Monetary Policy for Healthy Economic Performance

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Chairman Barr, ranking member Moore and members of the Committee, I appreciate this opportunity to present my views on the Federal Reserve's monetary policy. I begin with the ultimate goal of sustained healthy economic growth and higher standards of living. This of course is a laudable objective, but it requires the correct set and mix of policies. Policymakers must identify which policy tools are appropriate to achieve desired economic performance and the proper mix of policies. While fiscal, tax and regulatory policies heavily influence economic outcomes, today's hearing focuses on the Fed's conduct of monetary policy.

Two things have become obvious during the 2002-2007 economic expansion that was marked by the debt-financed housing bubble, the financial crisis and deep recession of 2008-2009 and the current lengthy but slow-growth expansion. First, monetary policy plays a critical role—and serves best by being even-keeled and pursuing a low inflation target during expansions and actively countercyclical in response to downturns and financial crises. Second, there are limitations to what monetary policy can achieve, as some of the sources of under-performance in the economic and labor market are beyond the control of monetary policy and best addressed through other economic, fiscal and regulatory policies—and pushing monetary policy beyond its limits does not improve performance but instead generates risks and uncertainties that undercut desired economic objectives.

The Fed's creative emergency measures during the 2008-2009 crisis helped stabilize financial markets and avert an even deeper and more damaging recession, but the efficacy of its sustained artificial low interest rates and massive asset purchases, well after the start of the economic recovery is questionable. It has not stimulated faster growth and has distorted economic and financial performance, and poses sizeable risks.

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The Fed's efforts to stimulate economic growth and employment, lift wages and improve other labor market conditions has extended the role of monetary policy beyond its normal scope. The Fed's massive asset purchase programs and maintenance of an excessively large balance sheet have crossed the border into fiscal policy and credit allocation. Confusion about the proper role of monetary policy and what it is capable of achieving relative to tax, fiscal and regulatory policies has made Congressional oversight of the Fed much more difficult.

The economy is now growing on a self-sustaining basis and is far beyond the point of needing the Fed's excessive monetary ease as a crutch. Now it is time to institute changes that set monetary policy on a course consistent with sustained healthy economic performance and establish a framework for dealing with emergency situations. The Fed should continue to normalize interest rates and modify its balance sheet unwind strategy. A framework needs to be established that clarifies the proper scope and operational conduct of monetary policy during emergency situations, along with the roles of the Treasury and Congress.

The Expanded Scope of Monetary Policy

Even after the economic recovery gained traction and was self-sustaining, the Fed dramatically expanded its balance sheet through massive purchases of treasury and mortgage-backed securities (MBS) while maintaining zero interest rates, all in an effort to stimulate economic growth and job creation. The Fed's macroeconomic models predicted that through the "real balance effect", maintaining low rates and providing more excess liquidity would encourage risk-taking and push up asset prices, all of which would stimulate faster growth in aggregate demand.

In reality, the Fed's QEIII and forward guidance stimulated financial markets and home values as predicted, but the response of aggregate demand was tepid at best—in fact, nominal GDP, the broadest measure of current dollar spending in the economy, actually decelerated. In the four years following the implementation of QEIII (through 2016Q4), nominal GDP growth averaged 3.7%. Most striking, business investment growth remained disappointing even though the Fed was successful in reducing the real costs of capital and business profits and cash flows were rising to record levels. Employment rose and the unemployment rate receded, but wage gains fell far shy of expectations.

The economy would have grown along its modest pace and jobs gains would have occurred even if the Fed had not engaged in its asset purchases and would have gradually normalized interest rates. Not surprisingly, the Fed's interpretation of the slow growth has been different. It takes full credit for the

increase in employment. Until recently, the Fed argued that any monetary policy normalization would have sidetracked the economic expansion. These positions seem to reflect a good deal of hubris, but nevertheless led the Fed to delay unwinding its balance sheet out of fear of any negative repercussions on the economy or financial markets.

History has shown clearly that following countercyclical monetary accommodation, once an economic recovery from recession has taken hold, Fed rate increases back to neutral do not harm economic growth. Granted, there is no experience of unwinding an excessively large balance sheet, but it is highly unlikely that a gradual unwind that still leaves an ample amount of excess bank reserves would harm performance.

The economy's lackluster response to the Fed's stimulus highlights the important influences of other factors and policies, and the Fed's limitations in achieving certain economic objectives. The Fed's efforts to stimulate the economy through monetary policy have been countered to a large degree by counterproductive government tax and regulatory policies. In general, a growing web of regulatory burdens and uncertainties about future tax and regulatory policies—at the Federal and state and local levels in both the financial and nonfinancial sectors—have constrained economic activity.

Banks have been deterred from lending by the burdensome regulations imposed by Dodd-Frank and the Fed's stress tests, as well as the Fed's policy of paying interest on excess reserves (IOER), which may have led banks to park excess reserves at the Fed. These factors have clogged the monetary policy channels. In the nonfinancial sector, the increasingly burdensome tax and regulatory environment has constrained business and household spending. Of note, uncertainties about these government-imposed burdens have led businesses to raise their required hurdle rates for investment projects, offsetting the attractiveness of low costs of capital. This has led businesses to scuttle investment expansion plans. The Fed's overly-cautious forward guidance ("if we raise rates at all it may throw the economy back into recession") may have added to business and household caution. In addition, low interest rates have increased demand for holding money. As a result of these factors, despite the dramatic surge in the Fed's monetary base resulting from the Fed's asset purchases, in recent years M2 has grown at a modest 6% rate and nominal GDP has grown even more slowly, reflecting the persistent decline in money velocity.

Along with weak productivity gains, the tepid response of nominal GDP to the Fed's unprecedented efforts to stimulate activity has been a key reason why inflation has remained below the

Fed's 2 percent target. Along with soft productivity gains, it has also served to constrain wage increases. Inflation results from excess aggregate demand relative to real productive capacity. With nominal spending growth during this expansion through 2016Q4 hovering around 3.5% and estimates of real potential growth centering close to 2%, inflation has settled around 1.5%. To put this into historic context, nominal GDP grew 5.3 percent annualized during the 2001-07 expansion and at a 5.6 percent pace during the 1990s.

In addition to the slow productivity, soft growth of aggregate product demand has influenced wage and price setting behavior. Businesses know that the soft aggregate product demand environment constrains their flexibility to raise product prices, which reduces their willingness to grant higher wages. In the last two quarters (2017Q3-Q4), nominal GDP has accelerated to a 4.6% growth pace and productivity has picked up. If these trends are sustained, wage gains will rise.

The Fed's Balance Sheet

The Fed's asset purchases ballooned its balance sheet to $4.45 trillion by mid-2014. The Fed's policy of reinvesting maturing assets has maintained that level of assets. The Fed's portfolio includes $2.5 trillion of U.S. Treasury securities of various maturities and $1.8 trillion of MBS, primarily with long maturities. The Fed is now the largest holder of each, with 17 percent of outstanding federal publicly held debt and 12 percent of MBS outstanding. (The Fed's holdings of Treasuries are counted as publicly-held debt because the Federal Reserve Banks are legally capitalized by the private-sector banks in their districts). Prior to the financial crisis, the Fed's balance sheet was roughly $850 billion, comprised nearly entirely of short-term Treasuries and other liquid securities.

The Fed's out-sized balance sheet and its MBS holdings directly infuses monetary policy into fiscal and credit policies, and involves significant risks, including risks to the Fed's independence. The Fed's significant earnings—it effectively funds its long-dated portfolio with short-term borrowing—are remitted to the US Treasury. These remittances peaked at $117 billion in Fiscal Year 2015 and have receded to roughly $81 billion as average bond yields have fallen and the Fed has raised its Federal funds rate, which triggers higher IOER to commercial banks. These remittances have reduced budget deficits, but they entangle the Fed's monetary policy in the government's budget and fiscal policy in unhealthy ways and involve sizeable risks to current and future taxpayers.

Congress has a tendency to view the Fed's remittances as risk-free and permanent (it has already taken advantage of the Fed's balance sheet and profits to fund some spending legislation) and maintaining the

Fed's balance sheet involves sizeable interest-rate risks. Such risks may undercut the Fed's credibility and threaten its independence. The interest rate risks should be taken seriously. The Congressional Budget Office has estimated that a 1 percentage point increase in interest rates would raise budget deficits by $1.6 trillion over its 10-year projection period. Such a rise from current low levels would not be a surprise: the Fed's official forecasts call for a rising Fed funds rate, sustained economic growth and 2% inflation, and economic momentum is building.

The Fed's efforts to be more transparent about monetary policy should include a clear and honest assessment of the government's budgetary risks of its sustained outsized balance sheet. Congress must be more aware of the interest rate risks, and understand that taking advantage of the Fed's contributions to temporarily reducing deficits to finance spending programs is inappropriate and imprudent.

The Fed's sustained holdings of MBS directly involve the Fed in credit allocation and are inappropriate. The Fed's first MBS purchases at the height of the financial crisis in November 2008 had a distinct purpose—to stabilize a completely dysfunctional and illiquid market that posed a threat to global markets. Soon after these first purchases, then Fed Chair Bernanke stated that the MBS purchases were in response to an emergency situation, and that the Fed would unwind them on a timely basis. Instead, the Fed added dramatically to its MBS holdings through QEII, QEIII, and has maintained them through its reinvestment policy.

The Fed's MBS holdings effectively favor mortgage credit over other types of credit. Mortgage markets are functioning normally with sufficient liquidity, and even a casual observation of the housing market suggests that the Fed's ongoing explicit subsidies of the housing sector are irrational.

The Fed's LSAPs have not involved purchases of equities. Some financial market participants and fiscal policymakers have argued that it may occasionally be appropriate for the Fed to buy equities. It is not, under any circumstances. In emergency situations—so-called "unusual and exigent circumstances"—the Fed's efforts to stabilize financial markets would be much better served through temporary loans of other specified liquid financial securities, without the excess economic and political baggage of absorbing equities into its portfolio. Purchases of equities would be very risky on many dimensions, and should be deleted from the Fed's potential monetary policy "tool kit".

Recommendations for the Conduct of Monetary Policy

The Fed should continue to normalize monetary policy: it should continue to raise rates, but it should modify its balance sheet unwind strategy to gradually eliminate its entire holdings of MBS and aim to reduce its total asset holdings more than it is currently suggesting. These steps would not harm the economic expansion but would reduce distortions and improve the health of financial markets while reducing the risks involved in the Fed's current balance sheet policies.

In addition, the Fed needs to adopt a flexible rules-based approach of conducting monetary policy and establish clearer rules for when and how it executes emergency monetary operations. The roles of the Treasury and Congress must also be clarified. A flexible rules-based approach would be a favorable change from its current discretionary approach, increasing its transparency and enhancing the ability of Congress to supervise the Fed.

Interest rate and balance sheet normalization. Currently, the Fed funds rate is below inflation even as the real economy is growing above standard estimates of potential and gaining momentum. The Fed should continue to raise its target rate toward the natural rate of interest plus the Fed's 2 percent longer-run inflation target, consistent with its official forecast of the appropriate path of the Fed funds rate.

With the economy operating near estimates of potential and the unemployment rate below estimates of its natural rate, an acceleration of economic growth would naturally require quicker rate increases, while a material economic slowdown should slow the pace of normalizing rates. Tax or fiscal legislation that raises economic growth and expected returns on investment would be associated with a rise in the natural rate of interest. This should lead the Fed to adjust up its trajectory and end-point of the appropriate Fed funds rate.

The Fed should maintain its longer-run inflation target of 2 percent, but tolerate a lower range of inflation if inflationary expectations remain well-anchored and are not a factor that influences household or business spending and investing decisions. This is more in keeping with the Volcker-Greenspan consensus during the successful economic period known as The Great Moderation. The Fed should express less worries that inflation is too low; rather, the low inflation is favorable for economic performance. The Fed must tone back its tendency to fine-tune the economy and acknowledge that its best contribution to sustained healthy economic growth is to maintain an even-keeled monetary policy consistent with stable, low inflation.

The Fed has embarked on its current strategy of very gradually and passively unwinding its large portfolio of treasuries and MBS that involves reinvesting all but a small fraction of maturing assets ($6 billion per month in treasuries and $4 billion per month in MBS). It will gradually increase those amounts of unwind as deemed appropriate. The Fed has not set an official strategy for the size of balance sheet it ultimately aims to maintain, but several Fed members have stated that the goal should be to keep the balance sheet sufficiently large in order to maintain a large amount of excess bank reserves. Governor Jerome Powell, the nominee to be Fed Chair, has stated the aim of reducing the Fed's portfolio to $2.5-$3.5 trillion. Based on the current $1.5 trillion in currency in the economy, this implies the Fed would maintain over $1 trillion of excess bank reserves. Other Fed members have mentioned $3 trillion.

This strategy should be modified in two ways. First, the Fed should reset its strategy to fully unwind its MBS portfolio, but make it sufficiently gradual such that the mortgage market is allowed to absorb the Fed's reduced role in the MBS market. Although the bulk of the Fed's MBS holdings are of long maturity, their duration is significantly shorter, reflecting the natural amortization of mortgages and principle pay downs. Accordingly, this MBS unwind likely could be nearly fully achieved over a five year time period. The key point is the Fed should establish a reasonable unwind strategy and stick to it.

The Fed's intention of maintaining a large balance sheet and buffer of excess reserves implies a shift from pre-financial crisis operating procedures. The Fed would continue to remit substantial profits to the Treasury. Under this procedure, the Fed would continue its post-crisis policy to pay IOER and manage the effective Federal funds rate through a "floor system". This contrasts to its historic reliance on a market-based "corridor system". The Fed's argument for this new strategy is that it would benefit the Fed's conduct of monetary policy and enhance its ability to stabilize financial markets. I am not convinced of the benefits of this new procedure relative to its costs in terms of the Fed's expanded financial footprint and its ongoing exposure to fiscal policy and associated economic and political risks. However, this preference is less important than the higher priorities of fully winding down the Fed's MBS holdings and reining in the scope of monetary policy. More thorough cost-benefit analysis of this issue is required rather than agreeing to the Fed's arguments.

Resetting monetary policy. Resetting monetary policy to a flexible rules-based approach would steer the Fed away from a fully discretionary approach and its short-term oriented tendency to fine-tune the economy toward a flexible rule that operates as a guideline that focuses the Fed on a longer-term

strategy of achieving its dual mandate. One benefit of this approach would lead the Fed toward conducting monetary policy within its natural scope and avoid discretionary polices that historically have been the source of mistakes and undesired economic outcomes.

The debate about implementing a rules-based policy has been influenced by the notion that it would unduly constrain the Fed and prevent it from responding to an economic downturn or financial crisis. That is not its intention or the intention of pending legislation. Rather, a rules-based approach would be used as a guideline, and would allow the Fed to deviate from the rule, but require that the Fed explain those deviations to Congress and the public. This would improve transparency and facilitate improved Congressional supervision of the Fed. It would also be an important tool for reaching an understanding about the limitations of monetary policy and its proper role among other economic policies in achieving desired economic objectives.

Analysis shows that more rules-based policy over time would have generated smoother fluctuations in aggregate demand and improved economic performance compared to actual policy; but once again, such a framework must provide sufficient flexibility to quickly and aggressively maneuver monetary policy amid financial crisis or economic downturn. My observation is such a rules-based guideline would result in even-keeled monetary policy during normal times, and the efficacy of monetary policy during extraordinary times would depend on the discretion, judgment and leadership of the Fed, as is currently the case under fully discretionary policy.

Establishing the ground rules for emergency monetary policy. Ground rules need to be established for the conduct of monetary policy under extraordinary circumstances, including approval processes and responsibilities of the Fed, Treasury and Congress. Many of these governance issues are complex, but several things seem clear. While precisely defining emergency situations—unusual and exigent circumstances—that require extraordinary Fed intervention is difficult, responsibilities and approval processes within and across institutions must be established, and Congressional oversight of Fed operations must be open. I view several items as important. The Fed’s governance rules should be modified such that Fed decisions to engage in extraordinary monetary policy should be determined by the FOMC, rather than just the Board of Governors. The Treasury should be mandated to approve the Fed’s extraordinary interventions and capital exposure. The Congress should be involved in approving the budgetary impacts of the Fed’s emergency policies, and its supervisory role should be spelled out. The Fed, Treasury and Congress have learned a lot from the financial crisis, and they should coordinate to be prepared for future economic, financial or idiosyncratic shocks.