

Testimony of
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To the Subcommittee on Monetary Policy and Trade
Of the Committee on Financial Services
United States House of Representatives

Hearing on "A Further Examination of Federal Reserve Proposals"
January 10, 2018

Federal Reserve Accountability and Structure

Mr. Chairman, Ranking Member Moore, and Members of the Subcommittee, thank you for the opportunity to be here today. I am Alex Pollock, a senior fellow at the R Street Institute, and these are my personal views. As part of my many years of work in banking and on financial policy issues, I have studied the role and history of central banks, including authoring numerous articles, presentations and testimony regarding the Federal Reserve. Before joining R Street, I was a resident fellow at the American Enterprise Institute 2004-2015, and the president and CEO of the Federal Home Loan Bank of Chicago 1991-2004.

The proposals under consideration today are all parts of a timely and fundamental review of America's central bank. As Congressman Huizenga has rightly said, "With the Federal Reserve having more power and responsibility than ever before, it is imperative the Fed...become more transparent and accountable."

From James Madison, who wanted to protect the new United States from "a rage for paper money," to now, money has always been and is an inherently political issue, involving many questions which are not amenable to technocratic solutions, but require judgments about the general welfare. For example, Congress instructed the Federal Reserve in statute to pursue "stable prices." But the Federal Reserve decided on its own that the term "stable prices" means perpetual inflation--at the rate of 2% a year. This reasonably could be viewed as a contradiction in terms, but certainly raises the question: Who should have the power to make such judgments? The Fed by itself?

Under the current monetary regime, with the Fed as the creator of the world's dominant fiat currency, busy manipulating money, credit, and interest rates, we have experienced the great inflation of the

1970s, the financial crises of the 1980s, and the bubbles and financial crises of the 1990s and 2000s. (The outcome of the bubbles of the 2010s is not yet known.)

The problems are not due to bad intentions or lack of intelligence, but to the unavoidable uncertainty of the economic and financial future. Since this future is unknown and unknowable, the Fed is incapable of knowing what the results of its own actions will be. It will inevitably be faced with “conundrums” and “mysteries.” Monetary manipulation always involves judgments, which can also be called guesses and gambles. How should the Fed be accountable for its various judgments, guesses and gambles, and to whom? And at the same time, how should it be accountable for how it spends the taxpayers’ money and how it makes decisions?

I believe there are four general categories which should organize our consideration of today’s draft bills. These are, along with the related drafts:

1. Accountability of the Federal Reserve
 - Bring the Fed into the appropriations process
 - Define the blackout period
2. Checks and balances appropriate to the Fed
 - Vice Chairman for Supervision’s reports to Congress
 - Disclosures of highly paid employees and financial interests
3. Centralized vs. federal elements in the Fed’s structure
 - Revise the membership of the Federal Open Market Committee
 - FOMC to establish interest rates on deposits with the Fed
 - Modify appointment process for presidents of Federal Reserve Banks
4. Dealing with uncertainty
 - Staff for each Fed governor

Accountability

The power to define and manage money is granted by the Constitution to the Congress. There can be no doubt that the Federal Reserve is a creature of the Congress, which can instruct, alter or even abolish it at any time. Marriner Eccles, the Chairman of the Fed after whom its main building is named, rightly described the Federal Reserve Board as “an agency of Congress.” As the then-president of the New York Federal Reserve Bank testified in the 1960s, “Obviously, the Congress which has set us up has the

authority and should review our actions at any time they want to, and in any way they want to.” He was right, and that is the true spirit of “audit the Fed.”

To whom is the Federal Reserve accountable? To the Congress, the elected representatives of the People, for whom the nature and potential abuse of their money is always a fundamental issue.

It is often objected that such accountability would interfere with the Fed’s “independence.” In my opinion, accountability is an essential feature of every part of the government, which should never be compromised. If accountability interferes with independence, so much the worse for independence.

In any case, the primary central bank independence problem is independence from the executive, not from the Congress. The executive naturally wants its programs and especially its wars financed by the central bank as needed. This natural tendency goes far back in history. The deal which created the Bank of England was its promise to lend money for King William’s wars on the continent. Napoleon set up the Bank of France because “he felt that the Treasury needed money, and wanted to have under his hand an establishment which he could compel to meet his wishes.”

The Federal Reserve first made itself important by helping finance the First World War. To finance the Second, as a loyal servant of the Treasury, the Fed bought all the bonds the Treasury needed at the constant rate of 2 ½%. The Fed’s desire to end this deal with the Treasury in 1951, six years after the world war ended, gave rise to a sharp dispute with the Truman administration. That administration was by then having to finance the Korean War, a war that wasn’t going so well. For his role in making the Fed more independent of the Treasury, Fed Chairman William McChesney Martin was considered by Truman as a “traitor.” Two decades later, Fed Chairman Arthur Burns was famously pressured by President Nixon to match monetary actions to the coming election. Burns was marvelously quoted as saying that if the Fed doesn’t do what the President wants, “the central bank would lose its independence.”

The Federal Reserve Reform Act of 1977 and the Humphrey-Hawkins Act of 1978 were attempts under Democratic Party leadership to make the Fed more accountable to Congress. I think it is fair to say these attempts were not successful, but instead led principally to scripted theater.

The most fundamental power of the legislature is the power of the purse. If Congress wants to get serious about Federal Reserve accountability, it could make use this essential power. Every dollar of Fed expense is taxpayer money, which would go to the Treasury’s general fund if not spent by the Fed on itself. Since it is taxpayer money, the proposal of one draft bill to subject it to appropriations like other expenditures of taxpayer funds makes sense. The draft limits the expenditures so subject to those for non-monetary policy related costs. In fact, I think it would be fine to subject all Fed expenses to appropriations.

A second draft bill defines blackout periods for communications from the Fed, including communications to Congress, around Federal Open Market Committee meetings. The draft would precisely set the blackout period as a week before and a day after the relevant meeting. This certainly seems a reasonable definition.

Checks and Balances

Checks and balances are essential to our Constitutional government, and no part of the government, including the Federal Reserve, should be exempt from them. But how should the Fed, so often claiming to be “independent,” fit into the system of checks and balances?

The required appropriation of some or all of the Fed’s expenses would be one way. Another way is additional required reporting regarding its regulatory plans and rules, since the Fed has amassed huge regulatory power. It tends to get more regulatory power after a crisis, no matter how great its mistakes and failings were beforehand, as it did after the last crisis, including getting a Vice Chairman for Supervision.

One draft bill requires that this Vice Chairman for Supervision, or others if the position is vacant, regularly report to Congress in writing and in person on “the status of all pending and anticipated rulemakings.” Given the increase of the Fed’s regulatory power, especially its powerful role as the dominant regulator of “systemic risk,” this seems appropriate.

Another draft bill would require disclosures regarding highly paid Federal Reserve Board employees (those making more than a GS-15). The draft also would require disclosures of financial interests. Federal Reserve actions and announcements are market moving events. Addressing potential conflicts of interest is a standard policy.

Centralized vs. Federal Elements of the Fed’s Structure

The original Federal Reserve Act of 1913 tried to balance regional and central power. Hence the name, “*Federal Reserve System*,” as opposed to a single “Bank of the United States.” Carter Glass, one of the legislative fathers of the 1913 Act, it is said, liked to ask witnesses in subsequent Congressional hearings: Does the United States have a central bank? The answer he wanted was “No, it has a federal system of reserve banks.”

This theory lost out in the Banking Act of 1935, when power in the Fed was centralized in Washington, as promoted by Marriner Eccles (who still knew, as noted above, that the Federal Reserve Board is “an agency of Congress”).

Centralization in the Fed reached its zenith with the elevation of the Fed Chairman to media rock star status, as in the title, “The Maestro.” Some adjustment back to more dispersed power within the Fed arguably would make sense. Three of the draft bills move in this direction.

The first would expand the membership of the Federal Open Market Committee to include the presidents of all the Federal Reserve Banks, instead of five of them at a time. Since all the presidents already attend and participate in the discussions of the committee, the old voting rule does seem pretty artificial, especially since the Committee by and large operates on a consensus basis. If some proposal of the Chairman and the Board of the Fed were so controversial that it was opposed by a super-majority

of the presidents, such a proposal surely would deserve additional consideration rather than implementation under the old voting rules.

A second draft bill would make the FOMC responsible for the setting the interest rate on deposits with Federal Reserve Banks. Since this interest rate has now become a key element of monetary policy, placing it with related monetary decisions is quite appropriate.

A third draft in this area would return the election of Federal Reserve Bank presidents to the whole Board of Directors of the bank in question. This reflects the principle that in every board of directors, all directors, however elected or appointed, have the same fiduciary responsibilities. The Board of Governors will continue to appoint one-third of the directors of each Federal Reserve Bank.

Dealing with Uncertainty

I have asserted the essential uncertainty characterizing Federal Reserve decisions. One approach to uncertainty is to promote intellectual diversification within the organization rather than a party line.

The staff of a body like the Fed naturally tends to be focused on serving a successful, powerful and dominant chairman. This risks promoting group-think. A well-known problem for the other Fed governors is lack of staff support for other directions they may want to investigate or pursue.

A good provision of the draft bills is "Office staff for Each Member of the Board of Governors," which would provide each non-chairman governor at least two staff assistants. It seems to me this might provide these other governors greater ability to pursue their own ideas, theories and research, and thus allow them to be more effective members of the Board and potentially provide greater intellectual diversification to the Fed's thinking.

In sum, the Federal Reserve without question needs to be accountable to the Congress, be subject to appropriate check and balances, and be understood in the context of inherent financial and economic uncertainty. It would benefit from rebalancing of centralized vs. federal elements in its internal structures.

Thank you again for the chance share these views.