy and venture into the realm of fiscal policy (Plosser 2009, 2012). I include in this category the purchases of mortgage-backed securities as well as emergency lending under Section 13 (3) of the Federal Reserve Act, in support of the bailouts, most notably of Bear Stearns and AIG. Regardless of the rationale for these actions, one needs to consider the long-term repercussions that such actions may have on the central bank as an institution.

As we contemplate what the Fed of the future should look like, I will discuss whether constraints on its goals might help limit the range of objectives it could use to justify its actions. I will also consider restrictions on the types of assets it can purchase to limit its interference with market allocations of scarce capital and generally to avoid engaging in actions that are best left to the fiscal authorities or the markets. I will also touch on governance and accountability of the Fed and ways to implement policies that limit discretion and improve outcomes and accountability.

Fed Goals and Objectives

The Fed's goals and objectives have evolved over time. When the Fed was first established in 1913, the United States and the world were operating under a classical gold standard. Therefore, price stability was not among the stated goals in the original Federal Reserve Act. Indeed, the primary objective in the preamble was to provide an "elastic currency."

The gold standard had some desirable features. Domestic and international legal commitments regarding convertibility were important disciplining devices that were essential to the regime's ability to deliver general price stability. The gold standard was a de facto rule that most people understood, and it allowed markets to function more efficiently because the price level was mostly stable.

But, the international gold standard began to unravel and was abandoned during World War I (Bernanke 2013, Lacker 2013). After the war, efforts to reestablish parity proved disruptive and costly in both economic and political terms. Attempts to reestablish a gold standard ultimately fell apart in the 1930s. As a result, most of the world now operates under a fiat money regime, which has made price stability an important priority for those central banks charged with ensuring the purchasing power of the currency.

Congress established the current set of monetary policy goals in 1978. The amended Federal Reserve Act specifies the Fed "shall maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." Since moderate long-term interest rates generally result when prices are stable and the economy is operating at full employment, many have interpreted these goals as a dual mandate with price stability and maximum employment as the focus.

Let me point out that the instructions from Congress call for the Federal Open Market Committee (FOMC) to stress the "long-run growth" of money and credit commensurate with the economy's "long-run potential." There are many other things that Congress could have specified, but it chose not to do so. The act doesn't talk about managing short-term credit allocation across sectors; it doesn't mention inflating housing prices or other asset prices. It also doesn't mention reducing short-term fluctuations in employment.

Many discussions about the Fed's mandate seem to forget the emphasis on the long run. The public, and perhaps even some within the Fed, have come to accept as an axiom that monetary policy can and should attempt to manage fluctuations in employment. Rather than simply set a monetary environment "commensurate" with the "long-run potential to increase production," these individuals seek policies that attempt to manage fluctuations in employment over the short run.

The active pursuit of employment objectives has been and continues to be problematic for the Fed. Most economists are dubious of the ability of monetary policy to predictably and precisely control employment in the short run, and there is a strong consensus that, in the long run, monetary policy cannot determine employment. As the FOMC noted in its statement on longer-run goals adopted in 2012, "the maximum level of employment is largely determined by non-monetary factors that affect the structure and dynamics of the labor market." In my view, focusing on short-run control of employment weakens the credibility and effectiveness of the Fed in achieving its price stability objective. We learned this lesson most dramatically during the 1970s when, despite the extensive efforts to reduce unemployment, the Fed essentially failed, and the nation experienced a prolonged period of high unemployment and high inflation. The economy paid the price in the form of a deep recession, as the Fed sought to restore the credibility of its commitment to price stability.

When establishing the longer-term goals and objectives for any organization, and particularly one that serves the public, it is important that the goals be achievable. Assigning unachievable goals to organizations is a recipe for failure. For the Fed, it could mean a loss of public confidence. I fear that the public has come to expect too much from its central bank and too much from monetary policy in particular. We need to heed the words of another Nobel Prize winner, Milton Friedman. In his 1967 presidential address to the American Economic Association, he said that "we are in danger of assigning to monetary policy a larger role than it can perform, in danger of asking it to accomplish tasks that it cannot achieve, and as a result, in danger of preventing it from making the contribution that it is capable of making" (Friedman 1968: 5). In the 1970s we saw the truth in Friedman's earlier admonitions. I think that over the past 40 years, with the exception of the Paul Volcker era, we failed to heed this warning. We have assigned an ever-expanding role for monetary policy, and we expect our central bank to solve all manner of economic woes which it is ill-suited to address. We need to better align the expectations of monetary policy with what it is actually capable of achieving.

The so-called dual mandate has contributed to this expansionary view of the powers of monetary policy. Even though the 2012 statement of objectives acknowledged that it is inappropriate to set a fixed goal for employment and that maximum employment is influenced by many factors, the FOMC's recent policy statements have increasingly given the impression that it wants to achieve an employment goal as quickly as possible (Thornton 2012).

I believe that the Fed's aggressive pursuit of broad and expansive objectives is quite risky and could have very undesirable repercussions down the road, including undermining the public's confidence in the institution, its legitimacy, and its independence. To put this in different terms, assigning multiple objectives for the central bank opens the door to highly discretionary policies which can be justified by shifting the focus or rationale for action from goal to goal.

I have concluded that it would be appropriate to redefine the Fed's monetary policy goals to focus solely, or at least primarily, on price stability. I base this on two facts: Monetary policy has very limited ability to influence real variables, such as employment. And, in a regime with fiat currency, only the central bank can ensure price stability. Indeed, it is the one goal that the central bank can achieve over the longer run.

Governance and Central Bank Independence

Even with a narrow mandate to focus on price stability, the institution must be well designed if it is to be successful. To meet even this narrow mandate, the central bank must have a fair amount of independence from the political process so that it can set policy for the long run without the pressure to print money as a substitute for tough fiscal choices. Good governance requires a healthy degree of separation between those responsible for taxes and expenditures and those responsible for printing money.

The original design of the Fed's governance recognized the importance of this independence. Consider its decentralized, public-private structure, with governors appointed by the U.S. president and confirmed by the Senate, and Fed presidents chosen by their boards of directors. This design helps ensure a diversity of views and a more decentralized governance structure that reduces the potential for abuses and capture by special interests or political agendas. It also reinforces the independence of monetary policymaking, which leads to better economic outcomes.

Implementing Policy and Limiting Discretion

Such independence in a democracy also necessitates that the central bank remain accountable. Its activities also need to be constrained in a manner that limits its discretionary authority. As I have already argued, a narrow mandate is an important limiting factor on an expansionist view of the role and scope of monetary policy.

What other sorts of constraints are appropriate on the activities of central banks? I believe that monetary policy and fiscal policy should have clear boundaries (Plosser 2009, 2012). Independence is what Congress can and should grant the Fed, but, in exchange for such independence, the central bank should be constrained from conducting fiscal policy. As I have already mentioned, the Fed has ventured into the realm of fiscal policy by its purchase programs of assets that target specific industries and individual firms. One way to circumscribe the range of activities a central bank can undertake is to limit the assets it can buy and hold.

In its System Open Market Account, the Fed is allowed to hold only U.S. government securities and securities that are direct obligations of or fully guaranteed by agencies of the United States. But these restrictions still allowed the Fed to purchase large amounts of agency mortgage-backed securities in its effort to boost the housing sector. My preference would be to limit Fed purchases to Treasury securities and return the Fed's balance sheet to an all-Treasury portfolio. This would limit the ability of the Fed to engage in credit policies that target specific industries. As I've already noted, such programs to allocate credit rightfully belong in the realm of the fiscal authorities—not the central bank.

A third way to constrain central bank actions is to direct the monetary authority to conduct policy in a systematic, rule-like manner (Plosser 2008, Kydland and Prescott 1977). It is often difficult for policymakers to choose a systematic rule-like approach that would tie their hands and thus limit their discretionary authority. Yet, research has discussed the benefits of rule-like behavior for some time. Rules are transparent and therefore allow for simpler and more effective communication of policy decisions. Moreover, a large body of research emphasizes the important role expectations play in determining economic outcomes. When policy is set systematically, the public and financial market participants can form better expectations about policy. Policy is no longer a source of instability or uncertainty. While choosing an appropriate rule is important, research shows that in a wide variety of models simple, robust monetary policy rules can produce outcomes close to those delivered by each model's optimal policy rule (Orphanides and Williams 2002).

Systematic policy can also help preserve a central bank's independence. When the public has a better understanding of policymakers' intentions, it is able to hold the central bank more accountable for its actions. And the rule-like behavior helps to keep policy focused on the central bank's objectives, limiting discretionary actions that may wander toward other agendas and goals.

Congress is not the appropriate body to determine the form of such a rule. However, Congress could direct the monetary authority to communicate the broad guidelines the authority will use to conduct policy. One way this might work is to require the Fed to publicly describe how it will systematically conduct policy in normal times—this might be incorporated into the semiannual Monetary Policy Report submitted to Congress. This would hold the Fed accountable. If the FOMC chooses to deviate from the guidelines, it must then explain why and how it intends to return to its prescribed guidelines.

My sense is that the recent difficulty the Fed has faced in trying to offer clear and transparent guidance on its current and future policy path stems from the fact that policymakers still desire to maintain discretion in setting monetary policy. Effective forward guidance, however, requires commitment to behave in a particular way in the future. But discretion is the antithesis of commitment and undermines the effectiveness of forward guidance. Given this tension, few should be surprised that the Fed has struggled with its communications.

What is the answer? I see three: Simplify the goals; constrain the tools; and make decisions more systematically. All three steps can lead to clearer communications and a better understanding on the part of the public. Creating a stronger policymaking framework will ultimately produce better economic outcomes.

Financial Stability and Monetary Policy

Before concluding, I would like to say a few words about the role that the central bank plays in promoting financial stability. Since the financial crisis, there has been an expansion of the Fed's responsibilities for controlling macroprudential and systemic risk. Some have even called for an expansion of the monetary policy mandate to include an explicit goal for financial stability. I think this would be a mistake.

The Fed plays an important role as the lender of last resort, offering liquidity to solvent firms in times of extreme financial stress to forestall contagion and mitigate systemic risk. This liquidity is intended to help ensure that solvent institutions facing temporary liquidity problems remain solvent and that there is sufficient liquidity in the banking system to meet the demand for currency. In this sense, liquidity lending is simply providing an "elastic currency."

Thus, the role of lender of last resort is not to prop up insolvent institutions. However, in some cases during the crisis, the Fed played a role in the resolution of particular insolvent firms that were deemed systemically important financial firms. Subsequently, the Dodd-Frank Act has limited some of the lending actions the Fed can take with individual firms under Section 13 (3). Nonetheless, by taking these actions, the Fed has created expectations—perhaps unrealistic ones—about what the Fed can and should do to combat financial instability.

Just as it is true for monetary policy, it is important to be clear about the Fed's responsibilities for promoting financial stability. It is unrealistic to expect the central bank to alleviate all systemic risk in financial markets. Expanding the Fed's regulatory responsibilities too broadly increases the chances that there will be short-run conflicts between its monetary policy goals and its supervisory and regulatory goals. This should be avoided, as it could undermine the credibility of the Fed's commitment to price stability.

Similarly, the central bank should set boundaries and guidelines for its lending policy that it can credibly commit to follow. If the set of institutions having regular access to the Fed's credit facilities is expanded too far, it will create moral hazard and distort the market mechanism for allocating credit. This can end up undermining the very financial stability that it is supposed to promote.

Emergencies can and do arise. If the Fed is asked by the fiscal authorities to intervene by allocating credit to particular firms or sectors of the economy, then the Treasury should take these assets off of the Fed's balance sheet in exchange for Treasury securities. In 2009, I advocated that we establish a new accord between the Treasury and the Federal Reserve that protects the Fed in just such a way (Plosser 2009). Such an arrangement would be similar to the

Treasury-Fed Accord of 1951 that freed the Fed from keeping the interest rate on long-term Treasury debt below 2.5 percent. It would help ensure that when credit policies put taxpayer funds at risk, they are the responsibility of the fiscal authority—not the Fed. A new accord would also return control of the Fed's balance sheet to the Fed so that it can conduct independent monetary policy.

Many observers think financial instability is endemic to the financial industry and therefore it must be controlled through regulation and oversight. However, financial instability can also be a consequence of governments and their policies, even those intended to reduce instability. I can think of three ways in which central bank policies can increase the risks of financial instability. First, by rescuing firms or creating the expectation that creditors will be rescued, policymakers either implicitly or explicitly create moral hazard and excessive risking-taking by financial firms. For this moral hazard to exist, it doesn't matter if the taxpayer or the private sector provides the funds. What matters is that creditors are protected, in part, if not entirely.

Second, by running credit policies, such as buying huge volumes of mortgage-backed securities that distort market signals or the allocation of capital, policymakers can sow the seeds of financial instability because of the distortions that they create, which in time must be corrected.

And third, by taking a highly discretionary approach to monetary policy, policymakers increase the risks of financial instability by making monetary policy uncertain. Such uncertainty can lead markets to make unwise investment decisions—witness the complaints of those who took positions expecting the Fed to follow through with the taper decision in September 2013.

The Fed and other policymakers need to think more about the way their policies might contribute to financial instability. I believe it is important that the Fed take steps to conduct its own policies and help other regulators reduce the contributions of such policies to financial instability. The more limited role for the central bank I have described here can contribute to such efforts.

Conclusion

The financial crisis and its aftermath have been challenging times for global economies and their institutions. The extraordinary actions taken by the Fed to combat the crisis and the ensuing recession and to support recovery have expanded the roles assigned to monetary policy. The public has come to expect too much from its central bank. To remedy this situation, I believe it would be appropriate to set four limits on the central bank:

- First, limit the Fed's monetary policy goals to a narrow mandate in which price stability is the sole, or at least the primary, objective.
- Second, limit the types of assets that the Fed can hold on its balance sheet to Treasury securities.
- Third, limit the Fed's discretion in monetary policymaking by requiring a systematic, rule-like approach.
- Fourth, limit the boundaries of its lender-of-last-resort credit extension and ensure that it is conducted in a systematic fashion.

These steps would yield a more limited central bank. In doing so, they would help preserve the central bank's independence, thereby improving the effectiveness of monetary policy, and, at the same time, they would make it easier for the public to hold the Fed accountable for its policy decisions. These changes to the institution would strengthen the Fed for its next 100 years.

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Argentina Redux?

by Charles I. Plosser
Tuesday, July 26, 2016

Over the years, calls to reform the Fed have come and gone. We have seen periods when the Fed has been praised and vilified, sometimes simultaneously. In the best of times, central banks go about their business of stabilizing the value of the nation's currency with little attention from the broader public or from politicians. In recent years, however, the Fed has become a favorite whipping boy in some quarters. Indeed, whether it comes from the left or the right, criticism and the calls for reform have grown.

A number of proposals have been put forward to reform the Fed. But I see disturbing trends in how Congress and others seem to envision the appropriate role for our central bank. In particular, Congress has been using the Fed to explicitly avoid tough fiscal choices. This undermines the independence of the Fed with potentially dangerous repercussions.

For example, in December 2008, several members of Congress wrote a letter to then Chairman Ben Bernanke. In that letter they indicated that Congress couldn't decide what to do about the failing automobile companies. They inquired whether the Fed would loan money to the companies directly to keep them afloat while Congress took more time to think about what to do. This was not as ridiculous an idea as it might seem. After all, the Fed, mostly on its own, had already loaned money to aid the rescue of Bear Stearns and AIG. These were loans that were funded directly by the Fed's balance sheet. It was therefore not surprising that a number of individuals in Congress supposed that the Fed might allocate credit to help the automobile firms.

Fortunately, Chairman Bernanke gave the correct response. No! Yet this was an omen of things to come.

In 2010, with the passage of the Dodd-Frank legislation, Congress required the Fed to provide funding for the Consumer Financial Protection Bureau. Congress did not want to fight over appropriations for the CFPB so it funded it out of the Fed with a fixed percentage of the Fed's expenditures even though the Fed was not given any control or oversight responsibilities for the new bureau. The Fed acquiesced without a fight.

Of course this does not mean that the CFPB isn't being funded at taxpayer expense because the Fed will simply return less money to the Treasury than it otherwise would. But Congress was more interested in constructing a smoke screen to avoid having to pass annual appropriations for the new controversial agency. So now the expenses of the Bureau are not part of the appropriations process but are automatically paid by the Fed. Moreover, the legislation explicitly specified that the funds expended by the Bureau are not reviewable by Congress.

The most recent encroachment on Federal Reserve independence is perhaps the most serious. Last fall, Congress chose to fund a portion of a highway-transportation bill using the capital surplus account at the Fed and reducing the dividend payments to those large banks that have chosen to be member banks. This is poor policy from a number of perspectives. First, transportation infrastructure spending has typically, and correctly, been funded by taxes on users. This practice has now been abandoned. Worse, this action is further evidence that Congress increasingly seems to think of the Fed as a source of funding for fiscal initiatives. Central bank independence is incrementally being eroded.

Particularly troubling is the fact that the Fed has not put up much of a fight. Independence is a fundamental principle of sound central banking. The Fed should protest more vigorously and make clear to the American public the risks of such actions.

Good governance requires a healthy degree of separation between those responsible for taxes and expenditures and those responsible for printing money. The temptation of the fiscal authorities to resort to the printing press for short term relief from fiscal discipline becomes even more important when it is recognized that monetary policy works with considerable lags, be it on inflation or, perhaps, real activity.

It is instructive to review a case in point—Argentina. In 2010, the Central Bank of Argentina lost its last shred of independence. The central bank became the piggy bank of the government.

What led to this change? In early 2010, the governor of the bank, Martin Redrado, was forced from office by then president Cristina Kirchner. The governor was dismissed because he refused to turnover reserves of the central bank in order to fund huge government deficits created in part by corruption and unsustainable subsidies to nationalized industries.

With a new governor in place, transfers to the government from the central bank doubled from about 12 billion pesos in 2009 to about 25 billion pesos in 2010. By 2015, the annual transfer had grown to over 150 billion pesos. It is not hard to imagine the consequences. Inflation was reported to be less than 10 percent in 2009, but by 2015, it had risen to more than 25 percent.

Kirchner was ousted from office last fall and the new government is working to rectify this disaster. For their sake, let's hope they are successful.

Are we Argentina? Hardly, but the current cavalier attitude toward Fed independence is not encouraging. If a new Administration or Congress calls for massive amounts of infrastructure spending, don't be surprised if it asks the Fed to "share the burden." Who will protect Fed independence if the Fed itself won't stand up for the principles of sound central banking?

When a monetary solution is a road to perdition

Central banks cannot resolve unsustainable fiscal policies

Financial Times - May 17, 2012

by: By Charles Plosser

Governments can finance expenditure in only three ways: taxation, debt (future taxes), or printing money. In this sense, monetary and fiscal policy are intertwined. Yet there are good reasons for separating the functions and responsibilities of central banks and fiscal authorities.

History teaches us that unless governments are constrained institutionally or constitutionally, they often resort to the printing press to avoid making tough fiscal decisions. But history also teaches us that this can create high inflation and, in the extreme, hyperinflation. Thus it is wise policy to maintain a healthy separation between those responsible for tax and spending and those responsible for money creation.

Independent central banks must be responsible and accountable, but also constrained in the use of their powers. Otherwise, they risk their legitimacy, credibility and ultimately their independence.

What steps can be taken to draw clear boundaries between monetary and fiscal policy? One, give the central bank a narrow mandate – such as making price stability its sole or primary objective. Mandates that are too broad or vague invite excessive discretion and reduce accountability. Two, restrict the types of assets a central bank can hold on its balance sheet. This limits its ability to allocate credit to specific markets, a decision that rightfully belongs to fiscal authorities or the private sector. Three, conduct monetary policy in a more systematic manner, limiting the scope for discretionary actions that might blur boundaries between monetary and fiscal policy.

Unfortunately, the financial crisis and unsustainable fiscal policies have led to a breakdown of these barriers. Governments are pushing central banks to exceed monetary boundaries, and independent central banks are stepping into areas previously viewed as outside the scope of accepted practice.

For example, despite the known benefits of maintaining stable prices, there are calls in Europe and the US for central banks to abandon this commitment and create higher inflation. Such an inflation tax would devalue outstanding nominal government and private debt, and thus transfer wealth from those who have lent money in good faith to borrowers. Inflation is a blunt instrument for assigning winners and losers from excessive borrowing. Forced redistributions of this kind, if undertaken at all, should be done by the fiscal authorities, not through the backdoor by central banks.

In some circles, it has become fashionable to invoke "lender of last resort" arguments as a rationale for central banks to lend to failing businesses or, in some cases, failing governments. Yet this breaches the accepted principle outlined by Walter Bagehot in 1873, that central bankers can limit systemic risk in a banking crisis by "lending freely at a penalty rate against good collateral". Efforts to subvert this traditional role of central banking will encourage excessive risk-taking, sowing the seeds of the next crisis.

The Federal Reserve and other central banks have also taken actions that blur the lines between monetary, credit and fiscal policy. They did so in the belief that these actions were essential during the financial crisis. For example, the Fed announced in November 2008 that it would purchase housing agency mortgage-backed securities and agency debt to increase the availability and reduce the cost of credit in the housing sector. Yet when the Fed engages in targeted credit programmes that seek to alter the allocation of credit across markets, it is engaging in fiscal policy. While it is popular to view such blurring of the boundaries as "co-operation" or "co-ordination" between the monetary and fiscal authorities during a crisis, ignoring the boundaries puts an economy's longer-term performance at risk.

Once a central bank ventures into fiscal policy, it is likely to face pressure from the private sector, financial markets or the government to use its balance sheet to intervene in markets or substitute for other fiscal decisions. Such demands undermine the fiscal authorities' discipline and the central bank's independence.

Central banks and monetary policy cannot resolve unsustainable fiscal policies. The only real solution lies in the fiscal authorities' ability to make credible commitments to long-term fiscal sustainability. It is a difficult task. But a monetary solution is a bridge to nowhere at best; at worst a road to perdition – a world of rising and costly inflation and weakening fiscal discipline.

The writer is president and chief executive of the Federal Reserve Bank of Philadelphia

THE WALL STREET JOURNAL.

http://www.wsj.com/articles/the-veneer-of-consensus-at-the-fed-1449705161

OPINION | COMMENTARY

The Veneer of Consensus at the Fed

An urge to show a united front can mask wide disagreements, misleading markets and the public.

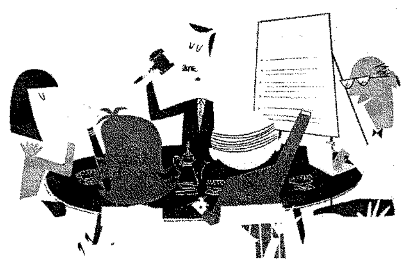

PHOTO: GETTY IMAGES/IKON IMAGES

By CHARLES I. PLOSSER
Dec. 9, 2015 6:52 p.m. ET

When the Federal Open Market Committee voted Sept. 17 not to raise its target for the federal-funds interest rate (the interest rate banks borrow and lend reserves to each other), the tally was a lopsided 9-1. Yet I suspect that the debate was quite lively, and the outcome a closer call than the final count suggests.

Why? The fed-funds target rate typically moves in tandem with the discount rate (the rate the Fed lends reserves to commercial banks). In the two weeks before the FOMC meeting, eight of the 12 Reserve Bank boards, in consultation with their presidents, recommended an increase in the discount rate. Thus at least eight of the 17 participants in the FOMC meeting had a predilection to move forward with a rate increase. Of those eight, three were voting members.

Why was the vote one-sided in the end? One factor might be the desire, inside and outside the Fed, for consensus decision-making. Markets don't like dissent or indecision, goes the argument. Some say that the presidents of the 12 Reserve Banks should quit talking to reporters and giving speeches, or at least refrain from questioning actions taken by the FOMC or the Fed chairman. By the same token, any opposition from the members of the Board of Governors might be seen as signaling a lack of confidence in the chairman.

This is not the way it used to be. Under Arthur Burns and Paul Volcker, disagreement, even by Fed governors, was not uncommon. From 1976-95 governors registered 101 dissents over FOMC decisions and presidents another 88. Since 1996 there have been two dissents by a governor and 77 by presidents.

The change in voting patterns is remarkable. Yet it is hard to imagine that 19 intelligent and capable people have simply ceased to hold different ideas about monetary policy—especially how to proceed during and after a crisis.

There is a downside to the desire for a consensus vote. Fed decisions that convey virtual unanimity require the policy statement following the meeting to be sufficiently vague and generic to elicit broad support. This is neither transparent nor informative, and it can mislead the public into believing in a sense of agreement and a degree of certainty that do not exist.

It also makes it difficult for the FOMC to articulate a coherent strategy or rationale since the statement must necessarily serve as a "big tent" that is unable to differentiate among competing views. Markets may move on the understanding that alternative policies are not under serious consideration or from the lack of a clear strategy. That in turn makes it difficult to pursue any alternative policies, for fear of upsetting expectations.

There is another way. Each member of the Monetary Policy Committee of the Bank of England has the responsibility to vote his or her views and is expected to explain and justify them to the public. And it is not unusual to see 7-2, 6-3 or 5-4 votes.

When this arrangement was put in place in 1998, many participants in financial markets worried that it would create confusion. It hasn't. The differing views help the public better understand the challenges and uncertainties facing policy makers, and highlight alternative approaches that are being considered.

There is nothing wrong with consensus per se. The danger is acting as if it exists when it really doesn't. How is the public to tell the difference? You might think the minutes of FOMC meetings are a vehicle for further enlightenment, but they rarely convey effectively the depth or breadth of alternative views.

Fed officials often speak of the credibility of the institution. They recognize that the public trust must rest with the institution and how it operates and not just with the individual that happens to occupy the chair. This is an important concept that is worth reinforcing.

Members of the FOMC should feel comfortable disagreeing with the leadership on occasion, without this being interpreted as an attack on the chairman. Mervyn King, governor of the Bank of England from 2003-13, frequently faced dissenting views; occasionally he was even on the losing side of a vote. Such behavior by a leader builds public trust and confidence in the institution and the decision-making process.

The Federal Reserve and the public should be more tolerant of tight votes and public expression of differing views, especially by members of the Board of Governors. The Fed leaders I served under— Ben Bernanke and Janet Yellen—cared, and care, more about getting it right than about who votes with whom. The talented and dedicated individuals who contribute to debates on the appropriate monetary policy should not feel hamstrung by a demand to reach an artificial consensus. Far healthier that their views be expressed, that they feel free to vote for them and tell the public why.

Mr. Plosser was president and CEO of the Federal Reserve Bank of Philadelphia, 2006-15.

Unconventional Monetary Policy, Normalization, and Reform

John B. Taylor*

Testimony before the Subcommittee on Monetary Policy and Trade
Committee on Financial Services
U.S. House of Representatives
December 7, 2016

Chair Huizenga, Ranking Member Moore, and members of the Subcommittee on Monetary Policy and Trade, thank you for inviting me to testify at this hearing on "Unconventional Monetary Policy."

Recent Policy

The Federal Reserve's move toward unconventional monetary policy can be traced back a dozen years to the so-called "too low for too long" period of 2003-2005. During this period the Fed held its policy interest rate—the federal funds rate—well below what was indicated by the experience of the previous two decades of good economic performance. During this 2003-2005 period the Fed also started giving forward guidance that its policy rate would remain very low for a "considerable period" and that it would be raised at only a "measured pace." These actions were a departure from the policy strategy that had worked well in the 1980s and 1990s.[1] Economists, historians, and biographers have been exploring the reasons why the deviation occurred.[2]

But regardless of the reasons, the results were not good. The excessively low rates along with promises that they would remain low brought on a risk-taking search for yield and excesses in the housing market. Along with a breakdown in the regulatory process, these policies were a key factor in the financial crisis and the Great Recession. And in a typical go-stop fashion the unnecessarily low rates in 2003-2005 brought unnecessarily high rates in 2007 and early 2008.

During the panic in the fall of 2008, the Fed did a good job in its lender of last resort capacity by providing liquidity to the financial markets and by cutting its policy interest rate.

But then Fed policy moved sharply in an unconventional direction. The Fed purchased large amounts of U.S Treasury and mortgage backed securities in 2009, financed by equally large increases in reserve balances, which enlarged the Fed's balance sheet. And long after the recession ended, these large-scale asset purchases continued and the Fed held its policy interest rate near zero when indicators used in the 1980s and 1990s suggested that higher rates were in order. The Fed also utilized forward guidance, but changed the methodology several times, which increased uncertainty.

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* Mary and Robert Raymond Professor of Economics at Stanford University, George P. Shultz Senior Fellow in Economics at Stanford's Hoover Institution, and former Under Secretary of Treasury for International Affairs, 2001-2005

My research and that of others over the years shows that these policies were not effective, and may have been counterproductive.[3] Economic growth was consistently below the Fed's forecasts with the policies, and was much weaker than in earlier U.S. recoveries from deep recessions. Job growth has been insufficient to raise the percentage of the population that is working above pre-recession levels. There is a growing consensus that the extra low interest rates and unconventional monetary policy have reached diminishing or negative returns. Many have argued that these policies widen the income distribution, adversely affect savers, and increase the volatility of the dollar exchange rate. Experienced market participants have expressed concerns about bubbles, imbalances, and distortions caused by the policies. The unconventional policies have also raised public policy concerns about the Fed being transformed into a multipurpose institution, intervening in particular sectors and allocating credit, areas where Congress may have a role, but not a limited-purpose independent agency of government.

In many ways this recent period can be characterized as a deviation from the more rule-like, systematic, predictable, strategic and limited monetary policy that worked well in the 1980s and 1990s. Empirical research has shown that such deviations worsen performance in the U.S. and in other countries.[4]

Normalization

The policy implication of this experience is clear. Monetary policy should be normalized. The Fed should transition to a sound rules-based monetary policy like the one that worked in the past while recognizing that the economy and markets have evolved. This appears to be the intent of the Fed,[5] but normalization, or transition, is difficult in practice, and the pace has been slow and uncertain. With the policy interest rate still below appropriate levels, a key step is to begin to raise the policy rate gradually and strategically.

As part of the normalization process, the size of the Fed's balance sheet should be gradually reduced. For the reasons I gave when I testified before this committee last May,[6] reserve balances should be reduced to the size where the interest rate is market determined rather than administered by the Fed's setting the rate on excess reserves. The composition of the Fed's portfolio should focus on Treasury securities so that the Fed is not involved in private credit allocation. Given that the supply of reserves is now many times greater than demand, the Fed has no alternative but to pay interest on reserves during the normalization period. Careful monitoring and communicating with markets will be required to prevent instability.[7]

Reform

Normalization is easier if there is an understanding of the basic monetary strategy. This and recent experience point to monetary reform. A good reform is now part of the Fed Oversight Reform and Modernization Act. It would require the Fed to "describe the strategy or rule of the Federal Open Market Committee for the systematic quantitative adjustment" of its policy instruments. The Fed would choose its strategy, and could change it or deviate from it if circumstances called for a change, in which case the Fed would have to explain why. Some worry that, with this reform, the central bank would lose independence, but having and clearly articulating a strategy would improve independence. It is important to emphasize the word "strategy" as stated in the legislation. Though economists frequently use the word "rule," that term may convey the false idea that a rules-based monetary strategy must be purely mechanical.

There is precedent for this type of Congressional oversight. Legislation that appeared in the Federal Reserve Act from 1977 to 2000 required reporting the ranges of the monetary aggregates. The requirement was removed in 2000, creating a void which would be filled by the new legislation.

Recent empirical research shows that if this legislation had been in place in recent years, the Fed would have had to explain the deviations, which would have likely reduced their size.[8] Recent research also shows that economic performance would improve if the Fed was accountable about the rule for achieving goals as well as about the goals.[9] This legislation would provide a transparent connection between technical policy analysis at the Fed and actual policy decisions, a connection which is essential to sound monetary policy. For these reasons and others, a number of Nobel Prize winners, former Fed officials, and monetary experts have supported such legislation.[10]

Monetary normalization and reform have important implications for the international monetary system. Unconventional monetary policies with near zero policy rates have spread internationally as the Bank of Japan, the European Central Bank, and other central banks adopted similar policies.[11] Thus the international monetary system has deviated further from a sound rules-based system. This has increased the volatility of the dollar and other exchange rates, which in turn has caused governments to impose capital controls and intervene in exchange markets, frequently in non-transparent ways that raise suspicions of currency manipulation.

A key foundation of a transparent rules-based international monetary system is a rules-based policy in each country. Therefore, normalization and reform by the Fed contributes to international monetary reform. In my view, it would lead other central banks to move away from unconventional policies. International monetary reform will in turn benefit the United States.

In conclusion let me emphasize that monetary reform, tax reform, regulatory reform and budget reform often go together. They reinforce each other. All are crucial to a prosperous economy. The opportunity for monetary reform is better than it has been in years. The goals of insulating the Fed from political pressures, creating a more predictable-transparent-accountable policy, and better achieving economic stability and price stability appear to be widely held. The rationale behind pursuing several reforms together can be found in our *Blueprint for America.*[12] As I state in my essay in that volume: Sound rules-based monetary policy and good economic performance go hand in hand.

Thank you. I would be happy to answer your questions.

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January 9, 2017

Answers to Questions submitted by Congressman Mick Mulvaney, Committee on Financial Services based on December 7, 2016 hearing.

Representative Mulvaney, I appreciate this opportunity to respond to the questions regarding the appropriateness of Federal Reserve purchases of equities and other non-Treasury assets. As described in my responses to your specific questions, I am opposed to such purchases and do not think the Fed should be given independent authority for such purchases.

What are your thoughts on this type of unconventional monetary policy? (Reference is to excerpt of speech by Federal Reserve Chair Janet Yellen regarding Fed purchases of broad range of risky assets).

I am against unconventional monetary policy involving Fed purchases of risky assets such as corporate bonds, equities, asset-based securities or household debt and even under extreme circumstances I am opposed to the Fed holding such risky assets on its balance sheet. Presently, I urge the Fed to proceed on a path toward normalizing monetary policy, including raising interest rates, reducing excessive reserves in its balance sheet and removing from it all non-treasury securities. I also urge the Fed to more carefully define the circumstances that it would consider appropriate to use unconventional monetary policy.

When the economy and financial markets are performing normally, as they have been in the last several years, the Fed should conduct monetary policy in a normal manner, adjusting interest rates and reserves with the objective of pursuing longer-run monetary objectives of stable low inflation as the best foundation for sustainable healthy economic growth and employment. Current economic and inflation conditions do not call for unconventional monetary policy.

During an extreme financial crisis, it may be appropriate for the Fed to use unconventional monetary policies. But in all but extreme cases this should not involve purchases of private credit and equity. Such purchases involve fiscal and credit policies and should be considered beyond the scope of monetary policy. As outlined by Dr. Charles Plosser in his testimony before the Financial Services Committee on December 7, 2016, in extreme situations when the Treasury deems it necessary to purchase non-Treasury securities, the Treasury should instruct the Fed to make the purchases. Similarly, the Treasury under extreme cases instructs the Fed to intervene in foreign exchange markets. Any such purchases by the Fed at the behest of the Treasury should subsequently be swapped with the Treasury for Treasury securities so that the Fed's balance sheet hold only Treasury securities. The Fed should not be put in a position of executing policies that involve credit or fiscal policy. The Fed's balance sheet should not be used as a substitute for the Treasury's balance sheet.

In general, Fed purchases of non-treasury securities such as corporate or household credit involves credit allocation that cross the boundary into fiscal and credit policy. Such policies distort financial and economic decisions and are very risky. Equity purchases designed to artificially prop up the stock market are equally misguided.

Among other observations of the Fed's use of unconventional monetary policies during the current economic expansion, three stand out: 1) these policies have stimulated financial markets but they have failed to stimulate any acceleration in aggregate demand, but instead have generated mounting financial distortions, 2) quantitative easing and artificially low interest rates have been pursued long after the threat of economic and/or financial crisis had passed, during a time when the economy has been growing close to the Fed's estimates of potential growth, and 3) these policies have been in place so long that many no longer consider them to be "unconventional", which establishes a poor and risky precedent for the future.

The Fed should be required to more carefully describe the circumstances in which unconventional monetary policies would be appropriate, and almost always conduct conventional monetary policies. Just because the economy is growing more slowly that desired is not a rationale for unconventional monetary policy.

Do you see any circumstances when the purchase of equities would be necessary? No, it's really hard to think of one. Purchasing equities simply does not serve the purpose of trying to achieve the Fed's dual mandate. Even in an extreme emergency, at the depths of the financial crisis, it's difficult to conceive of a situation in which it would be appropriate for the Fed to purchase equities and keep them on its balance sheet.

Can you anticipate or distinguish circumstances where it would be appropriate for other central banks to purchase equities, but not for the United States? If a central bank runs out of sovereign debt securities to purchase, then purchases of non-government debt may be required. But even in these cases, in reality it is likely that such purchases are covering up for other misguided policies or structural problems facing an economy, and would only serve to provide a temporary, artificial prop. This is presently the case in Japan, where the Bank of Japan is purchasing more than 100% of the increase in government debt and is also buying equities. These policies do not address the factors that are constraining Japan's economic growth and only serve to distort financial markets.

January 7, 2017

Response to the Questions Submitted by Rep. Mick Mulvaney
Committee of Financial Services
Hearing on "Unconventional Monetary Policy"
Hearing Date: December 7, 2016
By
Charles I. Plosser

Thank you Rep. Mulvaney for the opportunity to respond in writing to your question regarding the appropriateness of the purchase of equities by the Federal Reserve. My bottom line is that I do not think it is a good idea to grant the Fed authority to purchase equities. Thus I tend to agree with Dr. Taylor and Dr. Johnson who came to the same conclusion.

The authority to purchase assets of various kinds by the Fed is divided into two broad categories. One category is related directly to the conduct of monetary policy. The FOMC is authorized to purchase assets for the System Open Market Account (SOMA) as a means of influencing the overall level of interest rates and thus implementing monetary policy. Generally speaking the Federal Reserve Act limits such purchases to U.S. Treasury securities or other obligations that are fully guaranteed by an agency of the U.S. government. This provision permitted the FOMC to purchase mortgage-backed securities (MBS) and agency debt issued by Fannie Mae and Freddie Mac. However, it prohibits the FOMC from purchasing equities for the SOMA.

The second type of asset the Fed is permitted to buy is authorized under Section 13 (3) of the Federal Reserve Act. Under this provision, the Board of Governors (BoG), not the FOMC, is permitted to acquire assets (make secured loans) to individuals, partnerships, and corporations under "unusual and exigent circumstances." This provision permitted the Board of Governors, for example, to rescue the creditors of Bear Stearns and AIG. It is important to keep in mind that such a decision rests with the BoG not the FOMC. Financial stability is the usual justification for this provision, yet its implementation is highly discretionary as the controversies and differential decisions over Bear Stearns, AIG and Lehman Bros. so clearly illustrate.

The question you pose and the one seemingly addressed by the Chair pertains to the purchases of equities in the conduct of monetary policy and thus for the SOMA. The issue regarding 13(3) lending is an important one and deserves attention, but not what I will address in this comment.

So as far as monetary policy is concerned, I do not see any reason that the Fed would need to resort to purchasing equities. There are ample Treasury securities available in the marketplace to conduct monetary policy under normal conditions. Even at the height of the crisis when the Fed was engaged in large scale asset purchases, or QE, the Fed was not faced with a scarcity of assets to buy. For example, at the end of 2016, the SOMA contained about $4.2 trillion with about $2.4 trillion of Treasuries and about $1.8 trillion of MBS and agency securities. This represented only a portion of the outstanding $14 trillion in marketable Treasury securities.

January 7, 2017

Given the volume of Treasuries available, the only reason for the Fed to purchase equities would be to engage in credit allocation or fiscal policy. The Fed would have to consider which firms or industries it would invest and would likely come under considerable political pressure. Thus to move in this direction by granting the Fed the discretion to buy equities would be a mistake, it would put at risk its independence, politicize its actions to a greater degree than they are already, and invite it to engage in credit policies that should be the responsibility of Congress, not the central bank.

Chair Yellen noted that other central banks do have the authority to purchase private sector securities, including equities. To my mind this is not a justification to give such power to the Fed. Other central banks have this authority for reasons that are unique to their situation and market structure.

For example, the ECB is responsible to many sovereign countries, each with their own sovereign debt. The ECB is generally prohibited from buying sovereign debt so as to avoid "playing favorites" among the various countries. However, the Greek crisis has caused the ECB to make adjustments in the name of rescuing certain countries and this has caused much grief and, in some quarters, claims that the ECB is violating its constitution. In Japan, the purchase of equities is a consequence of a massive QE program and the scarcity of government debt. That is not the problem for the U.S.

In summary, I cannot imagine a scenario where it would either be necessary or desirable to have the Fed engage in the purchasing of equities. As I advocated in my testimony I would prefer to limit the Fed to an all-Treasuries portfolio and that explicitly prohibit it from purchasing equities or other private sector securities. Such a policy would protect the Fed and the public from inappropriate intrusions and pressures to allocate credit.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

December 2, 2016

The Honorable Mick Mulvaney
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the September 28, 2016[1], hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on October 17, 2016.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Mulvaney:

1. Chair Yellen, I appreciate the initial dialogue we had during the hearing concerning the Federal Reserve's authority to purchase equities. I appreciated your candor and agree with you that under current law, the Federal Reserve is not permitted to purchase equities and it would require a change in the law to do so. I also appreciated you sharing your perspective that the Fed may face longer term issues and difficulties with accommodative monetary policy, and while you are not asking for the authority to purchase equities, it may be something that Congress consider.

I also understand the day after our discussion, you spoke via videoconference on this topic with a group of bankers in Kansas City. Referring to the asset purchase stimulus programs, you said: "If we found, I think as other countries did, that they could reach the limits in terms of purchasing safe assets like longer-term government bonds, it could be useful to be able to intervene directly in assets where the prices have a more direct link to spending decisions," adding that buying equities and corporate bonds could have costs and benefits.

As a follow up, I would be appreciative if you could share some additional information about the Fed's review and analysis of equities purchases as a monetary policy tool.

When did you, other members of the Board, or Federal Reserve staff first begin internally discussing equities purchases as a monetary policy tool?

Have you and your staff been monitoring the purchases of equities by the Bank of Japan, the Bank of England, and the European Central Bank? What conclusions have you drawn?

What risks do you think buying equities entails? For the economies referenced above? For their impact on the international markets? For the U.S., if it were to adopt such a policy?

Similar to above, please detail the "costs and benefits" you referred to in your conversation with the Kansas City banking community.

Do you believe the risks associated with equities purchases include moral hazard? If so, I would appreciate your detailed thoughts on how to address these risks. And if not, why not?

Do you believe these risks involve the appearance of impropriety, politicization of markets, "playing favorites" for certain companies or industries, or result in the Fed casting proxy votes in corporate governance decisions? If so, I would appreciate your detailed thoughts on how to address these risks. And if not, why not?

How would the purchase of equities help the real economy? How would this mechanism function favorably, given that household wealth in the U.S. is around $89 trillion and relative to disposable income it is close to the highs in 2007? Does pushing it up even

higher have an effect on the real economy? If you believe so, please describe how you perceive that to happen.

In my remarks at this year's Economic Symposium in Jackson Hole, I noted the challenges for monetary policy posed by the effective lower bound on interest rates and the possibility that we may face these challenges more frequently in the future given the apparent decline in the so-called equilibrium real interest rate. To address such challenges, I noted that monetary policymakers may again need to rely upon unconventional tools such as forward guidance and asset purchases to promote statutory goals such as maximum employment and stable prices.

On the subject of asset purchases, it is important to note that the Federal Reserve Act provides authority for the Federal Reserve to purchase only a relatively narrow range of low-risk assets such as Treasury and agency securities. The Federal Reserve does not have the statutory authority to purchase a broad range of private sector obligations such as corporate bonds, equities, asset-backed securities, or household debt.

In contrast, other central banks such as the European Central Bank, the Bank of England, the Bank of Japan, and the Swiss National Bank have the authority to purchase a relatively wide range of financial assets. Moreover, these central banks have utilized their authority in recent years in different ways to address severe economic shocks that have depressed economic activity and generated disinflationary pressures.

There appear to be a number of advantages and disadvantages associated with the different approaches followed across countries regarding the authority for central bank purchases of financial assets. Factors that might favor establishing a fairly limited authority for central bank asset purchases include many of the types of considerations noted in the questions above—a desire to minimize the exposure of the central bank to financial risks, a desire to limit the scope for political pressures or other special interests to influence central bank decisions regarding asset purchases, a desire to avoid situations in which central bank asset purchases may adversely affect credit allocation or financial market functioning, and a desire to avoid creating adverse incentives for private investors. A factor that might support providing authority for a central bank to purchase a relatively broad range of assets is the potential to provide the central bank with tools to more effectively address adverse shocks and thus better promote macroeconomic objectives such as maximum employment and price stability. This type of authority might be particularly useful, for example, at a time of financial crisis when so-called "fire sales" of financial assets during a panic may have very negative and long-lasting consequences for the macroeconomy.

Regarding the specific issue of purchases of equity securities, I am not aware of any research, analysis, or discussions among members of the Board or Federal Reserve staff about the benefits and costs of purchasing equity securities as a monetary policy tool for the Federal Reserve. The absence of analysis of this issue no doubt owes importantly to the fact that the Federal Reserve does not have the statutory authority to purchase equity securities. Some other central banks, notably including the Swiss National Bank (SNB) and the Bank of Japan (BoJ), have purchased equity securities over recent years. In the case of the SNB, the purchase of equity securities has been seen as a way of diversifying investments of foreign exchange acquired in the SNB's efforts to manage the exchange value of the swiss franc. In the case of the BoJ, the purchase of equities through exchange traded funds has been described as a way of supporting business investment and helping to achieve the BoJ's inflation objective.