Statement before the Committee on Financial Services
Subcommittee on Monetary Policy and Trade
On "The Fed Turns 100: Lessons Learned over a Century of Central Banking"

The Fed Is as Poor at Knowing the Future as Everybody Else

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Hearing on "The Fed Turns 100: Lessons Learned from a Century of Central Banking"

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The Fed Is as Poor at Knowing the Future as Everybody Else

Mr. Chairman, Ranking Member Clay, and Members of the Subcommittee, thank you for the opportunity to be here today. I am Alex Pollock, a resident fellow at the American Enterprise Institute, and these are my personal views. Before joining AEI, I was President and CEO of the Federal Home Loan Bank of Chicago from 1991 to 2004. I have published numerous articles on banking and financial systems, including the role of the Federal Reserve and central banks in general.

A striking lesson of the 100-year history of the Federal Reserve is how it has been able from its beginning to now to inspire entirely unjustified optimism about what it can know and what it can accomplish.

Upon the occasion of the Federal Reserve Act in 1913, an *American Banker* writer opined, "The financial disorders which have marked the history of the past generation will pass away forever." Needless to say, the Fed has not made financial disorders disappear, and not for lack of trying, while it has often enough contributed to them.

In 1914, the then-Comptroller of the Currency expressed the view that with the creation of the Fed, "financial and commercial crises, or panics…seem to be mathematically impossible." They weren't.

The unrealistic hopes continued. As a forthcoming history says, "The bankers at the Federal Reserve kept the money flowing in to the American economy at a pitch that held interest rates low and kept expanding business and consumer credit… [but] there was no rise in prices. The business cycle…had finally been tamed—or so it seemed. Economists around the world praised the Federal Reserve. Some even predicted that a 'new era' in economics had begun." This passage sounds like it is describing the central bank optimism of the early 2000s with the so-called "Great Moderation," but in fact it is describing the 1920s. We know what came next, and the Fed is widely blamed for its deflationary blunders in the crisis of the early 1930s, and again in 1937.

In the 1940s, the Fed was the willing servant of the Treasury Department in order to finance the war and hold down the interest rates on government debt, thus doing in great scale exactly what the fathers of the Federal Reserve Act had tried to prevent: monetizing government debt. (The Fed had also lent its full efforts to finance the government during the American participation in the First World War.)

After enjoying the American global economic hegemony of the 1950s, the 1960s brought a new high point in optimism about what discretionary manipulation of interest rates and financial markets could achieve. Otherwise intelligent and certainly well-educated economists actually came to believe in what they called "fine tuning": that the Fed and government policy "could keep the economy more or less perfectly on course," as discussed by Fed Chairman Bernanke in his new book, *The Federal Reserve and the Financial Crisis*. Some economists even held a conference in 1967 to discuss "Is the Business Cycle Obsolete?" It wasn't.

The fine tuning notion "turned out to be too optimistic, too hubristic, as we collectively learned during the 1970s," Bernanke writes, "so one of the themes here is that—and this probably applies in any complex endeavor—a little humility never hurts." Very true.

Indeed, the performance of the Federal Reserve at economic and financial forecasting in the last decade, including missing the extent of the Housing Bubble, missing the huge impact of its collapse, and failing to foresee the ensuing sharp recession, certainly strengthens the case for humility on the Fed's part, especially when it attempts to forecast financial market dynamics. The poor record of economic forecasting is notorious, and the Fed is no exception to the rule.

If only the Chairman, the Governors, the Presidents and the scores of economists of the Federal Reserve could really know the future! Then they could carry out their discretionary actions without the many mistakes, both deflationary and inflationary, which have marked the history of the Fed. These mistakes should not surprise us. As Arthur Burns, Fed Chairman in the 1970s and architect of the utterly disastrous Great Inflation of that decade, said: "In a rapidly changing world, the opportunities for making mistakes are legion."

In a 1996 speech otherwise famous for raising the issue of "irrational exuberance," then-Fed Chairman Alan Greenspan sensibly discussed the limits of the Fed's knowledge. "There is, regrettably, no simple model of the American economy that can effectively explain the levels of output, employment and inflation," he said. (Since it is effectively the world's central bank embedded in globalized financial markets, the Fed would need not merely a model of the American economy, but one of the world economy.)

"In principle," Chairman Greenspan continued," there may be some unbelievably complex set of equations that does that. But we [the Fed] have not been able to find them, and do not believe anyone else has either." They certainly have not, as subsequent history has amply demonstrated. Moreover, in my view, not even in principle can any model successfully predict the complex, recursive financial and economic future—so the Fed cannot know with certainty what the results of its own actions will be.

Nonetheless, the 21st century Federal Reserve and its economists again became optimistic, and perhaps hubristic, about the central bank's abilities when Chairman Greenspan had been dubbed "The Maestro" by the media and knighted by the Queen of England. It is now hard to remember the faith he and the Fed then inspired and the confidence financial markets had in the support of what was called the "Greenspan put."

Queen Elizabeth would later quite reasonably ask why the economists and central banks failed to see the crisis coming. One lesson we can draw from this failure is that a group of limited human beings, none of whom is blessed with knowledge of the future, with all the estimates, guesses, and fundamental uncertainty involved, by being formed into a committee, cannot rationally be expected to fulfill the mystical notion that they can guarantee financial and economic stability.

In the early 2000s, of particular pride to the Fed was that the central bankers thought they were observing a durable "Great Moderation" of macro-economic behavior, a promising "new era," and gave their own monetary policies an important share of the credit. With an eye on a hoped-for "wealth effect" from rising house prices, the Fed pushed interest rates exceptionally low as the housing bubble was rapidly inflating, which many observers, including me, view as a critical mistake. Chairman Bernanke has since insisted that the Great Moderation was "very real and striking." Yet, since it is apparent that the Great Moderation led to the Great Bubble and then to the Great Collapse, how could it have been so real?

Economic historian Bernard Shull has explored the paradox that throughout its 100 years, no matter how many mistakes the Fed makes, or how big such mistakes are, it nonetheless keeps gaining more power and prestige. In 2005, he made the following insightful prediction: "We might expect, on the basis of the paradoxical historical record, still further enhancements of Federal Reserve authority." Indeed, in the wake of the bubble and collapse, the political and regulatory overreaction came, as it always does each cycle. The Dodd-Frank Act gave the Fed much expanded regulatory authority over financial firms deemed "systemically important financial institutions" or "SIFIs," and a prime role in trying to control "systemic risk."

But the lessons of history make it readily apparent that the greatest SIFI of them all is the Federal Reserve itself. It is unsurpassed in its ability to create systemic risk for everybody else through its unlimited command of the principal global fiat money, the paper dollar. As former-Senator Bunning reportedly asked Chairman Bernanke, "How can you regulate systemic risk when you *are* the systemic risk?" A good question! Who will guard these guardians?

A memorable example of systemic risk is how the Fed's Great Inflation of the 1970s destroyed most of the savings and loan industry by driving interest rates to levels previously thought impossible. In the 1980s, the Fed under then-Chairman Paul Volcker, set out to "fight inflation"-—the inflation the Fed had itself created. In this it was successful, but the high interest rates, deep recession and sky-high dollar exchange rate which resulted, then created often-fatal systemic risk for heartland industries and led to a new popular term, "the rust belt." A truly painful outcome of some kind was unavoidable, given the earlier inflationary blunders.

A half-century before that, in 1927, the then-dominant personality in the Federal Reserve, Benjamin Strong, famously decided to give the stock market a "little coup de whiskey." In our times, the Fed has decided to give the bond market and the mortgage market a barrel or so of whiskey in the form of so-called "quantitative easing." This would undoubtedly have astonished previous generations of Federal Reserve Governors, and have been utterly unimaginable to the authors of the Federal Reserve Act.

How will this massive manipulation of the government debt and mortgage markets turn out? Will it make the current Fed into a great success or become another historic blunder? In my opinion, neither the Fed nor anybody else knows—about this all of us can only guess. It is a huge and fascinating gamble, which has without doubt induced a lot of new systemic interest rate risk into the economy and remarkable concentration of interest rate risk into the balance sheet of the Federal Reserve itself.

In the psychology of risky situations, actions seem less risky if other people are doing the same thing. That is why, to paraphrase a celebrated line of John Maynard Keynes, a "prudent banker" is one who goes broke when everybody else goes broke. That other central banks are also practicing versions of "quantitative easing" may induce the same subjective comfort. A decade ago, bankers felt a similar effect when they all were expanding mortgage debt together.

Robert Solow recently claimed that "Central banking is not rocket science." Indeed, it isn't: discretionary central banking is a lot harder than rocket science. This is because it is not and cannot be a science at all, because it cannot operate with determinative mathematical laws, because it cannot make reliable predictions, because it must cope with ineluctable uncertainty and an unknowable future. We should have no illusions, in sharp contrast to the 100 years of illusions we have entertained, about the probability of success of such a difficult attempt, no matter how intellectually brilliant and personally impressive its practitioners may be.

It is often debated whether the Fed can successfully achieve two objectives, the so-called "dual mandate," rather than one. It does seem doubtful that it can, but the question oversimplifies the problem, for the Fed has not two mandates, but six.

The precise provision of the Federal Reserve Reform Act of 1977, which gives rise to the discussion of the "dual mandate," is almost always mischaracterized, for that provision assigns the Fed three mandates, not two. The Fed shall, it says, "promote effectively the goals of maximum employment, stable prices, and *moderate long-term interest rates*." This is a "triple mandate," at least. The third statutorily assigned goal is almost always forgotten. It is doubtful indeed that the Fed can simultaneously do all three.

But in addition to these, the Fed has three more mandates. These are: to furnish an elastic currency, the historically first mandate and the principal reason for the existence of the Fed in the first place; to act as the manager of the risks and profits of the banking club, now expanded to include other "SIFIs"; and finally, to provide ready financing for the deficits of the government of which it is a part, as needed.

Let us do a quick review of how the Fed is doing at each of its six mandates.

To begin with "stable prices": this goal was in fact dropped long ago. The Fed's goal is not and has not been for decades stable prices, but instead permanent inflation—with a relatively stable rate of increase in prices. In other words, the Fed's express intention is a steady depreciation of the currency it issues, another idea which would have greatly surprised the authors of the Federal Reserve Act. At its "target" of 2% inflation a year, average prices will quintuple in a normal lifetime. Economists can debate whether a stable rate of price increases rather than a stable price level is a good idea, but you cannot term perpetual inflation "price stability" with a straight face.

Turning to "maximum employment": Nobody believes any more, as many people believed when this goal was added to the governing statute in 1977, that there is a simple trade-off between inflation and sustained employment. It was still believed when the Humphrey-Hawkins Act of 1978 was passed, although it was already being falsified by the great stagflation of the late 1970s. Humphrey-Hawkins added a wordy provision requiring the Fed to report to and discuss with Congress its plans and progress on the triple mandate. Did these sessions succeed? They obviously did not avoid the financial disasters of the 1980s and 2000s, or the inflation of giant bubbles in tech stocks and housing.

On “moderate long-term interest rates”: As the Treasury’s servant in the 1940s, the Fed kept the yield on long-term government bonds at 2 ½%. After this practice was ended by the “Treasury-Fed Accord” of 1951, a 30-year bear bond market ensued, which ultimately took long-term interest rates to 15% in the early 1980s—this was not a “moderate” interest rate, to be sure. With the Fed’s current massive bond buying, rates on long-term government bonds got to 1½%-2%, which was zero or negative in real terms—also not a “moderate” interest rate.

The fourth mandate stood right at the beginning of the original Federal Reserve Act in 1913. The authors of the Act told us clearly what they wanted to achieve:

> “An Act to provide for the establishment of Federal reserve banks, *to furnish an elastic currency*….”

An elastic currency is most definitely what we have got, not only in the U.S., but given the global role of the dollar, in the world. Indeed, we have one much more elastic than originally intended. This is very handy during financial panics when the Fed is acting as the lender of last resort. The unanswered question is: given a pure paper currency (not originally intended, of course) with unlimited elastic powers, what limits should there be other than the demonstrably fallible beliefs and judgments of the members of the Federal Reserve?

Charles Goodhart’s monograph, *The Evolution of Central Banks*, makes a strong argument that it helps to understand central banks, including the Fed, by thinking of them as the manager of the banking club, which tries to preserve and protect the banking industry. This becomes most evident in banking crises. It was explicitly expressed in an early Fed plaque: “The foundation of the Federal Reserve System is the co-operation and community of interest of the nation’s banks.” Such candor is not currently in fashion—the fifth mandate is now called “financial stability.” As discussed, this mandate has been expanded by Dodd-Frank beyond banks to make the Fed the head of an even bigger financial club.

Sixth is the most basic central bank function, and Fed mandate, of all: financing the government, a core role of central banks for over three centuries. As economist Elga Bartsch has correctly written, “The feature that sets sovereign debt apart from other forms of debt is the unlimited recourse to the central bank.” Thus for governments that wish to finance long-term deficits with debt, like the United States, central banks are exceptionally useful, which is one reason virtually all governments have one-- no matter how disappointing the central bank’s performance at stable prices, maximum employment, moderate long-term interest rates, and financial stability may be. Needless to say, the power of financing the government is also dangerous.

Allan Meltzer, an eminent scholar of the Federal Reserve and our colleague on this panel, near the end of his magisterial *A History of the Federal Reserve*, quotes the classic wisdom of monetary thinker Henry Thornton from 1802-- 211 years ago, who proposed:

> “to limit the total amount of paper issued, and to resort for this purpose, whenever the temptation to borrow is strong, to some effectual principle of restriction: in no case, however, materially to diminish the sum in circulation, but to let it vibrate only within certain limits; to allow a slow and cautious extension of it, as the general trade of the kingdom enlarges itself…. To suffer the solicitations of the merchants, or the wishes of the government, to determine the measure of bank issues, is unquestionably to adopt a very false principle of conduct.”

These are sensible guidelines, as my friend Allan suggests. But another lesson of 100 years of Federal Reserve history is that we have still not figured out how to implement them.

Thank you again for the opportunity to share these views.