Testimony submitted to the House Financial Services Committee, Hearing on "Legislation to Reform the Federal Reserve on Its 100-Year Anniversary," at 10am on Thursday, July 10, 2014. Embargoed until the hearing starts.

Submitted by Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; and co-founder of http://BaselineScenario.com.[1]

A. Summary Points

1) All prosperous industrial democracies have a central bank that has considerable operational independence, combined with a reasonable amount of democratic accountability. Experience over the past 100 years and across a wide range of countries has repeatedly demonstrated the paramount importance of creating a buffer between officials appointed to control monetary policy and elected politicians. At the same time, everyone involved in designing and implementing monetary policy and financial regulation should ultimately be accountable, at least indirectly, to the electorate.
2) Effective independence for monetary policy involves and requires:
    a. Fixed term appointments, without the possibility of being dismissed or pressured out over policy disagreements. In the US, for example, this means 14-year terms for members of the Board of Governors of the Federal Reserve System.[2]
    b. The ability to make day-to-day decisions, sometimes under significant time pressure, without risk of being overruled by another branch of government.
    c. Limits on the extent of judicial review. For example, courts cannot rule that interest rates in the US (or other industrial democracies) have been set in an unreasonable way or at an inappropriate level.
    d. Budgetary independence – the Fed's budget is not a Congressional appropriation.
3) As much as possible, monetary policy and financial regulation should be conducted free of partisan or political influence. Interest rates should not be set with an eye on the electoral cycle. [3]

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[1] Also a member of the private sector Systemic Risk Council, a member of the Congressional Budget Office's Panel of Economic Advisers, and a member of the F.D.I.C.'s Systemic Resolution Advisory Committee. All views expressed here are personal. Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at http://BaselineScenario.com, where we also provide regular updates and detailed policy assessments for the global economy. For additional affiliations and disclosures, please see this page: http://BaselineScenario.com/about/.

[2] In modern America, most Board governors serve for considerably less than 14 years – and new governors are then appointed to fill incomplete terms. For more details and some history, see Peter Conti-Brown and Simon Johnson, "Governing the Federal Reserve System after Dodd-Frank," Peterson Institute for International Economics, Policy Brief 13-25, October 2013.

[3] For example, Paul Volcker's ultimately successful effort to bring inflation under control was made possible by the independence of the Federal Reserve System.

4) The Board of Governors of the Federal Reserve System also regulates an important part of the financial system, including (under Dodd-Frank) any firms or activities that could pose systemic risks. Large financial institutions, especially those seen as "too big to fail", typically oppose meaningful limits on their activities. They are particularly opposed to limits on their ability to increase leverage (i.e., to have a large amount of assets relative to their equity). As executives at these banks are usually paid based on their return on equity, not fully adjusted for risk, such an approach generates substantial expected private benefits. There are also substantial negative externalities from such a high leverage strategy, but these are not internalized by any one financial firm.[4]
5) In the U.S. since 2008, very large bank holding companies have resisted: the Volcker Rule, more restrictive capital requirements, a tighter cap on leverage, and other changes. They have also pushed back against many CFTC rules on derivatives and they continue to resist SEC changes on a variety of issues.
6) The U.S. has long handled monetary policy and financial regulation by appointing experts, subject to oversight by relevant politicians (e.g., through Senate confirmation, appearances at hearings in the Senate and in the House, and through being subject to reappointment.) The goals for these experts are stipulated by law and are kept simple. Other industrial democracies follow a similar approach – and over time have moved towards some aspects of US practice, although there are differences across countries in the weights attached to various objectives.
7) These experts need to have the ability to act in a responsive manner. As the economy and financial system change, officials must be able to adjust policy appropriately.
8) The Federal Reserve Accountability and Transparency Act (H.R. 5018), as currently drafted, would impose undue and excessive constraints on the ability of officials to respond fully and in a timely manner to changing economic and financial circumstances. Section B below explains my concerns in more detail.
9) The U.S. does have an unusual governance structure for monetary policy, relative to other leading central banks. In our Reserve Bank structure, bankers have a great deal of potential influence over the presidents on those banks – and these individuals serve on the Federal Open Market Committee (on a rotating basis, apart from the president of the New York Fed, who is a permanent member). In this way we have allowed private sector bankers to have much more potential sway over interest rates than is commonly the case in other high income countries today.
10) Section C of this testimony suggests that, if Congress is seeking to improve the governance of the Federal Reserve System, the New York Fed would be the best place to start. The

[4] For more on the economics of incentives around high leverage and the case for higher capital requirements, see Anat Admati and Martin Hellwig, *The Bankers' New Clothes*, Princeton University Press, 2013. See also the speeches and analytical work published by Tom Hoenig, vice chairman of the Federal Deposit Insurance Corporation (FDIC):
http://www.fdic.gov/about/learn/board/hoenig/capital.html, and
http://www.fdic.gov/about/learn/board/hoenig/capitalizationratios4q13.pdf (his Global Capital Index).

president of the New York Fed is one of the most powerful officials in the US (and the world). He (or she) is vice chairman of the FOMC and has a lead role in implementing monetary policy and in public debt management (effectively on behalf of the Treasury). This person has also played been important in deciding whether or not to bail out (or to force a "bail in") for particular sets of investors – and negotiating the detailed terms for such transactions. The president of the New York Fed should be a presidential appointment, subject to confirmation by the U.S. Senate. The operations of the New York Fed should not be under the control of a board of directors selected or suggested by financial institutions.[5]

B. Specific Comments on Proposed Legislation[6]

The Federal Reserve Accountability and Transparency Act, as currently drafted, appears to have three main goals. First, to put pressure on Federal Reserve policymakers to follow a specific monetary policy rule – stipulated in detail by Congress – that would determine interest rates, rather than allowing them to use their own best judgment. In part this would be achieved through the mechanism of "audits" of the Fed's monetary policy decision-making by the Government Accountability Office (GAO), acting under the direction of congressional committees.

The second goal is to require that the Fed publish all details of its regular stress tests for banks. And the third goal is to ensure that the Fed implement a particular form of cost-benefit analysis when it draws up regulatory rules.

There are some other smaller changes in the current draft, for example regarding the testimony that should be provided by the vice chairman for supervision, and requirements that should be fulfilled before entering into international negotiations.

I take up each of these points in turn below.

Monetary Policy Rule

Modern central banks put great emphasis on clear communication, both for their objectives and their actions. The Federal Reserve is no exception.

The proposed legislation heads in a different direction by attempting to specify in detail what should be the default rule determining monetary policy (i.e., the level of policy-controlled interest rates) and by establishing some narrow and very specific criteria for this rule.

The proposed framework raises the following specific questions:

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[5] New York has an appropriate interest in ensuring that its particular regional economic concerns are represented, but the way to do that is through an economic advisory committee -- not through a board of directors that has or appears to have a role in selecting management or overseeing the work of the reserve bank, including its employees, policies, and research.

[6] This section is responding to the version of June 30, 2014 (3:05pm), which I was sent by the committee.

a) What happens when measures of GDP are updated or revised, as happens with some regularity?
b) What is "the monetary aggregate" referred to the proposed new directive policy rules; Sec. 2C(a)(4)(C)(ii)?
c) In the calculation of the reference policy rate, what happens when real GDP is above potential GDP? Similarly, what happens when there is deflation (falling price level)?
d) What exactly is meant by "stable prices"? Similarly, what is the precise meaning of "maximum natural employment over the long term"?

The mechanism for the GAO audit is specified in some detail, and seems designed to put pressure on the Federal Reserve's Open Market Committee. The potential effect is likely to be chilling, creating obstacles to productive work and bringing more partisan pressure to bear.

If the GAO determines that the actual policy being followed is not in compliance with the framework specified here, the chairman of the Federal Reserve System must testify within 7 legislative days on this point.

The most unclear part of the proposed legislation is probably the section on the GAO audit, which says "the Comptroller General shall audit the conduct of monetary policy," and that this should be "upon request of the appropriate congressional committee." Also, I note that "Such committee may specify the parameters of such audit."

This would introduce a great deal of uncertainty into monetary policy making. What would be the criteria for such an audit? When and how exactly would those criteria be set? Would they vary across audits? What would be the effect or implications of such audits? Do they end up becoming some sort of repeated quasi-prosecutorial fishing expedition, with every single interest rate move being investigated?

The net effect on financial markets would be to increase volatility. This would presumably discourage investment and depress economic activity relative to what it would be otherwise.

Stress Tests

Recent rounds of stress tests have had some success in identifying weaknesses, both in the balance sheets and risk-management tools of large complex financial institutions.

These firms are now pushing back, arguing that they would like all details of the stress test requirements and related models to be published in advance – and moving away from any dimension of qualitative assessment. Large bank holding companies also want to force the Fed to disclose all aspects of its models, so that employees at these banks can more effectively game what they put in their submissions for the stress tests.

The legislative approach proposed here is not appealing, as it has the potential to turn the stress tests from a potentially useful tool determining capital adequacy to an uninformative box-

checking exercise. Even worse, if large financial institutions can find grounds for making a process complaint against the Fed, they will be able to use this to slow down or obstruct all forms of decision-making that have the potential to reduce the level of systemic risk.

Cost-Benefit Analysis

The legislation would create the onerous burden of a particular form of "cost-benefit analysis," along the lines of what the industry has tried to impose on regulators such as the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC).[7] As drafted, the legislation also appears to impose this kind of cost-benefit analysis on monetary policy decision-making.

Any well-functioning central bank, such as the Federal Reserve, considers the pros and cons of its actions. And the Fed's senior officials explain and defend its policies on a regular basis, in speeches, testimony, and in other formats.

For example, in formulating the recently finalized Volcker Rule—a process involving the Fed and other agencies—there was an extended period for comments, and a great deal of interaction between officials and the industry.

The cost-benefit analysis proposed here would slow down all forms of rule-making. Although this is not specified explicitly, it would presumably also open up decisions of the Federal Reserve's Board of Governors to broader judicial review. As we have seen with regard to other regulators, this can make it much harder to implement rules effectively and with any reasonable degree of certainty.

The legislation also stipulates that the regulators could find that "no regulation" is their preferred option. This could directly contradict congressional legislation that requires regulation on a particular issue. Regulators are supposed to work out the details of how to implement what Congress has decided; it is not their job to second-guess elected legislators on what should or should not be in the law.

There is also an important asymmetry in this "cost-benefit" process, from a legal perspective. In a typical instance, representatives of industry write many comment letters in which they claim there would be various costs – sometimes with considerable exaggeration. If the regulators do not take all of these details seriously (after all, this is a form of paid lobbying), they are sued by

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[7] For an assessment of why such analysis is not required and how it would impede SEC regulation, see "Setting the Record Straight on Cost-Benefit Analysis and Financial Reform at the SEC," a report by Better Markets, July 30, 2012. The same is true regarding CFTC rulemaking, as set forth in the Amicus brief filed by Better Markets in an industry challenge to a CFTC rule: https://www.bettermarkets.com/sites/default/files/DTCC%20v%20%20CFTC%20(DDC)%20Better%20Markets%20Amicus%20Brief%20For%20Filing.pdf. Litigation over applying cost-benefit analysis to the SEC and CFTC has had the effect of slowing down the design and implementation of rules required or implied by the Dodd-Frank Act.

the industry. However, if the regulators err on the side of the industry and impose rules that are too weak or ineffective, members of the public cannot generally sue – as they lack standing, despite the fact that they would benefit from an effective rule (e.g., the Volcker Rule, which limits proprietary trading and some other forms of excessive risk-taking that can damage the economy, including employment and other outcomes that matter a great deal for individual members of society).

"Cost-benefit analysis" of this precise form is therefore a legal ploy that tilts the playing field towards the industry. The goal is to create potential technical faults that can allow the courts to determine that the rule was not written properly or with full consideration for the industry opinions that were expressed. This slows down the regulatory process and makes it much more cumbersome – as has been the experience at the SEC and the CFTC. For example, failing to cite a study that was commissioned by the industry – and that did not have credible findings – can be enough to overturn a rule (or to send it back for more work).

The courts do not have the expertise or, under current interpretation, the mandate to assess the substance of cost-benefit analysis. This is purely about creating a procedural hurdle.

On these points, the net effect and perhaps unintended consequence of the legislation would be mostly to add red tape and procedural obstacles that will make it harder to operate effectively. This includes all forms of post-adoption assessment specified here in cumbersome detail. Adding such paperwork requirements is one way to ensure that bureaucracy and the size of government expands in an unproductive manner. This is not a good idea in general or an appealing approach to central banking.

In this context, it is striking, and a little odd, that the potential impact on price stability – and the Fed's ability to achieve such price stability – is not mentioned, for example under "additional considerations".

And any assessment of costs and benefits should definitely include the probability of a significant financial crisis, along the lines of what we experienced in 2008.[8] We should be careful not to put equal weight on all jobs created – for example, if these are of a purely rent-seeking nature or the result of massive, opaque, implicit government subsidies, they are presumably of less value from a social perspective.

To be effective, our central bank must retain some flexibility. Top experts should be and are appointed to the Board of Governors. They need to be allowed to do their job.

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[8] The costs of the last crisis were around one year's GDP. For more details, see this report by Better Markets, http://bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis_2.pdf.

Vice Chairman for Supervision

The Dodd-Frank Act requires that "The Vice Chairman for Supervision shall appear before the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives and at semi-annual hearings regarding the efforts, activities, objectives, and plans of the Board with respect to the conduct of supervision and regulation of depository institution holding companies and other financial firms supervised by the Board."

The legislation adds the requirement that if this position is vacant, the other vice chairman (or the chairman) should testify instead. This does not seem unreasonable.

We definitely need to make progress with regard to filling the position of vice chair for supervision at the Federal Reserve Board.[9] We also need this person to push forward with key parts of implementation for Dodd-Frank, including making the "living wills" for large financial institutions into something that can actually be used in a meaningful way (Title I), and ensuring that we have workable resolution procedures in case a large bank holding company fails (Title II). In this context, we need a funding structure for bank holding companies that is comprised primarily of "loss-absorbing" liabilities – preferably in the form of common equity.

International Negotiations

The legislation seeks to impose a longer and more formal comment period, in the event that the Federal Reserve or the FDIC wants to enter into international negotiation.

Given the importance of cross-border issues for potential resolution of failing financial institutions, imposing such a requirement would make it harder to put in place any kind of workable regime. This would be most regrettable as it would make it harder to fully end any notion that some firms are "too big to fail".

Large firms are also opposed to effective cross-border capital requirements, particularly those focused on leverage (i.e., without using risk-weights). As currently drafted, the legislation would assist large international banks in resisting sensible capital regulation.

More generally, international standards for banks and some other financial institutions are now being raised. The industry is determined to slow this process down as much as possible.

[9] For more on this specific point, see the paper by Peter Conti-Brown and Simon Johnson, cited in footnote 2 above.

C. Governance and the Federal Reserve System[10]

The current draft of this legislation does not address what may be the most important current governance issue within the Federal Reserve System: the appointment and responsibilities of the president of the Federal Reserve Bank of New York. At the heart of this issue is an unfortunate anachronism – the mechanism that determines who sits on the board of directors of the New York Fed.[11]

The New York Fed staff is comprised of smart, highly professional people who work hard to make the financial system more stable. At the same time, both the New York Fed and the Fed's Board of Governors, which is responsible for all aspects of how the New York Fed operates – including who sits on its board – seems to have developed a tin ear with regard to governance issues and how these can threaten the Fed's independence.

As with all other regional Federal Reserve Banks, the New York Fed's board, working with senior staff members, picks potential board members, all of which are subject to approval by the Fed's Board of Governors in Washington.

Senator Jack Reed of Rhode Island addressed this issue during the debate on Dodd-Frank in 2010,[12]

> "Although the Senate bill included my proposal to require the head of the Federal Reserve Bank of New York to be Presidentially appointed and Senate confirmed, the provision was stripped out during conference. If the Governors of the Federal Reserve System in Washington are required to be confirmed by the Senate, then the President of the Federal Reserve Bank of New York, who played a pivotal and perhaps more powerful role in obligating taxpayer dollars during the financial crisis, should also be subject to the same public confirmation process. Wall Street should not have the ability to choose who is in such a powerful position. Although the final bill limits class A directors--who represent the stockholding member banks of the Federal Reserve District--from participating in the process, it still allows the other directors, who could be bankers or represent other powerful interests, to vote for the head of the New York Reserve Bank. I believe that more still needs to be done to make this position truly accountable to the taxpayers."

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[10] Governance issues at regional Federal Reserve Banks, including the composition of their boards of directors, were raised in an earlier version of the Federal Reserve Accountability and Transparency Act (H.R.3928): http://thomas.loc.gov/cgi-bin/query/F?c113:1:./temp/~c11378f0UD:e25955:, which proposed to eliminate Class C directors.

[11] For more details on the evolution of governance at the Fed over time and the importance of the 1935 Banking Act in this regard, I recommend the forthcoming book by Peter Conti-Brown, *The Structure of Federal Reserve Independence* (Princeton University Press, 2015).

[12] See http://www.reed.senate.gov/news/speech/floor-statement-on-the-dodd-frank-wall-street-reform-and-consumer-protection-act.

Senator Reed's analysis remains correct on all points. The president of the New York Fed occupies an office with great powers, both with regard to monetary policy – as vice chair of the FOMC and as a key implementer of FOMC policy – and with regard to regulation (as the eyes and ears of the Fed system on Wall Street). He (or she) also matters for fiscal policy – a Treasury function – because the New York Fed serves an important interface between the official sector and the market for government debt. These are not powers that rotate among other regional Fed presidents.

Under Dodd-Frank, Class A directors (bankers representing bankers) no longer participate in the selection of regional Fed presidents. But Class B directors are non-bankers elected by bankers (supposedly to represent the public). And the Class C directors at the New York Fed have, with some prominent exceptions, been noticeably close to big banks.

Class C directors should become more independent of the banking sector – their responsibility is to watch out for the economy as a whole, not for one specific interest group. This could be achieved by the Board of Governors shifting its criteria for the people who become Class C directors, particularly at the New York Fed. Abolishing Class C directors would not be a good idea, as this would put more hands in Class B directors, who are appointed by the banks.

In addition, it would be much more consistent with best practice internationally and elsewhere in our political system if the president of the New York Fed were to be appointed by the president of the United States, subject to confirmation by the U.S. Senate.