Joint Economic Committee
Representative Kevin Brady ● Chairman

CHAIRMAN KEVIN BRADY
JOINT ECONOMIC COMMITTEE
MARCH 26, 2014

Unwinding Quantitative Easing: How the Fed Should Promote Stable Prices, Economic Growth and Job Creation

Vice Chair Klobuchar, Members, and Distinguished Witnesses:

The subject of today's hearing is how the Federal Reserve should proceed to normalize monetary policy after the extraordinary actions taken during and after the Great Recession—consistent with promoting stable prices, economic growth, and job creation for America.

Three months ago the Federal Open Market Committee (FOMC) began to taper its large-scale asset purchase program, known as quantitative easing. Financial market participants anticipate the program's termination before then end of the year. Yet ending quantitative easing is simply the first step toward normalizing monetary policy.

The FOMC will also have to raise its target rate for federal funds to a level consistent with long-term price stability; and then as it presumably allows its mortgage-backed securities to gradually unwind, it will have to deal more proactively with its unprecedented build-up of excess bank reserves—currently at a stunning $2.64 trillion. These excess reserves represent the fuel for significant price inflation.

We truly live in challenging economic times. The United States suffers from a massive Growth Gap—missing 5.6 million private-sector jobs and $1.3 trillion in real GDP as compared with the average recovery of the past 50 years. Using the same comparison, families are struggling with a cumulative loss of $8,961 per person in real disposable income since the end of the recession.

The slow-growth economic policies pursued by President Obama bear responsibility for this Growth Gap—polices like higher taxes on small businesses, capital gains, and dividends; the *Affordable Care Act*, resisting the development of traditional energy sources on federal lands, and the onslaught of anti-growth regulations.

The Federal Reserve both contributed to the cause of the financial crisis and deserves praise for its extraordinary actions at the height of panic in 2008, which helped to stabilize financial markets. However, more than four years after this recovery began, the benefits from quantitative easing and extraordinarily low interest rates have diminished.

The Fed's policies have boosted Wall Street but left Main Street and middle-class families behind. Since the recession ended the current return adjusted for inflation on the S&P 500 is 98%, but real disposable income per capita has risen by a meager 3.6%.

Ultimately, though an accommodative monetary policy may cushion real output and employment in the short term, it cannot stimulate real output and employment over the long term. Sound monetary policy cannot compensate for bad spending, tax, trade and regulatory policies.

Meanwhile the benefits are diminishing and the risks are rising from quantitative easing and extraordinarily low interest rates. I am concerned that the FOMC may be unintentionally inflating new asset bubbles and possibly setting the stage for significant price inflation and a further decline in the purchasing power of the dollar.

Today's hearing addresses a topic that should be of great interest to Americans from all walks of life. The Federal Reserve operates under a dual mandate for monetary policy— established in 1977—which gives equal weight to achieving long-term price stability and the maximum sustainable level of output and employment.

Yet as Federal Reserve Chairmen Paul Volcker and Alan Greenspan correctly foresaw, monetary policy could contribute to achieving full employment—if and only if—the Federal Reserve focused solely on price stability.

Under their guidance, the Fed turned to an increasingly rules-based monetary policy. The results were outstanding: low inflation and two long and strong expansions, interrupted only by a brief, shallow recession.

Since the Great Moderation, monetary policy has again become discretionary and interventionist. Not surprisingly, the results are disappointing. Beginning in 2008, the Fed explicitly deviated from the Volcker-Greenspan view, invoking the employment half of its mandate to justify its extraordinary actions.

Now we approach the end of quantitative easing. For three consecutive meetings, the FOMC has announced incremental decreases of $5 billion in its monetary purchase of both federal agency mortgage-backed securities and long-term Treasury securities.

Yet the complex and uncertain task of unwinding quantitative easing remains. As of March 19th the Fed's balance sheet was $4.26 trillion—more than quadruple its September 3, 2008 level of $945 billion, and excess bank reserves held at the Fed is $2.64 trillion—compared with $11.9 billion on September 3, 2008.

I will be very interested to hear our witnesses' views on how monetary policy should be normalized, and I am hopeful that they can also help us gain insights on how the FOMC should respond if current forecast are wrong and significant price inflation materializes.

Also I am very interested in our witnesses' thoughts on the economic effects of financial repression—particularly paying higher interest rates to keep bank reserves from flowing into the economy; and any thoughts on the Fed turning toward using reverse repos instead of the Fed Funds rate, as a tool to affect interest rates.

While the Federal Reserve is supremely confident that it can end the bond buying, normalize interest rates, sell the mortgage backed securities back into the market and finesse the excess bank reserves while improving the economy and avoiding inflation, I am not.

Today we are joined by two very distinguished and veteran JEC witnesses. Dr. John Taylor is the creator of the Taylor rule that central banks have used to implement a rules-based monetary policy, and Dr. Mark Zandi is the chief economist of Moody's Analytics. We are fortunate to have them with us.

With that, I look forward to their testimony.