Testimony before the
Joint Economic Committee at the Hearing on
"Monetary Policy Going Forward: Why a Sound Dollar Boosts Growth and Employment"

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Chairman Casey, Vice Chairman Brady, and other members of the Committee, thank you for the opportunity to testify on "Monetary Policy Going Forward: Why a Sound Dollar Boosts Growth and Employment." As requested, in this written testimony I will focus on proposals to alter the Federal Reserve's existing dual mandate, limit the composition of Federal Reserve open purchases, and shift voting on the Federal Open Market Committee to include all District Federal Reserve Bank Presidents. I would be pleased to answer any other questions you may have.

Clear Lessons from Years of Experience

We have now had nearly 100 years of practical experience and detailed empirical studies of monetary decision making at the Federal Reserve.[2] As a result, we have plenty of evidence that more systematic rules-based monetary policies work and more unpredictable discretionary policies do not.[3]

The past 50 years are particularly instructive in this regard. From the mid-1960s through the 1970s, monetary policy consisted of a series of unpredictable discretionary go-stop interventions with increases and decreases in money growth and interest rates that led to frequent recessions, high unemployment, low economic growth, and high inflation.

In contrast, through much of the 1980s-1990s and until recently monetary policy was conducted in a more predictable, rule-like manner with the main goal of reducing inflation and keeping it down. This was a period of generally lower unemployment, lower inflation, lower interest rates, longer expansions, and eventually stronger economic growth.

More recently we have seen a move back to discretionary policies. In 2003-2005 the Federal Reserve deviated from the policies it followed in most of the 1980s and 1990s by

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[1] Parts of this testimony are based on Chapter 4, "Monetary Rules Work and Discretion Doesn't," of John B. Taylor, *First Principles: Five Key's to Restoring America's Prosperity*, New York: W.W. Norton, 2012.

[2] Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867- 1960*, Princeton, NJ: Princeton University Press, 1963. Allan H. Meltzer, *A History of the Federal Reserve*, Chicago: University of Chicago Press, Volume 1, 2003 and Volume 2, 2009.

[3] As Meltzer puts it in Volume 2 if his *History*: "Discretionary policy failed in 1929-33, in 1965-80, and now." "The lesson should be less discretion and more rule-like behavior." (p. 1255)

holding interest rates too low for too long and thereby setting off excesses in housing and other markets which helped bring on the most recent boom and bust. The Fed's continuing departure in recent years from a rules-based monetary policy—with enormous discretionary purchases of mortgage-backed and long-term treasury securities, as well as operations to twist the maturity structure of the Federal debt—have increased the size and shifted the composition of its balance sheet by unprecedented amounts creating economic uncertainty and endangering its independence.

The most fundamental lesson from this experience is that in order to increase economic growth, stability, and employment, monetary policy going forward should restore and lock-in consistent rule-like decision making and avoid unpredictable discretionary actions and interventions.

Reform Proposals

Basic economic principles and common sense provide a starting point. In any organization, a clear well-specified goal usually results in a consistent and effective strategy for achieving that goal. Too many goals blur responsibility and accountability, causing decision makers to choose one goal some times and another goal at other times in an effort to chart a middle course. In the case of monetary policy, multiple goals enable politicians to lean on the central bank to do their bidding and thereby deviate from a sound money strategy. More than one goal can also cause the Federal Reserve to exceed the normal bounds of monetary policy—moving into fiscal policy or credit allocation policy—as it seeks the additional instruments necessary to achieve multiple goals.

There is no justification for an independent agency of government to undertake interventions in these areas. In the spirit of the Constitution, they are best left to the Congress and the president to handle through the regular appropriations process. Central bank intervention is a poor substitute for sound fiscal policy, and it removes incentives for the Congress and the president to do their own jobs well: If the central bank hangs out a "We Do Fiscal Policy" shingle, or is expected to bail out fiscal policy errors, the Congress will try to avoid making tough decisions that might harm their reelection chances.

Despite these obvious pitfalls, a multiple mandate for the Fed swept in during the great interventionist wave of the 1970s, when Congress passed and President Carter signed into law the Federal Reserve Reform Act of 1977. This law explicitly gave the Federal Reserve the goals of promoting both "maximum employment" and "stable prices." This certainly was the wrong remedy for the inflationary boom-bust economy at the time, and monetary policy worsened for a while.

It was not until Paul Volcker arrived as chairman in August 1979 that things changed. Volcker knew that he had to focus on inflation like a laser beam. Of course he had to interpret the law in a way consistent with his change in policy. To achieve maximum employment, Volcker argued, he first had to reduce inflation even if that increased unemployment in the short run. While that approach eventually worked well, it also set a precedent that the dual mandate was open to interpretation by Fed officials. In recent years the dual mandate has been used by the Fed to justify massive interventions on the questionable grounds that these will reduce unemployment in the short run.

Thus, the first step toward a more consistent policy would be to remove the dual mandate and bring focus to a single goal as does H.R. 4180, *The Sound Dollar Act of 2012*, in which the goal is "long-run price stability." The term "long-run" makes it clear that the mandate does not mean that the Fed should overreact to minor short-run ups and downs in inflation from month to month or even quarter to quarter. The single mandate wouldn't stop the Fed from providing liquidity when money markets freeze up as they did after the 9/11 terrorist attacks, or serving as lender of last resort to banks during a panic, or reducing the interest rate in a recession.

To better understand this, consider a monetary policy strategy, or rule, of the kind I proposed in 1992 for the Federal Reserve to follow in setting interest rates.[4] In designing this rule, I assumed a particular goal for price stability—a target inflation rate of 2 percent per year. But under this rule the Fed, or any other central bank, is supposed to change its interest rate in systematic ways in response to *both* inflation and GDP. Specifically, the rule says that the Fed should set the interest rate equal to 1½ times the inflation rate, plus ½ times the percentage amount by which GDP differs from its long run growth path, plus 1. Thus when inflation rises the Fed is supposed to raise the interest rate. In addition, when there is a recession and GDP declines, the Fed is supposed to cut the interest rate; this helps mitigate the recession, reduce economic instability, and help generate long-term price stability. In other words, even though there is a single mandate underlying this strategy for policy, there is systematic response of the interest rate to inflation *and* other variables such as GDP or employment.

Some worry that a focus on the goal of price stability would lead to more unemployment. But history shows just the opposite. One reason the Fed kept its interest rate too low for too long in 2003-05 was the concern that raising the interest rate would increase unemployment, contrary to the dual mandate. If the single mandate had prevented the Fed from keeping interest rates too low for too long, then it would likely have avoided the boom and bust that was a factor in the financial crisis and which led to very high unemployment.

A quick look at recent history shows that a single mandate would help to avoid the excessive discretionary interventions. In years since 2008, the Fed has explicitly cited the dual mandate to justify its unusual interventions, including the bouts of "quantitative easing" from 2009 to 2011, when the Fed purchased massive amounts of mortgage-backed securities and longer-term Treasury securities. During the 1980s and 1990s, Fed officials rarely referred to the dual mandate, even during the period in the early 1980s when unemployment rates were as high as today. When they did so, it was to make the point that achieving price stability was the surest way for monetary policy to keep unemployment down.

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[4] "Discretion Versus Policy Rules in Practice," *Carnegie-Rochester Series on Public Policy*, North-Holland, 39, 1993, pp. 195-214. Over time the rule has come to be called the Taylor rule—a kind of benchmark for policy.

Until the recent interventionist period, written policy statements and directives from the Fed did not mention the "maximum employment" part of the dual mandate in the Federal Reserve Act. There was not a single reference from 1979, when Paul Volcker took over as Fed chair, until the end of 2008, just as the Fed was about to embark on its first bout of quantitative easing. It increased its references to maximum employment in the fall of 2010 as it embarked on its second bout of quantitative easing.

In my view a single mandate would reduce excessive discretionary interventions and encourage more rule-like policy. Nevertheless, it would be wise to consider supplementing such a reform with the Fed placing greater emphasis on the strategy or rule for setting the monetary policy *instruments* (the interest rate or the monetary aggregates). Until the year 2000 the Federal Reserve Act had a specific reporting requirement about the growth of the monetary aggregates. It called for the Fed to submit a report to Congress and then testify about its plans for money growth for the current and next calendar years.

The legislation only required that the Fed report its plans for money growth, not that it set them in a way specified by Congress. The Fed had authority to choose the growth rates of the aggregates. But if the Fed deviated from the plans it had to explain why. If Fed policymakers determined that their reported objectives or plans, according to the words of the act, "cannot or should not be achieved because of changing conditions" they "shall include an explanation of the reasons for any revisions to or deviations from such objectives and plans."

The reporting requirement was fully repealed in 2000, because the data on money growth had become less reliable as people found alternatives to money—such as credit cards or money market mutual funds—to make payments. The Fed therefore focused more on the interest rate when it made its decisions. While it was perfectly reasonable that money growth reporting was removed in 2000, the problem was that nothing comparable about interest rate reporting was put in its place.

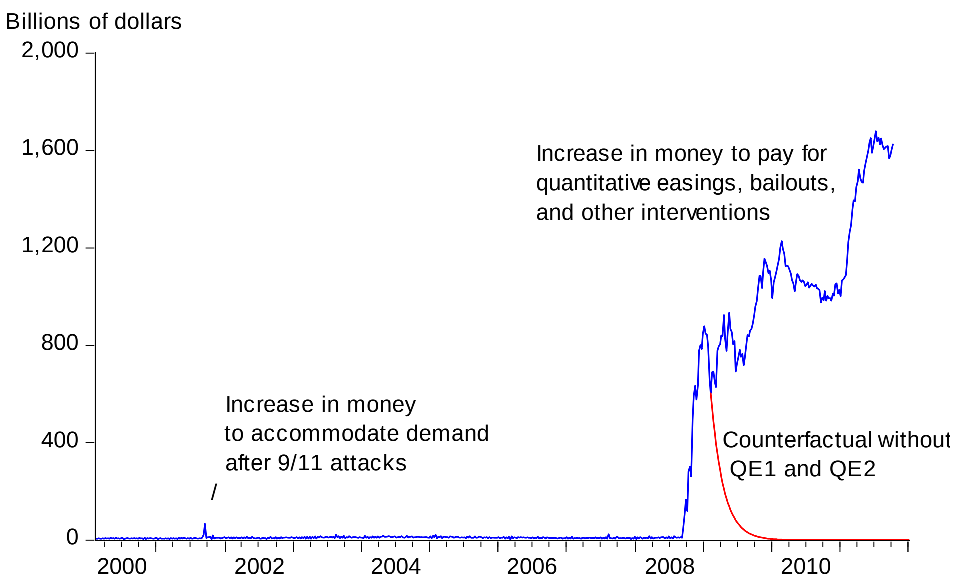
In order to further encourage more rule-like monetary policy, the Congress could reinstate the reporting and accountability requirements that were removed in 2000. But rather than focus only on money growth, it could focus directly on the systematic response of the interest rate. In doing so, it would not require that the Fed choose any particular rule for the interest rate, only that it establish some rule and report what the rule is. But if the Fed deviates from its chosen strategy, it must provide a written explanation and testify at a public congressional hearing. Such requirements would provide a degree of control by the political authorities without interfering in the day-to-day operations of monetary policy.

The Federal Reserve's Balance Sheet

The discretionary interventions of the Federal Reserve have been ratcheted up in such unprecedented ways in recent years that they raise fundamental questions about the future of monetary policy and deserve special consideration in monetary reform discussions. It is difficult to overstate the extraordinary nature of these interventions. To understand how these actions have already begun to change the very nature of monetary policy, put aside the unprecedented interventions leading up to and during the panic in the fall 2008 (including the bailouts of the creditors of Bear Stearns and AIG) and focus on the "Quantitative Easing: QE1 and QE2"—the large scale purchases of mortgage-backed securities and longer term treasuries—which occurred long after the emergency of the panic was over.

In order to pay for the mortgages and other large-scale securities purchases, the Fed had to credit the banks with electronic deposits—or, in other words, create "bank money," or more formally reserves balances that the banks hold at the Fed. As a result of the hundreds of billions of dollars of mortgage backed and other securities, there has been an enormous and completely unprecedented explosion of bank money, as shown in the following chart.

To provide some perspective the chart starts in the year 2000. The "reserve balances" the banks hold at the Fed—this so-called bank money—is shown on the vertical axis in billions of dollars. A tiny blip appears on the chart around the September 11, 2011 terrorist attacks. The Fed had to increase the amount of bank money at that time because the attacks on the World Trade Center damaged the payments system and banks needed money to make payments. The Fed wisely and appropriately provided the money. But that amount is completely dwarfed by the recent explosion.



Bank Money Created by the Fed

The large recent increase started in the fall of 2008 during the panic. Before the panic the amount was about $10 billion. By the end of 2008 it was $800 billion. By the end of 2011 it was $1,700 billion. In the fall of 2008 the money was used mainly for making loans to U.S. banks, securities firms, and foreign central banks. As the panic subsided the demand for those loans diminished and the bank money would have retreated back to where it was before the crisis. But instead the Fed started the large scale purchases of mortgages and Treasury bonds, first under QE1 and then under QE2, which expanded the balances by much more.

This large monetary overhang creates risks to the financial system and the economy. If it is not reduced, then the bank money will eventually pour out into the economy and cause a huge inflation. But if it is reduced too quickly, the banks may find it hard to adjust and the economy would take a hit. In order to unwind the programs in the current situation, the Fed must sell its mortgages.

Uncertainty also abounds about the impact of the large-scale asset purchases (QE1 or QE2 as defined here) on markets or the economy. For example, in my view, the empirical evidence is weak that the mortgage backed securities purchases had any significant impact on mortgage yield spreads[5] once one controls for prepayment and credit risk. Experience from the 1960s suggests that operation twists have little lasting effect on long term interests rates, over and above what would be expected from expectations of future short term yields.

Another element of unpredictability and uncertainty concerns whether or not the Federal Reserve will continue to undertake more quantitative easing if the economy does not grow strongly enough or if unemployment does not come down rapidly enough. Indeed, there is already considerable chatter and speculation in the markets about the circumstances under which the Fed would start buying mortgage backed securities again. The fact that the Fed can, if it chooses, intervene without limit into any credit market—not only mortgage backed securities but also securities backed by automobile loans, or even student loans—raises more uncertainty, and of course raises questions about why an independent agency of government should have such power.

To reduce such uncertainty and unpredictability—again with the aim of increasing economic growth and stability, some restraints on the composition and the size of the Federal Reserve's portfolio are in order. In particular, it is therefore appropriate, in my view, to limit asset purchases by the Fed to U.S. Treasury securities, as called for in *H.R. 4180, The Sound Dollar Act of 2012* with exceptions as provided in the Act.

With the Fed already holding large amounts of mortgage backed securities, it is also important for the Fed to develop a gradual and credible plan to reduce these holdings as part of an overall plan to reduce the monetary overhang and get its balance sheet back down toward pre-crisis levels. Had it not undertaken QE1 or QE2 it would already have removed the overhang—as shown by the counterfactual in the above chart—and there would not be considerably less uncertainty about monetary policy down the road.

The Advantage of Reform Legislation

Years of experience show that a clearer rules-based framework for monetary policy decisions is needed in order to increase economic growth, stability and employment. The Federal Reserve ought to begin to put forth and implement such a policy framework now, whether or not legislative reform is enacted.

[5] Johannes Stroebel and John B. Taylor, "Estimated Impact of the Fed's Mortgage-Backed Securities Purchase Program," *International Journal of Central Banking*, forthcoming 2012

But legislative reforms such as those in the *Sound Money Act of 2012* and would help lock in such a framework in the future.

A single mandate of “long-run price stability” would encourage more rule-like policy and help avoid excessive discretionary interventions. In my view it would result in more stability and thus less unemployment.

Rules to limit massive expansions of the Fed’s balance sheet, including through requirements that open market operations be conducted in U.S. Treasuries, short term repurchase agreements, and reverse repurchase agreements, would clarify that the Fed’s role does not include allocating credit between different sectors; it would also help reduce uncertainty and put monetary policy back on the road to a sounder more rules-based approach.

Longer run reform should also expand voting responsibility to give all Federal Reserve District Bank Presidents voting rights at every Federal Open Market Committee meeting. Such a reform, which is also part of the *Sound Money Act of 2012*, would equalize voting power across the entire economy and offset any tendency for policy decisions to favor certain sectors or groups in the economy over others. This too, in my opinion, would help instill more predictable rule-like decision-making.