Remarks by U.S. Rep. Kevin Brady, Vice Chairman of the Joint Economic Committee
Before the Shadow Open Market Committee
Yale Club of New York City
12:00 noon, Monday, April 20, 2012

Members of the Shadow Open Market Committee, directors and staff of E-21, and guests:

Since its founding in 1973, the Shadow Open Market Committee has been the leading intellectual forum for the evaluation of the Federal Reserve's monetary policy. As a member of Congress, I'm honored to speak in this forum.

Like many of you, I've been fortunate in that the question of "what drives our economy" has been a major part of my life. Prior to Congress, as a local chamber of commerce executive, I spent 18 years helping to start new businesses, recruit new industries, and create a sound business climate in three communities – one in the Midwest and two in Texas. The economies were diverse and challenging: agriculture, international tourism, and military in the Black Hills of South Dakota, the exciting boom-and-bust "Spindletop" economy of southeast Texas that included oil refining, a strong union influence, and back then a national reputation as a hotbed for excessive litigation. During the early 1980's unemployment neared 30 percent in some parts of the Golden Triangle of southeast Texas.

In the Houston region, our economy is driven by trade, energy, the largest medical center in the world as well as a marvelous entrepreneurial spirit. In my congressional district, add to that paper mills, steel mills, timber, and biotechnology firms.

When I arrived in Congress, I continued to seek ways to create more jobs in America. The Ways & Means Committee and the Joint Economic Committee have been perfect fits for my interests. I'm a free trader—all the way. I believe 110% in the economic freedom to buy, sell, and compete around the world with as little government interference as possible.

In Congress, I've had the opportunity to be involved in the successful passage of twelve of the fourteen trade agreements the U.S. has in place, as well as moving China into the World Trade Organization. These actions have opened new markets and found new customers for America's companies and farmers in the global marketplace. We need to lead much more aggressively on trade, because America continues to fall behind our global competitors.

When it comes to the global economy, some have characterized the 1800's as the British century, the 1900's as the American century and the current one as China's century. I reject that prediction.

It's clear though, that to ensure the 21st century is another American century we must renew our commitment to what works well—our free market system—and reform what does not—our inefficient federal government.

Looking to our economic future, our goal should be clear: ensuring that America has the world's strongest economy throughout the 21st century. To do that, we have to get our monetary policy right and our fiscal policy right so that our free market system can flourish.

Not far from here on West 141st Street stands the Grange, the recently restored home of Alexander Hamilton, our first Secretary of the Treasury. After careful consideration, Hamilton devised a monetary system that revived a moribund American economy and fostered rapid economic growth. As Hamilton did in his day, we must thoughtfully and clearly define the role of the Federal Reserve going forward.

A sound dollar is the sure and strong foundation for long-term economic growth. A sound dollar creates certainty and facilitates new business investment and long-term job creation. I believe the focused role of the Federal Reserve should be to protect the purchasing power of the dollar by maintaining long-term price stability.

Are there many other actions that Congress and the President must take to retain America's economic preeminence for the next 100 years? Of course. We must:

- Make our tax system simpler and more internationally competitive by lowering marginal tax rates and eliminating distortions that pick winners and losers.

- Reform important entitlement programs—including Social Security, Medicare, and Medicaid—to make them sustainably solvent so that they can continue to serve those Americans dependent upon them;

- Transform our regulatory system so that we can achieve our common goals—including a clean environment and safe workplaces—in more efficient, balanced, and less destructive ways; and

- Aggressively pursue trade agreements to open foreign markets to sell more American goods and services to the 95 percent of the world's population that lives outside of our borders.

However, these reforms by themselves will be insufficient if the Federal Reserve fails to maintain the purchasing power of the dollar over time. You only need look to the Great Depression of the 1930's and the Great Inflation of the 1970's to see that both price deflation and price inflation are twin evils that reduce real output and employment.

Learning from the past and looking to the future, Congress must select the right monetary policy mandate, maintain a Fed independent of political pressure, and hold the Fed accountable for the results.

So let us examine what monetary policy should be going forward.

As you know, in 1977, Congress mandated that the Federal Reserve pursue monetary policy "so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."[1] Since inflationary expectations affect long-term interest rates, the goals of stable prices and moderate long-term interest rates are interrelated. This is why the Federal Reserve is described as having a dual mandate for both price stability and full employment.

The employment half of the dual mandate reflects the *Employment Act of 1946*, which required the federal government to pursue economic policies that "promote maximum employment, production, and purchasing power."[2] The price stability half of the dual mandate reflects rising public concerns about price inflation in the 1970's.

Given the experiences of the past forty years and the unprecedented Fed actions of the past four, it's time for Congress and policy-makers to have a thoughtful, constructive debate about the dual mandate and the role of the Fed in our economic future.

Nobel Laureate economist Robert Mundell observed: "To achieve a policy outcome, you must use the right policy lever."

Recently, in the Federal Open Market Committee (FOMC) statement of January 25th of this year, Chairman Ben Bernanke and the other members recognized that monetary policy is the right lever to maintain the purchasing power of the dollar by declaring, "The inflation rate over the longer run is primarily determined by monetary policy."

In contrast, the FOMC acknowledged that monetary policy is the wrong lever to promote job creation by declaring "[t]he maximum level of employment is largely determined by nonmonetary factors." The FOMC is right on both counts: inflation is influenced by monetary policy and long-term employment is not.

While the dual mandate may be politically appealing, it makes no sense for Congress to charge the Federal Reserve to control what it cannot. Except in the very short term, monetary policy can't boost real output and job creation.

Instead, using monetary policy as a short-term tool to speed growth may actually harm the economy in the long run. As Richard Fisher, President of the Federal Reserve Bank of Dallas, recently warned, the U.S. economy does not need any more "monetary morphine" that temporarily eases pain but does nothing to cure the underlying disease.

His point – and I agree – is that the President and Congress, not the Federal Reserve, can and should control the budget, tax, regulatory, and trade policies that create the business climate which drives sustainable economic growth and job creation.

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[1] *The Federal Reserve Reform Act of 1977*, Pub.L. 95-188, 91 Stat. 1387, enacted November 16, 1977 as modified by the *Full Employment and Balanced Growth Act of 1978*, Pub.L. 95-523, 92 Stat. 1887, enacted October 27, 1978.
[2] Pub.L. 79-304, ch. 33, Sec. 2, 60 Stat. 23, enacted February 20, 1946.

Our global competitors already recognize this. Since Congress gave a dual mandate to the Fed, governments in many other countries have revised the charters of their central banks to focus either on a single mandate for price stability or a primary mandate for price stability with other goals clearly subordinated. Among the 47 central banks and monetary authorities in major countries surveyed by the Bank for International Settlements, only the Bank of Canada and the Federal Reserve have organizational laws that give other goals equal weight to price stability.[3]

Getting the mandate right is only half the job. How the Federal Reserve pursues its mandate is equally important.

According to Stanford University economist John Taylor, the key choice is between a discretionary regime and a rules-based regime. A discretionary regime generates uncertainty because it relies upon the subjective assessments of central bank policymakers. By contrast, a rules-based regime reduces uncertainty because it follows well-established rules, based on observable economic data, with a clear focus on a long-term goal.

Inflation-targeting is a rules-based regime under which a central bank establishes a target inflation rate expressed in terms of a broad-based price index of goods and services. A central bank tightens monetary policy when the actual inflation rate rises above its target and loosens monetary policy when the actual inflation rate falls below its target.

The last four decades of U.S. monetary policy demonstrate the advantages of a rules-based regime over a discretionary one. During the 1970's, the Federal Reserve had “go-stop” policies, in which monetary policy quickly swung from ease to tightness and back again. This incoherence produced a highly volatile real economy and a rising inflation rate.

A sea change occurred with the appointment of Paul Volcker as Fed chairman in 1979. Under Volcker the FOMC aggressively tackled price inflation by controlling the growth of the money supply. This successful strategy was a significant step forward toward a rules-based monetary policy. While the economy did suffer back-to-back recessions,[4] inflation dropped from 13.3 percent in 1979, the year Volcker joined the Federal Reserve, to 3.8 percent in 1982.[5]

Between 1983 and 2000—the period known as the Great Moderation—the Federal Reserve continued to pursue price stability through an increasingly rules-based monetary policy, effectively ignoring the second half of its dual mandate. Two long economic booms resulted, with very low inflation. The booms were only interrupted by a short, shallow recession related to the first Persian Gulf War.

Unfortunately, between 2002 and 2005, the FOMC deviated from this successful rules-based regime, moving to a discretionary regime by keeping interest rates too low for too long. This loose monetary policy contributed to the inflation of an unsustainable housing bubble that eventually triggered a global financial crisis.

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[3]Ortiz, Guillermo and Yam, Joseph (Chairs of the Central Bank Governance Group), *Issues in the Governance of Central Banks*, Bank of International Settlements (May 2009).
[4] The back-to-back recessions were January 1980 to June 1980 and July 1981 to November 1982.
[5] The annual inflation rate as measured by the consumer price index.

Since the height of the financial crisis in the fall of 2008, Washington has increasingly become dependent on the Federal Reserve to take unusual, interventionist actions—such as tripling the size of its balance sheet under QE1 and QE2 by purchasing the debt and residential mortgage-backed securities (RMBS) issued by Fannie Mae and Freddie Mac as well as Treasuries. Indeed, the FOMC justified these extraordinary actions by invoking—for the first time ever in late 2008—the employment half of the Federal Reserve's dual mandate.

Ultimately the FOMC took these actions, in part, to compensate for President Obama's failure to establish a strong, sustainable recovery. And just as low borrowing costs continue to mask the true pain of our nation's historically high federal budget deficits, the Federal Reserve's monetary experimentation has allowed the White House and Congress to shirk their responsibility to enact fiscal policies that create a competitive business climate which unleashes investment and spurs job creation.

The Federal Reserve's monetary experimentation of the last decade must end. Congress should give the Federal Reserve a single mandate for price stability, and the Federal Reserve should return to a rules-based system of inflation targeting to achieve that mandate.

To provide a foundation for long-term economic growth, I recently introduced the *Sound Dollar Act* in the House of Representatives. Senator Mike Lee of Utah, an articulate and studious member of the Joint Economic Committee, has introduced a companion bill in the Senate. The measure was introduced after many months of vetting with interested economists, current and former Fed staff as well as current and former members of the Federal Reserve Board of Governors – including discussions with Chairman Bernanke.

The *Sound Dollar Act* seeks to reform the Federal Reserve in several important ways. Specifically, the *Sound Dollar A*ct replaces the dual mandate with a single mandate for long-term price stability; increases the Federal Reserve's accountability and openness; diversifies the FOMC; ensures credit neutrality for future FOMC purchases; and institutes congressional oversight of the Consumer Financial Protection Bureau.

As expected, in Washington critics have quickly charged that focusing on a sound dollar implies the Federal Reserve will ignore the employment needs of Americans. They're wrong. America can only maximize its real output with long-term price stability. Protecting the purchasing power of the dollar over time provides the strongest foundation for lasting economic growth and job creation.

Others have reacted as if a single mandate is a shocking proposal—an affront to all that is right and good. But as we know, the United States won World War II, enjoyed three decades of prosperity, and put a man on the moon without a dual mandate. It's not a fundamental part of our constitutional fabric or carved in granite—it's a policy directive that Congress can and should change to ensure the future prosperity of our nation.

A mandate for price stability gives the Federal Reserve the right goal. Moving away from a discretionary regime and back toward a rules-based regime will help ensure the Fed achieves price stability.

In January 2012, the FOMC announced an inflation target of 2 percent defined in terms of the price index for personal consumption expenditures. I strongly applaud Chairman Bernanke and the other members of the FOMC for this step toward a rules-based, inflation-targeting regime.

However, this is merely a policy statement that could be reversed. Therefore, the *Sound Dollar Act* mandates that the FOMC continue inflation targeting over the long-term.

Accurately measuring inflation isn't easy. In the last decade, we clearly saw that price indices of goods and services don't always record all of the price movements in our economy, allowing asset bubbles to inflate undetected. The FOMC's current inflation target relies upon the price index for personal consumption expenditures.

This index is the primary indicator that the Federal Reserve uses for measuring inflation. However, to identify incipient asset bubbles before they inflate to dangerous levels, the *Sound Dollar Act* also requires that the FOMC monitor and report to Congress on: (1) the prices of, and returns on, broad classes of assets including equities, corporate bonds, state and local government bonds and agricultural, commercial, industrial and residential real estate; (2) the price of gold; and (3) the foreign exchange value of the U.S. dollar.

To be clear, the *Sound Dollar Act* doesn't prescribe any specific action that the Federal Reserve must take if it detects an asset bubble. The appropriate responses are highly dependent upon circumstances. They might include a tightening of monetary policy, supervisory suasion or regulatory actions to reduce the flow of credit to fund purchases of the bubbling asset.

Discretion with respect to the best response should be left to the FOMC. However, identifying potential asset price bubbles earlier may help to avoid the overinvestment and the malinvestment that must eventually be liquidated at a heavy cost in terms of lower real output and lost jobs.

Some supporters of the *Sound Dollar Act* concept express a concern that the FOMC could misinterpret monitoring asset prices as a mandate to control asset prices. To address that concern, we've made the legislative language clear and will make it clearer if need be. To quote the bill's language, the FOMC will merely observe asset prices to determine whether such price indices "are comprehensively reflecting price movements in the economy; and whether any price movements not captured by the price indices of goods and services are causing a significant misallocation of capital in the United States economy."

Simply put, monitoring asset prices is intended as a check against inflation slipping through the cracks.

Another reform broadens input and geographic diversity in FOMC decision-making. The S*ound Dollar Act* grants a permanent vote on the FOMC to the presidents of each regional Federal Reserve Bank. As important as New York and Washington are, there is much more to America's economy and the FOMC should better reflect that.

Today—as a result of a decision seventy years ago—only the Federal Reserve Governors and the President of the Federal Reserve Bank of New York have permanent votes. While all of the regional Federal Reserve Banks participate in the discussions, just four of the remaining eleven presidents vote at any one meeting—rotating on and off the FOMC.

There may be other ways to achieve this diversity—and I'm open to them—but I'm seeking change that will provide Main Street with a greater voice in determining monetary policy.

I am firmly committed to the independence of the Federal Reserve in conducting monetary policy. That's why I'm particularly troubled by the FOMC decision in September 2011 to reinvest the proceeds from maturing federal agency debt and RMBS into new federal agency RMBS—instead of allowing these holdings to decline as originally intended. This policy reversal occurred amid intense pressure from special interest groups for federal actions to support the ailing housing market.

When the FOMC deals in securities other than Treasuries, repurchase agreements, and reverse repurchase agreements for the System Open Market Account, the Federal Reserve is allocating credit among different sectors of our economy. Credit allocation exposes the Federal Reserve to political interference. And in Washington, D.C. subsidies die hard.

To maintain the independence of the Federal Reserve, the *Sound Dollar Act* requires the FOMC to deal only in Treasuries, repos, and reverse repos for the System Open Market Account unless the FOMC finds by a 2/3 vote that "unusual and exigent circumstances" exist. The FOMC could then purchase other securities for the account so long as they are liquidated within five years after the end of the emergency.

Next, the *Sound Dollar Act* requires the Federal Reserve to publish its lender-of-last-resort policy. In nearly a century of existence, the Federal Reserve has never articulated this critical policy.

Dr. Allan Meltzer, one of the founders of the Shadow Open Market Committee, describes the problems this void creates:

> *The absence of a [lender-of-last-resort] policy has three unfortunate consequences. **First**, uncertainty increases. No one can know what will be done. **Second**, troubled firms have a stronger incentive to seek a political solution. They ask Congress or the administration for support or to pressure the Federal Reserve or other agencies to save them from failure. **Third**, repeated rescues encourage banks to take greater risk and increase leverage. This is the well-known moral hazard problem.*[6]

Each of these problems became manifest in 2008. And while some believe the *Dodd-Frank* legislation provided the solution to the next crisis, I don't believe that's the case.

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[6] Ciorciari, John D. and Taylor, John B. (Eds.), *The Road Ahead for the Fed*, Hoover Institution (November 2009).

To be reasonable, the bill doesn't call for a precise tactical plan. As President Dwight D. Eisenhower observed regarding the complicated engagements of war: "Plans are worthless, but planning is everything."[7] Similarly, while the Federal Reserve can't anticipate every nuance of the next financial crisis, publishing a lender-of-last-resort policy has merit and could help reduce market uncertainty.

Next, I applaud Chairman Bernanke for his steps to increase transparency in monetary policy decision-making, but there is an additional step that the Federal Reserve should take. The *Sound Dollar Act* speeds the release of transcripts of FOMC meetings from five years to three years. Currently, if a President nominates a Fed Chairman for a second four-year term, Senators cannot review any of the FOMC transcripts during his or her tenure.

Some have expressed concerns that this would inhibit free discussion at FOMC meetings. But in a time when information flows globally in the blink of an eye, three years is an eternity.

Given the quality of the individuals serving on the FOMC, I'm not concerned about legacy building in FOMC meetings. What I am concerned about is a future Senate being asked to confirm a second term for the Fed chairman with no real insight into the critical decision-making of that chairman in FOMC deliberations. Results matter, and so does the thought process behind them.

The *Sound Dollar Act* also eliminates a slush fund that has been abused by Secretaries of the Treasury in both Democratic and Republican administrations. In 1934, Congress placed the profits from the nationalization of privately owned gold and the subsequent devaluation of the U.S. dollar in the Exchange Stabilization Fund and authorized its use to intervene in foreign exchange markets.[8] In 1968, Congress placed the special drawing rights issued by the International Monetary Fund into the Exchange Stabilization Fund.[9] After the Bretton Woods system of pegged exchange rates collapsed in 1971, the Treasury has used the non-SDR assets in the Exchange Stabilization Fund for purposes that Congress never intended, such as bailing out Mexico in 1995 and guaranteeing money market mutual funds in 2008. To prevent abuses in the future, the *Sound Dollar Act* transforms the Exchange Stabilization Fund into a Special Drawing Rights Fund; liquidates all of the $50 billion of non-SDR assets over three years; and uses the proceeds to reduce federal debt.

Finally, the *Dodd-Frank Act* funded the Consumer Financial Protection Bureau by diverting the Federal Reserve's profits, which would otherwise be paid to the Treasury, to the CFPB. This is a dangerous precedent, leaving the CFPB unaccountable to Congress and ultimately hardworking American taxpayers. Nothing other than the operating costs of the Federal Reserve should be paid out of its revenue. Thus, the *Sound Dollar Act* ends this diversion and requires that the CFPB seek annual appropriations from Congress—just as other federal agencies do.

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[7] Dwight David Eisenhower, Remarks at the National Defense Executive Reserve Conference, November 14, 1957. For complete context, see the full text of the speech, third paragraph, in Public Papers of the Presidents http://www.presidency.ucsb.edu/ws/index.php?pid=10951&st=&st1=#axzz1nuPphFqo.
[8] *Gold Reserve Act of 1935*, Pub.L. 73-87, 48 Stat. 337, enacted January 30, 1934.
[9] *Special Drawing Rights Act of 1968*, Pub.L. 90-349, 82 Stat. 188, enacted June 19, 1968.

In summary, the *Sound Dollar Act* helps the United States retain its economic preeminence by preserving the purchasing power of the U.S. dollar, charging the Federal Reserve to pursue a single mandate for price stability and strengthening the Federal Reserve's independence even as the *Act* increases the Federal Reserve's accountability.

My goal is to jumpstart a thoughtful, constructive debate on the proper role of the Fed going forward. Merely the introduction of the *Sound Dollar Act* has begun to evoke responses. Given your substantial backgrounds and interest, I would ask you to do the same—to weigh in through your articles, conferences, interviews, and speeches.

This is a debate worth having. And given what's at stake for the economic future of America, it's worth having now.

Thank you.