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THE FED AT 100: CAN MONETARY POLICY CLOSE THE GROWTH GAP AND PROMOTE A SOUND DOLLAR?

HEARING

BEFORE THE

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THURSDAY, APRIL 18, 2013

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to call, at 9:31 a.m. in Room 216 of the Hart Senate Office Building, the Honorable Kevin Brady, Chairman, presiding.

Representatives present: Brady, Duffy, Paulsen, Hanna, Maloney, and Delaney.

Senators present: Klobuchar, Coats, Lee, and Wicker.

Staff present: Corey Astill, Doug Branch, Conor Carroll, Gail Cohen, Connie Foster, Al Felzenberg, Niles Godes, Paige Hallen, Colleen Healy, Robert O'Quinn, Jeff Schlagenhauf, Andrew Silvia, John Trantin.

OPENING STATEMENT OF HON. KEVIN BRADY, CHAIRMAN, A U.S. REPRESENTATIVE FROM TEXAS

Chairman Brady. Well good morning, everyone, and welcome to the Joint Economic Committee hearing "The Fed at 100: Can Monetary Policy Close the Growth Gap and Promote a Sound Dollar?"

This year marks the centennial of the Federal Reserve, so it is appropriate for the Joint Economic Committee to examine the Fed's role in the current economic climate as well as its focus for the next 100 years.

Today's hearing on monetary policy is the third in a series that touches on our most vexing economic challenge: the growth gap.

We are all rooting for America to bounce back, but regrettably the U.S. economy is missing 4.2 million private sector jobs and $1.3 trillion in real output due to the gap that exists between this weak recovery and the average recovery of the last 70 years.

For every American, the growth gap means that he or she has $2,935 less in real disposable income at this point in the recovery.

This gap persists despite extraordinary actions by the Federal Reserve to stimulate growth and employment as part of its dual mandate.

Even more troubling, the Congressional Budget Office projects that the future growth rate for America's potential real GDP will be a full percentage point below its post-war average—which may not sound like much, but the consequences are alarming.

With one percent lower growth, our economy will be $31 trillion smaller in 2052, and the Treasury will collect $97 trillion less in tax receipts over the next four decades—making it significantly harder to balance the budget and reduce America's risky level of debt.

The question before this Committee is whether the extraordinary actions taken by the Federal Reserve are capable of closing this growth gap, and if a focus instead on price stability and establishing a sound dollar will provide a stronger foundation for economic growth over the long term.

Since 2008, beyond the appropriate role of lender of last resort to financial institutions and markets, the Federal Reserve has selectively bailed out investment banks, maintained interest rates at an extraordinarily low level for almost five years, engaged in three rounds of quantitative easing by buying massive amounts of Treasuries and mortgage-backed securities, and indicated that the Fed will continue this accommodative monetary posture until the unemployment rate falls to 6.5 percent.

But can the Federal Reserve boost real economic growth over time through discretionary monetary policy? Or should the Federal Reserve adopt a rules-based monetary policy to achieve price stability and let Congress and the President determine the combination of budget, tax, regulatory, and trade policies that will boost real economic growth to close the growth gap?

In 1977, Congress established a dual mandate for monetary policy that gave equal weight to achieving long-term price stability and the maximum sustainable level of output and employment.

During the 1970s, as you may remember, the Federal Reserve's monetary policy was discretionary and interventionist. The results were accelerating inflation, short expansions, frequent recessions, and rising unemployment.

In the early 1980s, Chairman Paul Volcker broke the back of inflation. Over the next two decades, monetary policy became increasingly rules-based. The results were outstanding: low inflation and two long and strong expansions, interrupted only by a brief, shallow recession.

Since the Great Moderation, as it's called, monetary policy has again become discretionary and interventionist. Not surprisingly, the results are disappointing.

From 2002 to 2006, Chairman Alan Greenspan kept interest rates too low for too long which helped to inflate an unsustainable housing bubble.

Chairmen Volcker and Greenspan correctly believed monetary policy could contribute to achieving full employment—if and only if—the Federal Reserve focused solely on price stability.

Beginning in 2008, however, the Federal Reserve explicitly deviated from this view, invoking the employment half of its dual mandate to justify its extraordinary actions.

In January 2012, the Federal Open Market Committee correctly observed in its "Longer-Run Goals and Policy Strategy" this statement:

The maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market.

Despite the clear admission of the limits of monetary policy to spur employment, in December of the same year the FOMC announced that it would (1) expand its current round of quantitative easing, and (2) retain its extremely low target range for federal funds for "at least as long as the unemployment rate remains above 6½ percent."

To achieve a policy objective, Nobel Laureate Economist Robert Mundell stated: Policymakers have to use the right lever. Monetary policy affects prices over the medium and long term. In contrast, budget, tax, and regulatory policies are what affect real output, real investment, and employment. Monetary policy cannot solve the problems that poor fiscal policy has helped to create.

By targeting the unemployment rate, the Federal Reserve is attempting to use monetary policy to achieve what the Fed acknowledged 11 months earlier that it cannot achieve—full employment—while risking what economists acknowledge that the Fed can achieve through appropriate monetary policy: long-term price stability.

To close the growth gap, my belief is that we must refocus the Federal Reserve on a rules-based monetary policy which is a necessary, but not sufficient, condition for robust real economic growth and job creation.

This is not a false choice between jobs or stable prices; it is the proven acknowledgement that stable prices and a sound dollar create the best foundation for job growth over the long term.

Congress, which has delegated its constitutional authority to coin money and maintain its value to the Federal Reserve, should provide it with a clear direction to return to an achievable mandate for price stability.

The Federal Reserve should also ensure a soft landing for the housing market by initiating a slow and orderly unwinding of its $1.1 trillion position in federal agency residential mortgage-backed securities.

Gradually reducing the excess reserves that could be the fuel for future inflation will reduce market uncertainty, strengthen the foundation for non-inflationary economic growth, and reduce the likelihood of undue political interference in Federal Reserve policy.

So looking to the future, today's hearing provides this Committee with the opportunity to hear from two of the most distinguished monetary economists in the world on their recommendations for the role of the Federal Reserve during its second 100 years.

Dr. John Taylor is the creator of "the Taylor Rule" which central banks have used to implement a rules-based monetary policy.

Dr. Adam Posen served on the Monetary policy Committee of the Bank of England, and is a widely acknowledged expert on Japan.

We are fortunate to have them with us today. We look forward to their testimony.

And with that, I would like to recognize the Vice Chairman of the Joint Economic Committee, Senator Klobuchar.

[The prepared statement of Chairman Brady appears in the Submissions for the Record on page 26.]

OPENING STATEMENT OF HON. AMY KLOBUCHAR, VICE CHAIR, A U.S. SENATOR FROM MINNESOTA

Vice Chair Klobuchar. Thank you very much, Chairman Brady. Thank you for holding today's hearing on our Nation's monetary policy and the mission of the Federal Reserve.

We are fortunate, as you have noted, to be joined by two witnesses with deep knowledge of these issues, and I want to thank both of you for being here today.

Since the financial crisis began in 2007, the Fed has used many tools to bolster the economy. It has kept short-term interest rates near zero since late 2008, and taken action to keep longer term interest rates and mortgage interests rates low. However, as I have said before, I always believe that we can do better, and we have been working in the Senate on a number of issues with accountability and greater transparency. And I appreciate the fact that Chairman Bernanke will be coming before this Committee in May.

While the economy is not yet out of the woods, and too many Americans still struggle to find work or make ends meet, we all know that there have been promising signs and that we are a lot better off than we were at the beginning of this downturn.

More than 1.2 million private-sector jobs have been added in the past 6 months.

Unemployment reached a 4-year low last month of 7.6 percent. I would note that in my own State it is 2 points better than that at 5.6 percent.

Housing, so critical to the construction sector, has begun to rebound, with new-home sales exceeding 400,000 for two consecutive months for only the second time since the crisis hit in September 2008.

But even with all the progress, we all know families that are working several jobs that don't have their employment situation back to what it once was; that there are some long-term unemployment issues; and that there are other problems that need to be solved.

The Fed, which is buying about $85 billion in Treasury Bills and mortgage-backed securities each month to further reduce long-term interest rates, continues to play an important role in the recovery.

A survey released today by a Minnesota business group shows Minnesota manufacturers remain very concerned about the economy.

The impact of the Federal Reserve's past and current efforts would have been diluted if the Fed were restricted to only purchasing short-term U.S. Government securities, as some have proposed.

In 1977, 64 years after the Federal Reserve System was created, Congress clarified that the Fed's mission was to promote maximum employment and stable prices. The question raised in today's hearing is whether now is the time to change the Fed's goals to focus only on price stability. I think now is not the time for the Fed to take its eye off promoting employment.

I note that presently inflation is in check—about 1.3 percent over the past 12 months according to the Fed's core measure, and there is no sign of inflation for the foreseeable future.

Additionally, the Federal Reserve has signaled that it has an exit plan to change course once the economy is stronger than it is today.

While there have been improvements in the employment situation, it is clear that the economy is still healing from the downturn. Yet requiring the Fed to focus solely on price stability would be directing it to essentially ignore employment.

I believe the Fed does not need a change of mission at this time in our Nation's recovery.

I am looking forward to questioning both of you on this, as well as Chairman Bernanke. I believe, though, that Congress must do more to bring our debt down in a balanced way. I think it is worth looking at the Senate's budget proposal. We did pass a budget a few weeks ago, as well as the one that has been proposed by the President and the House, and I am hopeful we can come together in a bipartisan way to bring the debt down without causing what Chairman Bernanke has called "the sharp contraction in the economy" by setting us back.

I believe we can bring the debt down with a mix of revenue and spending cuts, and at the same time invest in those core things that are so important: education, our economy, making sure we move forward with exports, doing all the things we need to do to train workers for the jobs that are available today.

With that, I have about a minute left and I would love to turn it over to Mr. Delaney to see if he would like to add a few words to my opening.

Representative Delaney. Yes. Thank you, Vice Chair Klobuchar.

I do think in today's discussion, which is important, we should also think about it in the context of what is happening in the real and political world. Because I agree with the Chairman that Congress is a much more precise instrument in terms of stimulating growth in our economy through comprehensive immigration reform, adopting a national energy policy, investing in our infrastructure, improving educational outcomes, changing trade policy, and to do many of these things we have to address our fiscal challenges, obviously.

But Congress's inability to use this precise instrument has to be considered when we think about changing the Fed's dual mandate. Because when we analyze the Fed's dual mandate, it is important not to do it in a vacuum but to do it in the context of the real world and the political world that we live in. Because Congress has been unable to do the things we need to do to stimulate economic growth in this country. And I think it is important that we evaluate the dual mandate of the Fed in that context, not in a vacuum.

Thank you.

Vice Chair Klobuchar. Thank you.

Chairman Brady. Thank you both.

We are honored to have these two witnesses with us today. This is the appropriate time to be asking some constructive, thoughtful questions about the Fed's role both in today's economic climate, and in its second century.

With that—and both Dr. Taylor and Dr. Posen are leading experts and widely respected in this field. So with that, Dr. Taylor, you are recognized for five minutes.

STATEMENT OF HON. JOHN B. TAYLOR, Ph.D., MARY AND ROBERT RAYMOND PROFESSOR OF ECONOMICS AT STANFORD UNIVERSITY AND THE GEORGE P. SHULTZ SENIOR FELLOW IN ECONOMICS AT THE HOOVER INSTITUTION, STANFORD, CA

Dr. Taylor. Thank you, Mr. Chairman and Vice Chair, for inviting me to be here. I appreciate it.

In the invitation letter, it asked me to comment on the departure from a more rules-based policy by the Federal Reserve. I think there has been such a departure. I think it is quite large, especially if you compare it with the type of policy of the 1980s and the 1990s until recently.

In my view, this departure has led to problems. It has led to a poorer economy than otherwise, and after all we have had a Great Recession and a very, very weak recovery.

In my view, the departure began around 2003, 2004, and 2005 where the Fed held interest rates much too low compared to the conditions in the economy at the time, and also compared to the policy that was followed in most of the 1980s and 1990s.

This was one of the reasons we had the excesses, the search for yield, the risk taking, the boom in housing, and ultimately the bust which led to the financial crisis itself.

In my view, those kinds of actions and interventions continued right up until the panic itself, and certainly did not prevent the panic. In my view, they were basically harmful.

During the panic period, I think it is very important to point this out, the actions of the Fed in providing liquidity were positive. They bolstered confidence. They got markets moving again.

However, when the panic subsided in late 2008, early 2009, rather than let those facilities draw down, the Fed continued its interventions. We began to see the Quantitative Easing, the massive purchases of Treasury Securities, the massive purchases of mortgage-backed securities, the Operation Twist, and the continued extension of the zero interest rate policy not only to the present but into the future.

It seems to me that if you look at this—and I have for this whole period—it should make you worry. Back in 2009, I warned that these kinds of policies would cause risks and would be harmful to the economy. And, to be sure, the results have been disappointing—outcomes have been much lower than what the Fed said would happen in this period.

It is hard to make the case that these policies are working.

It is for this reason that I think it would be appropriate for the Fed to begin to consider exiting from these policies. Of course it should be done in a gradual, credible way so as not to upset markets. And indeed, I believe that if it is done in such a way it will remove risks to the economy that are currently holding back the expansion.

I think there is an opportunity to make this exit if in fact we have a bit of a growth spurt this year. What it could lead to is an extension of a growth spurt, and we have seen several of them in this disappointing recovery. But an exit would make that growth spurt more sustained so we would get the real recovery that we have been hoping for, which will bring unemployment down.

In the invitation letter, I was also asked to comment on what kind of rules-based policy the Federal Reserve should follow.

It seems to me we have tremendous experience and things to learn from history in this regard. In particular, in the 1980s and 1990s, until recently, the Federal Reserve adhered more closely than really at any other time in its 100-year history to a more rules-based policy. It was not perfect, but it was very close.

The results were dramatic. Unemployment came down. Inflation came down. Economists look back on that period and see how stable it was. They have a name for it: The Great Moderation. Because it was so stable. It worked.

So in many respects, we need to get back to some kind of a rules-based policy for the instruments like that. The world is different. Policy does not have to be exactly the same. But rules for the instrument are essential.

It is very important to have a target for inflation, but that is not enough if it is accompanied by a do-whatever-it-takes philosophy, because that will lead to these interventions which quite frankly have been disappointing, as we all know.

One way to integrate a rules-based philosophy into monetary policy would be to go back to the requirements that the Fed report its strategy for its instruments. Those requirements were removed from the Federal Reserve Act in the year 2000. Those should be put back in. The Fed would be required to report its strategy for its instruments of policy, whatever it chooses to do so, and describe how they will follow them. And if they deviate for an emergency or for whatever reason, they would have to come back and explain this to the Congress.

I don't think the Congress should tell the Federal Reserve what kind of strategy to follow for its instruments. But it should ask the Fed to report explicitly on what that strategy is. And if the Fed deviates from that strategy, to say why as soon as possible.

It seems to me that way the Congress would be exercising its Constitutional authority without interfering with the day-to-day operations of the Federal Reserve.

Thank you for the opportunity to testify.

[The prepared statement of Hon. John B. Taylor appears in the Submissions for the Record on page 33.]

Chairman Brady. Thank you, Dr. Taylor.

Dr. Posen, thanks for joining us here today. You are recognized.

STATEMENT OF DR. ADAM J. POSEN, PRESIDENT, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, DC

Dr. Posen. Thank you, Mr. Chairman. Thank you, Vice Chair Klobuchar. Thank you, all. I will try to be very brief and as timely as my colleague, John Taylor, in hitting the mark.

I think it is entirely right and appropriate for committees of this Congress to be examining the performance, not only the performance but the goals of the Federal Reserve. And I think it is perfectly reasonable after five years from the crisis to be doing that.

I broadly support the idea of Chairman Brady that a commission about the Fed is—if done correctly, can be a productive thing. But let me give you three comments on how I think it needs to be done in order to be productive, and about what kind of goals need to be set.

Independent central banks are useful. They keep inflation down. They keep the politicians out of monetary policy. As Stanley Fischer pointed out 20 years ago, there is a distinction to be made between the instrument independence, the ability of a central bank to set its policy instruments at any given meeting or series of meetings, versus goal-independence, the ability of a central bank to say what it cares about.

I have always believed, along with he and a large number of other economists, that it is right for elected officials to set the goals, and it is wrong for elected officials to interfere with the instruments.

I think it is entirely viable to make that distinction, even though there are obviously specific cases where those things can get muddied, but that is no more of a challenge than when Congress oversees any other agency, or the military, or any other independent group.

Therefore, I think it is reasonable to speak about Congress, looking in a multi-year framework, at what should be the targets of the Fed? What should be the goals? As long as you don't do it too often—whether it's 100 years or 5 years, this Congress has not done it too often, so I welcome that.

I do think it is important, though, to realize that the goals have to be practical. So just to give three recent examples, in Japan they just turned over the new central bank head and they reaffirmed a stronger commitment to raising out of deflation. That was done in full respect of the central bank's independence. They waited until the governor's term was up before replacing him. They did not change the rules of how the Bank of Japan met. They simply asserted you haven't done a good job of meeting it, and here is how we are going to hold you to account.

In the UK where I served, they recently announced a review of the inflation-targeting regime that had been in place for 15 years. They did it with a finite length of time, a fixed transparent set of reports, and then they immediately said: Well, we want to fix this, and this, but we actually are pretty happy with the regime.

I am not going to say whether that was right or wrong, but the point was you have to have a commission or an examination that is open to making no changes if you come to the conclusion. You don't want to simply have threats of changes be a way to bully the central bank into doing what politicians want.

Third, we have the contrast with Hungary which right now, for a number of fronts, not just monetary, is going in an anti-democratic direction and they have, rather than examining the goals of their central bank, overthrown their central bank essentially, packed it with political people, fired a number of staff. Obviously no one on this Committee or this Congress would do that, but that is an example of how you can interfere too much.

So what in practice are the kinds of goals you might want to set? I say "practical" because if you just do broad goals like price stability, or full employment, it just gets into politization, too much vagueness, too much room for interpretation and discretion on the part of the central bank, and then too much debate about what accounts—what is accountability.

That is why I and Chairman Bernanke and others worked together advocating for things like inflation targeting for the U.S. some years ago. The point of inflation targeting is not a sole focus on inflation. We are very explicit about that. Nor am I saying that inflation targeting is necessarily the right way.

What we did say that I think is important is you need to have a transparent set of goals, a set of goals that is measurable, a set of goals that is subject to review, a clear hierarchy but allowing for there to be more than one goal depending on what the conditions are, a time framework of say two to three years on which progress is evaluated. These kinds of practical transparency steps I think are applicable to whatever goal the Congress sets the Fed.

Finally, on the question that has been raised about real activity or not, I will have to respond to this more I hope if you give me the opportunity in questions, but I see no conflict here. If the Fed was trying to put employment up above full employment as we did in the 1970s as the things to which Chairman Brady and Dr. Taylor referred, that would be one thing. But we are well below full employment. There is no sign of any inflation. And, all these credit bubbles that we are concerned about do not correlate with monetary policy.

There is no strong evidence of that. All there is is evidence that if you let bankers get out of hand, then you will end up getting a lot of corruption. That is bad. That is something we need regulation to deal with. But that is not a monetary policy issue.

The final question which was raised—five seconds—should we be limiting the Fed to just buying short-term instruments? The answer is: No. That is what the Bank of Japan did for 10 years, is they only bought things of less than three-year duration government bonds. They were essentially printing cash to buy cash. And as you would expect, that has no impact on other investors' behavior.

If you want to have traction on the economy, you have to buy something other than cash.

[The prepared statement of Dr. Adam J. Posen appears in the Submissions for the Record on page 37.]

Chairman Brady. Thank you, Dr. Posen.

Let me start with you, Dr. Taylor. As we discuss the mandate of the Fed, and as those of us who believe we ought to refocus it back to rules-based price stability which protects the value of the dollar over time, good money as it is, should we have that mandate? Does the Fed ignore employment factors in pursuing stable prices over time?

Dr. Taylor. No. Absolutely not. The experience, it seems to me, with this is when the Fed took specific actions to try to deal with unemployment—the 1970s is an example—it backfired. Unintended consequences were high inflation, and ultimately higher unemployment. Higher unemployment got to be 10.8 percent by the end of that episode.

I think the recent experience is similar. One of the reasons the Fed held rates low in 2003, 2004, 2005 was a concern about employment. What has happened? We have had much higher unemployment than anyone would want.

So the history is pretty clear that there are unintended consequences of these actions because the policies that are chosen are counterproductive.

I think the problem with the dual mandate now is it is really used as an excuse to do more interventions, more discretion than would otherwise be the case. So my hope is to put more focus of the Fed to price stability, which would generate more, overall economic stability that would be quite positive for unemployment. We would get a lower unemployment rate, and people are legitimately concerned about it, if you remove that mandate.

In reality, monetary policy works with lags. It is dynamic. It takes time. And what we have seen in history is these efforts go the wrong way, and it is a concern to me.

Chairman Brady. Do you believe the Fed's current accommodative monetary policy will help close the growth gap? Or do you view a more rules-based policy as helping remove the risks that at this point are a roadblock in the economic growth?

Dr. Taylor. No, I do not think they will help. In fact, the history of the last four years is that they have not. We have had really the weakest recovery in history for a downturn like we have had. And it is good to say positive things, to be sure, but this is a very disappointing expansion, a very disappointing recovery.

And there are a lot of reasons people point to, but I think one of them is the uncertainty, the great deal of interventions that the Fed has had here. And so to me, and history tells you, economics tells you, to get back to a more predictable policy. A policy where there is not so much interference with the economy would actually help the recovery, and I am hoping they will do that.

Chairman Brady. Thank you, sir.

Dr. Posen, I read your testimony last night. You touched on a lot of key points. I want to pursue your first point you made, which is that there is a right way and a wrong way for a legislative body to set goals and hold their central bank accountable.

The approach we are taking is to try to create a constructive, focused bipartisan approach, in fact a focused bipartisan approach over the next year to look both backwards on what is the role of the Fed in the economy in the first 100 years, financial security and all that, and also to create sort of a level playing field for ideas on what that role should be.

In your view, is that generally the right approach versus, as you've identified, there are some damaging approaches as well?

Dr. Posen. Mr. Chairman, no, I am very delighted to be here. And as I said in my testimony, part of the reason I am delighted to be here is because you and your colleagues and the staff of this Committee are framing this in a serious, objective, and—I don't know partisan/bipartisan, but open to debate way. And, that you would be open, I would hope, to evidence. As my colleague, John, talks about history, I interpret the history a little differently than he does. I would hope that we could have frank discussion about that.

And I think the key word that I used in my testimony, and again I know for this Committee I do not need to tell you that, is you do not want this to be about bullying. You do not want this to be about we do not like what the Fed is doing right now, or we are worried that the Fed is not doing enough of X right now, and therefore we threaten a change in the Reserve Act, Federal Reserve Act, to get right now what we want.

When you frame it, Mr. Chairman, when you and your colleagues frame it as a long-term consideration about what for the next 5, 10, 20 years—I hate to go beyond that—but 5, 10, 20 years should be the Fed's goal, I think that is an entirely legitimate and constructive focus.

Chairman Brady. Right. Thank you, Dr. Posen.

Vice Chairman Klobuchar.

Vice Chair Klobuchar. Thank you, both of you. I appreciate your testimony and your comments, Dr. Posen. We truly are trying to approach these things on a bipartisan basis here in a civil way as we look at the work that we are going to have to do together.

I cannot agree with Chairman Brady more than monetary policy alone cannot return this economy to good health. I think it has to be a combination of the work that we are doing in Congress. And, as Mr. Delaney articulately pointed out, there is a lot of work that needs to be done in Congress that has not been done.

But I want to get back to the point both of you made about this idea of setting goals from Congress. But at the same time, I know, Dr. Taylor, you said that the Congress should not be getting involved in dictating what instruments are bought and those kinds of things.

Could you expand on that, about what would happen if we got too involved in the details of this?

Dr. Taylor. Yes. There are lots of decisions that are made on a day-to-day basis, the technical decisions. It seems to me the best thing is for the Congress to delegate those decisions about the instruments of policy to the Federal Reserve, to our central bank. You would be exercising your Constitutional responsibilities that way.

I do think, though, that you have to do more than just, say, hit an inflation goal. Because, especially in the last few years, we have seen how a whole wide range of instruments will be used to try to achieve that.

It is not predictable. They have changed the strategy several times in the last four years. They are groping for something that will work. And so that is not a strategy. That is tactical. It is not something that people can understand—we are guessing all the time what the Fed is going to do next. That is not good. That is not predictable.

But the Fed can report to you, report to the Congress more generally, or to appropriate committee what its strategy is for the interest rate, or for reserves, whatever it happens to be, explicitly, as explicitly as it thinks appropriate. And you can judge that. Other people can judge it and make an assessment. And we can have a good debate about what it is. But we do not have that now.

The goal itself, for say price stability or whatever you want it to be, is not sufficient. Policy works with a long lag. It is not an accountable way to approach things. So that is why I think the strategy is so important.

Vice Chair Klobuchar. Okay. And Dr. Posen, do you think it is the right time to change the mandate of the Federal Reserve by statute?

Dr. Posen. Madam Vice Chair, no. Full stop. I think it is both a wrong time to do it because the Fed's policies right now are constructive in making a positive difference without in any way imperiling a sound dollar. And I think it would be a mistake based on the knowledge we have now about how central banks work, and how economies work, to change the dual mandate even when we are in recovery, I think it is the responsible and right thing to do.

Dr. Taylor spoke about instrument changes, and tactical requirements. I think too much is being made of that. There seems to be this horror of a central bank that actually tries to do its job and adapts to circumstances. I think that is a mistake. Any more than you would tell the military: God Almighty, you are using tanks and drones rather than foot soldiers? That must mean you are doing something wrong.

No, that is not how you act. You ask the military: Are you doing an acceptable job? Are you incurring too many casualties, causing too many side effects? Those are all reasonable questions.

But then getting into is this the right way to fight the fire? Is this the right way to land on the beach? That is not something Congress should be doing.

If I can make one more point, when you talk about history, as I said in my written testimony, these kinds of so-called "unconventional policies" were what central banks did for the preceding 200 years. They bought and sold private assets.

Now there were disadvantages to that, but they were small. And this rules-based period that Professor Taylor and others invoke as a gold era, the gold standard, for example, was a period when central banks were buying and selling private-sector assets with large balance sheets.

And so there was no contradiction between adherence to the gold standard and price stability, and having involvement in private markets. So I think we should stop fear-mongering about that and focus on the goals, rather than the instruments.

Vice Chair Klobuchar. And what do you think the best thing Congress should do right now? Just take it out of the Federal Reserve right now in terms of what we should be doing with the tools that we have, which as Congressman Delaney pointed out are much more targeted and we can do things more quickly?

Dr. Posen. I fully stipulate to what Congressman Delaney said. I mean—and this is still in the spirit of bipartisan of everything everyone has said so far, which is the Fed cannot really affect the maximum rate of sustainable employment; it is these longer term structural factors that matter. The Fed can affect how close we come to that at any given moment.

And so for the Congress to focus on things that would bring up the rate of sustainable employment would be positive.

Vice Chair Klobuchar. Okay. Thank you, very much.

Chairman Brady. Thank you. Representative Hanna.

Representative Hanna. The Fed has said—the FOMC set a target employment or unemployment rate, and they have said in their own words, the maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamic of the labor force.

Knowing that, in terms of America being competitive, in terms of, as Mr. Delaney said, education, immigration, a very complicated tax code, exports and a lack of a national energy policy, how realistic is it for them to have that in writing and believe that, I think, and set a policy of unemployment, knowing that all jobs are not the same, and that we have structural problems that are both long term and short term in our economy? Do they set themselves up for defeat by saying that?

Dr. Posen. No. They simply set themselves up for being—sorry, Congressman Hanna, in my view they simply set themselves up for being much humbler about what the Fed can achieve and how they should act than they did in the previous two decades.

I was very struck in Professor Taylor's remarks about how wonderful these various periods were when the Fed stuck to rules-based monetary policy, and how bad things are now, as though the monetary regime was the only thing that determined these wonderful outcomes, or these terrible outcomes, or at least was a dominant thing.

And as you just read, and as Mr. Delaney said, that is exactly wrong. The Fed basically has some control over credit conditions and over how hot the economy runs versus this limit.

And so I think it is entirely appropriate, but in no sense inconsistent, to say to the Fed: Don't presume you know exactly what the top level of unemployment is. Be subject to checking that, as you failed to do in the 1970s. But your job is, given whatever Congress decides, given what the elected representatives of the world leave you with, to try to get the most stable growth, and the most stable inflation you can, given those conditions.

And I see no contradiction as long as Congress and the media do not expect too much to the Fed saying we're creating jobs; we're getting us back to full employment. These may or may not be great jobs. That is for elected officials to decide, not for the Fed.

Representative Hanna. But are they setting themselves up with a wrong premise, a wrong-headed premise?

Dr. Posen. Not at all. I don't think, as you just read, I don't think there is anybody at the Fed, from the Chairman on down, who thinks that by trying to get the economy to grow, to recover, is doing anything about the long-term structural issues—except possibly the following: Which is, we know—and I think you and I discussed this before the meeting—that when people are out of work for a long time, it sometimes becomes very difficult for them to get back into work. It is sometimes very difficult for them to get rehired, whether they are an older worker who gets labeled, or a younger worker who fails to get on the ladder.

And so there is an excuse, or a reason for the Fed—I think it not an "excuse," I think it is a genuine justification, excuse my language, for the Fed to try to keep the economy running as close to full employment as possible under serious conditions because you do not want that to kick in.

Representative Hanna. Dr. Taylor.

Dr. Taylor. I think the Fed now says the long-term normal unemployment rate is 5.6 percent. I think that is what they have said. And they are trying to—their goal is to keep the fluctuations, or the deviations of unemployment from that number as small as possible.

But of course they have not accomplished that by any means. The performance is much worse in the period I'm referring to than it was say in the 1980s and 1990s, a much more stable economy as measured by their own criteria, the exact criteria they are using right now.

And I think monetary policy does have an impact. It is one of the most powerful macro economic instruments there are. And it can be a force of good, and it can be a force of harm. There is no question about that. Throughout the history of the Federal Reserve, I think you can point to more periods where it has been harmful.

Take the Great Depression. It was terrible economic—terrible monetary policy. I think the same is true of the period now. And we have good periods. And we should look at that history. And there are other things that go on in the economy. Your responsibility with the budget is very important. Regulation is very important.

But do not discount monetary policy as not a major factor in these economic developments.

Representative Hanna. Thank you.

Chairman Brady. Thank you. Representative Delaney.

Representative Delaney. Thank you, Mr. Chairman.

Two quick questions for Dr. Taylor, and then I have one for both Dr. Posen and Dr. Taylor.

Dr. Taylor, you said something interesting in your testimony that you think it would be a great opportunity for the Fed to unwind, or to begin to unwind its position during periods of growth that we may or may not see during the next year.

To the extent Congress were to put in place a grand bargain deal of significance, how much of an opportunity do you think that would create for the Fed to begin to unwind its position?

Dr. Taylor. Well if such a grand bargain is a responsible approach to fiscal policy and is positive for the economy, that would begin to create this good news. And I think it would be an opportunity for the Fed. But it does not have to be the Congress's action. It can be other action.

Representative Delaney. In case we needed another reason to work on something, I thought I would try to get that out for the record.

[Laughter.]

My second question for you is, you talked about how oftentimes there is a correlation between the Fed using monetary policy to stimulate employment and the fact that there has not been a measurable, immediate change in the trajectory of employment.

Is that really a fair standard? Because it seems to me the Fed often uses monetary policy to stimulate employment just at the time we start seeing accelerating unemployment; and that the Fed really should be judged based on how much it mitigates further unemployment, as opposed to holding it to a standard of achieving its unemployment goals.

Because again I come back to, I tend to think about the world, or these decisions in the context of the real, practical world as opposed to kind of abstract or standards in a vacuum. And I'm not sure it is fair to judge the Fed based on the fact that they haven't achieved, or we have not achieved what we all view as optimal employment, and to say that their policies have not worked.

Isn't there some truth to that statement? That we really have to look at the mitigation effect as opposed to just whether they are hitting absolute standards?

Dr. Taylor. It is a very good question. But I think my characterization of the events is more that the Fed took action, say in the 1970s, and later on you have these adverse consequences.

The Fed took actions in 2003, 2004, and 2005 and later on you have had this crisis.

Representative Delaney. Right.

Dr. Taylor. And so it is not the kind of——

Representative Delaney. But the crisis in 2007–2008, it was hard to—I mean, I think you could actually make an argument to the Fed's action after 9/11 did contribute to some of the asset bubbles that were created in the last 10 years. But it is not clear to me that the 2003–2004 actions were correlated to that.

Dr. Taylor. Well the evidence I look at says it is more 2003, 2004, 2005, and I think the Fed's provision of liquidity in 9/11 was appropriate. They provided $60 billion of liquidity. They removed it right away. I wish that's what had happened in 2008.

Representative Delaney. And my question for each of you is, when I think about the Fed's actions recently I view their actions around the crisis as heroic. I view their actions post-crisis as appropriate.

I do have questions about their recent actions, QE–3, if you will. And my concerns are that again it is a blunt instrument. It is not achieving the results as effectively as actions of Congress would. And I don't blame the Fed for that because they do have the dual mandate, and in the absence of Congress doing something they are compelled to do it.

I also feel like it hurts savers, and it largely helps people with assets. And to that degree, continues to drive income inequality in this country. But perhaps my biggest concern is that, as the Fed's balance sheet grows and it continues to be long assets, when that time does occur where rates need to be raised—which there is no evidence that that has to happen any time soon, based on the inflation data—do you think that the Fed will be affected in their decisionmaking process by the impacts that raising rates would have on its own balance sheets?

In other words, Fed monetary policy, while it is not an appropriation, does have a cost. And the cost is how we unwind this. And the Fed is not a traditional financial institution. It is not at risk based on what happens to asset prices, but it will create a lot of negative headlines, and there will be a lot of discussion about the Fed losing money. It may affect their ability to make payments to the Treasury.

So do you think—and this is a question for both Dr. Posen and Dr. Taylor, maybe Dr. Posen first, do you think this will have an affect on their ability to act on appropriate rate setting measures?

Dr. Posen. Thank you, Congressman Delaney.

I guess you raised an enormous number of issues, so let me just try to quickly respond. I think the distinction of QE–3 versus the crisis is one that is now becoming popular, and I am not sure it is entirely justified.

The Fed is continuing to do things that are perfectly reasonable and in line with central bank practice. More importantly, I think you are all going to see over the course of the next year, and in fact are already seeing in some of the statistics Vice Chair Klobuchar mentioned, the recovery in the housing market that is being directly fueled by the restoration of the MBS market through Fed action.

And that is going to be an important driver of growth in the year ahead, and it is not going to be a bubble because we have been so low below replacement rate on housing it is entirely appropriate for the Fed to do that. It is another example of them buying a non-Treasury asset having the right impact.

Second, I think you worry about hurting savers. There is so little private sector savings in this economy, except by rich people, that unfortunately anything we do that stabilizes the economy will always disproportionately benefit rich people—which would not be bad if it did not hurt other people; however, mass unemployment, mass under-employment, budget deficits that force cuts in progressive programs, and Head Start, and education and health, really hurt poor people.

And therefore what the Fed does to keep growth up is actually far more important than the effect on savers, including people like my mother who live off of T–Bill interest. It is still, on net, better for the poor in this country for the Fed to act.

In terms of the balance sheet issue, this actually raises something I should have said to Vice Chair Klobuchar when she was asking what Congress can do vis-a-vis the Fed in general.

I find it——

Chairman Brady. I'm sorry, Dr. Posen, because we're running—and perhaps we can return to this point with Representative Maloney as well.

Representative Paulsen.

Representative Paulsen. Thank you, Mr. Chairman.

Actually, I think some of my questions will be able to allow some of that same line of thought to occur. I was going to ask just regarding the issue of the impact of the Fed's policies on savers, on seniors, for instance, and maybe some folks of higher age category are not making wise asset allocations, for instance, and they may be pushed more toward riskier investments because of declining interest rates.

I know that Chairman Bernanke back in February of 2013, just recently he just testified actually that he said the notion that savers are harmed by the Fed's current policies are not really a factor because, he has argued, as much as there is harm to interest-bearing accounts, savers are also benefitting from other assets like stocks, and real estate.

He noted that the stock market has doubled in the last few years, and he has expressed conviction that the economy must move forward and pick up steam before interest rates are brought back up.

So it kind of follows—just to follow up, what is the proper balance for U.S. monetary policy in terms of achieving that price stability and lower employment in a way that does no harm to American savers, or to seniors who choose to forego present income for future security?

And maybe, Dr. Taylor, you can kind of start off and then go to Dr. Posen.

Dr. Taylor. Well I would say one way to look at this is to just go back to the 1980s and 1990s until recently. You basically had a policy which would ease in a recession, and it would tighten when inflation picked up. It worked very well.

It seems that is the kind of policy you are looking for now. But a policy that promises a zero short-term rate for years into the future, that is an interference with the markets that is very unusual—extraordinarily unprecedented. Don't think this is not unusual.

And the purchases of mortgage-backed securities is massive—this is not just a few dollars—is very unusual. And those create this uncertainty about how it is all going to be unwound. And the zero rates themselves, they do cause a search for yield. We have seen that in the past.

There is also an effort to drive down the long-term interest rates so they don't reflect the information that is coming into the economy, whether it is a pick up or a slow down. So it is a massive change in policy. And the effect on savers and what they do is just one example of this.

So it seems to me that we know how to deal with this. We have done it in the past, and I think we should try to do that in the future.

Representative Paulsen. And you have suggested that a return to a more rules-based monetary policy would result in normal market-determined interest rates that would reduce those incentives for pension funds and retirees to take on more dangerous risks. So are the Fed's policies right now contributing to a stock market bubble, to a potential housing bubble down the road? Bubbles burst. I mean, is it a contributing factor?

Dr. Taylor. One of the problems in economics is we don't know exactly when it is a bubble and when it is fundamentals. I think there are some good things going on with respect to profits. There has been a recovery. It is just terribly weak.

Many of the firms you are looking at, their stock prices are benefitting from foreign sales. The world, and especially emerging markets are doing quite well. And so there are lots of other reasons, more fundamental reasons, but I think you should be worried about bubbles especially in the fixed-income market.

And to the extent that the Fed is influencing that, I believe they are, that has to be removed at some time. It can only be temporary. The Fed cannot do this forever. We cannot rely on the Federal Reserve for the stock market in the United States forever.

Representative Paulsen. Dr. Posen.

Dr. Posen. Mr. Paulsen, I guess I am uncomfortable with your initial statement about the Fed should worry about inflation, employment, and no harm coming to savers. The Fed's goal should never be: no harm comes to any one group. Full stop.

That does not mean we should not be honest and look at those issues and admit that there are effects, and pluses and minuses, as I think Chairman Bernanke tried to account for, but the idea that the Fed should direct its policies towards any one person or any one type of person I think is a mistake.

To the degree that there are people in savings who have issues, it is a smaller number than sometimes people think for the reasons that have been discussed. But it is also a question of why haven't other assets gone up in value? Why aren't there other interest rates in the private markets moving? The Fed is not directly influencing those assets.

And that gets us back to what we were talking about earlier, which is: There are limits to what the Fed can do, but that is not the same thing as saying what they are doing is causing these other problems in the economy. And I think we have got to make that distinction.

Representative Paulsen. Thank you, Mr. Chairman. I yield back.

Chairman Brady. Thank you. Representative Maloney.

Representative Maloney. Thank you. And I thank the witnesses for their testimony.

Since the financial crisis began in 2007, the Federal Reserve has absolutely used every tool in their arsenal to stabilize the financial system and prevent another Great Depression.

The Fed, in my opinion, provided a very much needed stability during this time. They opened literally an alphabet soup of lending windows that provided liquidity during this time. Multiple rounds of quantitative easing have kept interest rates low, helped small and large businesses access credit, and spurred economic growth.

Without the Fed's expansionary monetary policy, in my opinion, our economy would be much worse than we are today. But unfortunately, the recovery is still very vulnerable. Private-sector job growth fell below 100,000 last month. Unemployment is still well above its pre-recession level, and there are more than 3 unemployed workers for every job opening.

Dr. Posen, do you believe the Fed should continue to use all the available tools in its arsenal to bolster the economy and help people get back to work? And also in response to Senator Klobuchar's question, what should Congress do to complement the Federal Reserve's expansionary monetary policy? And could you also talk about the risks of shutting down the Fed's bond purchases too early?

Dr. Posen. Okay. First, thank you, Congresswoman.

I agree they should be using every tool. I do not believe yet they have used every tool. There are—the commitments to low long-term rates I view as marginally cheap talk. I do not view that as a tool. I am on record suggesting that forward guidance, as they call it, is really unimportant. So I don't think it does much harm or much good.

What matters is the actual stance of policy and the actual purchases and commitments. And what happens in terms of actual rate decisions. So I think they should be continuing to look at buying MBS. I think they should be continuing to provide liquidity. And I think they have no risk in doing so.

In terms of what Congress should do, let me link the risks back to what Mr. Delaney was saying, and Vice Chair Klobuchar was saying.

If you are concerned that the Fed may be hesitant about withdrawing policy, and that is a source of uncertainty, or you are concerned that they will self-limit policy because they are worried that people will get agitated about the outstanding balance sheet, the best thing that the Congress can do is guarantee the Fed that they will recapitalize the Fed if there are losses on the Fed's balance sheet, just the same way that they get all the money back from the Fed when the Fed makes a profit.

This is all notional. The Fed is not a for-profit institution. That is not the motivation, nor should it be the criterion for judging Fed policy. You do not want that motivating Fed policy. So therefore, if this Congress were to commit to indemnify the Fed against losses done in its execution of monetary policy, that would be a constructive step and would take this issue off the table, which should not be a consideration of when they decide to exit or not.

Representative Maloney. And also could you talk about the risk of shutting down the Fed's bond purchases too early?

Dr. Posen. Yes. Thank you. As I mentioned to Mr. Hanna, there is a problem in this economy that we all recognize, that the labor market has gone really sour in a way that has not been seen in past U.S. recessions—at least not for decades.

We have seen participation in the labor force drop by four full percentage points. You mentioned in your question, in your statement, the recent poor numbers on the latest month.

If the Fed were to stop its bond purchases—since I don't believe forward guidance matters very much—I think it would constitute an insufficient amount of monetary stimulus and probably be perceived as a tightening, or at least a next step to a tightening. I believe unemployment would rise significantly, and we would get the demonstration of the effectiveness of Fed's policies by the reverse. Its withdrawal will cause problems.

Representative Maloney. I am interested in your experiences on the Monetary Policy Committee and the Bank of England. I know you have been a close observer. I understand you had some concerns about their austerity measures and the impact on the economy.

Could you comment on the Bank of England? It only has one mandate, as I understand it: Managing inflation. And has that single mandate led to better inflation outcomes than the United States, or worse?

Dr. Posen. As I say in my testimony, it has actually led to very similar policies and it has led to slightly worse inflation performance.

This is, arguably, in part because the UK is a much smaller economy than the U.S. It also has a less well—it is much more vulnerable to events in the Euro area, which has been a problem for it. And it has had a less sound currency. The pound came down 30 percent, or 25 percent, versus where it was, which the dollar has not.

So I think when you look at the UK monetary policy experience, it is not the mandate that matters, it is the nature of the economy. Broadly speaking, we—the Bank of England did many of the same things as the Fed and, broadly speaking, we prevented the counterfactual much worse outcomes.

Representative Maloney. Thank you very much. My time has expired.

Chairman Brady. Thank you. Senator Lee.

Senator Lee. Thank you very much, Mr. Chairman, and thanks to both of our witnesses for joining us today. We appreciate your insight, and it is good to have you with us.

Dr. Taylor, I was wondering if I could have you discuss how some of the following items might add to the cost of an open-ended quantitative easing process:

Unwinding the enormous Fed balance; investments running into risky equities to chase return; creating an assumption that near-term government debt service costs are sustainable; over-investment in a narrow set of growth assets and the creation of new bubbles; and misallocation of investments.

Could you just talk to us about those for a moment?

Dr. Taylor. Yes, Senator. Thank you. That list is long but I agree with each one of the points is a concern.

Unwinding the balance sheet requires selling the mortgage-backed securities, and selling the long-term assets. To the extent that the purchases have been beneficial, which is debatable, that will be counterproductive. It will be a restrictive in the economy.

It will also be occurring at the same time most likely, as when the Fed needs to raise the short-term interest rate. It is always hard to exit from an easy monetary policy. This one will be harder. So that creates risks.

Another point on your list is important. The policy a potential for a false hope on the budget because it makes the interest rate payments so low at this point now, again to the extent it is holding rates down, and it clearly is holding short rates down.

I think the search for yield that you mentioned, that people are going to be taking on risky assets that they probably shouldn't have, that will come back to be a negative, as we have seen in the past.

So all these, it seems to me, are serious risks that are being undertaken. And they may involve unfortunate policies going forward. For example, if the Fed is concerned about its balance sheet value, taking capital losses, that may delay its exit. They may hold onto those securities longer than they otherwise should. That is a very real possibility.

On the other hand, if they hold onto those securities, it is going to require that they pay banks huge amounts of money for the reserves, because they are now paying interest on reserves. And if they want to have the short-term interest rate be 1 percent, 2 percent, 3 percent, whatever it will have to be in the future without reducing the balance sheet, it will have to pay all that money directly to the banks. That is going to be a concern, as well.

So I've been studying monetary policy a long time. Exits are always difficult. And this one is going to be more difficult than ever. And I believe that is already causing concerns, about how it is going to unfold, which holds back the economy itself right now.

Senator Lee. Thank you. Since the Recession's technical end, now several years ago, there has been some troubling correlation between the change in unemployment rate and the size of the labor force. And last week in The New York Times economist Casey Mulligan noted: As unemployment has gone down, so has the labor force participation rate.

In the midst of this trend, the Fed has set a new precedent. It set a new precedent on December 12th of last year by declaring an official unemployment target of 6.5 percent based on headline unemployment.

Given these circumstances, how useful do you think the headline unemployment is as a target?

Dr. Taylor. Well I think it is more suspect than usual as an indicator of overall demand conditions in the labor markets. Because as you say, people are dropping out of the labor force at a much higher rate than you would expect in the current circumstance.

Awhile ago the CBO estimated that the unemployment rate would be about 1¼ percent higher if labor force participation had behaved according to the way it should in these times.

So it makes the unemployment rate more difficult to interpret, and it is one of the reasons I think people are concerned about the focus on a particular number like that. The Fed has allowed itself wiggle room. It says, well, it is not a for-sure thing they will change on that basis, but it is one of the other uncertainties that is making monetary policy difficult to interpret right now.

Senator Lee. Has measuring price stability changed in a similar way in recent history?

Dr. Taylor. I don't think so. I think there's always the question about, for example, should they focus on a core inflation rate? I've always been worried about a core measure, because ultimately you are concerned about the ultimate inflation rate. Another way is you could average the inflation rate over a few quarters to get a better indicator.

I think the statistical agencies should continue to try to improve the statistics to get better measures of inflation, but I don't think that is a major problem with monetary policy right now.

Senator Lee. And then finally, would any of this—does any of this suggest that it might be easier from a technical perspective to enforce a single mandate? I see my time has expired.

Chairman Brady. Would you like to answer, Dr. Taylor.

Dr. Taylor. I think it would be better because it would remove a lot of the ways and reasons the Fed moves in these discretionary ways. As the Chairman indicated, the dual mandate entered the law in 1977.

It was this period of a highly interventionist mentality with respect to policy. But as soon as Paul Volcker came in, it was continued by Alan Greenspan, they basically tried to interpret that law as get inflation down, get price stability that will generate more employment. And they were very successful in doing that.

Now really for the first time since the 1977 Amendments to the Federal Reserve Act, the Fed refers to the dual mandate all the time as reasons to do this, and reasons to do that. That I think is problematic. And that is one of the reasons I would think it would be better to try to focus on a single mandate, not to ignore what is happening in the economy but to simplify what the Fed is actually doing.

Senator Lee. Thank you, very much.

Chairman Brady. Thank you. Senator Coats.

Senator Coats. Thank you, Mr. Chairman.

Let me divert if I could just a little bit from what the chosen topic is today. But in response to the question that Congresswoman Maloney asked, what should Congress do? Two question. One for both of you, and one for Dr. Taylor. Let me start with Dr. Taylor.

Dr. Taylor, Dr. Posen's response to that was—first response to that was that the Congress should guarantee the Fed—that the Fed will be recapitalized if it has losses, given its current policies. Would you like to respond to that? I would like to get your take on that question and that answer.

Dr. Taylor. No, I don't think that is necessary or appropriate for the Congress to do. In that respect the Federal Reserve Act is just fine the way it is. It delegated some responsibility without backstopping the Fed in that particular way.

Senator Coats. My second question is relative to timing. The tools of the Fed versus the tools and the need for Congress to address fiscal policy issues.

There is growing consensus, if not full consensus, that the current situation relative to our debt and deficit is such that we are reaching a tipping point. The mandatory spending, it is pretty simple arithmetic, is simply running away with our revenues causing a lot of borrowing, and squeezing the discretionary side of the budget, which we have control over and which, as Dr. Posen said, there are things that ought to be addressed that may not be addressed simply because we do not have the resources to do so.

Now relative to timing, many are now saying that we have been talking about this for several years but there has not been significant structural changes proposed or enacted relative to this runaway mandatory spending. And, that if it is not done this year, the political process will potentially push this decision to the point where it can be actually accomplished through a political process to 2017. And therefore I think even the White House has acknowledged, the Executive Branch has acknowledged along with Congress, that it has got to be done now or we flip into 2014, an election year, then we flip into a new Presidential election process, and it may be 2017.

It seems to me two results can happen from that. It is either four more years muddling through, four more years of tepid growth, less than satisfactory, high unemployment, more squeeze on discretionary spending; or we reach that tipping point during this period of time, which brings another financial crisis.

Could each of you just briefly address that question and that issue?

Dr. Taylor. Well I will be very brief. I think it is very important to address these budget issues now. It is a good time to do it. I see some momentum. There is an orderly process on the budget that is finally coming back. The Senate has a budget.

I think the proposal to try to get the budget into balance in 2023 makes sense. That is possible to do with the gradual—it's not austerity, it's a gradual, credible plan. But at the same time, as you say, and is most important, for the long term to get the entitlement spending in line with the growth of GDP. It is exploding, and that is the problem.

So by all means, that is one of the most important policy issues we are all facing.

Senator Coats. And the possibility of this tipping point debt to GDP occurring in that period of time, if we don't take action now?

Dr. Taylor. Well I think the evidence should make you worry; that if you don't address it now it is going to be harder, and there will be a tipping point. But unfortunately I can't say what that time of tipping point will be. We don't know for sure. But why take the risk? It would be better for the economy if we take the action now. So why take the risk of a tipping point?

Senator Coats. Thank you. Dr. Posen.

Dr. Posen. Thank you, Senator.

What is striking I think about your set of questions and Professor Taylor's response on my issue about backstopping the Fed is that it illustrates how much this conversation is focused on the supposed uncertainty caused by the Fed; whereas, everyone has known what the Fed is doing. It has been very clear. They have precommitted. They have said, and there has been enormous uncertainty generated by the budget process between the Congress and the White House.

I know none of you deny that, and you are trying to fix that. I am just saying I think it is a very misleading statement to talk about the Fed being the cause of uncertainty that harms the economy, whereas the main source of uncertainty certainly for the last year-and-a-half has been the obscene budget back-and-forth between the Congress and the White House.

In that spirit——

Senator Coats. I don't disagree with you.

Dr. Posen. I know you don't. I just want to be clear that when we—if you start saying "uncertainty" is part of the problem here, that to me is the big source of uncertainty and therefore I support the responsible budget measures that are going forward.

Senator Coats. Thank you.

Thank you, Mr. Chairman.

Chairman Brady. On behalf of Vice Chair Klobuchar and myself and the Committee, I want to thank both of you for being here today, and your insight on monetary policy matters.

This is an appropriate and I think a critical time to be reviewing the role, both today and in the future. We will be calling on both of you in the future, as we pursue this issue and how we best close this growth gap, and how we return to and create a sound financial dollar, sound dollar over time, as a foundation for economic growth.

So again, thank you very much for being here. The hearing is adjourned.

[Whereupon, at 10:40 a.m., the hearing was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF HON. KEVIN BRADY, CHAIRMAN, JOINT ECONOMIC COMMITTEE

This year marks the centennial of the Federal Reserve, so it is appropriate for the Joint Economic Committee to examine the Fed's role in the current economic climate as well as its focus for the next 100 years.

Today's hearing on monetary policy is the third in a series that touches on our most vexing economic challenge: the growth gap.

We're all rooting for America to bounce back, but regrettably the U.S. economy is missing 4.2 million private sector jobs and $1.3 trillion in real output due to the gap that exists between this weak recovery and the average recovery of the last 70 years.

For every American, the growth gap means he or she has $2,935 less in real disposable income at this point in the recovery.

This gap persists despite extraordinary actions by the Federal Reserve to stimulate growth and employment as part of its dual mandate.

Even more troubling, the Congressional Budget Office projects that the future growth rate for America's potential real GDP will be a full percentage point below its post-war average—which may not sound like much, but the consequences are alarming.

With one-percent lower growth, our economy will be $31 trillion smaller in 2052, and the Treasury will collect $97 trillion less in tax receipts over the next four decades—making it significantly harder to balance the budget and reduce America's risky level of debt.

The question before this Committee is whether the extraordinary actions taken by the Federal Reserve are capable of closing the growth gap, and if a focus instead on price stability and establishing a sound dollar will provide a stronger foundation for economic growth over the long term.

Since 2008, beyond the appropriate role of lender of last resort to financial institutions and markets, the Federal Reserve has selectively bailed out investment banks, maintained interest rates at an extraordinary low level for almost five years, engaged in three rounds of quantitative easing by buying massive amounts of Treasuries and mortgage-backed securities, and indicated that the Fed will continue this accommodative monetary posture until the unemployment rate falls to 6.5 percent.

But can the Federal Reserve boost real economic growth over time through discretionary monetary policy? Or should the Federal Reserve adopt a rules-based monetary policy to achieve price stability and let Congress and the President determine the combination of budget, tax, regulatory and trade policies that will boost real economic growth to close the growth gap?

In 1977, Congress established a dual mandate for monetary policy that gave equal weight to achieving long-term price stability and the maximum sustainable level of output and employment.

During the 1970s, as you may remember, the Federal Reserve's monetary policy was discretionary and interventionist. The results were accelerating inflation, short expansions, frequent recessions, and rising unemployment.

In the early 1980s, Chairman Paul Volcker broke the back of inflation. Over the next two decades monetary policy became increasingly rules-based. The results were outstanding: low inflation and two long and strong expansions, interrupted only by a brief, shallow recession.

Since the Great Moderation, however, monetary policy has again become discretionary and interventionist. Not surprisingly, the results are disappointing.

From 2002 to 2006, Chairman Alan Greenspan kept interest rates too low for too long which helped to inflate an unsustainable housing bubble.

Chairmen Volcker and Greenspan correctly believed monetary policy could contribute to achieving full employment—if and only if—the Federal Reserve focused solely on price stability. Beginning in 2008, however, the Federal Reserve explicitly deviated from this view, invoking the employment half of its dual mandate to justify its extraordinary actions.

In January 2012, the Federal Open Market Committee correctly observed in its Longer-Run Goals and Policy Strategy statement:

> *The maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market.*

Despite the clear admission of the limits of monetary policy to spur employment, in December of the same year the Federal Open Market Committee announced that it would (1) expand its current round of quantitative easing, and (2) retain its extremely low target range for federal funds for "at least as long as the unemployment rate remains above 6½ percent."

To achieve a policy objective, Nobel laureate economist Robert Mundell stated, policymakers must use the right lever. Monetary policy affects prices over the medium and long term. In contrast, budget, tax, and regulatory policies are what affect real output, real investment, and employment. Monetary policy cannot solve the problems that poor fiscal policy has helped create.

By targeting the unemployment rate, the Federal Reserve is attempting to use monetary policy to achieve what the Fed acknowledged eleven months earlier that it cannot achieve through monetary policy—full employment—while risking what economists acknowledge that the Fed can achieve through appropriate monetary policy—long-term price stability.

To close the growth gap, my belief is that we must refocus the Federal Reserve on a rules-based monetary policy, which is a necessary, but not sufficient, condition for robust real economic growth and job creation. This is not a false choice between jobs or stable prices—it is the proven acknowledgement that stable prices and a sound dollar create the best foundation for job growth over the long term.

Congress, which has delegated its constitutional authority to coin money and maintain its value to the Federal Reserve, should provide it with a clear direction to return to an achievable mandate for price stability.

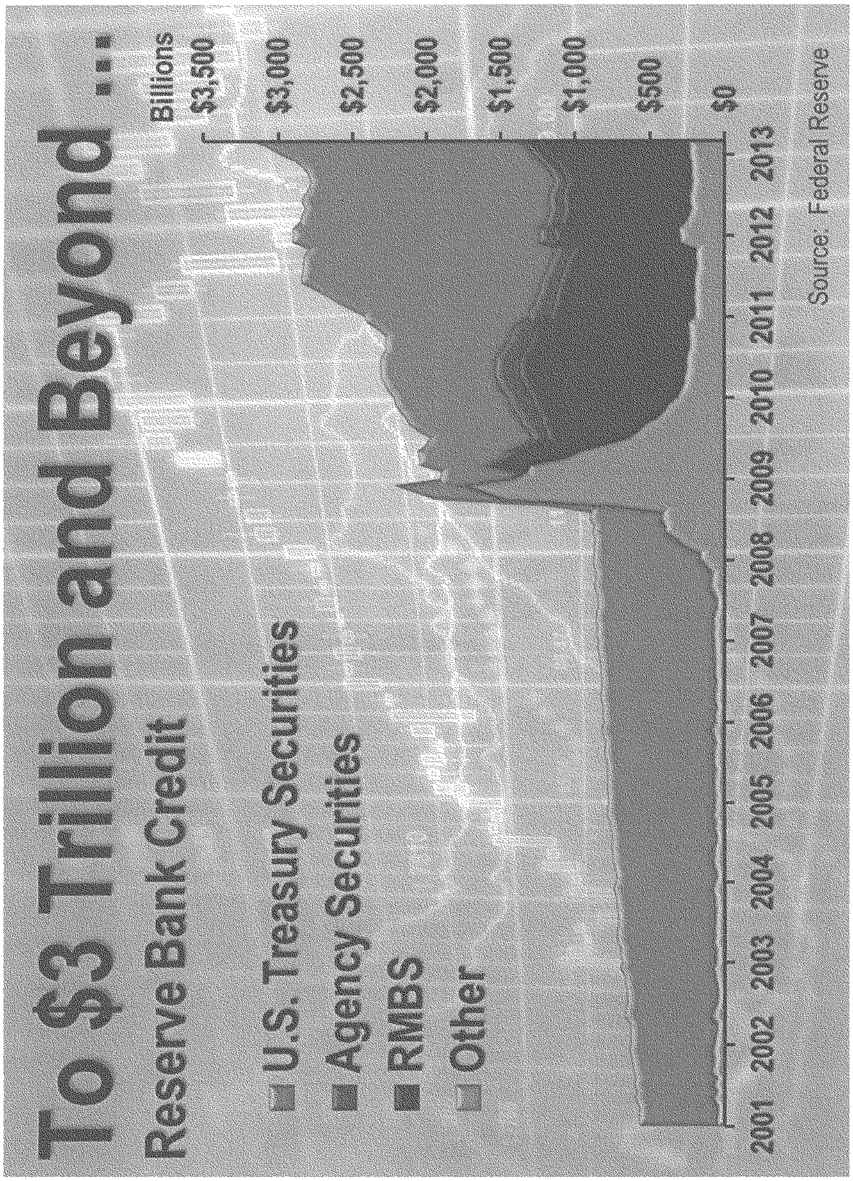
The Federal Reserve should also ensure a soft-landing for the housing market by initiating a slow and orderly unwinding of its $1.1 trillion position in federal agency residential mortgage-backed securities. Gradually reducing the excess reserves that could be the fuel for future inflation will reduce market uncertainty, strengthen the foundation for non-inflationary economic growth, and reduce the likelihood of undue political interference in Federal Reserve policy.

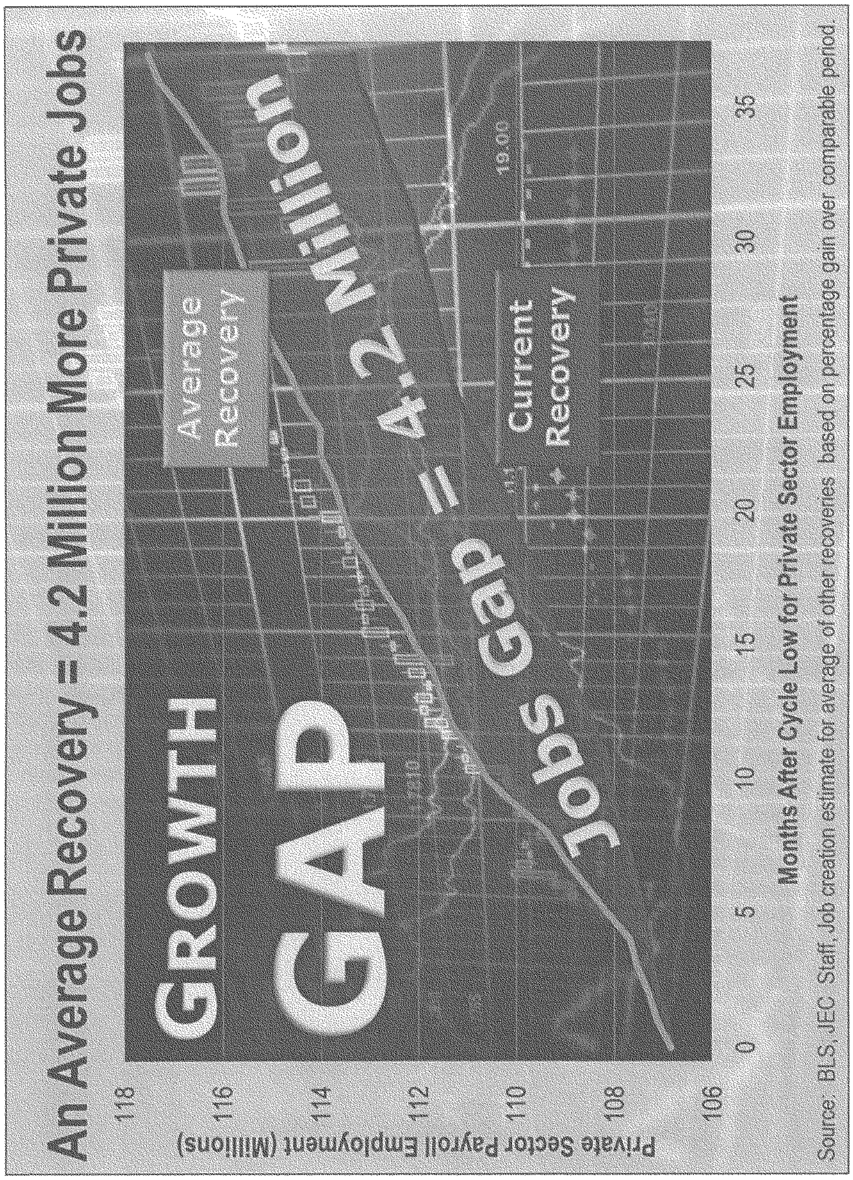
Looking to the future, today's hearing provides this Committee with the opportunity to hear from two of the most distinguished monetary economists in the world on their recommendations for the role of the Federal Reserve during its second 100 years.

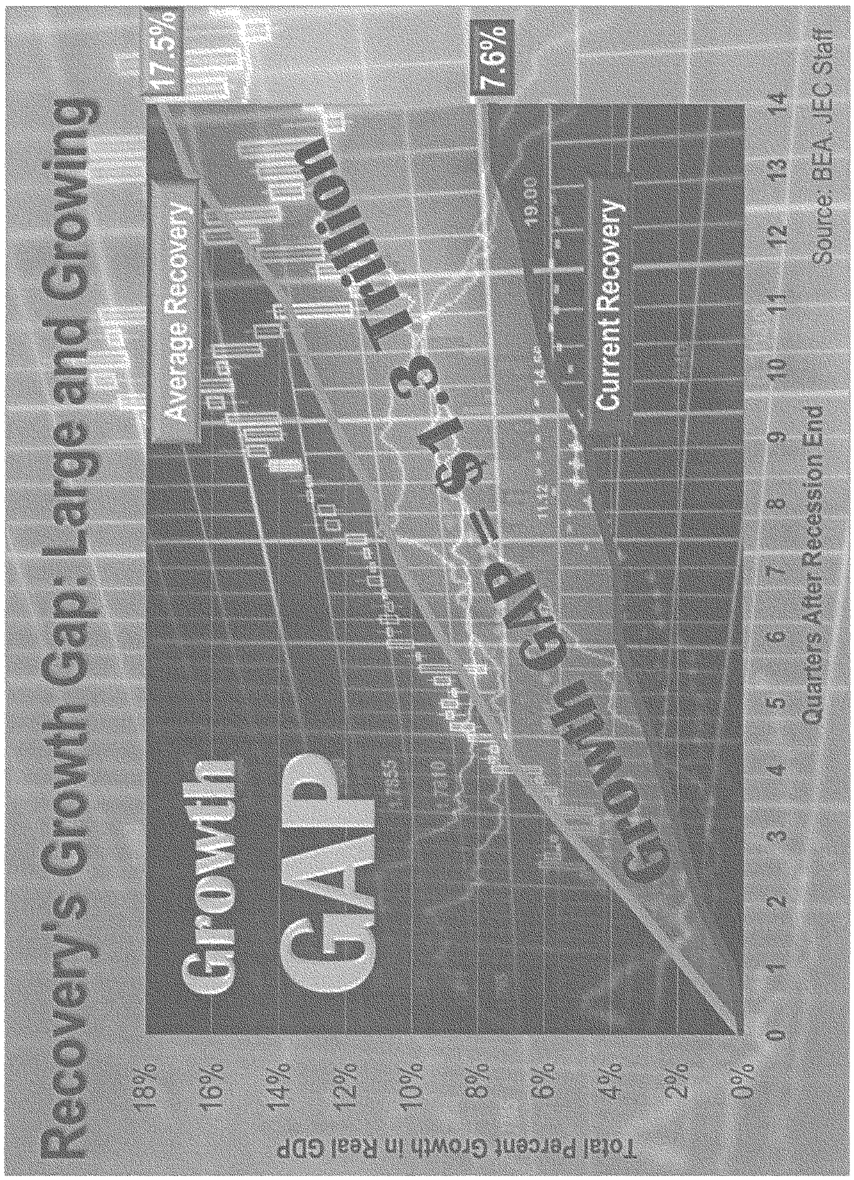
Dr. John Taylor is the creator of the Taylor rule, which central banks have used to implement a rules-based monetary policy. Dr. Adam Posen served on the Monetary Policy Committee of the Bank of England and is a widely acknowledged expert on Japan. We are fortunate to have them with us today.

With that, I look forward to their testimony.


When It Comes to Growth 1% is a Big Deal
Economy $31 Trillion Smaller, Cumulative Lost GDP $540 Trillion
Revenues Trillions 2012$
$15
$13
$11
$9
$7
$5
$3
Growth
GAP
3.2% Growth
Lost Revenue = $97 Trillion
2.2% Growth
2012
2017
2022
2027
2032
2037
2042
2047
2052
2057
2062
Source: CBO, Joint Economic Committee Staff

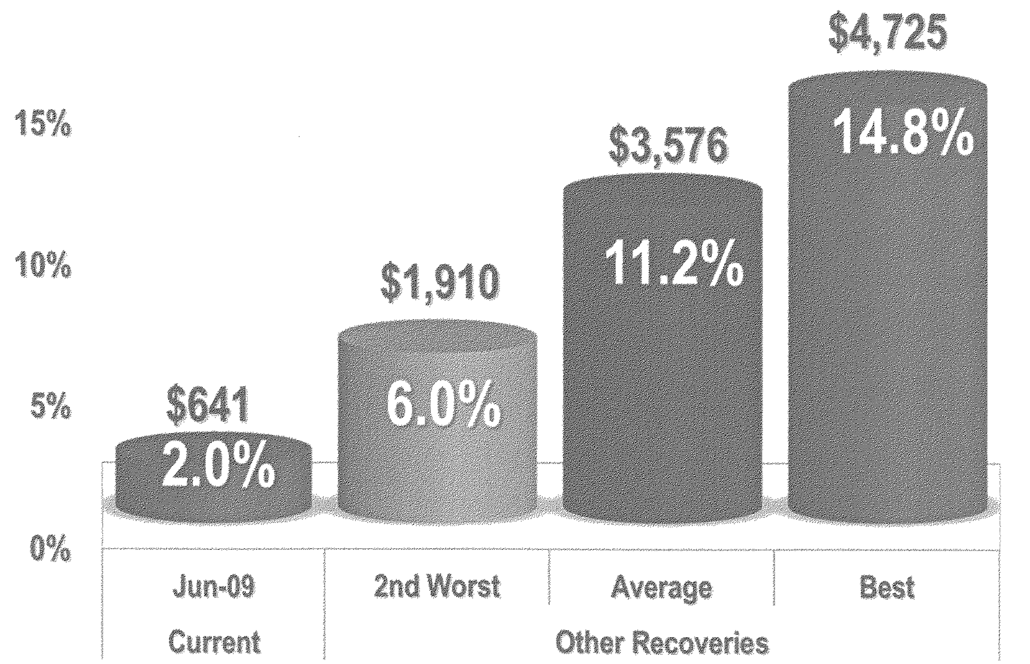

To $3 Trillion and Beyond ...
Reserve Bank Credit
U.S. Treasury Securities
Agency Securities
RMBS
Other
Billions
$3,500
$3,000
$2,500
$2,000
$1,500
$1,000
$500
$0
2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013
Source: Federal Reserve


An Average Recovery = 4.2 Million More Private Jobs
Private Sector Payroll Employment (Millions)
118
116
114
112
110
108
106
GROWTH
GAP
Average Recovery
Current Recovery
Jobs Gap = 4.2 Million
0
5
10
15
20
25
30
35
Months After Cycle Low for Private Sector Employment
Source: BLS, JEC Staff. Job creation estimate for average of other recoveries based on percentage gain over comparable period



Recovery's Growth Gap: Large and Growing
Total Percent Growth in Real GDP
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
0
1
2
3
4
5
6
7
8
9
10
11
12
13
14
Quarters After Recession End
Growth
GAP
Average Recovery
Current Recovery
Growth GAP = $1.3 Trillion
17.5%
7.6%
Source: BEA, JEC Staff

GROWTH GAP Total Growth in Real Per Capita Disposable Income Following Post-1960 Recessions



Source: Bureau of Economic Analysis, Joint Economic Committee Staff Calculations

A Steadier Course for Monetary Policy

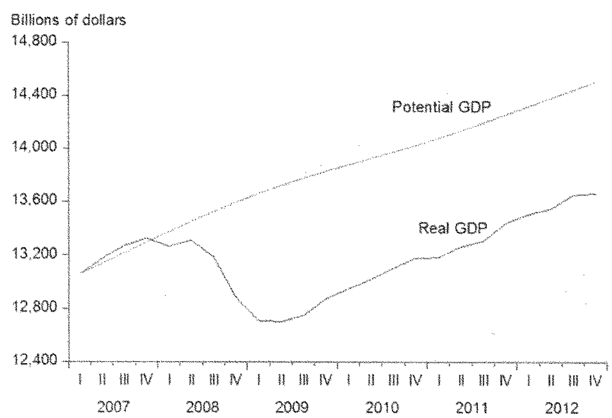
John B. Taylor[1]
Testimony before the
Joint Economic Committee on
"The Fed at 100: Can Monetary Policy
Close the Growth Gap and Promote a Sound Dollar?"

April 18, 2013

Chairman Brady, Vice Chair Klobuchar, other members of the Committee, thank you for the opportunity to testify. I will focus on the adverse impacts of the Federal Reserve's recent departure from a rules-based monetary policy and on the gains from a return to a steadier policy which would close the growth gap and maintain the purchasing power of the currency.

The Departure from a Rules-Based Monetary Policy Has Been Harmful to the Economy

The invitation to testify asked about "the Federal Reserve's departure from a rules-based policy." In my view such a departure has been the defining characteristic of monetary policy during the past decade in marked contrast to the steadier rules-based policy of the 1980s and 1990s. Monetary policy has consisted mainly of highly discretionary and unpredictable changes in the policy instruments in recent years, and, largely as a result, economic performance has not been good. We have had a deep recession and a very slow recovery, which have together created a huge growth gap—a main focus of this hearing. The persistent difference between potential GDP and real GDP illustrates the *growth gap*.



[1] John B. Taylor is the Mary and Robert Raymond Professor of Economics at Stanford University and George P. Shultz Senior Fellow in Economics at Stanford's Hoover Institution.

The recent departure from rules-based policy began when the Fed decided during 2003-2005 to hold its target interest rate target well below the level implied by monetary rules that had characterized policy in the previous two decades of good performance. As I have argued previously,[2] this intervention led to a search for yield and excessive risk taking which exacerbated the housing boom, leading to the housing bust and the financial crisis which turned the recession into the great recession.

Once the financial crisis was evident in August 2007 the Fed continued with its unusual policy interventions. These measures did not prevent the crisis from getting worse; in my view some of them were harmful and an outright panic broke out in September 2008. One example is the Term Auction Facility announced in December 2007, which did not have the intended effect of reducing interbank interest rates in early 2008—as I testified to the House Committee on Financial Services[3] at the time—and probably drew attention away from risks in the banking system.

When the panic did strike in late September 2008, however, the Fed's liquidity support provided from October to December was helpful, especially in rebuilding confidence and stabilizing the money markets and the commercial paper market.

More problematic has been the continued departure from rules-based policy from 2009 through the present. Rather than simply letting the liquidity facilities draw down after the panic of 2008, the Fed started its unconventional quantitative easing program with large-scale purchases of Treasury and mortgage-backed securities. And when the recovery did not pick up as it expected, the Fed increased the massive asset purchases, which are now running at a pace of $85 billion per month. The Fed also repeatedly extended the zero interest rate policy, which now it says—as part of its forward guidance—will continue at least until the unemployment rate hits 6.5%.

Since 2009 I have argued in Congressional testimony[4] and elsewhere[5] that continuing these unprecedented discretionary interventions would create economic uncertainty and risk, which are detrimental to the economy. And indeed the interventions have been accompanied by disappointing outcomes as the Fed's growth forecasts, based on the policies, have consistently proved overly optimistic. After four years of disappointing results, it is hard to make a convincing case that the policies have been working.

From the start, these policies have created a two-sided risk of either continued economic drag or a future pick-up of inflation due in part to the uncertain impact of the eventual exit from the policies. Soft landings are always difficult for monetary policy and they are now more difficult than ever because it is hard to estimate the impact of selling the assets that the Fed has

[2] "Housing and Monetary Policy," in *Housing, Housing Finance, and Monetary Policy*, Federal Reserve Bank of Kansas City, September 2007, pp. 463-476.
[3] "Monetary Policy and the State of the Economy," Testimony before the Committee on Financial Services, U.S. House of Representatives, February 26, 2008.
[4] "Monetary Policy and the Recent Extraordinary Measures Taken by the Federal Reserve," Testimony before the, Committee on Financial Services, U.S. House of Representatives, February 26, 2009
[5] "Systemic Risk and the Role of Government," Dinner Keynote Speech, Conference on Financial Innovation and Crises, Federal Reserve Bank of Atlanta, Jekyll Island, Georgia, May 12, 2009

purchased. Moreover, raising interest rates at the same time will add to the difficulty, especially when the market has grown used to zero interest rates and government support for longer term bonds over many years.

A Gradual Exit from the Unprecedented Actions Would Be Helpful

For these reasons, the Fed should consider exiting from these policies sooner than is apparently its intent and the market's expectation. The longer the Fed's zero rate policy continues and the more its balance sheet grows, the more difficult the exit will be.

Of course, any exit strategy should be gradual and credible so as to mitigate any adverse effects on financial markets, or on residential investment and other components of spending. The exit strategy should also resolve any dynamic inconsistencies. Currently there is an inconsistency between the promise to hold the federal funds rate to zero until the unemployment rate hits 6.5 %—currently estimated by the Fed to occur in 2015—and the appropriate level of the rate that year. A variety of monetary policy rules suggest that the rate should be above zero in 2015 with the Fed's forecasts.

A return to a more rules-based policy will help remove the risks that are holding the economy back now.[6] A return to normal market-determined interest rates will reduce the incentive for pension funds and retirees to take on dangerous risks to boost their miniscule yield. It will reduce the incentive for banks to carry rather than write off bad loans. It will reduce the incentives for excessive federal borrowing and fiscal interventions. It will help restore the Fed's independence, which has been threatened by its excursions into fiscal and credit allocation policy and questioned by those who do not see why an independent agency of government should have such powers. And it will restore market signals and price incentives to money, bond, and other markets where the Fed's presence is repressing essential market mechanisms. Most important it will reduce harmful unpredictability due to deviations from steadier policy

Perhaps the best opportunity for the Fed to initiate an exit would be if and when economic growth rises above 2% for more than a quarter or two. Remarkably, economic growth has never even reached a four-quarter growth rate of 3% in this entire recovery. A credible exit could turn a couple of quarters of strong growth into a sustained recovery.

What rules-based monetary policy should the Federal Reserve follow to close the growth gap and maintain the purchasing power of the U.S. dollar?

This crucial question—raised in the invitation to appear here today—is best answered by examining American history. During the 1980s, the 1990s, and until recently, the Fed came closer to adhering to a rules-based policy than during any other comparable length period in its

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[6] These risks are discussed in my testimony "A Review of Recent Monetary Policy," before the Subcommittee on Monetary Policy and Trade, Committee on Financial Services, U.S. House of Representatives, March 5, 2013

100-year history.[7] The main instrument of policy during this period was the short-term interest rate—the federal funds rate—which was regularly adjusted by the Federal Open Market Committee according to developments in the real economy and changes in inflation, first with the aim of reducing inflation and then with the aim of maintaining a low and stable inflation rate. It was recognized that having a strategy for the instruments of policy was a good way to maintain price stability—the purchasing power of the currency—while at the same time stabilizing the real economy and keeping unemployment low.

In fact inflation and unemployment came down dramatically during this period, and the overall economy was so stable that economists have dubbed the period the Great Moderation. This Great Moderation ended with the 2007-2009 Great Recession and the 2009-ongoing Not-So-Great Recovery. The main lesson from both the successful and unsuccessful periods of American monetary history is that a rules-based policy, which adequately constrains discretion, works well. The provisions of the Sound Dollar Act reflect that lesson.

Monetary policy should focus on a clear strategy for the *instruments* of policy as well as the goal of that strategy. A goal or a target for inflation or nominal GDP is not enough if it is simply part of a "whatever-it-takes" approach to the instruments of policy. Such an approach can result in highly discretionary and unpredictable changes in policy instruments with unintended adverse consequences, as we have seen in recent years.

A successful rules-based policy must have a strategy for the instruments of monetary policy—either the federal funds rate, reserves, or something else that the Fed can reasonably control directly. The most straightforward way to make such a rule an integral part of monetary policy would be to reinstate the formal reporting requirement for the instruments of policy that was removed from the Federal Reserve Act in 2000. But rather than focus only on money growth as the requirement previously did, it would focus directly on a rule-like response of the short-term interest rate or some other appropriate instrument that the Fed can control.

This reform would constrain discretion by requiring that the Fed establish and report on a policy rule for the instrument. It would not require that the Fed choose any particular rule for the instrument, only that it establish some rule and report what the rule is. If the Fed deviated from its strategy, it would have to provide a written explanation and answer questions about its explanation. So while discretion would be constrained, it would not be eliminated. Congress would thereby exercise its constitutional authority without interfering in the day-to-day operations of monetary policy.

[7] See Allan H. Meltzer "Federal Reserve Policy in the Great Recession," *The Cato Journal*, Vol. 32, No. 2, 2012 and *A History of the Federal Reserve*, Volume 2, University of Chicago Press, Chicago, 2009.

Testimony before the Joint Economic Committee
Hearing on "The Fed at 100: Can Monetary Policy Close the Growth Gap and Promote a Sound Dollar?"
Adam S. Posen[1]
April 18, 2013

Thank you, Chairman Brady and Vice-Chair Klobuchar, for the opportunity to appear before you and your colleagues today. I commend you and the Joint Economic Committee for calling a hearing on this topic. It is right in a democratic society that independent central banks be accountable to elected officials for their performance and – over sufficiently long intervals to allow for sound judgments - for the goals they pursue. 100 years seems like it would be a more than sufficient length of time for so doing, as would the 35 years since the 1978 Full Employment and Balanced Growth Act, to pick another anniversary. I would argue such a review is due nearly five years since the financial crisis and Great Recession began.

I would like to make three arguments today regarding the topic of today's hearing, the right goals for the Federal Reserve:

- The difference between goal and instrument independence for central banks;
- The need for practical targets rather than broad mandates or narrow rules;
- The necessity of responsible monetary policy to close the growth gap;

Accountability for Central Bank Goals -

Independent central banks, like the US Federal Reserve System, should have only instrument independence, meaning the ability to set monetary policy at any given policy board (i.e., FOMC) meeting or string of meetings without interference from politicians; they should not have goal independence, meaning the ability to set their own priorities for policy over the medium term.[2] The members of this Committee are well familiar with the arguments for maintaining the Federal Reserve's instrument independence. Without it, price stability and a sound dollar would be very difficult to maintain, and the sustainable growth of the US economy would be reduced. So we can all agree to maintain that kind of independence for the Federal Reserve.

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[1] Adam Posen is President of the Peterson Institute for International Economics, and was a member of the Bank of England's Monetary Policy Committee from 2009-2012. The views expressed here are solely his own, and not necessarily those of the Peterson Institute, any of its Directors, or any other member of its staff. Contact posena@piie.com
[2] This distinction was drawn by Stanley Fischer in Debelle and Fischer (1994) and Fischer (1995).

Central banks which have goal independence, however, give up too much democratic accountability for too little gain on credibility, and raise the possibility of capricious policymaking which would be destabilizing. Goal independent, and therefore too independent, central banks also raise political tensions inherently and justifiably with citizens who feel their well-being is affected by an unchecked institution. In addition to being a problem in itself, such tensions will undermine any policy commitments made by that central bank.

So the deal between an (instrument) independent central bank and the elected officials overseeing said central bank has be two-way. The central bank should be subject to having its goals reset by the responsible officials for multi-year periods, and having its performance judged subject to those publicly defined policy priorities between reviews of its goals. The elected officials, in turn, have to restrain themselves from using the threat of resetting the central bank's goals just for the sake of getting a politically motivated short-term policy change by the central bank. That kind of bullying pressure would harmfully interfere with instrument independence, while discrediting legitimate public discussion of the central bank's goals. Changing goals too often would undermine stability and credibility. Both would increase inflation and inflation volatility.

I know this Committee recognizes the worth of distinguishing between constructive long-term review of the Federal Reserve's goals, and abuse of the Congress' right to review the Federal Reserve's goals for short-term gain. I hope the other relevant committees in Congress will follow your lead in respecting this distinction, and act accordingly in this regard. We have just seen three examples abroad of reviews of independent central banks' goals, which illustrate the stakes of so doing.

- In January in Japan, the Abe Government reset the Bank of Japan's inflation target, and explicitly criticized the Bank's past leadership for failing to actively pursue the target over a period of nearly 20 years. They waited until the previous Bank of Japan Governor had completed his term of office, thereby respecting the Bank's instrument independence, before replacing its leadership with a group that would pursue the publicly set goals. (Think of Lincoln promoting Grant to run the Union Army) Since their appointment in mid-March, both government debt and stock markets in Japan have responded very positively. This illustrates how transparent accountability for central banks and goal resetting by politicians can be managed while enhancing (not eroding) monetary credibility.

- Last December in the United Kingdom, the Chancellor of the Exchequer announced a review of the Bank of England's inflation targeting framework after 15 years in place. There was a set date by which the Chancellor would publicly report any proposals for change resulting from the review. The review by elected officials came after three major independent evaluations of different aspects of Bank of England's performance in recent years, commissioned by the Chancellor, were published. In March, the Chancellor announced changes to the execution of the Bank's remit, particularly with respect to the short-term pursuit of growth and the use of forward-guidance, and otherwise largely endorsed the existing inflation target framework. Markets treated this announcement as largely a non-event, rather than as a disappointment, which is right. This demonstrates that, even after serious public review involving expert opinion, deciding *not* to make major changes to the central bank's goals is a valid path rather than acting just for change's sake alone.

- The contrast is clear with what has happened in Hungary. In March, the Hungarian Prime Minister altered the central bank law and the composition of the National Bank of Hungary's policy board. The new governor he put in place dismissed a number of senior staff. Transparency was reduced while the notional inflation target was supposedly unchanged. The European Central Bank and IMF have expressed concern about the removal of the central bank's independence. The uncertainty about the politicization of monetary policy has deepened Hungary's financial difficulties. Review of goals should not be legislative takeovers.

I hope my discussion gives the Committee a clearer sense of what is the right spirit and the right limits within which to conduct a public review of the Federal Reserve's policy priorities and goals, at least insofar as I read the historical and recent experience. I believe this is relevant to keep in mind, not just for today's and similar hearings, but especially if Chairman Brady's proposal to have a Centennial Monetary Commission goes forward. I support such reviews, within the aforementioned limits and spirit, as enhancing rather than impairing the exercise of central banks' instrument independence. Legitimacy and clarity make for better monetary policy.

Monetary mandates, policy goals in practice, and the limits of rules –

So responsible elected officials should review the policy goals of independent central banks at multi-year intervals, announce any changes (or not) to those goals, and then compel compliance by the central bank's policy board with the pursuit of those goals. Note that I said "pursuit of those goals." This is because you cannot always achieve what you want through monetary policy, even with the best of intentions and commitment. The evaluation of whether the central bank leadership did as well as they should and could have in such pursuit is a more recurring duty, and the usual role of Congressional oversight of the Federal Reserve.

I emphasize the word "pursuit" of the set or re-set policy goals for another reason as well, more directly relevant to the focus of today's hearing. Goals have to be practical to be meaningful, as much in monetary policymaking as in any other area of government and public policy. Broad aspirational mandates can cause trouble, by setting unreasonable expectations, leading to politicized definitional debates, or simply confusing the policymakers as a guide to contemporary decisions in real-time. Faced with an inoperable mandate, or perhaps one whose literal pursuit would be counter-productive in a given set of unforeseen conditions, monetary policy makers will understandably do what they think they have to and explain later.

The result is that broad central bank mandates in terms of noble concepts like "price stability" rarely have any traction on monetary policymaking in practice. Twenty years ago, I pointed out that while both the Deutsche Bundesbank and the Swiss National Bank abjured the inflationary policies of other central banks in the 1970s and early 1980s, they had meaningfully different legal mandates. Yes, the Bundesbank's mandate famously is for the pursuit of price stability above all, but the Swiss National Bank includes in its mandate "to ensure price stability and, in so doing, to take due account of economic developments," a view underscored by the SNB's reporting on many real and international factors – and still the two central banks had similar success in resisting inflationary pressures. [Laubach and Posen (1997)] Research shows that the pattern holds cross-sectionally, meaning there is no significant correlation between what a central bank's stated mandate or remit is, and the inflation outcomes they deliver. [Posen (1999)]

Central bank behavior during the recent financial crisis also reflected the irrelevance of too general mandates. Three of the four major central banks (Bank of England, European Central Bank, and Federal Reserve) pursued similar responses to the early stage of the crisis in 2008-09, and converged again in practice over the last year, with the fourth, the Bank of Japan, now catching up. [Pisani-Ferry and Posen (2012)] To the degree that the European Central Bank diverged from the others in 2010-11, it was in disregard of its set mandate – had it been following either the inflation or the monetary growth "pillars" that it is instructed to use as the guide for its policy, it would have eased further than it has.

An elected legislator might well ask, "What business do these unelected central bankers have ignoring their legal mandates?" and perhaps then to recommend stricter enforcement of rules on monetary policymaking. The regular re-emergence of proposals to put the US back on the gold standard or the like are in part motivated by such a desire for more rules-based monetary regimes that can be enforced. Yet, the history of the gold standard is itself instructive about the reasons for why in practice such binding rules do not work.

Central banks found that over the course of economic fluctuations, of demographic and technological developments, and of shocks to the supply of gold and other commodities, strict adherence to the gold standard caused huge swings in the real economy, in asset prices and credit markets, and in trade flows. These proved unsustainable economically and politically, as well as simply destructive. As a result, economies would enter and exit the gold standard at various times, relaxing the rule when needed.[3] The gold standard did not enforce tough commitments by central banks – rather economies stuck with the gold standard when their central banks were tough. And toughness was not a virtue in and of itself under all circumstances. A parallel tale with parallel lessons can be told about the recurrent failure of commitments to fixed exchange rate pegs as a constraint on monetary policy.[4]

This is a major reason why the vast majority of independent central banks moved to a more or less formal inflation targeting regime over the past 20 years, often at the instigation of or in partnership with the elected officials who oversee them – so long as the government cannot force direct purchases of government debt by the central bank, or fire the central bank governor without cause, this does no harm to price stability.[5] It is a form of what I have termed disciplined discretion, whereby there is: a clear hierarchy of policy goals; those goals are practical being defined in terms of targets that monetary policy should be able to achieve on average over the medium-term (of 2-3 years); there is a transparent framework for evaluating their pursuit; and there is sufficient flexibility built in that the policymakers can spare the economy sharp swings from slavish pursuit of a rule over too short a time frame. There certainly is room for the re-evaluation of inflation targeting these days, especially in light of the crisis. But I believe that these aspects regarding the structure of the central bank's goal and the transparency of that goal's pursuit remain worth retaining for the Federal Reserve and other central banks, even if the specific terms or priorities are changed.

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[3] Bordo and Rockoff (1996), Eichengreen (1992), and Ahamed (2009)

[4] Except for very small open economies with a clearly stable dominant trading relationship to which to peg their currencies, such as Denmark and the euro or Hong Kong and the dollar, for whom such pegs may be the best alternative.

[5] Bernanke, et al (1999), Kuttner and Posen (2001)

The responsibility of central banks to stabilize output –

The question on mark at the end of the title of today's hearing implies some conflict or tradeoff between monetary policy closing the growth gap and promoting a sound dollar.[6] That question mark is itself highly questionable on any number of grounds. I will explain what several of those reasons are, and therefore why both are reasonable goals for the Federal Reserve to pursue – that is, why the Federal Reserve should keep its dual mandate.

The first reason to doubt such a conflict is simply to reject the notion that there is any evidence of a threat to the soundness of the US dollar. Inflation has been well below US historical averages for the last several years, and the dollar has largely been stable or appreciating against the other major currencies over that period. Bond markets, the prices of TIPS, forward contracts on Treasuries and on the dollar, consensus forecasts, and household surveys – the full arsenal of ways we have to measure expectations of inflation at least roughly – all give the same message of no inflation in sight.[7] One might assert (wrongly) that QE makes the bond market uninformative, but every other one of those measures of inflation expectations is safe against tainting by the Federal Reserve's action. In fact, it would be easy for investors and households to dump the dollar and other dollar-denominated assets if they were concerned about inflation, even if the Federal Reserve were to buy up every available Treasury note. Markets reveal no such worries or activity, and that changed not one iota when the FOMC announced QE3 or a threshold for unemployment.

The second is the usual co-movement of economic activity and inflation pressures. When the business cycle moves due to aggregate demand, which it usually does, trying to close the output gap and the stabilization of prices are mutually consistent. That is certainly the case today, when unemployment is well above even conservative estimates of the natural rate, the growth of GDP is well below even conservative estimates of US potential GDP growth, and the last several years were even further below trend. It is possible to make the case that there is a much weaker relationship than there used to be between movements in aggregate demand around the potential rate of growth and fluctuations in inflation (in the jargon, the Phillips Curve has

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[6] I commend the phrasing "closing the growth gap." Obviously, monetary policy that tries to drive growth well beyond a zero output gap, or unemployment well below the natural rate, and keep it there, will cause inflation and risk the dollar's soundness, as the Fed did in the 1970s. That is not a tradeoff, that is a misguided policy. So long as the intent of the central bank is to be consistent with a zero output gap (full employment), any mistakes made by overestimating the room to expand should be discernible and remediable. Therefore in my testimony, I leave this aside and focus on the output gap.

[7] With the gold bubble crashing due to the same kind of purely speculative swings that inflated its price in the first place, I hope that reasonable people can dismiss gold as any kind of useful indicator.

flattened).[8] So doing, however, simply reduces any possible tradeoff between a sound dollar and shrinking of the output gap, and puts the determinants of inflation solely in the monetary realm.

That leads to the third reason there is no conflict for monetary policy between the pursuit of a sound dollar and closure of an output gap: monetary, or more importantly, credit growth is disengaged from the real economy and from monetary policy. One major lesson of the recent financial crisis in the US and Western Europe is that we have to beware of excess credit growth as a source of bubbles and busts. Excess credit growth is precisely that which is out of whack with either real GDP growth or narrow monetary aggregates (what the central bank can control rather than broad credit). We have seen central banks try to pop bubbles or stem credit booms with interest rate increases, and seen those efforts repeatedly fail.[9] In the other direction, we know that efforts to build up the recovery through quantitative easing have been limited in their ability to induce increased bank lending or credit growth (even though they have affected measures of confidence, some asset prices, and some interest rate spreads).

This is why discussion among central banks and finance ministries about how to prevent future booms and busts has focused on the creation of new 'macroprudential' tools – meaning policy instruments more direct than moving interest rates or central bank balance sheets that more directly influence the growth and allocation of credit. These tools may or may not work, that remains to be determined, but their development is a clear indication that monetary policy has little direct traction on credit and asset price booms. More to the point, this means that pursuit of real economic goals such as closing an output gap have no consistent effect, good or ill, on the development of credit booms and asset price misalignments. No matter how many people assert such a link, there is no support for it in the data.

One more issue raised has to do with what happens to price stability if continued QE proves to be insufficient to restore full employment. The notice of today's hearing, for example, says that "The Federal Reserve is taking unprecedented actions to attempt to drive employment gains...it's becoming increasingly clear there are limits to what monetary policy can achieve in the pursuit of the dual mandate." This statement strangely seems to imply that somehow the Federal Reserve trying to achieve full employment will cause a problem either because of the nature of the policies, i.e., large-scale asset purchases, which it is using in that pursuit, or just

[8] I would tend to counter that such flattening of the relationship is due to proximity of current inflation to zero, since wage movements are mostly bounded from below at zero, and the curve would steepen at more normal inflation rates with recovery.
[9] As discussed in Posen (2011), this visible pattern holds up to econometric scrutiny – in other words, loose monetary policy is not the cause of bubbles, no matter how many people wish to make the world simpler and less scary by believing that.

because those policies would be insufficient. I must, however, reject both halves of the hearing notice's characterization as confused and misleading at best.

Taking the second more obvious point first, the answer is that nothing happens to the dollar's soundness in that horrible situation of QE failing to be sufficient, and no other policy response being forthcoming. The tragic waste of American human resources, and the damage done to our citizens' lives through unemployment and lost income would continue to mount, but the credibility of price stability would be unaltered - unless the slow growth would induce deflation in itself or contraction in supply through, say, damage to the labor market. In that case, the right response would be to all the more aggressively pursue stimulative monetary policy. As I argued while serving on the Bank of England's Monetary Policy Committee in 2010, but with an eye towards Federal Reserve monetary policy as well:

> We will know we will have done enough with QE or other monetary stimulus only when we have clear indications that our policies are moving the desired variables...sufficiently and in the right direction on a sustained basis...[I]t is not enough for a central bank to say, "Look, expanded our balance sheet more than any time in history" or "we did things we never did before" and argue that "therefore we must have done a lot, if not too much."...that is backwards logic...like saying that "the fire must be out because we've already pumped more water than for any previous fire we've fought"...This is a worse fire than any of us have ever seen in our lifetimes,...and so we cannot judge our progress by how much effort or resources we have already put in. [Posen (2010), p.8]

Finally, what about this idea, implicit in the hearing notice for today, and explicit in a number of places, that the Federal Reserve is taking 'unprecedented actions' and by virtue of that characterization, the actions are dangerous? This view gets expressed sometimes in the form of concerns about the costs of QE or the risks of exit. I realize that many raise such concerns in good faith, including some current members of the FOMC, and there is an active attempt in various quarters to assess those hypothesized costs. To me, however, this is chasing phantoms when people for whatever reason refuse to believe the simple truths from the historical record of central banking.

There is nothing that unconventional about the monetary policy measures undertaken by central banks, including by the Federal Reserve, since 2008. For the preceding 200 or so years, central banks conducted policy solely through quantitative means, buying and selling a wide range of private- and public-sector assets. They took a lot of risk onto their balance sheets, and they made choices about which assets made the most sense to buy at any given time. It was only in the 1970s and later that central banks began to rely on their instrument interest rate to the exclusion of other procedures to conduct monetary policy. This shift came because there were some costs and distortions to conducting policy in that matter, but those were small inefficiencies.

The golden age of extreme price stability and sound dollar that some like to evoke as an ideal for today occurred while central banks were engaged in precisely this kind of quantitative easing and tightening behavior – or in the US, before 1913, when ad hoc groups of private financiers responded to panics and fluctuations in liquidity through their purchases and sales of private assets, in the absence of the Federal Reserve. I defy anyone to come up with a relevant historical example, let alone a consistent statistical pattern in the data, of the mere fact of central banks engaging in large scale asset purchases leading to significant inflation or the erosion of financial markets.

Of course, there are examples of central banks causing high inflation by monetizing public debt. That is not, however, what is occurring today under QE, given the need for the Federal Reserve to purchase Treasuries in the secondary market, the freedom of investors to exit the Treasuries market and the dollar, the ongoing consolidation of the US structural deficit, and the verifiable commitment of the independent Federal Reserve to stop QE when either inflation or unemployment cross their publicly set thresholds. Neither public debt levels nor government borrowing costs are goals of current Federal Reserve policy, nor will they become its goals unless the Federal Reserve's independence is taken away by Congress.

Please do not use either unfounded concerns about QE, or legitimate constructive review of the Federal Reserve's goals, as an excuse to do that. And as you review the goals of US monetary policy, please affirm not only the dual mandate, but the more specific goal of closing the output gap. If anything, the resulting economic recovery would drive up interest rates on government debt issuance and reduce debt accumulation, so genuine fiscal conservatives should support the Federal Reserve's aggressive pursuit of its output stabilization goal.

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