

Testimony on
“Monetary Policy Going Forward: Why a Sound Dollar Boosts Growth and Employment”

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Chairman Casey, Vice Chairman Brady, other members of the Committee, thank you for giving me the opportunity to comment on the proposed legislation. I will assess each provision in terms of what I see as its *intent* and *consequences*.

Several provisions represent sensible efforts to increase the clarity and transparency of monetary policy. These have merit and are worthy of consideration.

Several provisions, however, appear to be attempts to prevent the FOMC from responding to divergences from full employment, as in the Great Recession, and restrict the FOMC from carrying out stimulative policy once the federal funds rate is near zero, as it is today.

Let's start with preliminaries. Should the government, broadly defined, have a goal of promoting full employment (subject to a few caveats)? Who should be responsible? There has been timely and, I believe, somewhat effective use of fiscal policy to move the economy back in the direction of full employment. Still, monetary policymakers have advantages: They can respond more quickly and are not handicapped by partisan maneuvering.

But *can* the Fed effectively carry out *stabilization* policy? Are estimates of the minimum sustainable unemployment rate *so uncertain* that monetary policy is as likely to damage economic performance as it is to improve it? Does a dual mandate *undermine* the ability of a central bank to meet its price stability mandate?

The CBO, the IMF, the Board staff, most FOMC members, generations of CEAs, and Macroeconomic Advisers all believe the FOMC *can* effectively promote full employment. While there is some evidence that central banks with an *explicit* inflation target do a better job anchoring long-term inflation expectations, the difference relative to the U.S. is very small, the evidence is mixed, and, in any case, the FOMC now has an explicit inflation objective. But the

proof is in the pudding! Under Chairmen Volcker, Greenspan, and Bernanke, the FOMC effectively pushed long-run inflation expectations down from an unacceptable level in the 1970s and early 1980s to about 2%, and there has been no backtracking. In any case, the policy of keeping the funds rate near zero and the dramatic expansion of the Fed's portfolio do not risk soaring inflation. The Fed has all the tools needed to drain reserves and shrink the portfolio when appropriate. In any case, as long as it has control of interest rates, it can control inflation (not over the very short run, of course, but over the medium or longer term). This conclusion is consistent with the inflation projections of the CBO, the OMB, the IMF, FOMC participants, the Survey of Professional Forecasters, and Macroeconomic Advisers. *None* projects inflation above 2% over the next several years.

Now let's turn to specific provisions. First, should the Congress change the FOMC's mandate from a dual to a single mandate? The answer is that it depends! If the bill is intended to move the Fed to *flexible inflation targeting*, a regime practiced by virtually *every* other central bank in the world, this is a discussion worth having, though I still prefer the existing dual mandate.

Under the dual mandate, as the Chairman has emphasized and the bill notes, the two mandates are on an "equal footing." Flexible inflation targeting central banks *also* seek to achieve full employment and price stability, but, in my view, operate as if they have a *hierarchical* ordering of the two objectives: inflation is the *primary* objective, full employment *secondary*. However, the empirical evidence shows that dual mandate and flexible inflation targeting central banks operate in essentially the same way. That is, perhaps, why some FOMC members refer to the Fed's regime as flexible inflation targeting and why many central bankers who operate in flexible inflation targeting regimes say there is no difference from a dual mandate framework. I prefer the transparency and weighting of the objectives of a dual mandate regime.

But this provision reads like the goal is to move the FOMC to *hard* inflation targeting, a regime practiced by *no* central bank today. I strongly oppose this. Under such a regime, the central bank may *only* pursue price stability, and, therefore, *must* pay no attention to divergences from full employment, even in a case like the Great Recession. Perhaps Governor Mervyn King of the Bank of England sums it up best when he calls supporters of such a framework “inflation nutters!”

Should all presidents of Reserve Banks be voting members, that is, on the FOMC? The motivation of supporters, I suspect, is that currently there are more hawks among presidents than among Board members, so giving votes to all the presidents would increase the power of the hawks, perhaps prevent further quantitative easing, and dilute the power of the Chairman.

I find it very surprising that some members of Congress, as a general principle, would want to decrease the power of Board members who have been nominated by a democratically elected president and confirmed by democratically elected members of the Senate, and make Reserve Bank presidents, appointed by unelected and unrepresentative boards, a majority on the FOMC. Supporters apparently believe that there is not enough *regional* influence on the FOMC’s *national* policy decisions and that bankers do not have enough influence on monetary policy.

While there is much ambiguity in the proposed legislation relating to asset purchases, any proposal restricting the Fed to holding *only* short-term government securities in its portfolio would remove the FOMC’s ability to pursue quantitative easing, which is *defined* as the purchase of long-term securities to lower longer-term rates when shorter-term rates are zero. This would prevent the FOMC from providing additional stimulus when the funds rate is at a near-zero level and, indeed, promoting price stability in such circumstances. This is a restriction that, at least to

my knowledge, no other central bank faces. Indeed, most central banks have greater flexibility in their asset purchases than the FOMC does today.

Now for an editorial: I regret that the Fed has become so politicized. Some of the provisions of this bill appear to me clearly partisan. Please recognize that the greatest threat to the stability of long-term inflation expectations is an assault on the independence of the Fed's monetary policy decisions.

Congress should respect the following admonition: Changes in the Federal Reserve Act should only be seriously considered if there is wide *bi-partisan* support.

Thank you. I would be pleased to take your questions.