IMPACT OF MONETARY POLICY ON THE ECONOMY: A REGIONAL FED PERSPECTIVE ON INFLATION, UNEMPLOYMENT, AND QE3

HEARING

BEFORE THE

SUBCOMMITTEE ON

DOMESTIC MONETARY POLICY

AND TECHNOLOGY

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

JULY 26, 2011

Printed for the use of the Committee on Financial Services

Serial No. 112–50

U.S. GOVERNMENT PRINTING OFFICE

67–945 PDF WASHINGTON : 2011

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

SPENCER BACHUS, Alabama, *Chairman*

JEB HENSARLING, Texas, *Vice Chairman*
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
RON PAUL, Texas
DONALD A. MANZULLO, Illinois
WALTER B. JONES, North Carolina
JUDY BIGGERT, Illinois
GARY G. MILLER, California
SHELLEY MOORE CAPITO, West Virginia
SCOTT GARRETT, New Jersey
RANDY NEUGEBAUER, Texas
PATRICK T. MCHENRY, North Carolina
JOHN CAMPBELL, California
MICHELE BACHMANN, Minnesota
THADDEUS G. McCOTTER, Michigan
KEVIN McCARTHY, California
STEVAN PEARCE, New Mexico
BILL POSEY, Florida
MICHAEL G. FITZPATRICK, Pennsylvania
LYNN A. WESTMORELAND, Georgia
BLAINE LUETKEMEYER, Missouri
BILL HUIZENGA, Michigan
SEAN P. DUFFY, Wisconsin
NAN A. S. HAYWORTH, New York
JAMES B. RENACCI, Ohio
ROBERT HURT, Virginia
ROBERT J. DOLD, Illinois
DAVID SCHWEIKERT, Arizona
MICHAEL G. GRIMM, New York
FRANCISCO R. CANSECO, Texas
STEVE STIVERS, Ohio
STEPHEN LEE FINCHER, Tennessee

BARNEY FRANK, Massachusetts, *Ranking Member*
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
MICHAEL E. CAPUANO, Massachusetts
RUBÉN HINOJOSA, Texas
WM. LACY CLAY, Missouri
CAROLYN McCARTHY, New York
JOE BACA, California
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
GWEN MOORE, Wisconsin
KEITH ELLISON, Minnesota
ED PERLMUTTER, Colorado
JOE DONNELLY, Indiana
ANDRÉ CARSON, Indiana
JAMES A. HIMES, Connecticut
GARY C. PETERS, Michigan
JOHN C. CARNEY, JR., Delaware

LARRY C. LAVENDER, *Chief of Staff*

SUBCOMMITTEE ON DOMESTIC MONETARY POLICY AND TECHNOLOGY

RON PAUL, Texas, *Chairman*

WALTER B. JONES, North Carolina, *Vice Chairman*
FRANK D. LUCAS, Oklahoma
PATRICK T. McHENRY, North Carolina
BLAINE LUETKEMEYER, Missouri
BILL HUIZENGA, Michigan
NAN A. S. HAYWORTH, New York
DAVID SCHWEIKERT, Arizona

WM. LACY CLAY, Missouri, *Ranking Member*
CAROLYN B. MALONEY, New York
GREGORY W. MEEKS, New York
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
GARY C. PETERS, Michigan

CONTENTS

IMPACT OF MONETARY POLICY ON THE ECONOMY: A REGIONAL FED PERSPECTIVE ON INFLATION, UNEMPLOYMENT, AND QE3

Tuesday, July 26, 2011

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC MONETARY
POLICY AND TECHNOLOGY,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:12 p.m., in room 2128, Rayburn House Office Building, Hon. Ron Paul [chairman of the subcommittee] presiding.

Members present: Representatives Paul, Jones, Lucas, Luetkemeyer, Huizenga, Schweikert; Clay, Maloney, and Green.

Ex officio present: Representative Bachus.

Chairman PAUL. This hearing will come to order. Without objection, all members' opening statements will be made a part of the record.

I want to welcome our witness today, President Hoenig.

And I will begin the hearing with my opening statement.

Over the years, I have been interested in the transparency of the Federal Reserve (the Fed), and the Fed has been interested in the independence of the Fed. But since I know what Mr. Hoenig is interested in, I think he truly represents the right kind of independence that I like, because he is a rare individual to be at the Fed, or on occasion to be a member of the FOMC.

But I want to note that last year when virtually everybody was endorsing and welcoming QE2, he was dissenting against this position, I believe, about 8 times. So that to me is truly remarkable and shows that he is, obviously, an independent thinker.

My interest, of course, in the monetary system has been related to the accumulation of debt. I believe they are related and that the size of government is indirectly affected by monetary policy as well. If debt can be easily monetized, the temptation for Congress to spend money is always there. And I think that is a big, big distortion.

Mr. Hoenig has made his points made very clear, that maybe interest rates of 0 to 0.5 percent might be too much, and he actually has made statements about part of our problem prior to the crash of 2008 was the fact that interest rates were too low for too long.

And I often think about and like to clarify and expand as much as possible the relationship of the problems that we have today to our privilege of issuing the reserve currency of the world.

Obviously, nobody has quite that same benefit. And, therefore, our debt and our bubbles can get far more exaggerated than if you are an independent country and your debt is numbered in a currency that the world doesn't accept like they accept our dollars.

So though that might be a very positive thing in the short run, and give us some benefits, it also may be misleading to us, because it is deceiving us into thinking that this process can go on forever.

Today, we are in the middle of a default crisis. We are worrying about whether the national debt is going to be increased.

And I have an opinion that once the debt gets so big, default is virtually impossible to stop and that the default that we are worrying about right now is not strange and brand new, because in many ways, our country has already defaulted.

If you look at our inability to follow up on the promises to pay a gold certificate in the 1930s, that was a form of default. And then, we promised to pay foreigners gold for $35, and we eventually had to quit doing that.

We promised to pay the American citizens a dollar for a silver certificate, and we defaulted on that. And eventually, those silver certificates were not worth a silver dollar, but they were then worth a Federal Reserve Note.

And even in 1978, we met a major crisis. It was a dollar crisis, and we were not able to maintain the value of the dollar. And we went hat in hand to the IMF and actually got approximately $25 billion to $30 billion of boost to prop up our dollar at that time.

So for me, that is a form of default, and I believe we have embarked on a system where default is going to come. And I think the argument and the impasse is because nobody wants to really admit that the default is here, and we have to face up to it.

The argument is, how do we default? Are we going to quit sending the checks out, or are we going to do the ordinary thing that countries have done for years and that we continually do, and that is, we pay off our debt with money with a lot less value.

To me, that is a default, but I see that as being unfair, because some people suffer more than others. And, therefore, we will eventually be pushed into some serious talks about monetary reform, which I believe are actually occurring already in international circles.

But my 5 minutes has expired.

And now, I will yield 5 minutes to Mr. Clay.

Mr. CLAY. Thank you, Mr. Chairman. And thank you for conducting this hearing on the impact of monetary policy and the state of the economy.

The Full Employment and Balanced Growth Act of 1978, better known as Humphrey-Hawkins, set four benchmarks for the economy: full employment; growth in production; price stability; and the balance of trade and budget.

The Humphrey-Hawkins Act also charges the Federal Reserve with a dual mandate: maintaining stable prices; and promoting full employment.

According to the Department of Labor, in June, the Nation's unemployment rate was 9.2 percent. Over 14 million Americans are looking for work. Another 5 million are underemployed at jobs that pay much less than they previously earned, and offer few benefits.

And in urban areas like the district that I represent in St. Louis, the unemployment rate among African Americans and other minorities is over 16 percent.

The Majority party has been in power in this House for over 200 days, and yet we have not seen one jobs bill, and America is still waiting.

I am eager to hear what additional steps the Federal Reserve is willing to take to free up the flow of credit to small businesses and to encourage major banks to finally invest in this recovery, instead of sitting on the sidelines with trillions of dollars that could be creating millions of jobs.

I also look forward to the witness' comments regarding what other urgent steps Congress can take to spur private sector job growth and restore confidence in our economic future.

And with that, Mr. Chairman, I yield back.

Chairman PAUL. I thank the gentleman.

Now, I yield to Mr. Luetkemeyer.

Mr. LUETKEMEYER. Thank you, Mr. Chairman. Thank you, Mr. Chairman, for holding this hearing today and for continuing the dialogue.

I first want to recognize today's witness. President Tom Hoenig has been a voice for reasons and fiscal conservatism during a time when many of our economic policies have been weak.

Tom has often been a lone dissenter who has encouraged sound economic principles over politically expedient ones. Our Nation is grateful for his service.

President Hoenig has expressed concern over Federal Reserve monetary policies. Personally, I remain troubled by the expansionary role the Fed seems to have been championing over the last several years. What is more upsetting is the fact that we don't seem to be any closer to changing course and abandoning these policies, even though they don't seem to have worked.

While a Federal program of quantitative easing looms, our economy remains stagnant. Our jobless rate continues to hover above 9 percent. Bank lending is still constrained. And we have seen little evidence of a long-term economic growth.

Abroad, the credit markets have indicated that austere measures are being taken by troubled governments. We are headed down an identical path.

Since 2008, the Fed has purchased several trillion dollars of U.S. treasuries, many of which are still held by the bank. We have been warned time and time again that unless we get our fiscal house in order, our credit rating is likely to be downgraded. Considering the amount of treasuries held by the Fed, the solvency of our central bank will undoubtedly be affected by this downgrade, should it occur.

The current state of our economy, combined with the problems we could face in the near future, results in a recipe for economic distress. The Fed must begin to seriously examine the policies in place and plan for worst-case scenarios that could overwhelm our Nation in the coming months.

Congress rarely hears from the 12 regional Fed Presidents. This is unfortunate, given their role as a financial regulator in our communities and as an independent voting member on the Federal Open Market Committee.

I appreciate President Hoenig's willingness to be here today, and I look forward to his testimony.

With that, Mr. Chairman, I yield back.

Chairman PAUL. I thank the gentleman.

I now yield to Mr. Green from Texas.

Mr. GREEN. Thank you, Mr. Chairman.

And Dr. Hoenig, thank you for appearing today, sir. I trust that you will find our committee hospitable.

I think that we have many concerns that we can address. And, of course, I am concerned about inflation, concerned about unemployment, concerned about the quantitative easing and the possibility of another round of quantitative easing.

But I must also say to you, I still believe in America. I really don't want this to come across as, we have lost faith in the country that has produced so much for so many. America is still a pretty good place to live. A pretty good place to have your dreams, your hopes, and your aspirations fulfilled.

So as I—I will speak for myself—make my queries and make my inquiries known, I don't want to give the impression that I no longer have faith and belief in this, the greatest country in the world.

I am concerned, sir, about the widening gap, and I am not sure that you can address this, but if you have some intelligence that you will share, I would appreciate it, but the widening gap between what we commonly call the haves and the have-nots.

That is a real concern. I have seen some information published indicating that Latinos, African Americans and Asians have had a great widening in the gap between these groups and some others. That concerns me.

I am also concerned about this crisis that you have very little control over—you may be able to influence it, but little control—and that is the raising of the debt ceiling, as we call it. This ceiling is something that has become a crisis, but it really is a political problem that has somehow evolved into a crisis, a political problem that has evolved into an economic crisis, if you will, only because the politics have not come together appropriately.

And I still believe that we will get it right. I think that there is still time for us to raise the debt ceiling.

But these are some of the concerns that I hope you will be able to address today from your regional perch. I think highly of you, and I am interested in hearing your views. I have a lot of respect for you, and I thank you for appearing.

I yield back the balance of my time, Mr. Chairman.

Chairman PAUL. I thank the gentleman.

Now, I yield to the full committee's chairman, Mr. Bachus.

Chairman BACHUS. Thank you, Chairman Paul.

I commend you for holding this hearing to examine the state of the economy from the perspective of a regional Federal Reserve

Bank President, and I thank you for inviting Governor Hoenig, whom I consider to be a superb regional President.

Tom Hoenig, or Dr. Hoenig, is the longest-serving of the 12 Presidents of the regional Federal Reserve Banks. Perhaps happily for him, but sadly for many of us who admire his wisdom, he is soon to retire from that post.

You will be missed.

Dr. Hoenig has been a steadfast, independent voice among those in the inner circle of Federal Reserve Chairman Ben Bernanke, and before that, Chairman Alan Greenspan. He has been particularly outspoken recently in cautioning against the overly stimulative efforts of the Fed, including the so-called QE2, quantitative easing program that ended last month after adding an additional $600 billion in bonds onto the Fed's balance sheet.

The New York Times said that Dr. Hoenig's cautious views were clearly shaped by having worked at the Kansas City Fed during the runaway inflation of the 1970s and the bank failures of the 1980s, and "seem rooted in an agrarian and populist tradition that is mistrustful of concentrations of power."

I think that is a healthy fear. It is not surprising, then, that Dr. Hoenig has spoken forcefully on the subject of downsizing the biggest of the country's large banks, including a 2009 speech he titled, "Too Big Has Failed." I can tell you that on this side of the aisle, many of us are in wholehearted agreement with you. And we have looked on with alarm as there has been a greater and greater concentration of "too-big-to-fail" institutions.

I mention all this not only to salute you, Dr. Hoenig, for your career and your, I guess, bravery in speaking out, but also to make a comparison between your views and the view that is held by some in Washington that regional Fed Presidents should not be allowed to vote on monetary policy moves made by the Federal Open Market Committee.

Somehow, this view holds that regional Fed Presidents are captive of big business and the industry, and I can tell that you are a very good exhibit against that. In fact, I think that more often than not our regional banks are more attuned to Main Street.

And of course, you are not the only independent thinker among the regional Bank Presidents, but your appearance here today will serve as a good rebuttal to the view that the Federal Reserve Bank Board of Governors in Washington, D.C., need less input from the regional Feds and the rest of the country. Actually, they need more.

So thank you, Doctor.

And I yield back the balance of my time.

Chairman PAUL. I thank the chairman.

And if there are no other opening statements, we will go to the introduction of the witness.

I want to welcome Dr. Thomas Hoenig, who has been the President of the Federal Reserve Bank of Kansas City for the past 20 years and is the longest-serving policymaker at the Fed. While a voting member of the Federal Open Market Committee in 2010, he voted against keeping interest rates at zero, casting the only "no" vote at all 8 FOMC meetings.

He has been a vocal critic of the Fed's zero interest rate policy and QE2. He will be retiring in October, having reached the Fed's required retirement age of 65.

Mr. Hoenig, you are recognized.

STATEMENT OF DR. THOMAS M. HOENIG, PRESIDENT, FEDERAL RESERVE BANK OF KANSAS CITY

Mr. HOENIG. Thank you, Chairman Paul, and members of the subcommittee. I want to thank you for this opportunity to discuss my views on the economy from the perspective of a President of the Federal Reserve Bank of Kansas City, and, as you said, a 20-year member of the Federal Open Market Committee (FOMC).

The Federal Reserve's mandate reads: "The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

Within the context, then, of "long-run," the role of the central bank is in fact to provide liquidity in a crisis and to create and foster an environment that supports long-run economic health. For that reason, as the financial crisis took hold in 2008, I supported the FOMC's cuts to the Federal funds rate that pushed the target range to 0 percent to 0.25 percent, as well as the other emergency liquidity actions taken to stanch the crisis. However, though I would support a generally accommodative monetary policy today, I have raised questions regarding the advisability of keeping the emergency monetary policy in place for 32 months with the promise of keeping it there for an extended period.

I have several concerns with zero rates. First, a guarantee of zero rates affects the allocation of resources. It is generally accepted that no good, service or transaction trades efficiently at the price of zero. Credit is no exception. Rather, a zero-rate policy increases the risk of misallocating real resources, creating a new set of imbalances or possibly a new set of bubbles.

For example, in the Tenth Federal Reserve District, fertile farmland was selling for $6,000 an acre just 2 years ago. That land today is selling for as much as $12,000 an acre, reflecting high commodity prices but also the fact that farmland loans increasingly carry an interest rate of far less than the 7.5 percent historic average for such loans. And with such low rates of return on financial assets, investors are quickly bidding up the price of farmland in search of a marginally better return.

I was in the banking supervision area during the banking crisis of the 1980s, when the collapse of a speculative bubble dramatically and negatively affected the agriculture, real estate, and energy industries, almost simultaneously. Because of this bubble, in the Federal Reserve Bank of Kansas City's district alone, I was involved in the closing of nearly 350 regional and community banks. Farms were lost, communities were devastated, and thousands of jobs were lost in the energy and real estate sectors. I am confident that the highly accommodative monetary policy of the decade of the 1970s contributed to this crisis.

Another important effect of zero rates is that it redistributes wealth in this country from the saver to the debtor by pushing interest rates on deposits and other types of assets below what they would otherwise be. This requires savers and those on fixed incomes to subsidize borrowers. This may be necessary during a crisis in order to avoid even more dire outcomes, but the longer it continues, the more dramatic the redistribution of wealth.

In addition, historically low rates affect the incentives of how the largest banks allocate assets. They can borrow for essentially a quarter-point and lend it back to the Federal Government by purchasing bonds and notes that pay about 3 percent. It provides them a means to generate earnings and restore capital but it also reflects a subsidy to their operations. It is not the Federal Reserve's job to pave the yield curve with guaranteed returns for any sector of the economy, and we should not be guaranteeing a return for Wall Street or any special interest groups.

Finally, my view is that unemployment is too high today, in part because interest rates were held to an artificially low level during the period of the early 2000s. In 2003, unemployment at 6.5 percent was thought to be too high. The Federal funds rate was continuously lowered to a level of 1 percent in an effort to avoid deflation and to lower unemployment. The policy worked, but only in the short run.

The full effect, however, was that the United States experienced a credit boom with consumers increasing their debt from 80 percent of disposable income to 125 percent. Banks increased their leverage ratios—asset to equity capital—from 15-to-1 to 30-to-1. This very active credit environment persisted over time and contributed to the bubble in the housing market. In just 5 years, the housing bubble collapsed and asset values have fallen dramatically. The debt levels, however, remain, impeding our ability to recover from this recession. I would argue that the result of our short-run focus in 2003 was to contribute to 10 percent unemployment 5 years later.

That said, I am not advocating for tight monetary policy. I am advocating that the FOMC carefully move to non-zero rates. This will allow the market to begin to read credit conditions and allocate resources according to their best use rather than a response to artificial incentives.

More than a year ago, I advocated removing the "extended period" language to prepare the markets for a move to 1 percent by the fall of 2010. Then, depending on how the economy performed, I would move rates back towards more historic levels.

I want to see people back to work, but I want them back to work with some assurance of stability. I want to see our economy grow in a manner that encourages stable economic growth, stable prices, and long-run full employment. If zero rates could accomplish this goal, then I would support interest rates at zero.

Monetary policy, though, cannot solve every problem. I believe we put the economy at greater risk by attempting to do so.

Thank you, Mr. Chairman, and I do look forward to the committee's questions.

[The prepared statement of Dr. Hoenig can be found on page 32 of the appendix.]

Chairman PAUL. I thank you for your statement, and I would note that without objection, your written statement will be made a part of the record as well.

Mr. HOENIG. Thank you.

Chairman PAUL. I would like now to yield to Mr. Bachus for any questions he would like to ask.

Chairman BACHUS. I thank the chairman.

Dr. Hoenig, as I said in my opening statement, you have been firmly outspoken about monetary policy decisions.

The Fed recently issued guidelines on how and when Federal Open Market Committee members should discuss or could discuss monetary policy decisions. Do you view this as an attempt to control the message or to stifle dissenting voices?

And probably more importantly, Chairman Bernanke has promised a more open Fed, a more transparent Federal Reserve. And these guidelines, at least to me, seem a little inconsistent with restrictions on your ability to speak out. But I would like to know your views on that.

Mr. HOENIG. I hope not. I think part of the reason for the guidelines are that there were instances, frankly, where I would wake up on a Thursday morning and find what the future policy might be in the Wall Street Journal, not having known about it. And I think I raise objections to those kind of leaks and ask that they be vigorously pursued, to be quite frank. So I hope that is the reason.

Secondly, my approach is that I speak publicly, on the record. I try not to speak off the record, so that there isn't any confusion. And so when I come here, or wherever I go, I speak my views. I don't consult with the Board of Governors. I don't ask permission. I have until October, I realize, but I have never done so, and if I were staying on, I wouldn't do so in the future.

So I think it is a matter of personal choice. I don't think any of the members should disclose confidential information or leak to the media in advance. I strongly object to that, and I would have every intention to speak on the record my views publicly, regardless of what that statement might otherwise say. And I don't think that statement prevents me from doing so.

Chairman BACHUS. Good, so the guidelines are more designed to keep unauthorized releases and releases that aren't a part of the public record?

Mr. HOENIG. That is the context in which they came up.

The fact that they are there, I think could have the effect of stifling some, but I think that is a matter of someone saying, "I have spoken to this. This is my view," and show the leadership to speak their views.

Chairman BACHUS. Okay, good. And I am glad to hear that. I think that affirmation—I think Chairman Bernanke has tried to have a more open Fed, and I think he has been very candid with our committee.

In your testimony, you used the rapid increase in farmland value as an example of, maybe, credit misallocation resulting from what you see as a too-low Federal funds rate. Do you see any other bubbles building?

Mr. HOENIG. I don't—in fact, when people have asked me about the land, I have not said it is a bubble, but I—

Chairman BACHUS. Oh, yes.

Mr. HOENIG. But I do say that we have conditions. We have created conditions. Zero interest rates, QE1, QE2 create conditions that are amenable to bubbles.

And where we see asset values moving quickly, one example is in the farmland. I think you can see it in other areas, some of the bond markets and so forth. And so you have to be aware of that.

I think my issue is that, when you create conditions for certain outcomes, they will eventually arrive unless you withdraw those conditions in a timely fashion. And I think that is really the issue at hand.

Chairman BACHUS. Okay. The Fed used to say it specifically did not want to use monetary policy to reduce froth in the markets. Chairman Greenspan said it in front of this committee any number of times, or made that statement.

But is it appropriate for the Fed to avoid dealing with the buildup of asset bubbles but, on the other hand, conduct monetary policy aimed at reflating a market?

Mr. HOENIG. I think my view is that monetary policy should be conducted with a long-term focus, with, if you will, boundaries around its discretion, and therefore should not be in a position of creating froth in the market any more than it should try and somehow pinpoint some sector of the economy that it thinks is too frothy, and try and adjust that.

So, really, what you have to do is conduct monetary policy towards the long run. It is when you try and fine-tune monetary policy, direct it towards particular sectors, or to offset every short-term decline in the economy with extensive easing of monetary policy, that you create instability, as likely as deal with it.

Chairman BACHUS. Thank you. I will come back in the second round and ask other—I do want to say this, and I am just throwing it out for thought and not asking for a reply now. I have actually believed that QE2 gave the Congress an opportunity to—some time to move to make some long-term structural changes in our entitlement programs.

It is an opportunity that, whether it was intended for that purpose or not, it certainly gave us an opportunity, and kept financing the debt at a low rate, or lower rate, maybe. But the Congress has squandered that opportunity, at least at this time.

So I do believe that Chairman Bernanke's job has been made harder by the inability of this Congress to make the tough decisions and particularly to make needed structural changes in our entitlement programs. And I think we will continue to make problems for the Fed and probably result in inflation ourselves, some of our actions.

So, thank you.

Chairman PAUL. I thank the gentleman. I yield 5 minutes to Mr. Green.

Mr. GREEN. Thank you.

Again, I thank you for appearing today, sir.

Let us start with the debt ceiling. And if you could, be as terse as possible, because I have a couple of other questions. Can you give your opinion as to the consequences of our failure to raise the debt ceiling?

And if you can be brief, I would appreciate it, although I know it is impossible on this question.

Mr. HOENIG. The failure to address your budget issues is an action. It is a choice. And the consequences of doing that are to add to the uncertainty in the economy. So the effects will be, I think, in that sense, adverse.

I think the economy would do well with addressing the budget crisis and the budget problems and providing more stability and more certainty.

Mr. GREEN. In your opinion, would it be better to not raise the debt ceiling or to raise it and have it done in what we call a clean fashion—if it were those two choices?

I know there are many others, but is it better to raise it and have a clean raising of the debt ceiling, as opposed to not raise it at all?

Mr. HOENIG. The only answer I can give you to that is you really need—that is the Congress' area of responsibility—

Mr. GREEN. But I am talking about the consequences.

Mr. HOENIG. But you need to deal with it as forthrightly as possible.

Mr. GREEN. I understand, but are the consequences more severe if we don't raise it than if we raise it with a clean ceiling?

Mr. HOENIG. I think the consequences are there regardless. It is a matter of the timing of the consequences and how you want to accept those—

Mr. GREEN. So in your opinion, it could be just as bad to raise the debt ceiling as we have done in the past, just have a clean raising of the debt ceiling. That would be just as bad as not raising it at all?

Mr. HOENIG. I don't know what the consequences will be any more than anyone else does.

Mr. GREEN. I know, but you are in the business of prognosticating, because that is what you do to decide whether you should raise it the 1 percent that you are talking about here.

Mr. HOENIG. If you want my prognosis, honestly, I think what you need to do is address the budget crisis.

Mr. GREEN. I understand, but I am not ready to go there, you see. I am giving you a set of circumstances and I am asking you, if you would, to address this set of circumstances.

I know what you would like to do. I have been reading a little bit, here, and I understand your point of view. But I am taking you out of your comfort zone and—from time to time—

Mr. HOENIG. But it is not mine to decide. It is yours.

Mr. GREEN. I don't want you to decide. I just want you to tell me about consequences of not deciding.

Mr. HOENIG. If you don't raise the ceiling immediately, then the Congress and whomever else has to prioritize its future cash flows. If you do raise it, you also will have to prioritize it over time. In either case, you have—

Mr. GREEN. Let us go to another area, because—

Mr. HOENIG. —you have to make choices.

Mr. GREEN. I understand. My time is about up. Let me go to another area quickly.

You wanted to prepare the market for a 1 percent increase by the fall of 2010. Is that a fair statement?

Mr. HOENIG. Yes. And that was in an earlier part of 2010.

Mr. GREEN. Okay. All right, I understand the circumstances were different than now. But if we had done this, we had prepared the market, as you had hoped we would, what were your thoughts in terms of what would occur?

Mr. HOENIG. Interest rates would still be at historic low levels. Monetary policy would continue to be highly accommodative, but yet you would be off of zero. You would be no longer pumping enormous amounts of liquidity into the market.

And the market would know. Right now, the market—what you are doing is you are at zero. So you are creating—the market is adjusting to zero, in all its allocations, in its investments, in its bond funds, in its land, around an equilibrium of zero.

I think most people acknowledge that zero is not sustainable. So the longer you allow that to continue, the longer you allow that allocation of credit and assets around zero, the more fragile the equilibrium and the sharper the consequences when you finally do remove that zero.

And I think, the more—

Mr. GREEN. I wanted to have a quick follow up, because I only have 30-plus seconds.

You do agree that we don't have as much lending now as we need for the economy to recover. And if we don't have that lending at zero, what would be the circumstance at 1 percent?

Mr. HOENIG. I don't think that the issue around lending is related to the immediate policy of the Fed funds rate being zero. It is around the issues of the fiscal uncertainty. It is around the issues of whether we have a resurgence of manufacturing in this country that is sustainable. It is around the issues of how we create goods, because it is the creation of goods and services that brings jobs in.

And I don't think that the marginal choice for most businesses around whether they would do this of zero or a half a percentage point or 1 percentage point is the deciding factor in that instance.

Mr. GREEN. My time is up.

And you have been very generous, Mr. Chairman. I thank you. And I will wait for a second round.

Chairman PAUL. Thank you.

Mr. GREEN. And I will follow up.

Chairman PAUL. I thank the gentleman.

I will now take my 5 minutes.

I want to talk about the relationship of Federal Reserve policy and monetary policy with the debt increase. We all know that the Federal Reserve is the lender of last resort. The economy gets into trouble, liquidity dries up, the Fed is supposed to be there to help out.

But could it be that this concept of lender of last resort contributes to the deficit problem? And what I am thinking about here is that politicians, we in the Congress, get pressure from a lot of areas to spend money. And sometimes spending money helps us get reelected.

So, there are a lot of domestic needs, needs in our districts. And also, there is a lot of activity around the world, both violent and non-violent, that requires a lot of money.

And in the inflationary part of the cycle when things seem to be going well, it is very tempting for Congress to spend a lot of money.

But if the Fed is always there to keep interest rates low, doesn't that just encourage us? Congress generally is undisciplined, but doesn't the policy feed into this? Because if the Fed didn't do this, if they weren't our lender of last resort and interest rates started bumping up, we couldn't blame the Fed for our problems, we would have to blame ourselves—high interest rates—because we are sucking up all the credit.

Do you see a relationship between Fed policy and the encouragement or allowing Congress to spend more than they should be?

Mr. HOENIG. I think there is always the danger that the central bank can be put in the position of buying the government's debt. That is why you have an independent central bank and why the independent central bank has to pursue long-run monetary policy geared towards what the basic money-based requirements and needs are for the growth of that economy.

And it does require not only that the Congress be disciplined, but that the central bank be disciplined as well and not allow themselves to get drawn into that, yes.

Chairman PAUL. But in a way, doesn't your testimony verify that maybe the Fed didn't do their job because they kept interest rates too low for too long, and we were part of the problem. So how do you protect against that, if the Fed is as fallible as the Congress?

Mr. HOENIG. There is no system that is infallible. Whether it is the central bank doing this or the Congress doing it, there is no system that is infallible.

Yes, I think that in the early part of the decade of the 2000s—as I have said many times—the policy was kept too accommodative for too long. The consequence of that was to create a credit bubble. It affected not only the Congress, but, of course, the credit markets generally became very active.

That is why we had the tremendous expansion in credit in housing and later the consequence. That is an area that we have to learn from and go forward from. I don't think it is directly related in terms of the Congress and the debt, but it is related to the economic conditions broadly and the expansion of monetary policy during that period. And I think we have to be careful and mindful of that as a central bank.

Chairman PAUL. I would agree that no system is infallible, but it seems like we might get better information from the marketplace, dealing with interest rates. Prices are very important in the economy, and nobody is out there advocating wage and price controls. We have tried it and, hopefully, they never bring that back again.

But in a way, aren't we dealing with a price control and you are looking for the price of money, the cost of money? I think you talk about that, that the cost was too low. And it causes a misallocation of resources. So how do you know what the right price is?

Mr. HOENIG. I agree that you need to have a disciplined monetary policy that has a range. Our long-term growth over this decade has been about 3 percent real growth. Our policy should be mindful of that as we conduct monetary policy going forward.

And when we do go to zero and leave it there for an extended period, in reaction to a crisis, that is one thing. If we leave it there on a continuing basis, we do increase the risk that we misprice credit and misallocate resources, yes.

Chairman PAUL. It seems like it is a contest between confidence in the market setting the price or the interest rates versus somebody dealing with monetary policy. And some of us have come to the conclusion that we like the market to set that. We would like to see maybe the retirees get more for their CDs.

Mr. HOENIG. Right, and I understand, but the market makes terrible mistakes as well. And the market is responsible because it gets, if you will, euphoric in a direction, creates its own bubble around credit, because we are a fractional reserve system. It crashes. The market itself isn't prefect either. It causes—

Chairman PAUL. My time is up, but we are going to have a second round, and I want to ask about the fractional reserve system.

Mr. HOENIG. Okay.

Chairman PAUL. And now, I yield 5 minutes to Mr. Luetkemeyer.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

And welcome to my fellow Missourian.

Mr. HOENIG. Thank you.

Mr. LUETKEMEYER. Dr. Hoenig, it is good to have you here.

Mr. HOENIG. Thank you.

Mr. LUETKEMEYER. Since 2008, the Fed has purchased several trillion dollars worth of U.S. securities, treasury bills. And as we have seen over in Europe, over there the countries, in order to get their debt sold, have had to go to some very austere measures, sometimes go back 2 or 3 times to review their plans. Every time their interest rates have gone up in order to be able to accommodate them.

We are being told by the credit markets that if we don't do something within the next couple of weeks here, we are going to have our securities downgraded. How does that affect the solvency of the Federal Reserve to have all of those securities that they are holding all be downgraded suddenly?

Mr. HOENIG. It depends on how the markets view this downgrade. If it is downgraded and it doesn't affect the market pricing on those securities, because they have confidence that the Congress of the United States will come to a correct solution on that, I don't think it will have much effect at all on our solvency.

If the Congress fails to act, it will have a more lasting effect. But they are anticipating that the Congress will act.

Mr. LUETKEMEYER. As a former examiner, I am sure you—it would be interesting to have the Fed on the problem list, wouldn't it?

Mr. HOENIG. Yes.

Mr. LUETKEMEYER. Along that line, though, the same thing is happening with the rest of the banks in this country. If, for instance, we did get downgraded, suddenly now those banks—so your local community banks got a whole fistful of U.S. treasuries. And now they are being downgraded, and suddenly that affects their capital. It affects their rating.

How would you view that situation then—again, as a former examiner—the calamity that would happen to our local community banks?

Mr. HOENIG. If there was a serious effect from the downgrade on the pricing of the bonds to where there was capital loss in the bank, then of course it would have negative effects. I think the question is whether it would be a pricing effect, and I think that depends very much on the actions of the Congress.

Mr. LUETKEMEYER. It is an action that could happen on the part of the credit markets to where it could be an increase in risk that would have to be assumed there.

Mr. HOENIG. The failure to act is an action.

Mr. LUETKEMEYER. Okay. Thank you.

With regards to—you mentioned a while ago—my time is running out here—let me get to QE3.

We had Chairman Bernanke in here not too long ago, and he wouldn't say anything about QE3. But since he has been here, he certainly has not denied thinking about QE3. And to me, this is a devastating situation.

We have had a number of economists in here since he has been here, and every one of them I have asked the same question, "Do you see interest rates going up this fall as soon as QE2 stops here?" And every one of them said "Yes, unless you do a QE3, in which case you will probably have inflation."

Would you concur with that or do you have a different opinion on that?

Mr. HOENIG. First of all, I am not a supporter of QE3. I wasn't a supporter of QE2.

I think, by ceasing QE2, I don't know that interest rates necessarily will go up significantly. It depends on a whole host of factors in terms of how the economy is doing. It is not just whether you stop QE2 over time. I don't think we should mainly try and manage interest rates down. That is kind of the point of my testimony. I think there are consequences of doing that, that misallocate resources, and we have to be mindful of that.

Mr. LUETKEMEYER. Obviously, I agree with that. I am just going along that line of thought, that among other things, the Fed's job is to look long term with regards to interest rates, with regards to unemployment.

And to me, this would seem to fit into a QE2, QE3. Where do we stop this? At some point, we have to get control of—at some point, the economy has to be resilient enough to stand on its own two feet. We have to wean them off this.

If we are going to absorb all the debt that we are incurring—and every budget whether it is Democrat, Republican or whomever, we have debt out there. Everybody is agreeing we are going to have more debt. So we are going to have to have somebody to purchase it. And if the Fed doesn't purchase it, somebody else is going to have to.

Mr. HOENIG. Correct.

Mr. LUETKEMEYER. And if we get our securities downgraded, risk is there, interest rates are going to necessarily go up. So long term, how do you manage those monies to see that you can minimize that? What would be your idea or a solution?

Mr. HOENIG. I think that the mandate is a long-term mandate, and we need to keep that in mind. And if we do and if we pursue a policy that is long-run oriented towards price stability, then the economy—a market economy adjusts on its own.

The market is not particularly brilliant, but it is harsh. It corrects itself when there is a misallocation. And so that is why monetary policy has to look to the long run, provide sufficient liquidity, but not try and fine-tune or manage the economy so that markets can in fact discipline themselves.

So we should not be doing QE3. This is my view. There are plenty of excess reserves out there on the order of $2 trillion. I think that is plenty. Let the markets begin to heal, and let this market of ours allocate resources in our economy. And we should not try and fine-tune that.

I think when we do that, we inject instability as well, more likely than we do stability. So we have to be very mindful of that. In the short run, we can really inject instability. We have to have a long-run focus. And that is hard, I realize, but necessary.

Mr. LUETKEMEYER. Thank you for your comments.

And thank you for your indulgence, Mr. Chairman.

Chairman PAUL. I thank the gentleman.

I recognize Mr. Lucas for 5 minutes.

Mr. LUCAS. Thank you, Mr. Chairman.

Doctor, as you are well aware, of course, I live in the great Kansas City district in western Oklahoma. And about the time you were out doing all that hard work in the early 1980s, I was a senior at Oklahoma State. And I will always think of my father's lecture in the spring of 1982 when I would occasionally go to land sales with my grandfather: "Keep your hands in your pockets and your mouth shut."

It was wonderful advice in 1982. The reason I bring that up is we are now dealing with a set of circumstances here that you have discussed and touched around the edges that in some ways is reminiscent of those early 1980s. You remember, and sometimes there is an occasional view here that nothing is interconnected, that we are all little islands in the world.

You remember when Penn Square Bank went down, an energy-concentrated banking establishment, which then took down, directly or indirectly, Continental Illinois in Chicago, took down Seafirst in Seattle, took down two major, historic long-term players.

Partly that, in my opinion, and you can offer yours and I would be pleased to hear it, as a result of perhaps misguided fiscal policy by Congress and perhaps misguided monetary policy by the Fed in that late 1970s and early 1980s period. But it had a devastating consequence, and it wasn't just Oklahoma that imploded. We sucked people under with us.

I guess that brings me to my real question, and whatever comments you would care to offer. As my colleagues have alluded to, with the Fed balance sheet at a little under $3 trillion now, and even by a Texan's definitions, Mr. Chairman, that is a lot of money.

It took us 15 years to recover from the agriculture and the energy sector hangover from credit that started in 1982. In my opinion, in my quadrant, it was 1997 before the ship righted itself.

Three trillion dollars is a whole lot more credit than Penn Square was manipulating. When the right policy decisions are made, how long is it going to take this credit hangover to clear?

Mr. HOENIG. Let me first comment. I was on the discount window on Penn Square and was part of the group that recommended against lending against Penn Square. And I think it was the right decision there, although the consequences, as you said, were very harsh.

Mr. LUCAS. And for the record, a few officers of Penn Square did go to the Federal penitentiary. It was more than just a few bad decisions.

Mr. HOENIG. They did. Absolutely.

To your question of the degree of liquidity, the amount of time it will take to bring the liquidity off our balance sheet, the $3 trillion, I think, is reasonably a period of years.

Because we have brought this on, I think if you bring it out too sharply, you will shock the economy. And in our last minutes, the Open Market Committee talked about how they would go about doing it in terms of rates and no longer renewing their debt instruments.

But even under those, it will take years. How many years? It depends on how the economy does. It depends on what the roll-off of these instruments, the speed of the roll-off of these instruments and whether we choose to sell those. I don't know how long, other than I know it will take years, and there are risks to doing that.

And that is my point about zero interest rates and creating what I call "fragile equilibriums" around this very liquid policy that when you finally do begin to move has a negative effect, a negative consequence on the economy, both nationally and regionally. And that does get my attention.

Mr. LUCAS. Is it a fair statement to say, Doctor, that, of course, we will make a decision at some point. We will, at some point, I hope, achieve a consensus. We have legitimate disagreements within the ranks of the House over what the right policy is.

Mr. HOENIG. Right.

Mr. LUCAS. That is the nature of the body. But at some point, we will arrive at something. If we make the wrong decision, whatever decision we come to, are the consequences as frightening as I suspect they are?

Mr. HOENIG. Any time—

Mr. LUCAS. Without commenting on any particular decision.

Mr. HOENIG. Right, anytime you make a wrong decision, there are usually negative consequences. And if you make the wrong decision, there will be negative consequences, whatever that is.

Mr. LUCAS. And the financial markets are sophisticated enough that they will respond moment by moment with whatever policy decisions we make, and will, as prudent money managers, use what I would define from an Oklahoma perspective as "defensive policies" if they need to. And that will ripple, too.

Mr. HOENIG. The greater the uncertainty you create, the more defensive the actions will be. That much we can be sure of.

Mr. LUCAS. Thank you, Mr. President.

Thank you, Mr. Chairman. I yield back the time that I have left.

Chairman PAUL. I thank the gentleman.

We will go ahead and start a second round of questioning.

If we look at the markets in the last couple of weeks, in light of all the conversation about whether or not the debt limit will be raised, my estimation or my observation is that the markets aren't that worried. Would you agree with that? Or do you think the markets are showing problems, or at least potential problems?

Mr. HOENIG. To this point, I think the markets at least strike me as having the view that there will be a solution. And as long as that view is in place, they will tend to stay calm. If they lose that or if they begin to see more instability, more uncertainty around it, and therefore actions, then they would—as I said earlier—take more defensive actions.

But right now, I think they have confidence in you, the Congress, and the President to come to some kind of agreement.

Chairman PAUL. In monetary history, it has been said that when countries get to a certain level of debt, they have a lot of trouble, and the debt eventually has to be liquidated. I personally think we are at that point, so there will be liquidation of debt.

As a matter of fact, free market individuals recognize that whether it is government debt or whether it is private debt, liquidation actually serves a purpose in order to get back to square one and have economic growth again.

When we liquidate debt, I believe I mentioned in my opening statement, you can do it in two different ways. You can just default, which great nations don't do. Small nations will. But we are nowhere close, I believe, to doing that. I don't believe that for a minute.

But I do worry about the other part. I worry about the liquidation of debt, because if it is inevitable that the debt will be liquidated and what we do may be prolonging the agony, that is what I worry about, that instead of allowing the liquidation and rapidly getting back to square one like we did in 1921, that we prolong this, such as Japan did and such as we did in the 1930s.

Do you agree with that? Do you have concerns that liquidation will come in the form of inflation? And if you want to prevent that, what are your other options, if we are not going to default on our payments, which of course, I don't believe we will?

Mr. HOENIG. First of all, I agree with you. I don't think great nations default on their debt. Second of all, I will say that I agree with you also, that we have leveraged our economy.

As I mentioned in my remarks, the consumer has raised their debt-to-disposable income from 80 percent to 90 percent to 125 percent. The Federal Government has raised its debt to in gross numbers 100 percent of GDP. So we have increased our debt.

My concern is that, maybe back to your earlier point, perhaps, but when you have that kind of debt, over time there is increased pressure on the central banks to help relieve that debt pressure by helping finance that debt.

That puts pressure on the central bank. If they do that, it does risk inflationary outbreak, and then you basically repay your debt in cheaper dollars.

Chairman PAUL. But isn't that—

Mr. HOENIG. That is a risk, so how do you avoid that? The way you avoid that is you take, either through the Congress, through special committees, whatever, and develop a long-run plan that shows the American people how we are going to deal with our debt, Federal and otherwise, but in the Congress, Federal debt, and how the debt-to-GDP ratio is going to be brought back down.

And if it does that in a systematic fashion, with a strong binding point, then you will take care of the debt in a responsible way.

Chairman PAUL. But it seems to me in that attempt, the Fed came in and they propped up banks and corporations, that they were the ones that have been benefiting from this, and now they have been able to get back on their feet again.

At the same time, it really didn't help the people. The jobs didn't come back and the people lost their houses. So it seems like it is a failed policy to me.

Mr. HOENIG. I understand your point. My concern is that we have in this country allowed to develop "too-big-to-fail" institutions, the largest financial institutions, who bulked their assets, and became so important to the economy that any one of them that failed would bring down and risk the economy.

The market understood that and therefore gave them an advantage in terms of their position in the market, lowered their cost of capital, and allowed them unfettered access. And when we allowed that part, the safety net portion of that to get in with the high-risk portion, the investment bank, it only increased that by factors.

So we do need to address the issue of "too-big-to-fail." We do need to think about how we separate out the safety net from the high risk so that the economy can function under a market discipline, or at least more under market discipline, and we would all benefit from that.

Chairman PAUL. My 5 minutes are up, and I now yield to Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman. I will be honored to let you have 30 seconds of my 5 minutes, if you need it.

Let us talk for a moment about lowering the debt-to-GDP ratio. Do you agree that there is more than one way to do it?

Mr. HOENIG. Of course.

Mr. GREEN. Do you agree that cutting is a way to do it?

Mr. HOENIG. You can grow your economy—

Mr. GREEN. Grow the economy. You could also increase revenue.

Mr. HOENIG. Of course. That is up to the Congress, how they—

Mr. GREEN. I understand. But I just want you to be on the record indicating that we have more than one way to do it.

Mr. HOENIG. Right. And every choice has a consequence.

Mr. GREEN. Every choice has consequences. And not making a choice at all has its consequences as well.

Mr. HOENIG. That is a choice.

Mr. GREEN. Yes, sir.

Let us move to another area. You talked about markets and the market being calm. You do agree that the markets, generally speaking, don't like big surprises. When you give the market a big surprise, it has a reaction to a surprise. If you lead the market to believe that you are going in one direction, and if you go in another direction, then the market responds.

Mr. HOENIG. Correct.

Mr. GREEN. I think one of the best examples of this occurred when we had the $700 billion TARP vote, and the market anticipated one thing, and when the vote went another way, we saw the market spiral downward. You recall that, I am sure.

Mr. HOENIG. Sure.

Mr. GREEN. So you agree that markets don't, generally speaking, want to be shocked with surprises.

Mr. HOENIG. Correct.

Mr. GREEN. Okay. If this is true, and you have indicated that the market currently believes that we are going to resolve this—and, by the way, I pray that we will—but you agree that failure to bring about the resolution that the market anticipates will create a reaction in the market.

Mr. HOENIG. Sure. It certainly will. If the market is thinking one thing and you do something else, there will be a reaction.

Mr. GREEN. One final question—

Mr. HOENIG. And that also happens on Main Street.

Mr. GREEN. Yes. And Home Street as well.

Mr. HOENIG. As well.

Mr. GREEN. Yes. But let us go back now to your support for the 0 to 0.25 target.

Mr. HOENIG. I do not support it.

Mr. GREEN. You do not support it. But in 2008, you supported the cut in the Federal funds rate that pushed us to this target range, did you not?

Mr. HOENIG. I wasn't voting, but I am sure I would have supported it. Yes.

Mr. GREEN. Okay. And, by the way, reasonable people can have opinions that differ—

Mr. HOENIG. Absolutely.

Mr. GREEN. —even on the things that you supported, true?

Mr. HOENIG. Absolutely.

Mr. GREEN. And Mr. Bernanke, whom I happen to think highly of and I have a great deal of respect for, and he has opinions that are very well-respected, and there are other members of the board with opinions, and you meet and you confer and you vote, and then you come to conclusions.

Mr. HOENIG. Correct.

Mr. GREEN. So at the time what you were trying to do was provide what I am going to call a soft landing. Is that a fair statement, that we didn't want the economy to just crash?

Mr. HOENIG. Well—

Mr. GREEN. We wanted it to land a little bit softer than if we had done nothing at all.

Mr. HOENIG. "Soft landing" is a generous term. I think we did want to avoid a crash and depression, yes.

Mr. GREEN. Yes, a crash and a depression.

And if you say that you wanted to avoid it, it says to me that you are of the opinion that had we not acted, there could have been a crash and a depression.

Mr. HOENIG. Counterfactuals are always there, and that is a possibility, yes.

Mr. GREEN. And counterfactuals are hard to prove.

Mr. HOENIG. Right.

Mr. GREEN. But the reason you acted the way you did was because there was this concern—and I am being kind by saying "concern," because there are a lot of other ways to connote what was happening—but there were these concerns that we were headed for something close to a crash or a depression.

And your actions, probably if you were to write a book, you would say that your actions helped to avert this, would you not?

Mr. HOENIG. If you are speaking of our movement to zero interest rates and the liquidity we provided, yes, sir.

Mr. GREEN. Yes. Yes, that liquidity was helpful.

Mr. HOENIG. Yes.

Mr. GREEN. And just as it is difficult to prove a counterfactual as it relates to what you did, it is equally as difficult to prove it with reference to what Congress has done. Do you agree?

Mr. HOENIG. I assume so, yes.

Mr. GREEN. Okay. All right. What I am trying to do is establish this, sir. People of good will, and I consider you a person of good will, acted at a time of crisis—

Mr. HOENIG. Correct.

Mr. GREEN. —a time when it appeared as though we were about to go over the edge into an abyss unlike many of us had seen in our lifetimes.

And many of these things that we did, we won't be able to prove that we averted a great cataclysm, but we can surely conclude that what we did probably helped to avoid a rougher landing, a harder landing than we had.

Mr. HOENIG. Right.

Mr. GREEN. I want to thank you, Mr. Chairman. I will yield back the balance of my time.

Chairman PAUL. Thank you. I thank the gentleman.

I will yield to Mr. Luetkemeyer.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Dr. Hoenig, I have been watching what is going on over in Europe very carefully, and it is very concerning to me. And I know that in discussing this issue with a couple of other Fed members—board members—they don't seem to be quite as concerned about it as I am, so maybe I am an alarmist here. I don't know.

But I certainly see a contagion there that could easily spread to this country, especially whenever you look at our banks having about $1.3 trillion loaned to the various governments, invested in bonds of the various governments over there as well as, now, Dodd-Frank tying all those big banks together with "too big to fail."

It looks like there is a lot of connectivity between all of these things here. And you look at a line of dominoes, and it looks like we are in that line of dominoes.

So I know that the Fed has a swap line with the European central bank and perhaps some other reserve banks over there as well. And I am just wondering what your view is of that situation, how concerned are you?

Mr. HOENIG. I am concerned—do you mean about the European situation?

Mr. LUETKEMEYER. Yes, the European situation and how it will affect us or what kind of exposure we might have, our monetary policy, how it interacts. It is kind of a big question, but—

Mr. HOENIG. I understand your concern. The issues around those countries that keep coming up are also really around the banks, the European banks, because they, obviously, have exposure there. And that is a big part of the efforts we are trying to do to resolve this.

And like the United States, as I read it—and I only know from what I read in the paper—they are working toward some kind of solution, resolution around that.

But I think it proves to me not only in the United States, but internationally that we have institutions that are "too big to fail." And that is what this is really about. We have taken the market discipline away. We are now working with institutions globally that are extremely important to those economies, to our economy.

And to me, the whole issue continues to be around institutions that are so large that their own difficulties have broad effects on the economy, and that makes them "too big to fail" and therefore forces, if you will, governments to come in and bail them out.

And that is really what, I think, is going on in Europe and that is really what has gone on in our crisis in the United States.

Until we change that formula, until we break those institutions up into those that are under the safety net and those that are allowed to engage in high-risk activities, we will have these crises periodically into the future—not right away, perhaps, but in years to come.

Mr. LUETKEMEYER. And the pitfall there is that we have our taxpayer dollars at risk, because we are backing these "too-big-to-fail" folks. Is that right?

Mr. HOENIG. When you put a safety net over them and put the government's implied or explicit guarantee, the taxpayer is the backstop, yes.

Mr. LUETKEMEYER. In your position—and you are an economist, and having dealt with all of the financial things over the last several years, what do you see as the biggest concern to our economy today, whether it is international problems here we just discussed or oil prices or our monetary policy, our wars or—

What do you see as the biggest concern and how we can go to it from a financial aspect there?

Mr. HOENIG. That is a pretty important question.

Number one, I think that as far as our financial system goes, I continue to believe that "too big to fail" is an area that needs to be further addressed, and these institutions need to have their risk better divided between what is under the safety net and what is not.

Number two, I think that the budget crisis in the United States is important because it is drawing all of our attention into that. And yet the economy is in difficulty and we should be thinking about our policies, do we want to see if we can bring greater manufacturing onshore?

In 1960, 25 percent of our GDP was contributed by manufacturing. Today, it is 12.5 percent. We have 14 million people out of work. So what is our attitude towards manufacturing? What is our attitude towards creating businesses that create things then that hire people?

By not being able to pay attention to that in the Congress and elsewhere, I think we are handicapping ourselves in an international, global, competitive market, and we need to pay more attention to it so we have a brighter future. I think that is essential.

Mr. LUETKEMEYER. I appreciate your comments. My time is up. Thank you again for visiting with us today. I always enjoy discussing things with you. I really appreciate your perspective and all your hard work as well. I thank you again for your service, sir.

Mr. HOENIG. Thank you, Congressman.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Chairman PAUL. I thank the gentleman.

I have another additional question. If you care to stick around, you may.

But I am not going to let you go so easily. I need to find some answers. But I am very glad you are here and willing to take our questions.

In your introductory statement, you mentioned that one of the responsibilities of the Federal Reserve was to have maximum employment, which sounds like a good idea, and stable prices.

I would look around and I would say, results aren't all that good. When you look at stable prices of housing, you even brought up the subject of unstable prices in farmland. That quite possibly could be a bubble.

I would think that if you looked at bonds in prices, they are very unstable. And who knows where that is going. If the market overrides, which I believe is possible, markets are very, very powerful. I know the Fed is very powerful, but I also know markets are very powerful.

But also in your statement, I want to get back to it, we talked a little bit about this, and you said, "I have several concerns with zero rates. First, a guarantee of zero rates affects the allocation of resources."

To me, I think that is very key and very important, because it really brings up the subject that the free market economists are very attuned to.

Ludwig von Mises, in his "Human Action," talks about this as the misallocations and of malinvestment, excessive debt, money going into the wrong sectors, like farmland maybe or NASDAQ bubbles and houses.

But he took that and carried it much further. It seems like you have part of that philosophy, but not the full philosophy, but you are, I am sure, aware of what von Mises says about the Austrian theory of the business cycle.

Mr. HOENIG. Sure.

Chairman PAUL. How do you look at that? Can you say something favorable about his approach to it? Or can you draw a sharp line where interest rates are harmful and know how to divide the two? And what is your opinion of the Austrian business cycle theory?

Mr. HOENIG. I have read "Human Action." I have a lot of respect for von Mises and I have a lot of respect for the Austrian school of thinking. I think it has value.

I understand that when you overinvest, when you leave things artificially low and you overinvest you create a correction by doing that. There is an action with that.

My view is that is why central banks have to be mindful. No matter what the system is, if you have markets and capitalism, you are going to have cycles and you are going to have crises. And what you want the central bank to do is address the crises and provide over a long period of time a base liquidity of money that allows your economy to grow.

When you move beyond that, when you find the central bank focusing on short-term issues, trying to manage the economy, trying to fine-tune it, then you create, if you will, impulses of instability, because you are trying to take care of short-run issues instead of looking to the long run.

That is why when I say the duty of a central banker is to think long run, and that I think I am in agreement with the Austrian school, but I do think there is a role for central banks, as I have said.

Chairman PAUL. I certainly agree with your point. Once they overextend, they are into central economic planning, except many have accepted the notion that you get into central economic planning earlier than that, at the initial stages of believing that you can know what the interest rates should be.

Maybe you can give me a quick comment on this. Do you think the problems in the world today—try to put that in perspective. I think it is a very big problem, because I don't think we have faced it quite the same way, because we have a fiat dollar standard, and we are the issuers of the reserve currency of the world.

Do you think that has had an effect on what we are facing, the fact that we are issuing the reserve currency in the world, and it is much different than anything we faced before?

Mr. HOENIG. What I think is that the fact that we are the reserve currency is a consequence of decades of very good economic policy, the fact that we have had an economy that has grown, become very important to the world, and therefore, its currency has become very important.

I think that is a consequence, something you, as someone also said, you have earned. With that is carried a responsibility to look to long-run policy.

And to your point, if you have a gold standard, that is a legitimate alternative monetary base for your economy. But it does not eliminate crises. There is gold hoarding, there is positioning, there is mercantile practices. You will have crises.

So it doesn't matter if it is Congress, it doesn't matter if it is the central bank, it doesn't matter what the standard is. Good policy leads to good outcomes. Bad policy leads to bad outcomes. That is what you have to keep in mind.

Chairman PAUL. I would question whether we earned it or not. In some ways I think it was defaulted, because we were the standard. At least we pretended to be a good reserve standard, even though we weren't allowed to own gold. It was an international gold standard.

And then the confidence continued, surprisingly to some people. So that is just a matter of an understanding or semantics about whether it was earned or we defaulted into it.

But I have one more question. Because I have been interested in the monetary issues, I am delighted that you are here and so willing to visit with us.

But last week, I learned that gold was not money. So I have been able to put that out of my mind. Gold is not money, so I am still trying to figure out what money is. And I have asked these questions a lot of times, I have asked the Federal Reserve Board Chairmen over the years. And if I asked about dollar policy, they would say, “We are not in charge of dollar policy.”

They are in charge of creating all this money and regulating interest rates, but they are not in charge of the dollar. The Secretary of the Treasury does that. But the Secretary of the Treasury doesn’t give me any straight answers.

What I need to know from you to further my education is, tell me what a dollar is and where can I find the definition in our code?

Mr. HOENIG. The denomination is, I think—or the title was given back at just about the founding of our country. It was based on a gold standard at that time.

But money is, as you know, a medium of exchange, deferred means of payment and stored value. And as long as the public and the world understands that the dollar that is produced by the central bank of the United States, the base money, and then credit goes on beyond that, it is money.

As long as they take it as a medium of exchange, deferred payment and stored value. When that is lost, then it will no longer be money.

Chairman PAUL. But it is a note, it is a promise to pay. Actually, you are right about it being—

Mr. HOENIG. But it fills the three functions of money.

Gold can do the same thing. And if Congress designated that gold was the medium of exchange—

Chairman PAUL. This is why I am looking through the code, because the code, when I understand it, actually in the early years they wrote a dollar into the Constitution like they would write a yard, because everybody knew what it was, they didn’t even define it, it was so well known. It was 371 grains of silver.

But that has never been changed, as best as I can tell, and all of a sudden now we have a Federal Reserve Note, a promise to pay nothing, is now the dollar standard and we can create them at will out of thin air. And then sometimes people wonder why we have a shaky, rocky economy.

I will keep looking for the definition of a dollar. But as best as I can tell, we have never said a dollar is a Federal Reserve Note. And the dollar under the code still says it is 371 grains of silver.

I yield to Mr. Luetkemeyer.

Mr. LUETKEMEYER. I just have one follow-up question on something the chairman asked a minute ago with regards to the role of currency.

Because I think one of the consequences of us not doing something to resolve our debt crisis here and then be downgraded, it would seem to me to be a step down the path toward allowing ourselves to be no longer the world's reserve currency.

With China sitting over on the sidelines watching us twiddle our thumbs and waiting for an opportunity to get in the game, this is an opportunity. We are stumbling here and allowing them to do that.

What would be your thoughts on that comment?

Mr. HOENIG. I do think it is a serious matter. I think the U.S. currency, the dollar, is the reserve currency of the world and will remain so for some time.

And part of it is, what are your alternatives? You always have to ask the question. And the United States, for all of our issues and all the debate going on right now, it still has the deepest markets, is a market economy, has all the advantages. It has open capital markets. China doesn't have that. Europe has its issues.

So we still are the dominant economy. However, there is nothing guaranteed about that. That can change based upon the policies we choose going forward from here, both from a fiscal side and from a monetary side and from basically how we choose to have our economy operate in terms of the private sector and markets.

Those will all define the future of us as an economy and therefore the future of us as a nation as a reserve currency. It will be what we choose to do.

Mr. LUETKEMEYER. You just made the case from the standpoint that almost by default, we are the reserve currency, because China doesn't have all its ducks in a row yet to be that currency. Europe has its own set of problems. And so you look for the safest harbor, you look for the strongest economy. We are still there.

But if we keep twiddling our thumbs here, it could be endangered from the standpoint of the world sort of looking at us and saying, "Those guys can't get their act together—

Mr. HOENIG. I agree with that.

Mr. LUETKEMEYER. —and their economy is stumbling along. They don't have a manufacturing base anymore, and they are going to import almost all the oil, which means they are going to be at the mercy of the oil companies and the oil cartels around the world."

And all of a sudden our economy is looked at as kind of a shaky thing versus a very stable thing. And now, we have those other folks coming in there to fill the void.

And to me this debt debate, one of the sidelights and one of the side consequences is that we are going down this road, and nobody is thinking about allowing China to get their foot in the door on the world currency side.

It is not going to happen today or tomorrow, but I have heard some people project that in 5 or 10 years, if we don't get our fiscal house in order, by that time they will be in a position economically where they will have resolved a lot of the issues that you talked about, and they may be knocking on the door.

Mr. HOENIG. I agree.

Mr. LUETKEMEYER. So what do you see on the horizon for that?

Mr. HOENIG. I think that the debates that are going on right now are about the long-run future of this country—how we choose to deal with our debt, how we choose to deal with our economy going forward. Those are the debates that are in place right now.

My point is that monetary policy cannot manage the short run, it has to have a long-run focus also. And the Congress and how we choose to have our markets operate are choices that lie ahead of us. If we don't choose well, in a generation, I think the answer to that question could be different.

So it is in our power to change this or to keep us on the right path, but you have to choose to do it. And these debates are about the long run. There is no question about it.

Mr. LUETKEMEYER. I certainly appreciate your common sense and intellectual approach to all of our problems, Dr. Hoenig, and I hope that you stay engaged in some aspect—

Mr. HOENIG. I hope so, too.

Mr. LUETKEMEYER. —of monetary and fiscal and economic policy here. You are too much of a prized jewel to walk away from this. So thank you again for your service.

Thank you, Mr. Chairman.

Chairman PAUL. Thank you very much.

We are about to close, but I do have one more short question I think you can answer rather quickly. What would be the ramifications if they stripped away the voting rights of the regional Fed Presidents from the FOMC?

Mr. HOENIG. The ramifications would be you would lose an important set of voices in the Federal Open Market Committee. And I think it would be a mistake.

Right now in my region, as I deal with our board, a rancher from Wyoming, a bookseller in Oklahoma, a labor leader in Omaha—that is all input that comes into the process. I think you would lose that voice, and you would lose that input.

And you can say, make them advisers. But let me just tell you, voting and advising are two different things, and they are not even close to one another.

I would just say, since you have asked, I have been there. It is not democratic. It is not part of the political process. And my answer has been the selection of my successor will be a process that relies on our board, who represent, like I said, a grain dealer in Kansas City, an entrepreneur in Denver, a labor leader, a bookseller, a manufacturer, and a rancher from all over our region, six of our seven States.

And they very carefully go through a search, and then it has to be approved by the Board of Governors, the political appointees.

So, to me, that is a very democratic process. And it is in contrast to, if you select a Secretary of the Treasury who happens—if you are a Democrat and you select a former chairman of Goldman Sachs and you are a Republican and you select a chairman from Goldman Sachs, that is political, but I don't know that it is any more democratic than our process, and I don't recommend it.

Chairman PAUL. I thank you. I thank you for being here.

The Chair notes that some members may have additional questions for this witness, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to this witness and to place his responses in the record.

This hearing is now adjourned.

[Whereupon, at 3:37 p.m., the hearing was adjourned.]

A P P E N D I X

July 26, 2011

United States House of Representatives
Committee on Financial Services
Subcommittee on Domestic Monetary Policy & Technology

Impact of Monetary Policy on the Economy:
A Regional Fed Perspective on Inflation, Unemployment, and QE3
July 26, 2011

Congressman Ron Paul
Statement for the Record

Today's hearing is the second in a series of hearings examining the relationship between Federal Reserve policy and the performance of the United States economy. Today we are receiving testimony from the Federal Reserve banks. Of the half-dozen Reserve banks we contacted, only President Hoenig was willing to testify in front of this subcommittee, and we welcome him here today.

Like many critics of the Fed's monetary policy, I fear that quantitative easing will soon return. Despite what we hear from the cheerleaders in government and in the media, the economy remains in a complete shambles. Unemployment remains high and seven million jobs lost during the recession have yet to be regained. The Federal Reserve has kept interest rates at or near zero for over two and a half years and pumped trillions of dollars into the banking system in a vain attempt to revive the economy. Yet even now after the failure of the zero interest rate policy (ZIRP) and quantitative easing have become readily apparent, we still hear calls for more stimulus, more easing, more lose money. Like any other government program, the solution for failure is to throw more money at the problem, never mind the fact that throwing more bad money after good in such instances has never succeeded.

Reading the press releases from the Federal Open Market Committee (FOMC) we see that the FOMC intends to keep interest rates at a low level for an extended period. Chairman Bernanke has hinted at a further round of quantitative easing, the effects of which will undoubtedly be calamitous. Moneyholders seek a return on their holdings, and in an era of near-zero interest courtesy of the Fed, saving makes no sense. Combined with the still-shaky condition of the banking and financial sector, it is not surprising that much of the recently-created easy money has flowed into tangibles such as agricultural commodities, metals, and land. Rather than allowing the housing bubble to burst, overall prices to return to normal and overleveraged banks to break up, the Fed has thrown more fuel onto the fire and created the conditions for an even larger bubble that will eventually burst.

The Fed's easy money policy has also enabled the federal government to increase its total debt by 56% since 2008, an increase of over $5 trillion. Thanks to the Fed driving down interest rates and purchasing debt as fast as the Treasury has issued it, the federal government faces a crunch not only in terms of running up against the debt ceiling, but also in the structure of the debt. Large amounts of short-term debt are coming due in a short period of time. ZIRP and quantitative easing cannot hold down interest rates forever, as at some point investors will rebel and insist on higher interest rates for US debt. At this point this maturing debt will either have to be paid off or rolled over at higher interest rates, both of which will be very costly for taxpayers.

While I disagree with Pres. Hoenig on many matters of monetary policy and especially on key policy issues such as the existence of the Federal Reserve System, we both have been critical of the Fed's policy of quantitative easing and its maintenance of zero interest rates. Pres. Hoenig has been the most outspoken member of the Federal Reserve System against Chairman Bernanke's policies, consistently voting against the Chairman during meetings of the Federal Open Market Committee last year. Due to Pres. Hoenig's impending retirement, the Fed will lose a much-needed counterbalance to the inflationists who dominate at the Fed.

Both Pres. Hoenig and I realize that printing money out of thin air as the Fed has done and threatens to continue to do is not a panacea. If zero interest rates and quantitative easing could really solve unemployment, there would be no reason not to maintain such policies in perpetuity. Such policies, however, lead to the formation of asset bubbles, as both Pres. Hoenig and I know. Chairman Bernanke's predecessor Alan Greenspan fueled the dot-com bubble and attempted to stave off its collapse by resorting to one percent interest rates. That created the housing bubble whose collapse Chairman Bernanke is attempting to stymie through zero percent interest and massive quantitative easing. The next bubble is already forming, although which sector will be hit hardest remains to be seen. Pres. Hoenig has alluded to some possible bubble sectors in his district, so I look forward to his testimony and his answers to our questions.

Statement of

Thomas M. Hoenig

President

Federal Reserve Bank of Kansas City

before the

House Subcommittee on Domestic Monetary Policy and Technology

United States House of Representatives

July 26, 2011

Chairman Paul, Ranking Member Clay and members of the subcommittee, thank you for the opportunity to discuss my views on the economy from the perspective of president of the Federal Reserve Bank of Kansas City and as a 20-year member of the Federal Reserve System's Federal Open Market Committee (FOMC).

The Fed's mandate reads: "The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

The role of a central bank is to provide liquidity in a crisis and to create and foster an environment that supports long-run economic health. For that reason, as the financial crisis took hold in 2008, I supported the FOMC's cuts to the federal funds rate that pushed the target range to 0 percent to 0.25 percent, as well as the other emergency liquidity actions taken to staunch the crisis. However, though I would support a generally accommodative monetary policy today, I have raised questions regarding the advisability of keeping the emergency monetary policy in place for 32 months with the promise of keeping it there for an extended period.

I have several concerns with zero rates. First, a guarantee of zero rates affects the allocation of resources. It is generally accepted that no good, service or transaction trades efficiently at the price of zero. Credit is no exception. Rather, a zero-rate policy increases the risk of misallocating real resources, creating a new set of imbalances or possibly a new set of bubbles.

For example, in the Tenth Federal Reserve District, fertile farmland was selling for \$6,000 an acre two years ago. That land today is selling for as much as \$12,000 an acre, reflecting high commodity prices but also the fact that farmland loans increasingly carry an interest rate of far less than the 7.5 percent historic average for such loans. And with such low rates of return on financial assets, investors are quickly bidding up the price of farmland in search of a marginally better return.

I was in the banking supervision area during the banking crisis of the 1980s, when the collapse of a speculative bubble dramatically and negatively affected the agriculture, real estate and energy industries, almost simultaneously. Because of this bubble, in the Federal Reserve Bank of Kansas City's district alone, I was involved in the closing of nearly 350 regional and community banks. Farms were lost, communities were devastated, and thousands of jobs were lost in the energy and real estate sectors. I am confident that the highly accommodative monetary policy of the decade of the '70s contributed to this crisis.

Another important effect of zero rates is that it redistributes wealth in this country from the saver to debtor by pushing interest rates on deposits and other types of assets below what they would otherwise be. This requires savers and those on fixed incomes to subsidize borrowers. This may be necessary during a crisis in order to avoid even more dire outcomes, but the longer it continues, the more dramatic the redistribution of wealth.

In addition, historically low rates affect the incentives of how the largest banks allocate assets. They can borrow for essentially a quarter-point and lend it back to the federal government by purchasing bonds and notes that pay about 3 percent. It provides them a means to generate earnings and restore capital but it also reflects a subsidy to their operations. It is not the Federal Reserve's job to pave the yield curve with guaranteed returns for any sector of the economy, and we should not be guaranteeing a return for Wall Street or any special interest groups.

Finally, my view is that unemployment is high today, in part, because interest rates were held to an artificially low level during the period of the early 2000s. In 2003, unemployment at 6.5 percent was thought to be too high. The federal funds rate was continuously lowered to a level of 1 percent in an effort to avoid deflation and to lower unemployment. The policy worked in the short term.

The full effect, however, was that the U.S. experienced a credit boom with consumers increasing their debt from 80 percent of disposable income to 125 percent. Banks increased their leverage ratios--assets to equity capital-- from 15-to-1 to 30-to-1. This very active credit environment persisted over time and contributed to the bubble in the housing market. In just five years, the housing bubble collapsed and asset values have fallen dramatically. The debt levels, however, remain, impeding our ability to recover from this recession. I would argue that the result of our short-run focus in 2003 was to contribute to 10 percent unemployment five years later.

That said, I am not advocating for tight monetary policy. I'm advocating that the FOMC move to carefully move to non-zero rates. This will allow the market to begin to read credit conditions and allocate resources according to their best use rather than in response to artificial incentives.

More than a year ago, I advocated removing the "extended period" language to prepare the markets for a move to 1 percent by the fall of 2010. Then, depending on how the economy performed, I would move rates back toward more historic levels.

I want to see people back to work, but I want them back to work with some assurance stability. I want to see our economy grow in a manner that encourages stable economic growth, stable prices and long-run full employment. If zero interest rates could accomplish this goal, then I would support interest rates at zero. In my written testimony, I have included three speeches that describe in more detail my position on monetary policy.

Monetary policy cannot solve every problem. I believe we put the economy at greater risk by attempting to do so.

Thank you Mr. Chaiman. I look forward to your questions.

Rebalancing Toward Sustainable Growth

Thomas M. Hoenig
President and Chief Executive Officer
Federal Reserve Bank of Kansas City

The Rotary Club of Des Moines and the Greater Des Moines Partnership
Des Moines, Iowa
June 30, 2011

The views expressed by the author are his own and do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives.

Introduction

The U.S. economic recovery is under way, but it remains more uncertain and volatile than anyone would like. Some believe that the Federal Reserve can speed up the recovery by keeping the federal funds rate near zero, where it has been for nearly two-and-a-half years, and by promising to keep it there for an extended period. If I judged—or if evidence suggested—that a zero rate would solve our country's unemployment problem or speed up the recovery without causing other adverse consequences, I would support it. However, monetary policy is not a tool that can solve every problem.

In today's remarks, I will outline my current views on the economy, and suggest what alternative options and policies our leaders might consider as we search for ways to build a stronger, more resilient economy.

U.S. economic conditions

First, it is a testament to the U.S. economic system that even as this nation carries a heavy public and private debt burden, the economy is completing its second year in recovery. The level of activity, as measured by GDP, has now surpassed its pre-recession peak after growing at a nearly 3-percent pace last year. However, I am concerned that in working to offset the effects of this devastating crisis and to restore the economy to health, an extended zero-interest-rate policy is producing new sources of fragility that we need to be aware of and allow for in our future policy choices.

Governments, businesses and consumers have made financial choices and allocated resources with an understanding that a zero-interest-rate policy will remain in place indefinitely.

The longer we leave interest rates at zero, the more asset values will be defined by these low rates and the greater the negative impact will be once the inevitable move up in rates begins.

Complicating the fragility around monetary policy, fiscal policy as a pro-growth policy instrument also appears to be approaching its limit. The government's stimulus efforts to support the economy, along with lower tax revenues, have resulted in historically large fiscal deficits and a very large debt level. Without a dramatic change, the deficit and the debt will only become more daunting with the rising cost of entitlement programs and likely higher interest rates.

For well over a decade, the U.S. consumer has been a principal source of world demand and economic growth. As a result, the United States has incurred consistently large trade deficits, contributing to imbalances in the global economy. As we have painfully learned from the housing bust, growth built on imbalances is ultimately unsustainable.

Circumstances require, therefore, that we transition from an economy that relies too heavily on consumption and government spending for growth toward more sustainable sources of demand and economic prosperity. How we undertake this transition will define our economy and country's economic future.

To start, over the next several years, we must change our national savings, consumption and investment habits. Such shifts, though fundamental to long-term economic health, are admittedly difficult to accomplish. They require changes in behavior and expectations. They involve dramatic shifts in resource use, which are not painless as workers are temporarily displaced and industries are disrupted. The pain is immediate, and the payoff comes slowly. However, the gains also can be significant, as more sustainable long-run economic growth is well worth the effort and sacrifice.

In a recent visit to Singapore, I witnessed that nation's commitment to job creation. For example, during the recent crisis and recession, Singapore developed a program to retrain unemployed workers to ensure they would have the skills needed when its manufacturing sector recovered. As is well understood, workforce training matters. I spoke with individuals who described the drive to bring new factories on-line, with the goal of bringing a factory on-line with minimal delays and, by their description, without compromising safety.

Lessons from Germany

Other countries have made similar changes out of necessity or during a time of economic distress such as we are experiencing today. Countries have made deliberate choices and not relied on chance to change economic incentives and behavior that served to improve economic performance. I'm not advocating that we pick winners and losers—in fact, that is my biggest argument against too-big-to-fail financial institutions. Rather, I have observed a number of countries that are building and expanding their manufacturing bases—such as Korea, Singapore and China—that have been able to experience strong GDP growth over long periods of time.

Germany offers another example of a country having made significant changes to accomplish real employment goals. In the mid-1990s, Germany's trade deficit was similar to that of the United States. Since then, Germany has moved away from trade deficits to surging surpluses, while the United States has continued to run large trade deficits. Complementing this shift, German levels of employment have made great strides, and its unemployment rate has touched its lowest point in nearly 20 years.

I am not suggesting that the United States attempt to be Germany or Singapore, two countries that differ from us in many ways. I am also not advocating that we suddenly strive to achieve a large U.S. trade surplus. This might only create other global imbalances and distortions. However, adjustments in our economy are necessary, and other countries have shown it can be done.

Perhaps the most immediate, and obvious, observation is the simplest: We must change our national savings rate. To rebalance the U.S. trade position from deficit to balance requires that the sum of private and public savings match domestic investment. In other words, a country must not produce less than it consumes if it wishes to balance its trade position with the rest of the world.

During the 2000s, Germany's personal savings rate increased and is currently about double the U.S. rate. German households paid down debt and avoided heavily relying on debt, in contrast to the United States and so many other countries' households.

The personal savings rate in the United States has modestly increased since the start of the recession, which is an important positive trend. Unfortunately, this improvement has been more than offset by the dramatic deterioration in public saving reflected in the nation's fiscal deficits. Though a significant amount of the recent deterioration in public finances is related to the U.S. financial crisis, the fact remains that our national savings crisis has been under way for nearly three decades. Since the early 1980s, our nation has consistently chosen to spend rather than save, as witnessed by the long-term decline in our private savings rate and our tendency toward fiscal deficits. Most importantly, when we look across the more developed countries, we see that those with higher national savings rates tend to have smaller trade deficits and higher domestic production per person.

Germany has also benefitted from managing unit labor costs in a manner that keeps its labor force globally competitive. Over the last decade, the German economy experienced relatively modest wage increases and important productivity gains. Both of these factors contributed to keeping unit labor costs in check. However, another important component of its success came in the form of labor policy reforms.

In the early 2000s, Germany, with labor and management input, passed a series of labor market enhancements called the "Hartz laws." These laws modified some of the more generous employee benefits and reduced restrictions on temporary workers and the ability to lay off workers. Germany's reforms also sought to incentivize unemployed workers to transition to employment by making changes to job training programs for the unemployed and creating targeted subsidies to support some manufacturing job creation.

Finally, Germany developed export markets by focusing on meeting the needs of parts of the world experiencing the fastest growth and demonstrating strong demand for capital goods that German manufacturers produce: emerging economies in Asia, Europe and Latin America.

The United States is well-positioned to match this kind of performance, if it chooses to do so. For example, since 2000, the share of our exports going to the BRIC countries—Brazil, Russia, India and China—has more than doubled. If we choose to increase our savings rate, if government, labor and management see the mutual advantage of investing in and building a competitive manufacturing environment, then job growth will follow.

As the U.S. economy shifts gears to shrink its trade imbalances, many parts of the country will have a role to play. I fully expect Iowa to be an integral participant in this shift. Iowa already possesses a strong manufacturing base that is a key driver of the state economy. By some estimates, about half of the manufacturing firms in the state are small- and medium-sized enterprises, which provide some parallels with Germany's renowned export powerhouses, known as the *Mittelstand.*

Real solutions versus economic shortcuts

Rebalancing our economy and improving our trade position is a necessary development, but unfortunately, it will take time. And as our immediate desire is to rush to improve our economy, I warn against the all-too-common impulse to take shortcuts and suffer their unintended consequences. Here in Iowa, for example, one area where I suspect this tradeoff might be playing out is in the recent rapid run-up in agricultural land prices.

Agricultural exports have played a significant role in the rapid rise of land prices. Since 2000, agricultural exports from Iowa have increased by a factor of six. A portion of this growth reflects surging commodity prices due to factors on the supply side—such as extreme weather in parts of the world—and on the demand side, including the well-documented, rapidly growing food demands of emerging economies.

In addition to anticipated strong future demand for agricultural commodities, there is another factor affecting these prices: exceptionally low interest rates. As a bank regulator in the 1980s, responsible for financial institutions in Nebraska, Kansas, Oklahoma, Missouri, Wyoming, Colorado and New Mexico, I witnessed the devastating effects of easy credit and leverage in agriculture, real estate and energy. We closed or assisted nearly 350 banks in our region alone.

With interest rates near zero and with additional massive liquidity poured into our economy, all interest rates are affected. Therefore, asset values of every kind are also being affected, including land values in Iowa. Loans for land are available at rates well below historical levels—in some instances, 400 basis points below historical averages. The effect on land assets, like any asset, is to artificially boost its value. And there is ample experience that tells us that if rates were to rise quickly, this would affect world demand for commodities and raise the cost of capital on land almost instantly. When—not if—the adjustment occurs, we will see a dramatic drop in values. In the meantime, if operators and speculators have incurred large amounts of debt, then a new crisis will emerge.

Finally, we know that a crisis can affect more than one segment of the economy. It nearly always affects the broad economy and employment. Shortcuts don't work. We need to focus on the real economy. We need to focus on real reform.

Conclusion

My point today is simply that as powerful as monetary policy is, it sometimes is not enough. It cannot ensure an economy that balances its savings and investing needs. It by itself cannot correct our current account deficit or enhance savings and investment. These will require important changes in our real economy. Providing the right environment in which government can play its role in supporting business and the consumer to save, invest, manufacture and service national and global needs in the end will create real income and wealth.

We need to focus on long-term, stable monetary policy and fiscal policy goals that support these broader goals. Having seen the effects of financial crisis after financial crisis as short-term policies beget short-term policies, we should know that an ever-present short-run focus, even if well intentioned, is the road to ruin.

THE FEDERAL RESERVE'S MANDATE: LONG RUN

Thomas M. Hoenig
President
Federal Reserve Bank of Kansas City

National Association of Business Economists Annual Meeting
Denver, Colo.
October 12, 2010

Introduction and Framework

Thank you, and it is a pleasure to welcome you to Denver. This is the largest metropolitan area in the Tenth Federal Reserve District and home to one of three branches of the Federal Reserve Bank of Kansas City. The Denver branch serves Colorado, Wyoming and New Mexico—three of the seven states of our region.

I appreciate this opportunity to engage and interact with business economists from around the country regarding the policy choices now confronting the nation, especially those confronting the Federal Reserve.

In setting out my views, I'll first spend a minute describing the economy's performance and then turn to the matter of quantitative easing versus my preferred path of gradual steps to a renormalization of monetary policy.

Short-Term Outlook

Currently, a major and necessary rebalancing is taking place within our economy. This includes the deleveraging of consumers, businesses and financial institutions, and it's during a time that state and local governments are struggling with budgets and mounting debt loads. In this context, a modest recovery with positive overall data trends should be seen as highly encouraging.

Following a bounce back from restocking earlier this year, the economy has slowed but it has not faltered. GDP growth has averaged about a 2½ percent annual pace since the first of the year. Industrial production is showing growth of almost 6 percent, and high-tech more than double that. The consumer continues to buy goods, with personal income growing at more than a 3 percent rate, personal consumption expenditures at about 3 percent, and retail sales at more than 4 percent. And the U.S. economy has added more than 850,000 net new private sector jobs since the first of the year. While modest, these are positive trends for the U.S. economy.

The issue is, of course, that while private jobs are being added within the economy, it is not enough to bring unemployment down to where we all would like to see it. Unemployment remains stubbornly high at 9.6 percent. With such numbers, there is, understandably, a desire and considerable pressure for the Federal Reserve to "do something, anything" to get the economy back to full employment. And for many, including many economists, this means having the Federal Reserve maintain its zero interest rate policy or further still, engage in a second round of quantitative easing – now called QE2. Some are even suggesting these actions are necessary for the Federal Reserve to comply with its statutory mandate.

Interpreting the Policy Mandate

The FOMC's policy mandate is defined in the Federal Reserve Act, which requires that: "The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

There is, within the Act, a clear recognition that our policy goals are long-run in nature. In this way, the Act recognizes that monetary policy works with long and variable lags. Thus, the FOMC should focus on fostering maximum employment and stable prices in the timeframe that monetary policy can legitimately affect – the future. The FOMC must be mindful of this fact and be cautious in pursuing elusive short-term goals that have unintended and sometimes disruptive effects.

In recent weeks, some have argued that with inflation low and the jobless rate high, the Federal Reserve should provide additional accommodation. Such an action – the purchase of assets by the central bank as a policy easing tool – would mark a second round of quantitative easing. While there are several ways to accomplish this, many suggest that the most likely method would be for the Federal Reserve to purchase additional long-term securities, including U.S. Treasuries.

Proponents of QE2 argue that it would provide a near-term boost to the economy by lowering long-term interest rates while raising inflation. These benefits would arise from the purchase of U.S. Treasury securities, which would lead to lower U.S. Treasury and corporate rates. These lower interest rates would then stimulate consumer and business demand in several ways, including encouraging mortgage refinancing that could lead to increased consumer spending, boosting exports through a likely lower exchange rate, and fostering higher equity prices, thereby creating additional wealth. Such a move is said to be consistent with the FOMC's September 21, 2010 announcement, which stated that it was "prepared to provide additional accommodation if needed to support the economic recovery and to return inflation, over time, to levels consistent with its mandate."

Such easing, it is hoped, would bring inflation back up to something closer to 2 percent, a rate that many judge to be consistent with the Federal Reserve's mandate. In addition, higher inflation would increase demand as consumers move purchases forward to avoid paying higher prices in the future.

So, with these purported benefits, why would anyone disagree?

New Risks and QE2

I believe there are legitimate reasons to be cautious when considering this approach. A meaningful evaluation of QE2 must consider not simply whether benefits actually exist but, if they do, how large they are and whether they are larger than possible costs.

Based on recent research and the earlier program of purchasing long-term securities—known as LSAP—I think the benefits are likely to be smaller than the costs.

Some estimates suggest that purchasing $500 billion of long-term securities might reduce interest rates by as little as 10 to 25 basis points. The LSAP program was effective, in part, because we were in a crisis. Financial markets were not functioning properly, or at all, during the depths of the financial crisis. In such a situation, it is reasonable that central bank purchases would be useful and effective. However, currently the markets are far calmer than in the fall of 2008. The financial crisis has passed and financial markets are operating more normally. One could argue, in fact, that with markets mostly restored to pre-crisis functioning, the effect of asset purchases could be even smaller than the 10 to 25 basis point estimate.

I would also suggest that even if we achieved slightly lower interest rates, the effect on economic activity is likely to be small. Interest rates have systematically been brought down to unprecedented low levels and kept there for an extended period. The economy's response has been positive but modest.

In fact, right now the economy and banking system are awash in liquidity with trillions of dollars lying idle or searching for places to be deployed or, perhaps more recently, going into inflation hedges. Dumping another trillion dollars into the system now will most likely mean they will follow the same path into excess reserves, or government securities, or "safe" asset purchases. The effect on equity prices is likely to be minor as well. There simply is no strong evidence the additional liquidity would be particularly effective in spurring new investment, accelerating consumption, or cushioning or accelerating the deleveraging that is hopefully winding down.

If the purported benefits are small, what are the possible costs?

First, without clear terms and goals, quantitative easing becomes an open-ended commitment that leads to maintaining the funds rate too low and the Federal Reserve's balance sheet too large. The result is a further misallocation of resources, more imbalances and more volatility.

There is no working framework that defines how a quantitative easing program would be managed. How long would the program continue, and what would be the ultimate size? Would purchases of long-term assets continue until the unemployment rate is 9 percent or 8 percent or even less? Would purchases continue until inflation rises to 2 percent or 3 percent or more? Would the program aim to reduce the 10-year Treasury rate to 2¼ percent or 2 percent or even less? Without answers to these and other questions, QE2 becomes an open-ended policy that introduces additional uncertainty into markets with few offsetting benefits.

As central bank assets expand under quantitative easing, what will be the exit strategy? In the midst of a financial crisis, we may not have the luxury of thinking about the exit strategy. In current circumstances, however, we must define an exit strategy if the objective is to raise inflation but contain interest rate expectations. If history is any indication, without an exit strategy the natural tendency will be to maintain an accommodative policy for too long.

While I agree that the tools are available to reduce excess reserves when that becomes appropriate, I do not believe that the Federal Reserve, or anyone else, has the foresight to do it at the right time or right speed. It may work in theory. In practice, however, the Federal Reserve doesn't have a good track record of withdrawing policy accommodation in a timely manner.

Second, we risk undermining Federal Reserve independence. QE2 actions approach fiscal policy actions. Purchasing private assets or long-term Treasury securities shifts risk from investors to the Federal Reserve and, ultimately, to U.S. taxpayers. It also encourages greater attempts to influence what assets the Federal Reserve purchases. When the Federal Reserve buys long-term securities – such as the $1.2 trillion in mortgage backed securities it purchased during the financial crisis – it favors some segments of the market over others. And when the Federal Reserve is a ready buyer of government debt, it becomes a convenient source of cash for fiscal programs. During a crisis this may be justified, but as a policy instrument during normal times it is very dangerous precedent.

Third, rather than inflation rising to 2 or 3 percent, and demand rising in a systematic fashion, we have no idea at what level inflation might settle. It could remain where it is or inflation expectations could become unanchored and perhaps increase to 4 or 5 percent. Not knowing what the outcome might be makes quantitative easing a very risky strategy. It amounts to attempting to fine-tune inflation expectations—a variable we cannot precisely or accurately measure—over the next decade.

And why might inflation expectations become unanchored?

The budget deficit for 2011 is expected to be about $1 trillion. Even if the Federal Reserve were to purchase only $500 billion—and this amount in itself is a source of considerable uncertainty—that would appear to monetize one-half of the 2011 budget deficit. In addition, the size of the Federal Reserve's balance sheet—now and over the next decade—will influence inflation expectations. Expanding the balance sheet by another $500 billion to $1 trillion over the next year, and perhaps keeping the balance sheet at $3 trillion for the next several years, or increasing it even further, risks undermining the public's confidence in the Fed's commitment to long run price stability, a key element of its mandate.

While QE2 might work in clean theoretical models, I am less confident it will work in the real world. Again, I will note that the FOMC has never shown itself very good at fine-tuning exercises or in setting and managing inflation and inflation expectations to achieve the desired results.

Given the likely size of actions and the time horizon over which QE2 would be in place, inflation expectations might very well increase beyond targeted levels, soon followed by a rise in long-term Treasury rates, thereby negating one of the textbook benefits of the policy.

Non-Zero Rates as an Option

At this point, with a modest recovery underway and inflation low and stable, I believe the economy would be better served by beginning to normalize monetary policy. If long run stability is the goal, then re-normalizing policy is an important step toward realizing that goal. How might we achieve this goal?

First, rather than expand the Federal Reserve's balance sheet by purchasing additional U.S. Treasury securities, the Fed should consider discontinuing the policy of reinvesting principal payments from agency debt and mortgage-backed securities into Treasury securities. Given where we are, we would need to make such a change slowly but systematically. Allowing maturing mortgage backed securities to roll off, the Federal Reserve's balance sheet would shrink gradually, with relatively small consequences for financial markets.

Second, we should take the first early steps to normalize interest rate policy. This is not a call for high rates but a call for non-zero rates. In 2003 the FOMC delayed our efforts to raise rates. In that period we reduced the federal funds rate to 1 percent and committed to keeping it there for a considerable period. This policy fostered conditions that let to rapid credit growth, financial imbalances and the eventual financial collapse from which we are still recovering. Had we been more forceful in our action to renormalize policy then, it's likely we might have suffered far less in 2008 through 2010.

Also, any effort to renormalize policy would include signaling a clear intention to remove the commitment to maintain the federal funds rate at 0 to ¼ percent "for an extended period." As the public adjusts to this, we should then turn to determining the pace at which we return the funds rate to 1 percent. Once there, we should pause, assess and determine what additional adjustment might be warranted. A 1 percent federal funds rate is extremely accommodative, but from that point we could better judge the workings of the interbank and lending markets and determine the order of policy actions that would support sustained long-term growth.

Other Concerns Regarding Zero Rates

These are difficult times, no doubt, and it is tempting to think that zero interest rates can spark a quick recovery. However, we should not ignore the possible unintended consequences of such actions. Zero rates distort market functioning, including the interbank money and credit markets; zero rates lead to a search for yield and, ultimately, the mispricing of risk; zero rates subsidize borrowers at the expense of savers.

Finally, it is important to note, that business contacts continue to tell me that interest rates are not the pressing issue. Rather, they are concerned with uncertainties around our tax structure; they are desperate to see this matter settled. They need time to work through the recent healthcare changes; and they are quite uncertain about how our unsustainable fiscal policy will be addressed. They are insistent that as these matters are addressed, they will once again invest and hire. QE2 cannot offset the fundamental factors that continue to impede our progress.

Conclusion

We are recovering from a set of shocks, and it will take time. These shocks did not develop overnight, but came after years of interest rates that were too low, leverage that was too high, and financial supervision that was too lax. If we have learned anything from this crisis, as well as past crises, it is that we must be careful not to repeat the policy patterns we have used in previous recoveries, such as 1990-91 and 2001. If we again leave rates too low for too long out of fear that the recovery is not strong enough, we are almost assured of suffering these same consequences yet again. I am fully committed to the Federal Reserve's dual mandate to maintain long-run growth so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates.

What About Zero?

Thomas M. Hoenig
President
Federal Reserve Bank of Kansas City

Santa Fe, N.M.
April 7, 2010

Introduction

Good afternoon. I'm pleased to be in New Mexico today, and I extend my congratulations and best wishes to the city of Santa Fe on its 400th anniversary.

Last week, *The Wall Street Journal's* front page featured an article with a headline focused on the "epic comeback" of the corporate bond market. The article chronicled how a record $31.5 billion in new high-yield, high-risk "junk" bonds came on the market last month and how investments in bond mutual funds last year were the highest on record. Thanks to the combination of near-zero short-term interest rates and the Federal Reserve's large-scale purchases of mortgage-backed securities, investors are flush with cash. And, as is sometimes the case, cash earning so little is an enticement to take on additional risk in hopes of higher returns.

The bond market is not the only place where we are seeing the impact of cash-rich investors. Our contacts within the Tenth Federal Reserve District have shared anecdotal information suggesting that operators and investors in the Midwest are buying farmland and bidding up the price. We've seen this in the agricultural regions of our District in the past, notably in the run-up to the banking crisis of the 1980s.

Events such as these, along with new economic research now coming to light, are beginning to document a story about long-run risks that are created when money and credit are easy for too long, when interest rates are near zero, and when financial imbalances risk macroeconomic and financial instability.

As we all know, the last couple of years have been an extraordinary period in our nation's economic history. In response to the crisis, the Federal Reserve took unprecedented steps to drive down long-term interest rates and provide direct support to a fragile housing market. This was in addition to the steps taken by the administration and the Treasury. We will long study these events. Although we may disagree on the specifics of the actions taken during that period, most agree that without strong intervention, the outcome would have been dire.

But as the economy turns the corner and we move beyond the crisis, what about the challenges we now face, and what about policy actions over the next several quarters? The economy appears to be on the road to recovery, and we find ourselves having to face important questions of how the Federal Reserve will unwind the policy response to the crisis. In particular, what are the hazards of holding the federal funds rate target close to zero? The risks of raising rates too soon are clear and compelling. My comments, however, concern the risks of raising rates too late. Such risks also can be significant but all too often seem more distant and less compelling, and therefore hold great long-term danger for us all.

The economic outlook

As a preface to a discussion on the issues, I first should outline my expectation for the U.S. economy. Policy choices can be realistically considered only after first defining how we judge current conditions and our outlook for the future.

From my vantage point, the outlook is generally good. A number of indicators suggest the economy has begun to recover and is expanding at a steady pace since hitting bottom last summer. GDP grew nearly 4 percent in the second half of last year, and growth of almost 3 percent is expected in the first quarter of this year. The pace of growth should modestly pick up over time, and looking ahead, I expect GDP growth of about 3 percent for 2010.

While labor markets remain weak, they seem to have stabilized. The pace of job losses gradually slowed over the course of 2009 and early 2010. In the first three months of the year, unemployment has remained essentially unchanged at 9.7 percent. Importantly though, Friday's report from the Labor Department showed the largest increase in non-farm payrolls in three years with more than 160,000 jobs added. Further, forward-looking indicators such as temporary help services, which has grown rapidly since the middle of last year, suggest broader job growth will continue. This is good news because such progress is essential for sustained growth. And like most, I am following it carefully. Unfortunately, it tends to lag the recovery and makes the implementation of policy always difficult to manage during the early stages of a recovery.

Consumer spending has been growing at a solid pace, and most forecasters put first quarter consumption growth at more than 3 percent. These are critical improvements because consumer spending, which has accounted for about 70 percent of GDP, will be a critical force strengthening the recovery. The manufacturing sector has followed the consumer and also has been expanding at a strong pace. Production has increased at an annual rate of about 8 percent since hitting bottom last summer. In turn, business spending on equipment and software appears to be picking up.

These are encouraging signs that the forces necessary for a sustained recovery seem to be moving into place and that this is not just a temporary boost from the fiscal stimulus package and sharp slowing in the pace of inventory liquidation.

Residential and non-residential construction continues to struggle, although to varying degrees. Residential construction spending has fallen sharply in the last few months after a strong uptick in the second half of last year, thanks in large part to the homebuyer tax credit. Looking ahead, spending should pick up considerably in response to the extended tax credit and then rise at a more moderate pace after the credit expires.

The picture is considerably bleaker for the non-residential sector. Private spending fell at an annualized rate of more than 25 percent in the last three months and is likely to fall further for most or all of this year. There has been an increase in vacancy rates for office, retail, and industrial space. Meanwhile, non-residential property values are down. The soft market is due in part to problems with financing. With many banks facing the prospect of considerable losses in commercial real estate, lending remains weak.

Looking at the economy more broadly, inflation has drifted lower in recent months and is following the pattern common during and after a recession. While energy prices have kept consumer price inflation at around 2 percent, inflation in non-food and non-energy price – core inflation – stands at about 1 percent. In the absence of any current cost pressures from tight labor markets or other input prices, inflation will likely remain low for the next year or two.

Risks of a commitment to near-zero rates

With the economy gradually recovering from a severe recession, monetary policy is by any measure highly accommodative. The key challenge for the Federal Reserve's Federal Open Market Committee, is the question, "For how much longer should it remain so?"

The FOMC statement, issued after several meetings including the most recent, has said that "conditions will likely warrant keeping the fed funds rate, which is our key monetary policy tool, at exceptionally low levels for 'an extended period.'" The statement elaborates that this view is based on "economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations."

By itself, the current state of the economy warrants an accommodative monetary policy. However, as the economy continues to improve, risks emerge around the act of holding rates low for an extended period.

I have dissented at the last two FOMC meetings specifically because I believe the "extended period" language is no longer warranted and I am concerned about the buildup of financial imbalances creating long-run risks.

There is no question that low interest rates stimulate the interest-sensitive sectors of the economy and can, if held there too long, distort the allocation of resources in the economy. Artificially low interest rates tend to promote consumer spending over saving and, over time, systematically affect investment decisions and the relative cost and allocation of capital within the economy.

Today, as we look back over the past decade, there is a case to be made that too many resources were channeled into financial market activities and into real estate construction, both residential and non-residential. Some researchers have argued that keeping interest rates very low in

2002-2004 contributed to the housing boom and bust. Exceptionally low rates, while perhaps not the single cause, played an important role in creating the conditions leading to our recent crisis.

We now find ourselves with a Federal Reserve System balance sheet that is more than twice its size of two years ago. The federal funds rate is near zero and the expectation, as signaled by the FOMC, is that rates will remain so for an extended period. And the market appears to interpret the extended period as at least six months. Such actions, moreover, have the effect of encouraging investors to place bets that rely on the continuance of exceptionally easy monetary policy. I have no doubt that many on Wall Street are looking at this as a rare opportunity.

These actions are not taken to enrich one group over another. They are taken with the well intended purpose of assuring a strong economic recovery and to create an environment of sustained job growth and strong business investment. I take no exception to this goal. However, the unintended negative consequences of such actions are real and severe if the monetary authority goes too long in creating such conditions.

Low rates, over time, systematically contribute to the buildup of financial imbalances by leading banks and investors to search for yield. *The Wall Street Journal* article tells a story about the market coming back that also makes my point. The search for yield involves investing in less-liquid assets and using short-term sources of funds to invest in long-term assets, which are necessarily riskier. Together, these forces lead banks and investors to take on additional risk, increase leverage, and in time bring in growing imbalances, perhaps a bubble and a financial collapse.

I make no pretense that I, or anyone, can reliably identify and "prick" an economic bubble in a timely fashion. However, I am confident that holding rates down at artificially low levels over extended periods encourages bubbles, because it encourages debt over equity and consumption over savings. While we may not know where the bubble will emerge, these conditions left unchanged will invite a credit boom and, inevitably, a bust.

What next?

So, what options are available to policymakers?

I appreciate the inclination for staying the course that financial markets have come to expect: keeping the federal funds rate target near zero and maintaining a commitment to very low rates for an extended period of time. That view is motivated by concerns over an unemployment rate of nearly 10 percent and persuaded by the fact that core inflation remains below 2 percent.

Continuing with current policy may also reflect confidence that the longer-term risks of financial imbalances are quite small and could be mitigated as they emerge. The Federal Reserve could correct imbalances through interest rate action or regulatory changes as the imbalances become apparent later.

However, in times of uncertainty policymakers tend to reassure themselves that an accommodative course of action can be reversed always in a timely fashion. Inevitably, though, the policy bias is to delay, to let accommodative conditions stand, and to reverse only when the economy is beyond recovery and into an expansion. The outcome too often is greater inflation, significant credit and market imbalances, and an eventual financial crisis.

An alternative policy option is to be more proactive, but cautious. This would require initiating a reversal of policy earlier in the recovery while the data are still mixed but generally positive. Small reversals in rates would leave policy highly accommodative and supportive of our economy's recovery but would put more weight on mitigating the risk of longer-run financial imbalances. It would end the borrowing subsidy more quickly and would moderate credit conditions in a more timely fashion. It would reduce the likelihood that inflationary pressures might build, or that financial imbalances might emerge. And over time it would contribute to greater macroeconomic stability.

Under this policy course, the FOMC would initiate sometime soon the process of raising the federal funds rate target toward 1 percent. I would view a move to 1 percent as simply a continuation of our strategy to remove measures that were originally implemented in response to the intensification of the financial crisis that erupted in the fall of 2008. In addition, a federal funds rate of 1 percent would still represent highly accommodative policy. From this point, further adjustments of the federal funds rate would depend on how economic and financial conditions develop.

Conclusion

As we look forward from here, I expect that all options will be considered and discussed fully as we navigate the course of monetary policy. As we consider our choices, I want to end my remarks by emphasizing that I am confident all of us want the best outcomes for the U.S. economy. The Federal Reserve understands its mission of stable prices and long-term, stable growth. Perhaps because I have been part of the history of the central bank for these past three decades, I am as concerned about the introduction of instability into the economy as I am about managing it when it occurs. I am convinced that the time is right to put the market on notice that it must again manage its risk, be accountable for its actions, and cease its reliance on assurances that the Federal Reserve, not they, will manage the risks they must deal with in a market economy.