

The Federal Reserve, the Centennial Monetary Commission, and the Sound Dollar Act

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Thank you for this invitation to speak at Cato. We have fought together in many battles for the principles of economic freedom and a limited, Constitutional government. While the policies of the Obama Administration have been troubling, revelations over the past five days are awakening many more Americans to the dangers of unrestrained government.

Big government is a breeding ground for political abuse and harmful social experimentation. Americans should not be Washington's lab rabbits. With news stories breaking about the enforcement cudgel of the IRS being brought to bear on political enemies, and the Justice Department's wire-tapping of the Associated Press, something is clearly wrong.

The work that Cato does in pursuit of economic freedom and limited government is more important than ever. For years, Cato has been a leader in the debate on monetary policy. I commend President John Allison for his recent commentary, "The Federal Reserve's Unsound Policies," in the *Cato Policy Report*. Thus, I am honor that Cato would invite me to talk about monetary policy today.



First, let me frame monetary policy in the broader context of the most critical economic challenge that we face—the Growth Gap.

In the near term, the Growth Gap is the difference in economic performance between this recovery and an average post-World War II recovery. Indeed, this recovery has produced \$1.2 trillion less in real GDP and 4.1 million fewer private sector jobs than an average recovery during the last seven decades.

Even more troubling is the possibility that the ability of economy to grow has been permanently diminished. The Congressional Budget Office recently reduced its estimate for future growth in potential real GDP from 3.2 percent to 2.2 percent. A one-percentage point difference may not sound like much, but it is huge. Over the next 50 years, a one-percent Growth Gap is the difference between an \$80 trillion economy and a \$50 trillion economy in 2062. Moreover, a one-percent Growth Gap means \$97 trillion less in federal tax collections over fifty years.¹

The United Kingdom was the world's economic superpower during 19th century. The 20th was the American Century. Many people believe that China will become the dominant economy in the 21st century. I do not subscribe to that view. However, if we want the United States to remain the world's economic superpower, we must close this Growth Gap.

When I became Vice Chairman of the Joint Economic Committee in the 112th Congress, I asked the JEC Republican staff to determine what must be done to ensure that the 21st century is another American Century. In response, the staff answered my question in a series of analyses and studies. The bottom line is that we have to get our act together in three major areas of economic policy:

- We must reduce federal spending and federal debt as a percent of GDP, and we must pursue a pro-growth tax reform that would lower the cost of capital for new business investment.
- We must overhaul the federal regulatory process to ensure necessary regulations are balanced and cost-effective.
- We need to return to a predictable, rules-based monetary policy that maintains the purchasing power of the U.S. dollar over time.

Today, we focus on monetary policy. Most Members of Congress focus on fiscal policy; monetary policy is generally regarded as an unruly step-child. Yet, the Growth Gap is forcing Congress to re-examine what is inhibiting growth and what must be done to re-invigorate our economy. This re-examination inexorably leads to monetary reform.

¹ Dollar amounts are given in constant 2012 dollars.

Simply put, fiscal policy by itself is insufficient. Consider:

- Pro-growth tax cuts enacted in 2001 and 2003 did not stave off the Great Recession in 2008; and
- Keynesian stimulus since the 2008 financial crisis left us behind other post-war recoveries.

Let me be clear. I strongly support—we strongly support—reducing federal spending relative to the size of our economy; making entitlement programs sustainably solvent; and enacting a pro-growth tax reform. However, these reforms are necessary, but not sufficient conditions for closing the Growth Gap.

Get monetary policy right, and our economy will have the wind at its back. Get monetary policy wrong, our economy will face headwinds that good fiscal and regulatory policies may not be able to overcome.



Early in our nation's history, the first Congress delegated its monetary power to a central bank. Building on the precedent of the First and Second Banks of the United States, Congress created the Federal Reserve in 1913:

- To provide an elastic currency within the context of the gold standard; and
- To serve as lender of last resort to the financial system.

While the early Fed was successful in providing an elastic currency, eliminating the frequent, seasonal financial panics of the 19th century, the Fed failed to perform its role as lender of last resort between 1929 and 1933, leading to unnecessary bank failures that intensified the Great Depression.

After President Richard Nixon broke the last link between the U.S. dollar and gold on August 15, 1971, Chairman Arthur Burns pursued a discretionary and interventionist monetary policy, known as “go-stop,” that caused rising inflation and instability. In response to “stagflation,” Congress gave the Fed a dual mandate assigning equal weight to achieving stable prices and full employment.

During the 1980s and 1990s, Chairmen Paul Volcker and Alan Greenspan conducted monetary policy as if the Federal Reserve had a single mandate for price stability. Volcker and Greenspan recognized that price stability is a necessary prerequisite for maximum output and employment.

In so doing, they were consistent with the best thinking on monetary policy. Monetary policy can only have a direct, positive effect on employment in short, temporary spurts—at the cost of future economic growth and employment. In contrast, using monetary policy to achieve stable prices creates the best environment for maximizing economic growth and employment over time.

Today—with two exceptions—every central bank in the developed world either has a single price stability mandate, or a primary price stability mandate, with other goals subservient to price stability. The exceptions are the U.S. and Canada.

Volcker inaugurated what became known as the Great Moderation. In the early 1980s, Volcker broke the back of inflation. In doing so, he raised the target rate for federal funds from 11 percent to 20 percent before lowering it to 8 percent. The economy suffered back-to-back recessions, but inflation dropped from 13.3 percent to 3.8 percent, and averaged 3 percent over the next 20 years as Volcker and Greenspan implemented, with some exceptions, a transition toward a more rules-based monetary policy.

The rules-based monetary policy that evolved under Volcker and Greenspan had two characteristics:

1. Implicit targeting of the inflation rate over the medium term; and
2. The implicit use of the Taylor rule to set the target rate for federal funds to achieve the inflation rate target over the medium term.

Devised by Stanford University economist John Taylor, the Taylor rule is a monetary policy rule that generally directs the Federal Reserve to increase the federal funds rate as inflationary forces intensify and lower the rate as inflationary forces decrease.

This rules-based approach to monetary policy created a long period of favorable economic performance. Macroeconomic volatility decreased; two robust economic expansions occurred—the first expansion lasted 31 quarters, and the second expansion lasted 40 quarters; and the unemployment rate trended downward. By contrast, the longest economic expansion of the 1970's was only 10 quarters. Many supply-side economists attributed the stagflation experience to end of Bretton Woods and Nixon's gold decision that eliminated the last vestiges of a value anchor for the U.S. dollar.

The confluence of the bursting tech-stock bubble; the September 11th terrorist attacks; and the 2001 recession—which sparked deflationary concerns—finally moved the Fed away from a rules-based monetary policy. The Fed reduced its target rate to 1.82 percent; held the rate too low for too long; and helped fuel the housing bubble, which peaked in the summer of 2006. During this period, the target rate for federal funds averaged 2.17 percentage points below the level prescribed by the Taylor rule.

To date, most policymakers have largely focused on the microeconomic causes of the housing bubble, the financial crisis, and subsequent global recession. However, we should pay more attention to the macroeconomic cause: the Fed's excessively easy monetary policy between 2002 and 2005. This contributing factor was wholly avoidable had the Fed simply followed well-established norms—like the Taylor Rule—rather than engage in discretionary policies.



Since 2008, monetary policy has gone into discretionary and interventionist hyper-drive. Whereas Volcker and Greenspan correctly believed that monetary policy could contribute to achieving full employment if—and only if—the Fed focused solely on price stability, beginning in 2008, the Fed explicitly deviated from this view, invoking the employment half of its dual mandate, for the first time ever to justify its extraordinary actions.

All subsequent FOMC policy statements have prominently mentioned the full employment half of the dual mandate, using it as justification for Quantitative Easing; Quantitative Easing Two, Operation Twist, and what many are describing as Quantitative Easing Infinity.

Under QE1, the Fed began purchasing federal agency debt, federal agency residential mortgage-backed securities, and long-term Treasuries. Through the RMBS, the Fed was allocating credit toward the housing finance market to lower home mortgage interest rates in the hope that refinancing activity would increase discretionary income and consumer purchases. While QE1 helped to boost stock prices, its effects on the real economy were quite small.

In the late fall of 2010, the Fed embarked upon QE2 with increased purchases of long-term Treasuries. The following year, the FOMC announced its communications channel, through which it advised that low interest rates would remain through certain dates. Operation Twist came in the fall of 2011, which extended the average duration of the Fed's Treasury holdings though, unlike quantitative easing, it did not affect the size of the Fed's balance sheet.

Given the ineffectiveness of this discretionary and interventionist monetary policy, there was some hope of a return to a rules-based policy when in January 2012 the FOMC issued a *Statement of Longer-Run Goals and Policy Strategy*, in which—in setting an official inflation target of two percent—the FOMC noted that,

*The maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market. These factors may change over time and may not be directly measurable. Consequently, it would not be appropriate to specify a fixed goal for employment; rather, the Committee's policy decisions must be informed by assessments of the maximum level of employment, recognizing that such assessments are necessarily uncertain and subject to revision.*²

² Press Release, Federal Open Market Committee Statement of Longer-Run Goals and Policy Strategy (January 25, 2012). Available at: <http://www.federalreserve.gov/newsevents/press/monetary/20120125c.htm>

Nonetheless, any hope that this statement represented a shift by the FOMC quickly faded with the Federal Reserve's adoption QE-Infinity in December. Today, it remains unclear how providing additional liquidity through yet another round of quantitative easing can accelerate economic growth. Moreover, as noted by John Allison, "*The significant expansion of the monetary base (printing money) is surely creating misinvestments in the economy.*"³

In a confusing shift from its date-oriented communications channel, the Fed moved to an unemployment rate-based position, noting that it would keep the rate in this exceptionally low while unemployment remains above 6.5 percent. This new position directly conflicts with the FOMC statement that a "*fixed goal for employment*" would be inappropriate because "*employment is largely determined by nonmonetary factors that ... may change over time and may not be directly measurable*"⁴ made just 11 months earlier.

What are the benefits of quantitative easing? Fed officials argue that QE is responsible for rising asset prices. However, Martin Feldstein, Chairman of the Council of Economic Advisors under President Reagan, argues that while QE certainly has played a limited role in rising asset prices, it is earnings that are the most important determinant of stock prices. Feldstein concludes:

*The rise in equity prices also reflected a general increase in earnings per share and an increase in investor confidence after 2009 that the economy would not slide back into recession.*⁵

Whatever its short-term benefits may be, quantitative easing poses great risks over time. Let me outline three:

1. The creating of asset price bubbles, which is fairly self-explanatory.

³ Allison, John A., "The Federal Reserve's Unsound Policies," *Cato Policy Report*, May/June 2013. Available at: <http://www.cato.org/policy-report/mayjune-2013/federal-reserves-unsound-policies>

⁴ Press Release, Federal Open Market Committee Statement of Longer-Run Goals and Policy Strategy (January 25, 2012).

⁵ Feldstein, Martin, "The Federal Reserve's Policy Dead End," *Wall Street Journal*, May 9, 2013. Available at: <http://online.wsj.com/article/SB10001424127887324326504578467592090881604.html>

2. The current excess reserves on the Fed’s balance sheet are the fuel for future inflation. So far, we have not had inflation due to the desire of banks to maintain larger reserves and a shortage of credit-worthy borrowers. When economic growth accelerates, however, banks will use their excess reserves to make loans, creating inflation unless the Fed acts swiftly to reduce the size of its balance sheet. Once the “inflation Genie” is out of the bottle, it’s hard to get it back into the bottle without a recession.
3. Finally, the Fed’s bloated balance sheet creates a perverse incentive for financial repression.
 - o When countries accumulate excessive government debt relative to the size of their economy, they tend to engage in financial repression channeling the savings of their citizens toward government debt to lower government interest costs.
 - o Since 2009, the Fed has purchased the equivalent of 24 percent of all newly issued Treasuries. Economic growth and inflationary pressure would normally cause the Fed to raise its target rate for federal funds and sell Treasuries. Selling Treasuries while interest rates are rising would force the Fed to recognize losses on its balance sheet, potentially giving the Fed negative equity.
 - o The uncertainty arising from “technical bankruptcy” would likely cause the Fed to avoid this outcome at all costs. Instead, the Fed would likely boost the interest rate that it pays banks on their reserves and increase reserve requirements. However, these actions would cap economic growth by limiting bank loans to U.S. businesses and families. The net effect would be financial repression— redirecting credit from the private sector to the U.S. Treasury through the Fed— to help contain federal interest costs.



Now, let me turn to the two major monetary bills that I have introduced.

First, it’s time for a thorough review of U.S. monetary policy, and I have introduced legislation—the *Centennial Monetary Commission Act*—to provide this review.

A century ago, such a commission, established by Congress—the National Monetary Commission—devised the framework for the Federal Reserve. Thirty-six years ago, the Congress established the dual mandated. U.S. monetary policy is long-overdue for a review that would:

- Examine how the Federal Reserve performed in terms of economic growth, employment, prices, and financial stability over time;
- Evaluate the various operational regimes for conducting monetary policy, including:
 - o Discretion in determining monetary policy without an operational regime;
 - o Price level targeting;
 - o Inflation rate targeting;
 - o Nominal gross domestic product targeting;
 - o The use of monetary policy rules; and
 - o The gold standard.
- Recommend a course for monetary policy going forward, including:
 - o The legislative mandate;
 - o The operational regime;
 - o The securities used in open market operations; and
 - o Transparency issues.

Membership would be bipartisan: 6 Republicans, 6 Democrats, and 2 non-voting members—from Treasury and the Fed. This bipartisan review of our nation’s monetary policy could result in valuable recommendations for monetary reforms going forward.



Next, the Sound Dollar Act (H.R.1174)—which I introduced earlier this year with 51 original House cosponsors—is my vision for where monetary policy should be to close the Growth Gap and ensure that the 21st century is another American Century.

The Centennial Monetary Commission provides a neutral forum for debating the merits of different approaches to monetary policy, though I am convinced that this forum will ultimately gravitate to the positions of the Sound Dollar Act. This is because experience suggests that the Fed does best when it has a clear mandate for a rules-based monetary policy, coupled with operational independence—free from political interference—to achieve its mandate.

This is exactly what would happen under the Sound Dollar Act, which has also been introduced in the Senate (S.238) by Sen. Lee with Sens. Cornyn and Rubio as original cosponsors.

The *Sound Dollar Act* would reform the Fed’s mandate from promoting: “the goals of maximum employment, stable prices, and moderate long-term interest rates;” and change it to pursuing “the goal of long-term price stability, in order to achieve the maximum sustainable rate of output growth and the maximum level of employment through time.” The difference is that the current plural “goals” places equal weight on what the Fed can control, and what it cannot really control. The reform is a single “goal” of price stability, in which the best environment for economic growth and high employment is created.

This is not a false choice between jobs or stable prices. Stable prices and a sound dollar are what create the best foundation for job growth over the long term. Price stability is the key to growth and jobs because it encourages employers to invest and create jobs; investment is much more difficult with inflation or deflation. Employment would be better served if the Fed adopted a single price stability mandate.

Moreover, in achieving price stability, the *Sound Dollar Act* would require the Fed to monitor a broad range of assets—beyond goods and services—including gold and the foreign exchange value of the dollar, in order to avoid future asset bubbles. The idea here is that more deliberately monitoring asset prices will help the Fed to identify incipient price bubbles before they inflate. How to address bubbles would depend upon circumstances and be left to the discretion of the Fed.

The *Sound Dollar Act* would also require the Fed to articulate its lender-of-last-resort policy. The Fed's role of lender of last resort is to banks—preventing unnecessary failures of solvent but illiquid institutions; limiting the spread of financial contagion; and minimizing the impact of financial crises on the economy—is crucial. Yet, the Fed's failure to articulate a lender-of-last-resort policy in its 100-year history has created an expectation for bailouts. Articulating its lender-of-last-resort policy would increase economic certainty; decrease instances of financially-distressed firms seeking political solutions; and reduce moral hazard from firms taking excessive risks based on faulty assumptions that the Fed will bail them out.

Next, the Sound Dollar Act would allow the Fed to invest only in Treasuries, repos and reverse repos, except during emergencies. The Fed should not pick winners and losers by allocating credit, but should invest solely in U.S. Treasuries except during a grave emergency. And after the emergency is over, non-Treasury assets should be liquidated in an efficient and orderly manner.

This is important for the housing market because, since 2008, the Fed has been investing more broadly in mortgage-backed securities. This poses a threat to housing because if someday the Fed must quickly unwind these assets to combat inflation, it would be devastating to housing. My legislation provides for a slow and orderly liquidation of non-Treasury assets to ensure that no harm comes to the housing market.

The primary inflationary danger presently lies with whether the Fed can identify a change in economic conditions and execute an exit strategy before price inflation occurs and inflationary expectations take root? It is technically possible, but history teaches that central banks have a poor track record of identifying economic inflection points and adjusting monetary policy in a timely manner. Gradually reducing the excess reserves that could be the fuel for future inflation will reduce market uncertainty, strengthen the foundation for non-inflationary economic growth, and reduce the likelihood of undue political interference in Federal Reserve policy. This is what the *Sound Dollar Act* would do.

Lastly, the *Sound Dollar Act* would also increase voting membership on the FOMC to include all regional bank presidents; and it would move the release of FOMC transcripts from 5 years to 3 years. These changes will increase the geographic and professional background diversity among voting FOMC members; and it will allow for a more timely release of transcripts in a way that will still ensure the integrity of the Fed's decision making process.



The time is ripe for monetary reform. Getting monetary policy right is the foundation for economic growth. Let's unite behind moving workable monetary reform to the front-burner.