Testimony before the Subcommittee on Monetary Policy and Trade of the Committee on Financial Services of the U.S. House of Representatives

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Chairman Huizenga, Ranking Member Moore, and members of the subcommittee: I thank you for the opportunity to testify on this important piece of legislation.

I am John Cochrane. I am a Senior Fellow of the Hoover Institution, a nonpartisan research institute at Stanford University. I represent my own views only.

It is wise for Congress and the Federal Reserve to rethink the fundamental structures under which the Fed operates. I think that the Fed wants guidance, and a settled relationship with Congress, as much as you want clarity. I view this legislation as an important first step in that process.

Principles

Two great principles underlie this effort: Independence and rules.

The Federal Reserve enjoys great independence. This independence is almost universally viewed as a good thing.

However, in our democracy, independence must be paired with clearly limited powers. And to the extent the Fed is granted or assumes larger powers, it must lose some of its independence.

For example, the Federal Reserve does not and cannot print money and hand it out, or drop money by helicopters in Milton Friedman's famous story. This kind of "stimulus" would be very powerful. In the depths of the recession, Federal Reserve officials surely would have wanted to do it. Many economists advocated "helicopter drops." But the power to write checks to voters in our democracy resides with the Treasury department and Congress. And for obvious reasons. Just who gets the checks and how much are deeply political decisions, and only an Administration and Congress which regularly face the wrath of voters can make them.

We also believe in rules, laws, and rule of law. We believe that independent agencies and their officials should, as much as possible, implement laws and rules, or at least traditions and precedents. They should not issue decrees at their discretion. And the more an agency follows rules, the more limited its powers, the more independent it can be.

Your task, and the Fed's, is to rethink the limits on Federal Reserve powers, to develop rules, to preserve its independence. And where such limits and rules are not possible, to limit that independence and oversee its decisions in the name of citizens, voters, and taxpayers.

Policies

Conventional monetary policy consists of setting short term interest rates, in response to, and with an eye to stabilizing, inflation and unemployment. Conventional monetary policy was limited to buying and selling short-term Treasuries to affect short-term rates, but will likely consist in the future of simply offering banks higher or lower interest rates on reserves and in loans from the Fed. You have heard much about rules in this context, and I think the bill before you does a good job of encouraging a fruitful framework for discussion between yourselves and the Federal Reserve.

But that is the tip of the iceberg. In the wake of the financial crisis and deep recession, the Federal Reserve has been given (by the Dodd-Frank act) and has taken on a wide range of new powers and responsibilities. Even more is being hotly discussed, under the label of "macro-prudential" policy. The Fed's perceived mandates — the central outcomes it should try to control — and its tools — what levers it can pull — have each expanded.

As natural with anything new, this has been a period of great experimentation and thus discretion. But as these experiments merge into regular policy, it is time to bring them in to the usual framework.

My main point today, is to encourage you to look beyond conventional monetary policy, and to consider what rules, mandates, limits, and oversight the Fed will follow in these newly expanded roles, or which of these mandates and tools you wish the Fed to stop pursuing and using.

Interest rate policy now goes beyond inflation and unemployment. The Fed is accused of stoking a housing "bubble" with too low rates in the early 2000s. Now, the big discussion concerns whether the Fed should raise rates to offset a perceived "reach for yield," high home prices, stock prices and bond prices.

Well, should the Fed be reacting to, or manipulating mortgage rates, exchange rates, and stock, bond, and housing prices? Is it even appropriate for Fed officials to offer opinions on whether stocks are too high or too low?

I think not. There is really no solid economic understanding of any link between the level of short term rates and these other assets. The Fed is as likely to do harm than good, to induce instability in prices from intense speculation about its actions. And manipulating asset prices is an intensely political decision, as the Chinese central bank is finding out, requiring a loss of independence. But I have come to pose the question, not to offer my answers

Perhaps the most important implication of a rule, say linking interest rates to inflation and unemployment, or a mandate, instructing the Fed to stabilize inflation and unemployment, is the long list of things that by implication the Fed should, at least in normal times, *not* respond, *not* try to control, and for which you, the Congress, will not hold the Fed responsible. This may be a useful interpretation for you to emphasize.

The Fed's arsenal of tools now goes far beyond setting overnight rates between banks.

In the recession, the Fed tried to manipulate long-term Treasury rates and mortgage-backed security rates, directly by buying lots of those securities. In the crisis, the Fed also bought commercial paper, to raise those prices. Some central banks buy stocks.

Should the Fed try to manipulate asset prices directly, by buying and selling assets? If so, under what conditions; i.e. with what rules, or with what supervision and loss of independence? Again, I think not. But again, you have to think about it.

Here, the Fed-Treasury separation I praised over fiscal policy has broken a bit. The Treasury's Office of Debt Management traditionally manages the maturity of government debt in private hands, and thus the Treasury's exposure to interest rate risk. In the period that the Fed was buying up long-term debt, trying to reduce the amount in public hands, the Treasury was issuing lots of long-term debt, trying to increase it. They each undid the other's actions. Clearly, some accord is needed over who has responsibility for the maturity structure of the debt.[1]

The Fed is also the prime financial regulator. Since 2008, under the Dodd Frank act, and of its own volition, the Fed's regulatory role has expanded enormously. "Systemic stability" is an implicit third or fourth mandate. And the Fed is contemplating "macro-prudential policy," combining regulatory and expanded monetary policy tools to achieve both macroeconomic and financial goals. What rules and limits will this effort respect?

The Fed now exercises "enhanced supervision" of the "systemically designated" banks, exchanges, and insurance companies. Dozens of Fed staff live full time at these institutions, reviewing details of their operation. This exercise follows few rules, great discretion, and little accountability to you.

The "stress tests" are one example, which this bill begins to address. The Fed made up this procedure in the financial crisis, and it seemed to give confidence in the banks. But this temporary expedient has now become a permanent ritual. The stress tests follow no preset rules. The Fed deliberately tries to surprise the banks with novel tests each time. The thinking goes, I suppose, that if the banks knew the rules ahead of time, as they know their capital requirements or leverage ratios, they would jigger the books to pass the tests. But the result is a highly discretionary decision by Fed officials, on which billions of dollars and the competitive fortunes of banks rest. That is not a good basis for a permanent policy. I am glad that your bill brings some structure to this enterprise. But not totally glad, as the bill then institutionalizes stress tests and perhaps we should get rid of them instead.

An earlier example is starker. In the robosigning affair, the Federal Reserve joined with the US and states Attorneys General, and used its "safety and soundness" regulatory power to force banks to write down mortgage principal — not on the robosigned homeowners, but on completely unrelated homeowners — and to give money to "nonprofit housing counseling organizations." Writing down prinicipal — a transfer from bank shareholders to homeowners — is a fiscal and macroeconomic policy. Whatever its wisdom, it clearly detracts from bank safety and soundness. Though the example is small, I think it provides a clear case of compromised independence, and the use of regulatory powers to effect macroeconomic and fiscal policy

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[1]See Robin Greenwood, Samuel G. Hanson, Joshua S. Rudolph, and Lawrence Summers, "Government Debt Management at the Zero Lower Bound." Hutchins Center Working Paper, No. 5, September 2014, for details.

interventions[2]. You may or may not approve; you may or may not want the Fed to do such things with complete independence.

The heart of "macroprudential" proposals is the idea that central banks will vary capital ratios, lending standards (loan to value ratios) or other regulatory tools over time, along with interest rates, to stop emerging "bubbles," or to "stimulate" as need be. The Fed may even try to constrain bank lending in regions of the country, such as those with high housing prices, or to encourage others. Well, your bubble is my boom, and home buyers and builders will be calling you when the Fed restricts credit. These are political decisions. Do they rise to the writing-checks-to voters standard that an independent agency should not perform? You must decide the limits on this sort of power you wish to impose, and what rules you wish the Fed to follow.

This bill's requirements for cost benefit analysis are an important step in managing the regulatory explosion. The costs of regulatory compliance and the costs to competitiveness, innovation, and entry into financial services strike me as quite large. But one should not expect the filling out of more mountains of paper to mechanically stop the juggernaut, or more importantly to produce better and clearer regulation, especially when so much rule-making is mandated by Congress itself under the Dodd-Frank act.

The Fed is hotly debating other important changes. Will it maintain a large balance sheet and pay interest on reserves, or revert to the previous rationing of reserves? I prefer the former, for its great financial stability benefits. Will it allow people and non-banks to access interest-paying reserves, the most safe, liquid, and run-free asset imaginable? People will like that, banks will not like being undercut.

The Task

These are all examples of the momentous changes underway in our central bank, as in other central banks around the world. Just how the Fed should approach these issues, which tools and goals it can follow while remaining independent, what rules and legal constraints it can follow in its decisions, what the structures of oversight will be, and how independent it can remain are important issues for you, and the Federal Reserve, to decide.

My main message for you today is to use this bill as a first step in that much broader discussion, and to think beyond conventional monetary policy.

Final thoughts on monetary policy

In part, monetary policy is not, now, obviously broken. The outcomes we desire from monetary policy are, one must admit, about as good as one could hope. Inflation is basically non-existent. Short term rates are as low as we have seen in two generations. The labor market is functioning normally. Economic growth has been steady and bond markets quiet.

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[2] My source here is the Federal Reserve website, and I applaud the Fed's transparency in making these materials public.
http://www.federalreserve.gov/newsevents/press/enforcement/20120209a.htm
http://www.federalreserve.gov/newsevents/press/enforcement/20120213a.htm
http://www.federalreserve.gov/newsevents/press/enforcement/enf20120213a1.pdf

Yes, growth is far too slow, not enough people participate or participate fully in the labor force, wages are stagnant, and we face many other economic problems. But these are problems that the monetary policy really can't do much about. Congress asked for price stability ([which somehow the Fed interpreted to mean 2% inflation), maximum employment, and low interest rates, and we got them. The Fed has limited powers and limited responsibilities, and the purpose of this bill is to define such limits. Each of us has our own opinions whether the Fed should raise rates or not, but there is no strong professional consensus that the Fed is, right now, doing something dramatically wrong.

This benign outcome is, one must also admit, a bit of a puzzle. When interest rates hit zero, traditional Keynesians predicted a deflationary vortex. When the Fed bought nearly 3 trillion dollars of bonds, creating new money in exchange, traditional monetarists predicted hyperinflation. The Fed's own forecasts — along with everyone else's — have been wrong 7 years in a row. With interest rates stuck at zero, conventional monetary policy has obviously nothing to do with this outcome. We all have our theories - I'll be glad to fill you in on mine, if you'd like — but there is no professional consensus on how this remarkably benign state of affairs was reached.

Monetary policy is also much less powerful than most commentators — and most Fed officials — will admit. Money is like oil in the car. Not enough, and the car will stop. But once you have enough oil, adding more does not help the car to go faster. Controlling the car's speed by slightly starving it of oil is not wise. And more oil will not substitute for clogged fuel injectors.

Like most commentators, I feel that the Fed's discretionary monetary policy is damaging, as evidenced by financial markets that hang on every sneeze by Fed officials. A more predictable policy may add some stability to financial markets, and enable people who are investing in businesses to do so with more confidence. At least they could be paying more attention to fundamentals and less to parsing Fed officials' pronouncements. But the combined facts of a benign outcome, at least so far, limited scientific understanding of just how monetary policy works, and limited power of conventional monetary policy, lead me to recommend that this not be the main focus of your efforts.

The massive expansion of Fed responsibilities, the many new tools it is now using, and in particular the temptation to use direct regulatory control to achieve nearly unlimited economic objectives, strike me as the most important topics for a discussion about rules, independence, mandates, and accountability.