Testimony of Mark A. Calabria, Ph.D.

Director, Financial Regulation Studies, Cato Institute

Before the

Committee on Financial Services

United States House of Representatives

Hearing entitled "Legislation to Reform the Federal Reserve On Its 100-Year Anniversary"

July 10, 2014

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Chairman Hensarling, Ranking Member Waters, and distinguished members of the Committee, I thank you for the invitation to appear at today's important hearing. I am Mark Calabria, Director of Financial Regulation Studies at the Cato Institute, a non-profit, non-partisan public policy research institute located here in Washington, D.C. Before I begin my testimony, I would like to make clear that my comments are solely my own and do not represent any official positions of the Cato Institute. In addition, outside of my interest as a citizen and taxpayer, I have no direct financial interest in the subject matter before the Committee today, nor do I represent any entities that do.

Let me first commend the Chairman, along with Subcommittee Chair Campbell, on the establishment of the Federal Reserve Centennial Oversight Project. Every government program should be reviewed regularly and subjected to vigorous oversight. The American people deserve nothing less. I can think of no part of the federal government more in need of review than the Federal Reserve.

It should also be clear that review and oversight of the Federal Reserve is likely to be insufficient. Legislative change of the Federal Reserve's structure, powers and operating procedures is badly needed. While neither I nor the Cato Institute endorse specific pieces of legislation, as a general matter, I do believe the general principles behind the "Federal Reserve Accountability and Transparency Act of 2014" are sound and admirable. My testimony will touch upon the various sections of this legislation, offering both minor technical and substantive changes, as well as broader changes that should be considered.

"Federal Reserve Accountability and Transparency Act of 2014"

Sec. 2 Requirements for Policy Rules of the Federal Open Market Committee; Limited Fed GAO Audit Requirement

It has long been accepted in the economics profession that discretionary monetary policy has an "inflation bias". The problem is that in the short run "surprise" inflations by a central bank can produce increases in employment and output. Over time, however, market participants come to anticipate this inflation with employment and output reverting to baseline. The result is higher inflation but no long-run improvement in either employment or output. To the extent that inflation distorts relative prices, economic efficiency is lost and the increased level of inflation can result in reduced employment and output. We saw such an outcome arise here in the U.S. in the 1970s.

It is not surprising that the 1970s also witnessed a re-birth[1] in the economic debates over rules versus discretion in monetary policy[2], most associated with the work of Kydland and Prescott[3], Calvo[4], McCallum[5], as well as that of Barro and Gordon[6]. As my fellow panelist, John Taylor, was an important active contributor to that debate[7], there is probably little I could add to his insights in this area. I will however make a few observations about the issue that bear some emphasis.

First, all policy decisions are based upon models. To take action A one must believe that outcome B will result. That's a model. Generally policymakers do not explicitly state the parameters of their model, but such does not imply there is no model. In terms of monetary policy, the existence of the Fed's "dual mandate" implies a particular model as to the effect of monetary policy. Of course to have a model is not necessarily having an accurate representation

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[1] For an overview of earlier debates see Robert Hetzel (1985), "The Rules versus Discretion Debate Over Monetary Policy in the 1920s," *Economic Review*, Federal Reserve Bank of Richmond; and George Tavlas (2014), "In Old Chicago: Simons, Friedman and the Development of Monetary-Policy Rules," Becker Friedman Institute, University of Chicago, Working Paper #2014-02.

[2] For an overview of this literature see Chapter 7 of Carl Walsh (2010) *Monetary Theory and Policy*, 3rd edition, the MIT Press; as well as Alesina, A. and A. Stella (2010), "The Politics of Monetary Policy," *Harvard Institute of Economic Research* Discussion Paper #2183.

[3] Kydland, F. and E. Prescott (1977), "Rules rather than discretion: The inconsistency of optimal plans," *Journal of Political Economy*, 85, 473-490.

[4] Guillermo Calvo (1978), "On the Time Consistency of Optimal Policy in a Monetary Economy," *Econometrica*, Vol. 46, No. 6 (Nov), pp. 1411-1428.

[5] McCallum, Bennett (1984), "Monetarist Rules in the Light of Recent Experience," *American Economic Review* 74: 388-91.

[6] Barro, R. and D. Gordon (1983), "Rules, Discretion, and Reputation in a Model of Monetary Policy," *Journal of Monetary Economics*, 101-121; and Barro, R. and D. Gordon (1983), "A Positive Theory of Monetary Policy in a Natural-Rate Model," *Journal of Political Economy*, 91.

[7] See among others, John Taylor (1985) "What Would Nominal GNP Targeting Do to the Business Cycle?" *Carnegie-Rochester Conference Series on Public Policy* 22: 61-84.

of reality. Many models used in economics are quite elegant and well constructed, yet lack much semblance to reality. Whether stated explicitly or not, and whether accurate or not, the Federal Reserve is currently operating under a particular policy model of our economy.

What Section 2 of the bill under consideration does is require the Federal Reserve to reveal that model to the rest of us. Section 2 does not require a specific model. In no way does it limit the Fed's choice of model. It simply requires that the Fed publicly share that model. All of the Fed's actions in recent years would have still been possible had Section 2 been in place. There is nothing in Section 2 that is inconsistent with the Fed's "dual mandate". Nor is there anything in Section 2 that would require the Fed to raise (or lower) rates. There is no compromise of the Fed's operational independence.

Why is it important to reveal the Fed's current operating model? So that it can be examined and tested by those outside the Fed. Only under such examination can we learn how accurately that model captures the real world. Forcing the Fed to specify and reveal its operating model would push the Fed to be clearer in its deliberations and better focus the conduct of monetary policy.

My own criticism of Section 2 is that it leaves the Fed with too much discretion. Again there is nothing in Section 2 that requires the Fed to make different choices. For instance one issue which led the Fed astray in the past is its estimate of potential GDP. As former Obama economic advisor Christina Romer and her husband have noted, one of the Fed's mistakes in the 1960s was in assuming a very large potential GDP relative to actual GDP.[8] Similar debates are

[8] Christina Romer and David Romer (2002), "The Evolution of Economic Understanding and Postwar Stabilization Policy," in *Rethinking Stabilization Policy*, Federal Reserve Bank of Kansas City, pages 11-78,

happening today. The process of the Fed learning from its 1960s mistakes was a costly and painful one. With greater transparency over the Fed's decision-making, we may avoid having to incur those large costs again.

In summary, while I would place tighter constraints on Fed decision-making, Section 2 as drafted represents a significant improvement in transparency and accountability for the Federal Reserve that has considerable potential to improve the quality of decision-making at the Fed.

Sec. 3. Federal Open Market Committee Blackout Period

While I believe the Federal Reserve's current blackout period, in which members of the FOMC do not engage in public appearances, is generally a wise policy, I also believe the concerns expressed in Section 3 of the bill are very real. At times the Fed's current blackout policy has been used as a cover to ignore Congressional inquiries and stymie Congressional oversight. I can think of no reason that the Fed's current blackout period apply to prudential or supervisory matters. Allowing discussion of such matters, as does Section 3, is a useful clarification that can improve Congressional oversight of the Fed's regulatory efforts.

Sec. 4. Transparency of Stress Test and Regulatory Activities

Stress tests have become a central feature of the Federal Reserve's oversight of large financial institutions. These stress tests have been developed largely as private negotiations between the largest banks and the Federal Reserve. Given their increased importance, and often questionable assumptions, I believe it is crucial that the parameters and structure of the stress tests be subject to a public rulemaking process.

Although the stress tests are advertised as an avenue for reducing systemic risk, I am very concerned that as practiced they may actually increase it. First, I believe the financial crisis demonstrated, among other things, the failure of a heavy reliance on mathematical modeling. The Fed stress tests continue to rely upon a number of questionable statistical assumptions, such as normality, that have been shown to underestimate tail risk. The stress tests run a very real risk of being a substitute for sound risk management rather than a complement.

Perhaps the greatest danger from the stress tests is that they encourage greater uniformity across bank balance sheets. We have seen how the Basel Capital Accords have encouraged banks to herd into similar assets, such as mortgage-backed securities and sovereign debt. When everyone is a holder of a particular asset, there are few buyers when everyone wants to be a seller. This can contribute to the severity of fire sales and cause shocks to particular asset classes to become systemic when they would otherwise not. A more robust financial system would be one with a greater diversity of asset holdings, business models and funding sources. The stress tests are encouraging greater homogeneity in our financial system. Perversely the Stress Tests themselves may become a significant source of systemic risk. The Cato Institute will shortly release a policy paper detailing many of the failings of the current stress tests[9]. Greater congressional and public input may help to reduce this risk.

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[9] Kevin Down (forthcoming) *Math Gone Mad: Regulatory Risk Modeling by the Federal Reserve*. Cato Institute Policy Analysis.

Sec. 5. Appearances before the Congress

Given the central role of the Federal Reserve in our financial markets and larger economy, coupled with its lack of transparency and accountability, increased congressional oversight of the Federal Reserve is crucial. The shift in Section 5 from a minimum twice yearly to quarterly congressional testimony for the Federal Reserve Chair would help to improve communications between Congress and the Federal Reserve.

Such a change would be particularly important to more junior members of the Committee. Generally the committee chair and ranking member will have some regular access to the Federal Reserve Chair. Such access is not evenly shared across the Committee. To some extent that is to be expected and appropriate. Additional scheduled Federal Reserve Chair appearances, however, would help to "democratize" the Committee's relationship with the Federal Reserve.

It would also help to strengthen the Federal Reserve's independence from the executive branch. The Federal Reserve Chair generally meets on a regular basis with the Treasury Secretary. It would be an understatement to say that the Federal Reserve has often acted as an adjunct of the executive branch in recent years. This behavior has greatly undermined the Federal Reserve's independence from the executive branch. Section 5 would offer a small step in helping to restore that balance and independence.

Sec. 6. Vice Chairman for Supervision Report Requirement

The Section 6 requirement that the Federal Reserve's Vice Chairman for Supervision report on pending and anticipated rulemakings would be a welcomed change. Such a report would allow greater public awareness of Federal Reserve rulemakings and hopefully encourage a greater diversity of public commentary on those rules. It would also be useful if this report on pending and anticipated rulemakings was concurrent with the testimony published in the Federal Register.

Sec. 7. Economic Analysis

As a general matter we as a society should prefer that regulations be structured in such a manner, within the statutory discretion given, that maximizes benefits and minimizes costs to society and not simply select parties. Obviously all policies are subject to both costs and benefits. There are no "free lunches" in terms of either regulation or statute. As the Committee is aware, the Federal Reserve is not required by statute to conduct cost-benefit analysis. It should be. Cost-benefit analysis also nudges regulators to state the assumptions behind the regulations in question. This allows clear thinking about the impact of such regulations.

First the Federal Reserve clearly has the capacity. The Federal Reserve Board employs hundreds of Ph.D.-level economists. The regional Federal Reserve Banks also employ hundreds. Perhaps only the USDA has more economists on staff. So clearly there isn't a lack of staff available and capable of performing cost-benefit analysis. The Federal Reserve should and could do so today.

Some might object that requiring the Federal Reserve to conduct cost-benefit analysis would slow or stifle the regulatory process. Similar concerns were expressed when the Administrative Procedures Act was passed in the 1940s. That notice and comment would slow the process. That public input would slow the process. One could argue that having two houses of Congress slows the legislative process. But our objective should not be speed but quality. All too often in Washington, policymakers sacrifice deliberation and diligence for speed. The question should be: would cost-benefit analysis improve the quality of regulations issued?

After decades of cost-benefit analysis conducted by agencies other than the financial regulators several things should be clear. First, the requirement of cost-benefit analysis has not brought the regulatory state to a standstill. Look at the Environmental Protection Agency if you want to see how cost-benefit analysis has not stopped an agency from issuing expansive, costly regulations. Second, cost-benefit analysis has expanded the parameters of the regulatory debate and forced agencies to consider a broader range of options than they would have otherwise. Given how badly the Federal Reserve suffers from groupthink, anything that forces the consideration of a greater diversity of options is likely to improve the process.

To be effective we must insure that cost-benefit analysis within an agency is independent of the rule-making process. Too often agencies have allowed the program offices writing and implementing regulations to oversee the cost-benefit analysis. In some agencies the General Counsel's office has directed the cost-benefit analysis. The conflict of interest here should be blindingly obvious. I would add to Section 7 a requirement that cost-benefit analysis within the Federal Reserve be conducted by an independent office within the Federal Reserve and be reported directly to members of the Board.

Sec. 8. Salary Disclosure, Office Staff of the Fed Board & Ethics Requirements

The salary disclosure and ethics requirements in Section 8 strike me as reasonable and representative of what other regulators are subject to. The disclosure burden also strikes me as quite minimal.

Of greater importance is Section 8's requirement that each Federal Reserve Board member have their own dedicated staff, with a minimum of two members. This is the norm for many agencies, such as the Securities and Exchange Commission,so there's certainly nothing unusual here. Given the Chair's control over the Federal Reserve staff, I believe allowing each board member to have some dedicated staff would help those members engage in Federal Reserve decision-making in a more informed manner. Such would allow a greater diversity of viewpoints to be heard in Board meetings. Such a change could help reduce some of the groupthink that so dominates the Federal Reserve. This would be particularly important for non-economists on the Board who are forced to rely heavily upon the staff economists and defer to Board members who are economists. Likewise the economists on the Board would benefit from having dedicated legal staff to help them interpret relevant statutes and regulations. I see this change as perhaps one of the more important in the bill and one that should be relatively uncontroversial.

Sec. 9. Requirements for International Negotiations

Given the secretive nature of international negotiations on financial regulations, and the prevalence of groupthink among the World's financial regulators, I believe the disclosure requirements of Section 9 are badly needed. Section 9 would assist Congress and the public in providing greater oversight of the international negotiations of financial regulators, helping to insure that a greater diversity of voices is heard outside the financial establishment.

Some Additional Suggestions

A number of the provisions of the "Federal Reserve Accountability and Transparency Act of 2014" would improve the decision-making process at the Federal Reserve without mandating a particular outcome. To some extent these provisions do so by increasing the diversity of perspectives incorporated into the Federal Reserve's monetary and regulatory policy-making process. I believe the Federal Reserve suffers from substantial groupthink and is badly in need of vigorous and open debate. The narrow views that dominate the Federal Reserve must be expanded if we are to avoid future harm to our economy.

In that spirit, I would suggest the Committee consider the following additional provisions: Section 10 of the Federal Reserve Act establishes a variety of qualifications for Board membership, including a requirement for geographic diversity. That requirement has regularly been ignored. I find it troubling that several members of the Board hold position in direct violation of Section 10 of the Federal Reserve Act. Section 10 has been violated in the past with tortured definitions of residency that effectively render the statute a dead letter. Most recently, when MIT Professor Peter Diamond was nominated, it was claimed that a single lecture he delivered at Northwestern University made him a Chicago resident. Such disrespect for the law would be laughable if it were not so damaging. I would urge the Committee to clarify the geographic residency qualifications of Section 10 of the Federal Reserve Act. Doing so would allow a greater portion of our country to be represented on the Board, as opposed to the usual Wall Street dominance of the Federal Reserve Board.

The independence of the Federal Reserve from the executive branch has greatly been eroded over time by the revolving door between the Federal Reserve and economic policy-makers in the executive branch, particularly the Treasury Department and the President's Council of Economic Advisors. I would suggest the Committee institute a ban on Federal Reserve Board membership for any person holding an appointed position in the executive branch in the four years preceding the appointment.

While several provisions of the "Federal Reserve Accountability and Transparency Act of 2014" would improve the supervisory and rule-making process at the Federal Reserve, I believe we should ultimately remove the Federal Reserve from the area of financial regulation. Their track record in that area has not exactly been impressive. I would suggest the Committee transfer the Federal Reserve's financial regulatory and supervisory responsibilities to the Federal Deposit Insurance Corporation (FDIC). While the FDIC has had it failings, they pale in comparison to those of the Federal Reserve. Recent scholarship has also found that separating banking supervision from monetary policy leads to better outcomes both in terms of macroeconomic and financial stability.[10] Removing financial regulatory responsibilities from the Federal Reserve would also increase its independence in the area of monetary policy. The so-called Greenspan "put" was an expectation by markets that Fed liquidity would be provided whenever financial markets were stressed. If the Fed has responsibility for the health of financial

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[10] See Barry Eichengreen and Nergiz Dincer, *Who Should Supervise? The Structure of Bank Supervision and the Performance of the Financial System*, NBER Working Paper No. 17401 September 2011 http://www.nber.org/papers/w17401

institutions it faces the temptation to use monetary policy to offset its regulatory failings, reducing the ability of financial markets to weed out poorly managed firms.

Some may object to the proposals offered in the bill under debate. The mostly likely objection is that it undermines the ability of "experts" to pursue the "correct" policies free of political independence. This view ignores that the so-called experts at the Fed had vast discretionary powers before the crisis and failed to use them. Regulators did not lack for powers. They lacked for wisdom. They lacked for proper incentives. And of course they lacked for information and knowledge. Our founding fathers rightly rejected the view that we should be governed by experts insulated from politics (that is democracy). The great strength of American government is its checks and balances. Exempting the Fed from these checks and balances will lead to worse outcomes not better.

Conclusions

I want to again thank the Chairman and Ranking Member for the invitation to appear at today's important hearing. There are few parts of the federal government with less transparency and accountability than the Federal Reserve. This is all the more troubling given the Federal Reserve's outsized role in our economy. Its failings have inflicted substantial harm on our labor market, our financial markets and the financial health of American households. Without substantial reform, the Federal Reserve is almost certain to continue its record of failure.[11] I applaud the Committee for holding today's hearing and for its effort to improve the functioning of the Federal Reserve. I can think of few issues more pressing.

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[11] George Selgin, William D. Lastrapes, Lawrence H. White, "Has the Fed been a failure?", *Journal of Macroeconomics*, Volume 34, Issue 3, September 2012, Pages 569-596